# REFORMING THE REGULATION OF COMMUNITY BANKS AFTER DODD-FRANK

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## INTRODUCTION

In 2013, community banks face significant threats to their existence. The American banking industry has experienced significant consolidation over the past several decades, leading to an increasing concentration of assets in a small number of mega-banks. There are several natural reasons that led to this consolidation, but this Article argues that the over-regulation of community banks, most recently by The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[3] unjustifiably hastened that process.

Since Dodd-Frank was signed into law, various Congressional committees and federal financial regulators have held hearings on the potential unintended consequences of Dodd-Frank, 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

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3. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

> 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.[4]

Small bank representatives like Mr. 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. They did not package and sell securitized mortgages. They did not 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 have a significant impact on community banks. Dodd-Frank is a massive and complicated piece of legislation—16 titles over 838 pages—the consequences of which will not be known for years since it relies so heavily on rulemaking by regulatory agencies.

One reason this is important is that our policy choices have a real impact on the market, and the ability of these regulated financial institutions to compete within it. Seven of the 16 titles of Dodd Frank are expected to impact community banks. Hundreds of regulations are anticipated to be promulgated.[5] Most of these rules are complex, and the costs of understanding and then complying with these additional and complex rules will be extremely high. A $165 million bank is less able to absorb regulatory burden than a $2 trillion bank. By imposing unnecessary regulations on smaller institutions, we are awarding the larger banks a further competitive advantage.

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 JP Morgan Chase to comply with Dodd-Frank will be "close to $3 billion" over the next few years.[6] However, in a February 2013 note to clients, Citi financial services analyst Keith Horowitz described a conversation with Dimon regarding the impact of new

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4. THE COMMITTEE ON FINANCIAL SERVICES, ON THE RECORD: COMMUNITY BANKERS SPEAK OUT ON THE IMPACT OF DODD-FRANK REGULATIONS (Oct. 17, 2011), http://financialservices.house.gov/blog/?postid=264807 [hereinafter ON THE RECORD].

5. U.S. Gov't Accountability Office, GAO-12-881, Community Banks and Credit Unions: Impact of Dodd-Frank Depends Largely on Future Rule Makings 6 (September 2012)

6. David Benoit, *Jamie Dimon's Letter: The Highlights*, WALL ST. J., Apr. 4, 2012, *available at* http://blogs.wsj.com/deals/2012/04/04/jamie-dimons-letter-the-highlights/.

regulations on the financial services sector in which Dimon predicted that JP Morgan Chase's market share would grow because the reforms "make it tougher for smaller players."[7] As Dimon acknowledged, Dodd-Frank has the potential to have a very costly impact on community banks, threatening their ability to compete and accelerating 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.

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%.[8] 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.

7. Jessica Pressler, *122 Minutes With Jamie Dimon*, N.Y. MAGAZINE, August 12, 2012, *available at* http://nymag.com/news/intelligencer/encounter/jamie-dimon-2012-8/. ("[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.")

8. *Historical Statistics on Banking (HSOB)*, FED. DEPOSIT INS. CORP., http://www2.fdic.gov/hsob (follow "Commercial Bank" hyperlink; then click "CB01: Number of Institutions, Branches and Total Offices") (last visited Feb. 17, 2013).

| ***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 |

**Table 1: Number of Bank Failures 2002-2012**

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, there have been 6.5 mergers for every bank failure.[9]

Both failures and mergers disproportionately impact smaller banks. The number of banks with assets of less than $100 million decreased by more than 80% from 1985 to 2010 while the number of banks with assets greater than $10 billion nearly tripled over the same period.[10] Meanwhile, the concentration of capital in those large banks increased. A mere 7.6% of banks currently hold about 86% of all banking assets in the United States.[11] The cumulative

9. Bob Solomon, *The Fall (and Rise?) of Community Banking: the Continued Importance of Local Institutions*, 2 U.C. IRVINE L. REV. 947 (2012).

10. *Id.* (citing Richard A. Brown, Chief Economist, FDIC, The FDIC Community Banking Research
Project: Community Banking by the Numbers, Presentation at the FDIC Future of Community
Banking Conference (Feb. 16, 2012), *available at* http://www.fdic.gov/news/conferences/community
banking/community_banking_by_the_numbers_clean.pdf.

11. Fed. Deposit Ins. Corp., *Statistics on Depository Institutions Report* (Dec. 31, 2010), http://www2.fdic.gov/SDI/main.asp (last visited Dec. 19, 2012) [hereinafter *FDIC Statistics Report*].

regulatory burden imposed by Dodd-Frank will exacerbate this problem.[12] For example, in September 2012, Shelter Financial Bank, a $200 million 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.[13] 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.[14]

So while policymakers enacted Dodd-Frank to avoid "too big to fail" situations, in reality, it encourages them. The Act will force greater asset consolidation in fewer megabanks by increasing the competitive advantage large banks have over smaller banks.

These failures and mergers are not without consequence. They will leave communities, particularly rural communities, without a

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12. In June 2013, leaders of Bank of the American Fork and Lewiston State Bank, both in Utah, attributed their upcoming merger to "[t]he increase in expenses, decrease in profits, and new government regulations over the past few years [which] made it harder for small banks to continue operating as they have done in the past." Paul Beebe, *Two Utah Community Banks Set Merger for 4Q*, The Salt Lake Tribune, June 19, 2013. In July 2013, two community banks in New Jersey announced that they were merging. The chief executive officer of one of the banks predicted that "more of New Jersey's smaller banks will look to merge with each other." Ed Deeson, *Two New Jersey banks announce merger*, The Star Ledger, July 14, 2013. 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." Robin Sidel, *Small Banks Put up 'For Sale' Sign*, The Wall Street Journal, June 18, 2012.

13. Francesco Guerrera, *Dodd-Frank, Seen from Missouri*, THE WALL STREET JOURNAL, January 21, 2013.

14. *An Examination of the Challenges Facing Community Financial Institutions in Ohio: Field Hearing before H. Subcommittee on Financial Institutions and Consumer Credit of the Com. on Financial Services*, 112th Cong. 116 (2012) (testimony of Martin R. Cole, President and Chief Executive officer, The Andover Bank).

local financial institution and will increase the number of unbanked and underbanked Americans.[15] 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.[16]

Although many policymakers in the early 1990s argued that consolidation would improve the "efficiency, safety, and profitability of the banking industry," culminating in the Riegel-Neal Act of 1994, scholars like Arthur Wilmarth have long argued that "banking industry dominated by a few big banks [is] likely to be less efficient, less profitable, more risky, and less competitive than the decentralized banking system that had long existed in the United States."[17]

That decentralized system is a system of regulation by accretion – it is the result of legislative responses to particular crises,[18] 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,[19]

15. "[M]any large banks have made clear that they prefer not to serve customers who maintain small balances in their deposit accounts. First Chicago recently imposed a teller service fee on customers who fail to maintain specified minimum balances in their deposit accounts. When this action triggered angry protests from consumer advocates and two members of Congress, big bank executives and consultants replied that it made economic sense for large banks to encourage small depositors to take their accounts elsewhere." Arthur E. Wilmarth, Jr., *Too Good to be True? The Unfulfilled Promises Behind Big Bank Mergers*, 2 STAN. J.L. BUS. & FIN. 1, 32-33 (1995)

16. Statement of Cliff McCauley, *supra* note 108.

17. Arthur E. Wilmarth, Jr., *Too Good to be True? The Unfulfilled Promises Behind Big Bank Mergers*, 2 STAN. J.L. BUS. & FIN. 1, 4 (1995).

18. See John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020 (2012) ("A good crisis should never go to waste. In the world of financial regulation, experience has shown – since at least the time of the South Sea Bubble three hundred years ago – that only after a catastrophic market collapse can legislators and regulators overcome the resistance of the financial community and adopt comprehensive 'reform' legislation."

19. Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 228 (2000).

the creation of the Federal Reserve after the monetary panic of 1907,[20] the creation of the FDIC following the stock market crash of 1929,[21] 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 cumulative burden is significant. Between 1990 and 2006, "more than 800 new regulations have been imposed on banks."[22] The net effect is a federal regulatory system for banking that is unnecessarily inefficient, expensive, 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)[23] 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,[24] which reduced barriers between depository banks and investment banks, the gap between community banks and large, complex financial institutions has grown and the focus of federal regulatory activity has been on large institutions.[25] It is simply not a principled policy choice to regulate them both under the current "one size fits all" approach. As discussed in Part II(A), 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 are counterproductive to the goals of Dodd-Frank and which are against our common interests.

This Article argues that we need take a step back and fundamentally rethink our regulatory approach to banking – to target our resources on real risks to the American consumer and the American economy rather than doubling down on a regulatory approach that represents more of a historical accident than a deliberate policy choice. It's a simple fact that a depository institution with $165 million in assets poses different risks and serves different functions to consumers and the economy than a $2

20. *Id.* at 231.

21. *Id.* at 236.

22. Stephanie E. Dreyer and Peter G. Weinstock, *Less is More: Changing the Regulator's Role to Prevent Excess in Consumer Disclosure*, 123 BANKING L.J. 99, 103 (2006).

23. AMERICAN BANKERS ASSOCIATION, THE BUSINESS OF BANKING 8 (2012).

24. Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106–102, 113 Stat 1338 (1999).

25. Gregory C. Yadley, Regulators' Responsibility for Small Banks' Inability to Finance Customers in the Wake of the Financial Meltdown, 7 Ohio St. Entrepreneurial Bus. L.J. 95, 100 (2012).

trillion bank and we should take a more tailored approach to regulating them both.

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. But the focus on standardization fails to recognize challenges faced by borrowers who lack the deep credit history or documentation necessary for the model-based transactional lending used by large financial institutions. Self-employed workers, seasonal workers, farmers, and people transitioning to work will be particularly at risk by increased standardization.

Financial activities that are fundamental to the average American are only worth the time of a large, complex financial institution if they involve a completely standardized product and if the borrower is a completely standardized borrower. You either fit in the box or you don't. As a result, millions of Americans are left out of that box altogether. According to the FDIC, one in four American households are either "unbanked" or "underbanked."[26] These households typically bear far higher costs than those fully served by banks.

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 community banks 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 an even more 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.

Community banks are valuable and need significant regulatory reform to reverse the trends of consolidation and standardization, to strengthen the relationship banking model and to continue to improve the lives of their customers.

## I. WHY COMMUNITY BANKS MATTER

The landscape of the American banking industry is very different from other Western countries because of the large number of small, local depository institutions. Community banks make up the vast majority of U.S. banks. As of December 31, 2010, community banks constitute 92.4% of chartered banking

26. FED. DEPOSIT INS. CORP., NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 4 (2012).

organizations in the United States.[27] That is—more than nine out of ten U.S. banks are community banks. Although numerically dominant, community banks hold only 14.2% of all banking institution assets.[28] The juxtaposition of banking presence to assets means that just 7.6% of banks hold 85.8% of all banking assets in the United States.[29]

| ***Type of banking organization*** | ***# of banks*** | ***% of total banks*** | ***Assets ($ in 000s)*** | ***% of total bank assets*** |
|---|---|---|---|---|
| Community Bank | 6,798 | 92.4% | 1,971,883,240 | 14.2% |
| Non-Community Bank | 558 | 7.6% | 11,920,361,536 | 85.8% |
| **Total** | **7,356** | **100.0%** | **13,892,244,776** | **100.0%** |

**Table 2: Distribution of Banking Organizations by Type of Bank**

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—the midsize community banks. These banks make up over half of all banks. 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.[30]

Before explaining the impact of Dodd-Frank on community banks, it is useful to first define how this Article uses the term, to explain the importance of community banks to the American economy, and finally to discuss the role that community banks played in the precipitating event to Dodd-Frank – the most recent financial crisis.

### *A. 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

27. *FDIC Statistics Report*, *supra* note ___.
28. *Id.*
29. *Id.*
30. *Id.*

activities while obtaining most of their funding from local deposits.[31] We use the term broadly because there is no set definition 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.[32] The OCC says community banks are banking organizations with less than $1 billion in total assets.[33] And, lastly, the FDIC formerly defined community banks as banking organizations with less than $1 billion in assets,[34] but recently revised its definition by moving to a more inclusive, multi-criteria approach.[35]

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.[36] 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 catch-all.[37] The net effect of this new definition is that certain institutions with more than $1 billion in assets—which, formerly failed to meet the community bank definition—are now designated as community banks because each meets the banking activity and geographic area tests.[38] For

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31. Fed. Deposit Ins. Corp., *FDIC Community Banking Study I* (2012) [hereinafter *FDIC Study*], *available at* http://fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

32. Elizabeth A. Duke, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks on Community Banks and Mortgage Lending at the Community Bankers Symposium (Nov. 9, 2012), *available at* http://www.federalreserve.gov/newsevents/speech/duke20121109a.htm.

33. OFFICER OF THE COMPTROLLER OF THE CURRENCY, COMMUNITY BANK SUPERVISION COMPTROLLER'S HANDBOOK 1 (2010), *available at* http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/cbs.pdf.

34. *Id.*

35. *FDIC Study*, *supra* note ___.

36. *Id.* at 1.1-1.5.

37. *Id.*

38. *Id.* 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.

purposes of this paper, we follow a method similar to the FDIC's revised definition.[39]

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 traditional financial services, operate in limited geographic areas, and are often located in rural areas. For example, 82% of community banks operated within three or fewer counties in 2011, while 37% of non-community banks operated within three or fewer counties.[40] Community banks are often found in small towns and sparsely populated regions, making up more than 70% of banking offices in rural areas.[41] Community banks are also more likely than non-community banks to locate their headquarters in a non-metro area (47% versus 17%), and almost three times more likely than non-community banks to locate offices in non-metro areas (38% versus 13%).[42]

One important difference between community banks and large banks is the way that they process information about customers and make underwriting decisions. The community bank model is often described as "relationship banking" while the large bank model is referred to a "transactional banking." Large banks, by virtue of their size, are able to exploit the economies of scale. Their traditional banking activities include taking deposits, providing intermediation services, and making loans. But "[b]ecause these transactional products are highly standardized, they require little human input to manage and involve information that is generally easily available and reliable. Thus, in transactional banking hard information drives performance."[43] Large banks rely heavily on mechanical processes such as credit scoring, which involve incorporating hard data into quantitative computer models to make underwriting decisions.[44] Transactional banking is efficient, particularly when replicated on a large scale, but because it focuses on hard data it largely excludes human judgment from underwriting decisions.

In contrast, relationship banking builds on longstanding customer relationships that give the bank more access to "soft"

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39. 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.

40. *Id.*

41. *Id.*

42. *Id.*

43. Scott E. Hein, Timothy W. Koch, and S. Scott Macdonald, On the Uniqueness of Community Banks, Federal Reserve Bank of Atlanta, Economic Review, First Quarter 2005 at p. 18.

44. *Id.* at 19.

information about the borrower.[45] Computer models may be used to enhance underwriting, but more authority is given to bank employees to make lending decisions. Soft information, by its nature, is not generally available and is difficult to quantify. It is more expensive to acquire and more expensive to process. However, studies have shown that many borrowers, particularly small businesses, farmers, and individuals, are better served by relationship banking than the transactional banking model.[46]

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 non-community counterparts.[47] Second, the relationship banking model relies upon repeat business within a limited population, which provides a strong economic disincentive to predatory lending and other practices exploitative of consumers. Although transactional banking is more efficient than relationship banking, Federal Reserve data consistently shows that large banks charge higher fees than community banks and have increased their fees more over time.[48] George Hansard, President and CEO of the Pecos County State Bank in Fort Stockton, Texas, a $150 million community bank, explained the market incentives:

> [C]ommunity 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.[49]

Federal Reserve Chairman Ben Bernanke expressed a similar sentiment, commenting, "[O]ne 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."[50]

### *B. The Role of Community Banks in the American Economy*

After defining what a community bank is, the question remains as to why community banks are important in the broader context of the American financial sector. Simply, the answer is that community banks provide significant portions of total U.S. banking

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45. Id at 17.
46. Id at 17.
47. *FDIC Study*, *supra* note 19.
48. Hein, Scott and Macdonald, *supra* note ___ at 17.
49. *An Examination of the Challenges Facing Community Financial Institutions in Texas: Field Hearing before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S House of Representatives*, 112th Cong. 106 (2012) (statement of George Hansard, President/CEO, The Pecos Cnty. State Bank, Fort Stockton, Texas).
50. AMERICAN BANKERS ASSOCIATION, *supra* note 10, at 9.

activity and they provide banking access to many Americans that otherwise would have no bank.

Large banks serve individual customers, but tend to focus on those who are easily and cheaply processed through the transactional banking model. They are interested in commodity banking (i.e. large volume credit cards), large commercial customers, and international customers.[51] Large banks rely more on purchased liabilities to fund lending, and community banks rely on core deposits. Because community banks are traditional bankers, they rely almost entirely on net interest margin (the spread between the cost of deposits and the interest rate charged on loans, minus expenses) and deposit service charges. Large, complex financial institutions have multiple lines of business that allow them to generate significant fee income.

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

> 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.[52]

As Mr. 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" bankers.[53] Community banks use personal knowledge of a customer's financial situation and local business

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51. Hein, Scott, and Macdonald, *supra* note ___ at 25.

52. *Regulatory Reform: Examining How New Regulations are Impacting Financial Institutions, Small Businesses, and Consumers: Field Hearing before the H. Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services,* 112th Cong. 79 (2011) (statement of Marty Reinhart, President, Heritage Bank, Spencer, Wis.).

53. *FDIC Study*, *supra* note 19; CRITCHFIELD, ET AL., COMMUNITY BANKS: THEIR RECENT PAST, CURRENT PERFORMANCE, AND FUTURE PROSPECTS, FDIC BANKING REVIEW (Jan. 2005), *available at* *http://www.fdic.gov/bank/analytical/banking/2005jan/article1.html*; WILLIAM KEETON, FED. RESERVE BANK OF KANSAS CITY, THE ROLE OF COMMUNITY BANKS IN THE U.S. ECONOMY 26-27 (2003), *available at* http://www.kc.frb.org/Publicat/ECONREV/Pdf/2q03keet.pdf.

conditions to make lending decisions.[54] 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 non-standard 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.[55] 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.[56] The community served by his bank is reliant upon timber and mining, both activities that are seasonal. 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% of small business loans issued by U.S. banks, 15.7% of residential mortgage lending, 43.8% of farmland lending, 42.8% of farm lending, 34.7% of commercial real estate loans, and hold 20% of all retail deposits at U.S. banks as of 2010.[57] Meanwhile, community banks provide financial services to sectors of the American economy—particularly rural areas—that would otherwise go underserved. Incredibly, community banks operate in 1200 U.S. counties where there is no other bank. Community banks are the only financial service providers available to more than one third of American counties.[58]

Analyzing the relative significance of community banks in these two important areas is essential to understanding why community banks matter in the U.S. economy. Below we explore each area of significance in more detail.

*1. Financial Services*

a. Small Business Lending.

Small businesses drive the American economy. As of 2010, small businesses accounted for 46% of private non-farm Gross Domestic Product ("GDP"), meaning that almost half of all production in the United States came from small businesses.[59]

54. *Id.*
55. Tim Critchfield, et al., *The Future of Banking in America, Community Banks: Their Recent Past, Current Performance and Future Prospects*, 16 FDIC BANKING REV. 3&4 at 4 (2004).
56. Interview with Tanya Marsh (February 2, 2013) (notes on file with author).
57. *FDIC Statistics Report*, *supra* note 18.
58. *FDIC Study*, *supra* note 19.
59. SBA OFFICE OF ADVOCACY, SMALL BUSINESS GDP: UPDATE 2002-2010, http://www.sba.gov/sites/default/files/rs390_1.pdf.

Small businesses also provide half of all employment in the U.S. and 42% of total U.S. payroll spending.[60] Policymakers on both sides of the aisle agree that small businesses are the "engine of job creation in America" and, therefore, vital to the economic recovery.[61]

Small businesses are dependent 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.[62]

At year-end 2010, U.S. banks had $334.2 billion in outstanding business loans to small businesses.[63] Small business loans are defined as loans secured by non-farm, non-residential properties with original amounts of $1 million or less.[64] At year-end 2010, community banks held $160 billion in small business loans on their books, representing 48.1% of total outstanding small business loans. In other words, one out of every two dollars lent to small businesses comes from community banks. Based on these numbers, if roughly half of U.S. GDP comes from small businesses, and half of small businesses have loans outstanding to community banks, then community banks provide funding for the production of at least a quarter of U.S. GDP, an extremely significant portion.

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60. U.S. Census Bureau, *Statistics of U.S. Businesses* (2010 annual data) (released Oct. 25, 2012) available at http://www.census.gov/econ/susb/.

61. Kate Anderson Brower, *Obama Says Economy Depends on Success of Small Businesses*, BLOOMBERG, Feb. 22, 2011 (noting that "[w]hen small businesses do well, then America does well."), http://www.businessweek.com/news/2011-02-22/obama-says-economy-depends-on-success-of-small-businesses.html; President Barack Obama, Weekly Address (Feb. 6, 2010) ("We can rebuild this economy on a new, stronger foundation that leads to more jobs and greater prosperity. I believe a key part of that foundation is America's small businesses – the places where most new jobs begin."), http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-calls-new-steps-support-americas-small-businesses; Letter from Republican leaders of United States House of Representatives to President Barack Obama (December 9, 2009) ("The truth of the matter is that small business, not government, is the engine of job creation in America.") *available at* http://boehner.house.gov/news/documentsingle.aspx?DocumentID=159982.

62. NFIB RESEARCH FOUNDATION, FINANCING SMALL BUSINESSES: SMALL BUSINESS AND CREDIT ACCESS (Jan. 2011).

63. *FDIC Statistics Report*, *supra* note 18.

64. *Id.*

| *Type of banking organization* | *Small business loans outstanding ($ in 000s)* | *% of all small business lending* |
|---|---|---|
| Community Bank | $160,923,062 | 48.1% |
| Non-Community Bank | 173,290,081 | 51.9% |
| **Total** | **334,213,143** | **100.0%** |

**Table 3a: Distribution of Small Business Lending by Type of Bank**

Unsurprisingly, small business lending by community banks follows the same distribution as bank size. 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% of all small business loans, likely reflecting their 47.3% share of all U.S. banking organizations.

| *Size of community bank* | *Small business loans outstanding ($ in 000s)* | *% 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** | **48.1%** |

**Table 3b: Distribution of Small Business Lending by Community Banks**

b. Residential Mortgage Lending.

Home ownership is an essential element to the American Dream and a vital part of the American economy. The U.S. government has encouraged home ownership for decades through various economic and tax policies.[65] The prevailing policy theory is

65. *See generally* Dennis J. Ventry Jr., The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest, 73 L*aw and* C*ontemporary* P*roblems* 233-284 (Winter 2010)(discussing housing-related tax subsidies defended on homeownership grounds as early as the 1950s); Avery, Robert B., et al., The Mortgage Market in 2010: Highlights from the Data Reported Under the Home Mortgage Disclosure Act." Federal Reserve Bulletin

that home ownership creates more stable neighborhoods, better environments for children, and less crime because home owners are more protective, more involved in their communities, and more familiar with their neighbors than renters. On a personal level, home ownership is a primary way for individuals to build wealth. According to the Federal Reserve, homes constitute 32% of total family assets, establishing a borrowing base and an appreciable asset.[66]

Few individuals are able to purchase a home without obtaining a mortgage loan. Only 11% of home purchases are all-cash by non-investor purchasers—meaning that about nine out of ten homeowners require a mortgage to purchase their house.[67] Clearly the availability of residential mortgage loans are essential to widespread homeownership in America.

At year-end 2010, U.S. banks held $2.5 trillion in residential mortgage loans. Out of this total, community banks held $398 billion, or about 15.7%. As we discuss later, 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.

| ***Type of banking organization*** | ***Residential Mortgage Loans outstanding ($ in 000s)*** | ***% of all Residential Mortgage lending*** |
| --- | --- | --- |
| Community Bank | $398,168,438 | 15.7% |
| Non-Community Bank | 2,138,394,700 | 84.3% |
| **Total** | **2,536,563,138** | **100.0%** |

**Table 4a: Distribution of Residential Mortgage Lending by Type of Bank**

The chart below depicts the relative shares of total U.S. 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.

97, 1-82 (December 2012) available at (50 percent of home-purchase loans are Government backed).

66. http://www.frbsf.org/publications/economics/letter/2006/el2006-30.html

67. http://www.realtor.org/news-releases/2013/02/january-existing-home-sales-hold-with-steady-price-gains-seller-s-market-developing.

| ***Size of community bank*** | ***Residential Mortgage Loans outstanding*** | ***% 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%** |

**Table 4b: Distribution of Residential Mortgage Lending by Community Banks**

c. Farm and Farmland Lending.

Farming added almost 1.0% to U.S. GDP in 2010.[68] American farms produced $132.6 billion of economic value in 2010, about the same as the Oil & Gas Industry or twice that of the Automobile Industry.[69] Farms also provide an additional economic impact through the downstream marketing services required to get the food to market. According to the USDA, farmers receive only 14% of each dollar spent on domestically produced food by U.S. consumers.[70] This means that the other 86% 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 are heavily reliant on U.S. farms as a food source. As of 2009, 83% of food consumed in the United States was produced domestically.[71]

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

68. Donald D. Kim, et al., *Annual Industry Accounts Advance Statistics on GDP by Industry for* 2011, U.S. DEP'T OF COMMERCE: BUREAU OF ECON ANALYSIS 14 (2012), *available at* http://www.bea.gov/scb/pdf/2012/05%20May/0512_industry.pdf.

69. Interactive Access to Industry Economic Accounts Data, Value Added by Industry, U.S. DEP'T OF COMMERCE: BUREAU OF ECON ANALYSIS (November 13, 2012) *available at* http://www.bea.gov/iTable/index_industry.cfm.

70. *Food Dollar Series*, UNITED STATES DEP'T OF AGRICULTURE: ECON. RESEARCH SERV., http://www.ers.usda.gov/data-products/food-dollar-series/food-dollar-application.aspx.

71. *U.S. Agricultural Trade, Import Share of Consumption*, UNITED STATES DEP'T OF AGRICULTURE: ECON. RESEARCH SERV., http://www.ers.usda.gov/topics/international-markets-trade/us-agricultural-trade/import-share-of-consumption.aspx.

for crop production and long-term capital funding. Indeed, community banks provide two out of every five dollars of credit used to finance agricultural production or to purchase farmland. As of year-end 2010, all U.S. 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, the term "farm loans" represents all outstanding farm loans with original amounts less than $500,000 as of December 31, 2010.[72] "Farmland loans," meanwhile, include all outstanding loans secured by farmland with original amounts less than $500,000 as of December 31, 2010.[73]

Consistent with their overwhelming banking presence in rural areas, community banks hold a vastly disproportionate share of all farm lending with 42.8% of farm loans and 43.8% of farmland loans. 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% of total bank assets but provide more than 40% of farm lending.

| ***Type of banking organization*** | ***Farmland loans outstanding*** | ***% of all farmland loans outstanding*** | ***Farm loans outstandin g*** | ***% of all farm loans outstandin g*** |
|---|---|---|---|---|
| Community Bank | 29,800,374 | 43.8% | 25,400,290 | 42.8% |
| Non-Community Bank | 38,179,839 | 56.2% | 33,927,474 | 57.2% |
| **Total** | **67,980,213** | **100%** | **59,327,764** | **100%** |

**Table 5a: Distribution of Farm and Farmland Lending by Type of Bank**

The chart below depicts the relative and total shares of farm loans and farmland loans by community bank size. Mid-size community banks were the largest contributors to community bank farm lending in 2010, accounting for 22.1% of total farm loans and 23.4% 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.

72. *FDIC Statistics Report*, *supra* note 18.
73. *Id.*

| *Size of community bank* | *Farmland loans outstandin g* | *% of all farmland loans outstandin g* | *Farm loans outstandin g* | *% of all farm loans outstandin g* |
|---|---|---|---|---|
| < $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%** |

**Table 5b: Distribution of Farm and Farmland Lending by Size of Community Bank**

Lack of substitutes for the banking services provided to rural areas further emphasizes the important role of community banks in farm lending.[74] With less than a 30% share of banking offices in rural areas, larger banks tend to be more geographically distant from farming operations.[75] As a result, large banks incur more monitoring costs when lending to smaller borrowers such as farms and rural small businesses. Because farm loans are more costly to larger banks, they are less willing to extend credit. Consequently, there is no evidence that larger banks would be willing or able to substitute for the local farm lending practiced by smaller community banks.

d. Commercial Real Estate Lending.

At year-end 2010, U.S. banks carried $1.07 trillion in commercial real estate ("CRE") loans on their books.[76] Commercial real estate includes non-residential property types such as offices, retail shopping centers, industrial and warehouse buildings, and multi-family residential properties. Community banks held $371 billion, or 34.7% of those loans.[77]

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74. WILLIAM KEETON, FED. RESERVE BANK OF KANSAS CITY, THE ROLE OF COMMUNITY BANKS IN THE U.S. ECONOMY 26-27 (2003), *available at* http://www.kc.frb.org/Publicat/ECONREV/Pdf/2q03keet.pdf.
75. *FDIC Study*, *supra* note 19.
76. *FDIC Statistics Report*, *supra* note 18. CRE loans are defined as non-residential loans secured by real estate, excluding farm loans.
77. *Id.*

| ***Type of banking organization*** | ***CRE loans outstanding ($ in 000s)*** | ***% of all CRE lending*** |
|---|---|---|
| Community Bank | $371,976,173 | 34.7% |
| Non-Community Bank | 701,217,992 | 65.3% |
| **Total** | **1,073,194,165** | **100.0%** |

**Table 6a: Distribution of Commercial Real Estate Lending by Type of Bank**

The composition of loan portfolios held by community banks has changed significantly over the past quarter decade. Nearly 80% of loans on the books of community banks in 2011 were secured by real estate.[78] 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% of all loans at community banks. By 2011, that percentage had dropped to 36%, 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% of community bank loan portfolios to 42%.[79] 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 U.S. CRE, and they are primarily financed by community banks.[80]

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78. 78. 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 of these loans are business loans in which the real estate owned by the business was encumbered by a mortgage as additional security. *FDIC Study*, *supra* note 19, at 5-15.

79. *FDIC Study*, *supra* note 19, at 5-1.

80. TANYA D. MARSH, TOO BIG TO FAIL VS. TOO SMALL TO NOTICE: ADDRESSING THE COMMERCIAL REAL ESTATE DEBT CRISIS, 63 ALA. L. REV. 321 (2011).

In 2010, the CRE sector contributed 2.6% to U.S. GDP, primarily through construction spending.[81] Through CRE lending, community banks directly provided credit for the production of 0.90% of U.S. 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 are 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.[82] Businesses that choose to lease the premises from which they operate have the flexibility to employ capital in the acquisition of equipment or payroll. If the CRE sector did not exist, many other small businesses that could not afford to purchase their own building would also not exist.

Like other financial services, community banks provide a disproportionately large amount of CRE loans to assets. While only holding 14% of assets, community banks provide 34% of commercial real estate loans. The chart below breaks out CRE lending by community bank size. Notably, smaller community banks—those with less than $100 million in assets—provide only 1.5% 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.

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81. Bureau of Economic Analysis, *NIPA Tables*, line 10 (Jan. 2013); Dennis P. Lockhart, President and Chief Executive Officer, Fed. Reserve Bank of Atlanta, Remarks on Real Estate and the Economic Recovery at the Meeting of the National Funding Association Council for Quality Growth (May 11, 2011), *available at* http://www.frbatlanta.org/news/speeches/110511_lockhart.cfm.

82. Testimony of Sandra Thompson, Director, Division of Supervision and Consumer Protection, Federal Deposit Insurance Corporation on *The Current State of Commercial Real Estate Finance and Its Relationship to the Overall Stability of the Financial System*, *Before the Congressional Oversight Panel*, (Feb. 4, 2011) at 14 (testimony of Sandra Thompson, Director, Division of Supervision and Consumer Protection, Fed. Deposit Insurance Corp. that "[s]mall businesses rely heavily on commercial real estate to collateralize borrowings for working capital and other needs.").

| ***Size of community bank*** | ***CRE loans outstanding ($ in 000s)*** | ***% of all CRE lending*** |
|---|---|---|
| < $100M | $16,148,387 | 1.50% |
| $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** | **34.7%** |

**Table 6b: Distribution of Commercial Real Estate Lending by Community Banks**

e. 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.[83] 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 non-transaction accounts like savings accounts and CDs. Here, retail deposits serve as a proxy for the overall banking services because checking accounts are closely related to total retail banking activity.[84] 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.[85]

At year-end 2010, U.S. banks held $6.98 trillion in retail deposits.[86] At the same time, community banks held $1.4 trillion in retail deposits, representing a 20% share. The fact that one in five deposited dollars is held by a community bank is illustrative of why community banks are important in the broader economy.

83. TIMOTHY CLARK, ET AL., FED. RESERVE BANK OF NEW YORK, THE ROLE OF RETAIL BANKING IN THE U.S. BANKING INDUSTRY: RISK, RETURN, AND INDUSTRY STRUCTURE 42 (2007), *available at* http://www.ny.frb.org/research/epr/07v13n3/0712hirt.pdf.
84. *Id.*
85. *Id.*
86. *FDIC Statistics Report*, *supra* 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.

| *Type of banking organization* | *Retail deposits held ($ in 000s)* | *% of all retail deposits held* |
|---|---|---|
| Community Bank | 1,404,138,220 | 20.11% |
| Non-Community Bank | 5,577,320,183 | 79.89% |
| **Total** | **6,981,458,403** | **100.0%** |

**Table 7a: Distribution of Retail Deposits Held by Type of Bank**

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 non-metropolitan areas, helping explain their 70% deposit share in rural areas.[87] Again, although community banks hold only 14% of total banking assets, they provide valuable, and potentially irreplaceable, services to many Americans, particularly those in rural areas.

As shown in the chart below, the share of deposits among community banks largely follows bank size with mid-size community banks holding the largest share of deposits and small community banks holding the smallest.

| *Size of community bank* | *Retail deposits held ($ in 000s)* | *% 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%** |

**Table 7b: Distribution of Retail Deposits Held by Community Banks**

Community banks are more focused than larger banks on core financial services, and that emphasis is demonstrated in their disproportionate involvement in key activities. As discussed above, community banks only hold 14.2% of total bank assets, but they provide 48.1% of small business lending, 43.8% of farm loans, 42.8% of farmland loans, 34.7% of commercial real estate lending, 15.7% of residential mortgage loans, and hold 20.1% 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

87. *FDIC Study*, *supra* note 19, at 3.5.

would otherwise find it difficult to avail themselves of credit or banking services.

### *2. Geographic Scope*

One of the most important ways that community banks contribute to the American economy is their service to rural areas that would otherwise go without banking access.[88] Rural areas make a significant contribution to the American economy. Counties with fewer than 10,000 in population contribute 4.4% of U.S. real economic output, while counties with populations between 10,000 and 50,000 contribute another 7.9%. Combined, these "non-metropolitan" areas contribute over 12% of U.S. economic activity.[89] These rural—and productive—areas are also highly dependent 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.[90] 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 U.S. counties that would otherwise go underserved. More than 1200 U.S. counties—with a combined population of 16 million Americans—would have severely limited banking access without community banks.[91] In 2010, 629 U.S. counties had no banking institution office other than a community bank.[92] So, consumers in those counties would have no banking access were it not for community banks. Finally, non-community banks operated three or fewer offices in another 639 U.S. counties.[93]

Comparing community bank share of all branches by state with state population density rankings makes a similar point. As summarized in the chart below, the average community bank share of all branches in the ten most population dense states is 31%.[94] That is, three of every ten bank branches in the densest states are community banks. By contrast, the average share for community banks in the ten least population dense states is 47%—a full 57%

88. Under FDIC analytical methods, rural and micropolitan counties make up the broader category of "non-metropolitan" 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 the *FDIC Study*, *supra* note 19.

89. *FDIC Study*, *supra* note 19.

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. FED. DEPOSIT INS. CORP., COMMUNITY BANKING BY THE NUMBERS (2012), *available at* http://www.fdic.gov/news/conferences/communitybanking/community_banking_by_the_numbers_clean.pdf.

higher than in the ten 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 non-community bank.

| The Ten Least Population Dense States | | The Ten 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%** |

**Table 8: Community Bank Share of Branches Operating as of the Second Quarter of 2010**

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 U.S. counties.

### *C. Community Banks and the Financial Crisis*[95]

Congress enacted Dodd-Frank on January 5, 2010, and President Obama signed it into law on July 21, 2010.[96] Passed

95. Note that in this section, we have used a simpler, asset-based definition of community banks for practical purposes. Here, "community banks" simply refers to all banking organizations with less than $1 billion in assets.

96. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); DAVIS POLK, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, ENACTED INTO LAW ON JULY 21, 2010 (2010), *available at* http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-

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. There is compelling evidence that community banks 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.[97] Many provisions of the Act, however, apply to both large, complex financial institutions and community banks. Below we present evidence showing that community banks did not participate in the perceived causes of the Financial Crisis.[98]

*1. Subprime Lending.*

Community banks participate significantly in the U.S. residential mortgage market due to their role as relationship bankers. At the end of 2010, community banks held about 15% of loans secured by single-family residences—about the same proportion as total banking assets held. For many customers, obtaining a mortgage loan is a financial service sought from the provider of the customer's 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 that customer is most comfortable with that bank and the bankers at Small Town Community Bank understand that customer's 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 U.S. economic policy promoted homeownership as a method for Americans to build wealth. Entire ancillary, and heretofore non-existent, industries sprung up around the housing market as a result. To get as many U.S. consumers in to homes as possible, some mortgage originators used innovative and risky loan arrangements, as discussed below. 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

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b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf

97. FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

98. There remains passionate disagreement about what caused the Financial Crisis. For the purposes of this Article, we do not believe it is important to determine or discuss what actually caused the Financial Crisis, but to refer to the thinking of those who drafted the legislation and what they hoped to accomplish through Dodd-Frank.

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, due to 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.[99] 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. When popular references are made to "subprime lending," it also includes Alt-A loans. These loans are generally made to borrowers with strong credit scores but which 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/or fees on subprime and Alt-A loans.

In 1990, subprime loans totaled $37 billion, or 9% of residential mortgage originations.[100] 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% of all residential mortgage originations.[101] In 2006, Alt-A and subprime loans combined to constitute 40% of all origination activity.[102] This origination volume was made possible because the vast majority of these loans were pooled into mortgage-backed securities ("MBS") and re-pooled into collateralized debt obligations ("CDO"s).

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 at unprecedented numbers—curtailing the cash flow underlying

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99. *Id.*

100. Financial Crisis Inquiry Commission, Preliminary Staff Report: The Mortgage Crisis 8 (April 7, 2010) http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-PSR_-_The_Mortgage_Crisis.pdf

101. Id.

102. Id.

many MBS and related CDOs—and creating a cascade of defaults throughout the financial system.[103]

Subprime mortgage lending was clearly a significant problem that contributed to the Financial Crisis; however, as shown below, it is equally clear that community banks played no role in that market.[104]

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 herein 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, the chart below 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.

Between 2003 and September 2012, residential mortgages originated and held by community banks significantly outperformed residential mortgages in general. Only 0.20% 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%, as shown in the chart below.[105]

Remarkably, this trend is magnified when comparing default ratios at community banks to all institutions for the period since 2009, when mortgage defaults ballooned. Since 2009, portfolio default rates have averaged 0.23% at community banks versus 3.62% at all institutions. That is—the default ratio has been 15.7 times higher for all institutions than for community banks since 2009.[106]

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103. *Id.*

104. In fact, loans that promoted the Financial Crisis were "primarily being made outside the regular banking system." Treasury research determined that 94% of "high priced loans" to "lower income borrowers" were originated by non-bank entities. Joseph R. Mason, et. al., *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 791 (2010)

105. *FDIC Statistics Report*, *supra* note 18.

106. The significance of the June data point reflects the trailing nature of housing defaults. The backlog in foreclosures and mortgage workouts is well known. Forbes estimates a $246 billion shadow inventory remaining in the housing market as of August 2012. Augustino Fontevecchia, *What Housing Recovery? Distressed Sales Still High, Shadow Inventory Massive*, FORBES.COM (Aug. 28, 2012, 6:57 PM), http://www.forbes.com/sites/afontevecchia/2012/08/28/what-housing-recovery-distressed-sales-still-high-shadow-inventory-massive/.

With total residential mortgage defaults at community banks making up only 2% 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.

*2. 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 and 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 investments for investors who sought a low-risk investment 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% of residential mortgage securitization activities between 2003 and 2010.[107] Fees generated from securitization activities accounted for a tiny amount of noninterest income for community banks between 2001 and 2011, but 8% of noninterest income for non-community banks.[108] At less than one tenth of one 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.

*3. 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 the risk. 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, thereby increasing systemic credit exposure

107. *FDIC Statistics Report*, *supra* note 18.
108. *FDIC Study*, *supra* note 19, at p. 4-3.

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 in order 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.[109] According to the GAO, only 11% of community banks held any derivatives in 2010.[110] 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 to 2010 did community bank derivatives activity make up more than a fraction of one percent of total banking institution derivatives activity. FDIC data on derivatives[111] shows that the average notional value of derivatives held on community bank balance sheets constituted about one tenth of one percent of all derivatives held by all banking institutions between 2003 and 2010. Moreover, community banks made up an insignificant portion of all credit derivatives trading. Community banks held just 0.003% of all credit derivatives held by banking institutions between 2003 and 2010.

Above 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 in order 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

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109. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF DODD-FRANK DEPENDS LARGELY ON FUTURE RULE MAKINGS (September 2012).[hereinafter GAO 12-881].

110. Banks with less than $1 billion in assets as determined by call report data released by the FFIEC.

111. *FDIC Statistics Report*, *supra* note 18. Figure represents the sum of the following: interest-rate contracts (as defined as the notional value of interest-rate swap, futures, forward and option contracts), foreign-exchange-rate contracts, commodity contracts and equity contracts (defined similarly to interest-rate contracts).

not cause the Financial Crisis, they must "unfortunately" deal with regulations to prevent another crisis.[112]

## II. The Regulation of Community Banks

### A. *Regulatory Structure*

The American banking system and regulatory regime are significantly different than other Western countries.[113] The system evolved organically and in response to historical conditions and events, rather than as a result of a deliberate planning process. In the very beginning, Alexander Hamilton and Thomas Jefferson clashed over the structure of banking in the United States.[114] Hamilton favored a federal bank and the establishment of a national currency. Jefferson advocated for a de-centralized system where the states chartered banks.[115] The ultimate result was the dual banking system that we have today.

During the early days of the American republic, each state established its own system for chartering banks.[116] At the same time, The First Bank of the United States was chartered by Congress in 1791. A bill to re-charter the bank failed in 1811.[117] As every lawyer who has taken Constitutional Law knows, the Second Bank of the United States was chartered in 1816 by Congress.[118] The state of Maryland, in an effort to protect its own state-chartered banks, imposed the tax on the Second National Bank and challenged its right to exist under the federal Constitution. In *McCullough v. Maryland*,[119] the Supreme Court determined that Congress did have the power to charter a bank. The Second Bank of the United States was dissolved in 1836 when President Andrew Jackson vetoed a bill to re-establish its charter.[120]

> The Jeffersonian and Jacksonian struggles against the First and Second Banks reflected a deeply rooted popular hostility

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112. *CFPB Director Richard Cordray Meets with CBAI Bankers*, CMTY. BANKERS ASSOC. OF ILL. (December 5, 2012) available at http://www.cbai.com/downloads/ CFPB_Roundtable_CBAI_E-News_12-21-2012.

113. Carl Felsenfeld & Genci Bilali, *Is There a Dual Banking System?*, 2 J. BUS. ENTREPRENEURSHIP & L. 30, 53 (2008) ("The structure of the U.S. bank regulatory system is unique in the world.")

114. MICHAEL P. MALLOY, BANK REGULATION 4 (2nd ed. 2003).

115. Jefferson and James Madison argued that Congress had no constitutional authority to charter a bank. Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 970 (1992).

116. LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 10 (4th ed. 2011) (North Carolina was the last state to establish a state-chartering system, in 1804).

117. *Id.*

118. *Id.* at 11.

119. 17 U.S. 316 (1819).

120. BROOME & MARKHAM, SUPRA, at 14-15.

> to centralized financial power, particularly power licensed by the federal government. The anti-Bank forces believed a decentralized, competitive system of state banks was the only safe alternative to a national bank monopoly.[121]

Following the demise of the Second Bank of the United States, a period known as the Free Banking Era began. By 1860, nearly 1,600 state-chartered banks were in operation, each issuing their own paper currency.[122]

The need to finance the Civil War and to control the issuance of currency by a myriad of state-chartered banks led to the 1863 National Currency Act, which created a system of national banks and permitted them to issue a standard currency.[123] The next year, this legislation was replaced by the National Bank Act, which began the process of establishing regulations for federally chartered banks.[124] Although these acts created a uniform national currency and limited the issuance of bank notes to federally-chartered banks, it did not create a strong central banking system. The Civil War was thus the precipitating event for the creation of the dual banking system currently in effect today.

Following the Panic of 1907, the next major development in American banking history was the 1913 Federal Reserve Act, which split federal bank regulation between the Treasury Department and the new Federal Reserve System.[125] The Office of the Comptroller of the Currency remained in charge of regulating national banks, but the Federal Reserve was given responsibility for clearing checks. The Federal Reserve Act also prohibited national banks from distributing their own currency and restricted the issuance of notes to the Federal Reserve Banks. In response to the Depression and the resulting widespread failure of banks, the Banking Act of 1933 created a system of federal deposit insurance and the FDIC.[126] Also in 1933, the Glass–Steagall act required the separation of investment banks and commercial banks. In 1994, the Riegle–Neal Interstate Banking and Branching Efficiency Act allowed banks to establish nationwide interstate banking for the first time.[127] This was the enabling step in the rise of large, complex financial institutions. In 1999, the Graham–Leach–Bliley Act repealed portions of the Glass-Steagall Act and allowed bank holding companies to own both investment banks and commercial banks.[128] The Patriot Act,[129] a response to the September 11, 2001 terrorist

121. Wilmarth, *supra* note ___ at 971. [Iowa]
122. *Id.* at 15.
123. *Id.* at 22.
124. *Id.* at 23.
125. Federal Reserve Act, 38 Stat. 351 (1913).
126. BROOME & MARKHAM, supra, at 38.
127. *Id.* at 54-55.
128. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).
129. USA PATRIOT Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

attacks, and the 2002 Sarbanes-Oxley Act,[130] a response to the Enron/WorldCom scandals, resulted in additional regulations for banks. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most significant alteration to banking regulation since 1933, was enacted.[131]

This brief history of the American system of banking regulation illustrates the legislative pattern of regulation by accretion. Following major historical events in our nation's history, such as the war of 1812, the Civil War, the Panic of 1907, the Depression, September 11th, and the 2007 financial crisis, major changes have taken place in the regulatory structure. This has led to a highly fractured system of banking regulation, particularly compared to other Western countries.

In the American dual banking regulatory structure, there are three broad categories of regulation: chartering, supervision, and examination.

Banks may be chartered by either states or the federal government.[132] State-chartered banks are subject to the regulation and supervision of the state in which they were chartered. However, state-chartered banks remain subject to supervision and examination by one or more federal agencies.

There are five main federal regulatory agencies for financial institutions: the OCC, which is part of the Department of the Treasury, the Federal Reserve, the FDIC, the Office of Thrift Supervision (the "OTC"), and the National Credit Union Administration.[133] Of these only the OCC, the Federal Reserve, and the FDIC regulate banks.

Banks may be members of the Federal Reserve system. The Federal Reserve Board is the primary supervisor of state-chartered banks who are members of the Federal Reserve. State banks that are not members of the Fed are primarily supervised by the FDIC. National banks are primarily supervised by the OCC.[134] In addition, Dodd-Frank created the Consumer Financial Protection Bureau (the "CFPB"), which has concurrent supervisory authority over banks with more than $10 billion in assets.[135]

American banks are therefore subject to regulation, supervision, and inspection by a variety of state and federal agencies. Banking regulations generally fall into four categories. First, regulators are concerned with protecting the safety and soundness of deposits. This is the primary concern of the FDIC, although other regulatory agencies are also concerned with safety and soundness. Second,

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130. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).
131. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
132. Henry N. Butler Jonathan, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988)
133. MALLOY, SUPRA, at 27-40.
134. *Id.* at 27-28.
135. BROOME & MARKHAM, SUPRA, at 66.

regulators are concerned with reducing systemic risk, i.e. the risk of disruption to the financial system and the broader economy as a result of one or more major bank failures. Reducing systemic risk was a major concern of the authors of Dodd-Frank. Third, regulators focus on preventing the misuse of banks, specifically the risk that banks will be used to further criminal endeavors such as laundering money.[136] The Patriot Act was particularly concerned with preventing the use of American banks to fund and further terrorist activities. Finally, regulators are focused on consumer protection and equality of access to credit and other banking services. The second primary goal of Dodd-Frank was to promote consumer protection, and numerous other legislation over the past thirty years has similarly focused on these issues.[137]

The Federal Reserve alone administers an alphabet soup of regulations that are concerned with monetary policy and reserve requirements, consumer protection, payment systems, and securities credit transactions. As of July 1, 2013, Federal Reserve regulations A through YY had been established.[138] Each of these regulations impose detailed requirements on banks and there is a significant compliance cost associated with understanding and implementing the bank's responsibilities under each of these regulations.

The American banking sector is a highly regulated segment of the American economy, and that regulatory system has evolved in response to historical events and crises that demanded solutions to specific problems. The variety of state and federal regulators, the sheer volume of regulations applicable to banks, and the complexity of the supervision and examination system result in significant compliance costs. For the average American community bank, which engages in traditional banking activities in a limited geographic area, many of these costs are out of scope with the risks posed by these banks to the American economy and the American consumer. It was against this fragmented backdrop that Dodd-Frank was enacted in 2010.

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136. See, e.g. The Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 114 (1970)

137. See, e.g. the Truth in Lending Act of 1968, Pub. L. No. 90-321, 82 Stat. 146 (1968); the Fair Credit Reporting Act of 1970, Pub. L. No. 90-321, 84 Stat. 1128 (1968); the Equal Credit Opportunity Act of 1974, Pub. L. No. 90-321, 88 Stat. 1521 (1974); the Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, 89 Stat. 1125 (1975); the Community Reinvestment Act of 1977, Pub. L. No. 95-128, 91 Stat. 1147 (1977); the Fair Debt Collection Practices Act, Pub. L. No. 90-321, 91 Stat. 874 (1977); the Electronic Fund Transfer Act of 1978, Pub. L. No. 90-321, 92 Stat. 3728 (1978); the Expedited Funds Availability Act of 1987, Pub. L. No. 100-86, 101 Stat. 635 (1987); the Truth in Savings Act, Pub. L. No. 102-242, 105 Stat. 2334 (1991).

138. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *Regulations*, http://www.federalreserve.gov/bankinfore g/reglisting.htm (last visited Aug. 1, 2013).

*B. Residential Lending: An Example of Disclosure Fatigue*

Even before Dodd-Frank was enacted, a variety of state and federal regulators had imposed numerous disclosure and reporting requirements on banks in the name of consumer protection.[139] While consumer protection is a laudable goal, it is arguable that the sheer volume and complexity of these disclosure requirements actually undermine the goals of consumer protection because the average consumer neither reads nor fully understands the documentation required.[140]

Residential lending provides a good example. To obtain a first mortgage residential home loan at a community bank in Florida,[141] a customer must first fill out a 70-page loan application package. The documentation contained in this package includes the following:

1. a four-page Uniform Residential Loan Application on Freddie Mac form 65 7/05 (rev. 6/09).

2. a three-page Good Faith Estimate (GSE) form developed by the U.S. Department of Housing and Urban Development (HUD).

3. a one-page Good Faith Addendum Lock-In Agreement and Application Fees.

4. a one-page Truth-in-Lending Disclosure.

5. a one-page Itemization of Amount Financed disclosure.

6. a one-page Hazard Insurance Closing Requirements Advance Notice disclosure.

7. a one-page Certifications, Disclosures, and Notices acknowledging that the applicant is aware of the Equal Credit Opportunity Act, the Fair Credit Reporting Act, anti-coercion requirements under state and federal law, and the Right to Financial Privacy Act of 1978.

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139. Congress specifically charged the Consumer Financial Protection Bureau with ensuring that consumer disclosures are "fully accurately and effectively disclosed to consumers in a manner that permits consumer still understand the costs, benefits, and risks associated with the product or service." 12 U.S.C.A. § 5532(a).

140. Jean Braucher, Form and Substance in Consumer Financial Protection, 7 Brook. J. Corp. Fin. & Com. L. 107, 124 (2012) ("Regulation by disclosure often fails to work for an array of reasons. Complexity and variety prevent transparency. Even when creditors try to explain complex features, they cannot always get through to consumers.")

141. The documents described in this section were provided by Eddie Creamer, President and CEO of Prosperity Bank in St. Augustine, Florida.

8. a one-page disclosure informing the customer that it has a right to receive a copy of an appraisal, several notices regarding the appraisal, the disclosure of the Flood Disaster Protection Act of 1973, an acknowledgment that the consumer has received the HUD booklet titled "Settlement Costs," an acknowledgment that the customer has received a booklet titled "Consumer Handbook on Adjustable Mortgages" published by the Federal Reserve Board and the Office of Thrift Supervision, and a Fair Lending Notice required by the Housing Financial Discrimination Act of 1977.

9. a one-page servicing disclosure statement.

10. a one-page Internal Revenue Service form 4506–T, Request for Transcript of Tax Return.

11. a one-page Borrower Certification and Authorization.

12. a two-page list of settlement providers in accordance with Section 3500.7 of HUD's Regulation X (RESPA).

13. a one-page Appraisal Fee Authorization.

14. a 43-page document prepared by HUD entitled "Shopping for Your Home Loan: HUD's Settlement Cost Booklet."

In total, the customer applying for the loan must sign her name a total 14 times and theoretically read 70 pages of disclosures, warnings, and references to dozens of laws.

If the customer is approved for the loan, then she receives a 68-page packet of documents at closing to read and execute. The typical bank closing package includes the following documents:

1. a three-page promissory note. Fannie Mae and Freddie Mac have promulgated promissory note forms that are generally utilized for residential mortgage loans.

2. a five-page amortization schedule.

3. a three-page settlement statement on a form created by HUD.

4. a 13-page mortgage, normally on a state specific form labeled as the Fannie Mae/Freddie Mac Uniform Instrument for Single-Family Loans.

5. A three-page Planned Unit Development Rider (if applicable) identified as the Multistate PUD Rider

Single-Family Fannie Mae/Freddie Mac Uniform Instrument.

6. a one-page Escrow Waiver and Disclosure.
7. a one-page Truth-in-Lending disclosure.
8. a one-page Itemization of Amount Financed disclosure.
9. a one-page First Payment Letter.
10. a one-page Signature/Name Affidavit.
11. a one-page Affidavit of Occupancy.
12. a one-page Occupancy Affidavit and Employment Certification.
13. a two-page Bank Privacy disclosure.
14. a one-page Borrower's Certification and Authorization.
15. a one-page USA Patriot Act Compliance Document.
16. a one-page Real Estate Tax Information disclosure.
17. the four-page Uniform Residential Loan Application, so that the customer can re-certify that all information in the application is correct as of the closing date.
18. a two-page Real Estate Loan Commitment Letter.
19. a one-page Temporary Payment Coupon.
20. a one-page Mailing Address Information form.
21. a one-page Closing Agent/Notary Public Certification Customer Identification Program Affidavit.
22. IRS form W–9 Request for Taxpayer Identification Number and Certification.
23. another copy of IRS form 4506–T Request for Transcript of Tax Return.
24. a one-page Compliance Agreement.

In the 68-page closing packet, the customer is required to sign 17 times.

The 138 pages of this typical residential lending application and closing package contain very important information about what is likely the single largest loan that the customer will ever take. But honestly, does anyone believe that the typical customer reads and understands all of this detailed information? Even sophisticated lawyers are willing to admit that they do not.[142] (At least one of the authors of this Article is willing to admit that she never reads these documents in their entirety, even though she is a real estate lawyer.) The consumer presented with this imposing package likely suffers from disclosure fatigue and obtains little benefit.[143]

Stephanie Dreyer and Peter Weinstock explained the irony of financial consumer disclosures:

> Perhaps the most ill conceived of the recent waves of regulatory rulemaking are the many regulations requiring banks to provide volumes of mind-numbing consumer disclosure. Although promulgated with the admirable intent of protecting unwary consumers, the disclosure rules tend to be long on cost and short on clarity. Ultimately, they are self defeating. . . . [T]he benefit of the regulation is typically greatest for the higher educated, those financially able to afford professional advice and the financially sophisticated who are already well-versed in the issues addressed by disclosure. Thus, the prototypical "naïve consumer" for whom the disclosure is intended to protect, may not receive any meaningful benefit from the information provided. Yet there is no doubt that all consumers are paying their share of the cost.[144]

The residential lending package is a good example of what happens in a regulatory system developed through accretion. Each of the disclosures contained in this packet is, individually, a good idea. The Good Faith Estimate form promulgated by HUD, in particular is a consumer-friendly method of communicating important information about the loan to the consumer. No one can argue that the Truth-in-Lending disclosure, the Itemization of Amount Financed, or the disclosure of alternative settlement

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142. It was reported that Judge Richard Posner of the 7th Circuit Court of Appeals told guests at a 2010 American Constitution Society conference that he did not read the documentation for his home equity loan, he simply signed the documents presented to him. Debra Cassens Weiss, *Judge Posner Admits He Didn't Read Boilerplate for Home Equity Loan*, ABA JOURNAL, June 23, 2010.

143. Senator Elizabeth Warren argues that one of the purposes of the Consumer Financial Protection Bureau is to "revise and update outdated regulations and useless disclosures as aggressively as it monitors the fine print layered on by lenders. If everything is on the table, including existing government regulations, the goals of transparency and consumer understanding can become a reality." Elizabeth Warren, *Warren Outlines CFPB's Mission for Consumers*, AM. BANKR. INST. J., April 2011 at 10.

144. Stephanie E. Dreyer and Peter G. Weinstock, Less is More: Changing the Regulator's Role to Prevent Excess in Consumer Disclosure, 123 Banking L.J. 99, 100-101 (2006).

providers is a bad idea.[145] Consumers should be aware of the Equal Credit Opportunity Act, the Fair Credit Reporting Act, anti-coercion provisions of state and federal law, the Right to Financial Privacy Act of 1978, the right to receive a copy of an appraisal, the Flood Disaster Protection Act of 1973, the Real Estate Settlement Procedures Act (RESPA), and the Housing Financial Discrimination Act of 1977. But if it seems unlikely that consumers will absorb all of this information at once, and that by virtue of these disclosures that they're likely to make better borrowing decisions, then we must consider the cost to banks and ultimately, to the consumer caused by this approach.[146]

Each document in the 138-page packet must be developed or acquired by a bank. Lawyers and consultants must be retained to ensure that the packet fulfills all of the bank's obligations under a myriad of state and federal laws. Bank employees must prepare these documents for each residential loan. They must process the documents and establish files to keep copies of the documents. These are not insignificant costs. Compare the 24 documents in the typical residential closing packet to the documents in a typical closing packet for a multi-million dollar commercial real estate loan. At closing, the borrower signs the promissory note, mortgage, perhaps a guaranty, an assignment of leases and rents, an environmental indemnity, and a closing statement. That's six documents.

Despite all the well-intentioned efforts of Congress and state legislators to protect residential borrowers, millions of American borrowers took out loans in the years leading up to the financial crisis that proved to be imprudent. However, as described in the Part I(C), residential mortgage defaults for loans held in portfolio at community banks between 2003 and 2010 made up only 2% of all residential mortgage defaults, despite the fact that community banks were responsible for approximately 16% of residential

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145. Consumer protection rules were instituted to remedy real problems. For example, the Community Reinvestment Act was passed by Congress in 1977 to eliminate the practice of "redlining" by financial institutions, including small banks. "Redlining refers to the systematic denial of credit to persons in minority or low-income neighborhoods. … In some cases, banks 'literally drew red lines on maps around minority or low-income areas that were to be avoided' by not opening branch locations and denying loan requests. Often, these red lines were drawn based on racial considerations instead of economic factors." Camden C. Betz, *Recent Changes to the Community Reinvestment Act and Their Impact on Community Banks and Rural Economies*, 10 N.C. BANKING INST. 157 (2006).

146. See Dreyer and Weinstock, *supra* note __ at 105 ("Compared to other realms of regulation, no one has demonstrated that federal consumer disclosure regulations deliver benefits commensurate with their costs. The current system of consumer disclosure comes at a high expense for banks and their customers. Those regulations act as a drag on economic growth by misplacing resources… The nature and volume of mandated disclosure prevents the fulfillment of the purpose of communicating information to enable consumers to make informed decisions. The system has become self-defeating.")

mortgage loans during that time period.[147] Even before Dodd-Frank, there was a disconnect between the regulation imposed on community banks, the cost ultimately passed on to consumers by virtue of that regulation, and the risk posed to consumers by community banks.

### *C. Dodd-Frank and Community Banks*

In the summer of 2008, the collapse of the American residential real estate market pushed the World's economy off a cliff. 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.[148] 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.[149] 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.[150] In order 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 Congressional majority in the 111th Congress,

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147. *See* Section I(C), *infra* pages ___ to ____.

148. *See generally* ANDREW ROSS SORKIN, TOO BIG TO FAIL (2009).

149. *See generally* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

150. *See* H. Rodgin Cohen, *Preventing the Fire Next Time: Too Big to Fail*, 90 TEX. L. REV. 1717, 1720 (2012) ("Whatever may have been the actual cause and effect, Lehman's failure had a traumatic impact on policymakers with respect to their ensuing decisions. There was now agreement as to the resolution of the Hobson's Choice between taxpayer-backed assistance to financial institutions and the potential of a catastrophic systemic failure in the absence of such assistance. The risk to the taxpayer and the other issues created by effective acknowledgment of TBTF were deemed to be outweighed by the risk to the financial system and the broader economy from a disorderly failure.")

and the Financial Crisis Inquiry Commission—convinced policy makers that the regulatory framework for American banking was broken and that only government intervention could fix it.[151] That intervention came in January 2010 when Congress passed Dodd-Frank.[152] Sponsors explained that Dodd-Frank was designed to "address the numerous failures that led to the near collapse of our financial system."[153] Specifically, sponsors 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 which led to the Financial Crisis.[154]

As the Government Accountability Office (GAO) noted in a September 2012 report, although Dodd-Frank was primarily aimed at large, systemically important financial institutions, seven of the Act's 16 titles are expected to have an effect on community banks.[155] Two years after Congress passed Dodd-Frank, it is remains unclear to what extent these provisions will impact community banks, due to the Act's heavy reliance on agency rulemaking.

Dodd-Frank directs federal regulatory agencies to implement the Act's provisions through 398 separate rulemaking 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 the discretion granted to regulatory agencies to determine whether or not a particular rule should be

151. Of course, not everyone agrees with this narrative of the Financial Crisis. *See, e.g.*, Peter J. Wallison, *Dissent from the Majority Report of the Financial Crisis Inquiry*, AM. ENTER. INST. FOR PUB. POLICY (2011). RESEARCH (Jan. 14, 2011).

152. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

153. 111 CONG. REC. H14409 (daily ed. Dec. 9, 2009) (testimony of Representative Edwin Perlmutter).

154. Although Dodd-Frank itself does not recite a clearly stated goal, the Financial Stability Oversight Council, the new super-committee 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).

155. GAO-12-881, *supra* note 87, at 2.

applied to a set of financial institutions.[156] While this language is fairly standard in regulatory rulemaking, 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 rulemaking 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.[157] For example, Section 1075 requires the Federal Reserve to limit interchange fees to a level that is "reasonable" and "proportional." 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 in order 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"[158] and that, in general, "there are quite a number of provisions in this set of directives that have been difficult to interpret."[159] As a result of these undefined terms, among others, Congress granted the Federal Reserve fairly wide latitude in its rulemaking 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

156. *Id.* at 6–7.

157. *Hearing before the House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Service*, Serial No. 112-8 (Feb. 17, 2011) (testimony of Sarah Bloom Raskin) [hereinafter Raskin Testimony].

158. *Id.* at 7.

159. *Id.* at 22.

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: "[W]hether 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."[160] 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."[161]

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 to say—it is impossible to quantify how "market dynamics" will be impacted by the implementation of rules that have not yet been written. 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 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.[162]

It is beyond the scope of this paper to comprehensively analyze the complete impact of the 838-page Dodd-Frank Act on community banks.[163] The two provisions of Dodd-Frank which are of the most

160. *Id.* at 11.
161. *Id.* at 27.
162. Davis Polk, *Dodd-Frank Progress Report* (January 2013).
163 For a more comprehensive analysis, see Tanya D. Marsh and Joseph W. Norman, *The Impact of Dodd-Frank on Community Banks*, American

concern to community banks are Title X, which created the Consumer Financial Protection Bureau, and Title XIV, which reformed residential lending.

*1. 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."[164] The limit to those powers, and how those powers may be implemented to impact 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.[165]

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.

Section 1031 grants the CFPB broad authority to define and prevent "unfair, deceptive or abusive acts or practices." This section should benefit consumers and community banks by regulating previously unregulated entities like payday lenders. However, John Adams has expressed concerns that although the terms "unfair" and "deceptive" are "well-understood by market participants" because they are used in section 5 of the Federal Trade Commission Act to prohibit "unfair or deceptive acts or practices in or affecting

Enterprise Institute (May 2013), http://www.aei.org/files/2013/05/06/-the-impact-of-doddfrank-on-community-banks_164334553537.pdf

164. Section 1022 transferred existing rulemaking authority to the CFPB.

165. Michael J. Aiello and Heath P. Tarbert, *Bank M&A in the Wake of Dodd-Frank*, 127 BANKING L.J. 909, 917 (2010) ("Although community banks and regional institutions with assets of less than $10 billion will avoid primary supervision by the CFPB, the new agency's substantive rules will nonetheless govern all financial institutions. Because small banks generally focus more heavily on consumers than the large money-center banks, they likely will be disproportionately affected.")

commerce," the term "abusive" is new and undefined.[166] Section 1031(d) provides that an act or practice is abusive if it:

> (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or (2) takes unreasonable advantage of – (A) a lack of understanding on the part of the consumer of material risks, costs, or conditions of the product or service; (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.[167]

Adams is concerned that

> [i]nterpreting section 1031(d)(2) broadly, a community banker selling a consumer financial product to a customer may be acting in an "abusive" fashion if he does not recognize that the customer has not understood the "material risks, costs, or conditions of the product or service;" cannot protect his or her own interests, or has reasonably relied on the community bank to act in his best interest. Banks have never been required to evaluate the legality of a transaction on the basis of subjective criteria. However, section 1031(d)(2) appears to impose this very obligation.[168]

The CFPB will likely also play a powerful role in establishing a baseline of standardized disclosures, practices, and products that will be perceived by other regulators and by the market 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 losing access to services entirely. Many Americans simply do not fit neatly in a box,

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166. John T. Adams, *Consumer Financial Protection and Community Banks*, 35 U. ARK. LITTLE ROCK L. REV. 227, 239 (2013)
167. Dodd-Frank, Section 1031(d).
168. Adams, *supra* note ___ at 239-40.

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.[169]

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 upon 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 non-bank 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.

### *2. Title XIV – Mortgage Reform and Anti-Predatory Lending Act*

Community banks did not engage in subprime lending. 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.

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."[170]

While 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. Far

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169. The uncertainty posed by the new "abusive" standard may also spur standardization by "[increasing] the risks of offering customized products." Adams, *supra* note ___ at 239.

170. Richard Corday, *Assuring consumers have access to mortgages they can trust*, CONSUMER FIN. PROT. BUREAU BLOG (Jan. 10, 2012) http://www.consumerfinance.gov/blog/assuring-consumers-have-access-to-mortgages-they-can-trust/.

fewer community bank residential mortgage loans are sold. Their standard practice is to make loans and keep those loans on their books until maturity or earlier repayment. They 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 was made that the borrower had the ability to repay, the lender is in violation of the Truth in Lending Act and 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 is the definition of "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. The final 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 month 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.

## III. REFORMING THE REGULATION OF COMMUNITY BANKS

Financial institutions with assets of more than $100 billion constitute 0.3% of all U.S. financial institutions. Banks in this category are behemoths, employing thousands of workers in their complex organizational and operational structures. JP Morgan Chase alone has $2.1 trillion in assets under supervision.[171] By contrast, the vast majority of the roughly 7,000 American banks are

171. Press Release, JPMorgan Chase, 4th Quarter 2012 Earnings Press Release, 10 (Jan. 16, 2013), http://investor.shareholder.com/jpmorganchase/earnings.cfm.

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.[172] Nearly 3,000 banks have fewer than 30 employees.[173] Large, complex 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. 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.

This section examines two specific impacts of Dodd-Frank on community banks: increased compliance costs and increased standardization. The answer, however, is not so straightforward as repealing a single piece of legislation, no matter how sweeping it was. Community banks need deeper, and more meaningful reform to erase the explicit and implicit subsidies, and resulting competitive advantages, that the current system awards to large, complex financial institutions.

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 upon 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 passage of Dodd-Frank, too much remains unknown to precisely quantify its effect. Of course, that lack of information is

172. AMERICAN BANKERS ASSOCIATION, THE BUSINESS OF BANKING 8 (2012).
173. *Id.*

the chief challenge facing community bankers—they must plan for a future in which the rules are largely unknown.[174]

The most likely impacts of Dodd-Frank are two-fold. 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.

### *A. 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, 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 the rules will affect their operations.

Second, the integration of regulatory compliance activities into normal bank operations complicates data gathering to establish a baseline of regulatory compliance costs before Dodd-Frank. This means that while it may be possible for banks to quantify existing direct compliance costs (i.e. compliance staff, continuing education, dedicated software, etc.), it would be costly and difficult for banks to attempt to quantify existing indirect compliance costs, such as the time spent by non-compliance personnel on compliance-related tasks. The smaller banks will likely find it even harder to separate out those costs due to 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

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174. *An Examination of the Challenges Facing Community Financial Institutions in Texas: Field Hearing before the House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services,* 112th Cong. 106 (2012) (statement of Ignacio Urrabazo, president, Commerce Bank, Laredo, Tex.) ("Community bankers are frustrated with the unknown...").

the same time, it would place a burden on community banks to obtain that data.

There is evidence that before Dodd-Frank, compliance costs imposed a significant burden on community banks. A 2004 study concluded that "the cost of complying with just 13 federal regulations was approximately $3.2 billion, or roughly 24 percent of banks' income before taxes."[175] Anecdotal information confirms that compliance costs at small banks have 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. In 2012, that number had ballooned to 48.[176] 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% over the same period.[177]

The president of an 80-year old $150 million community bank, located in Fort Stockton, Texas (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, "[b]ut 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."[178]

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 failure to understand and follow 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]."[179]

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% from 2010 to 2020, faster than

175. Dreyer and Weinstock, supra note ___ at 100, citing Susan E. Dudley, *The Hidden Tax of Regulation* (2004) (unpublished research paper prepared for the George Mason University, Regulatory Studies Program).

176. *Id.*

177. *Id.* at 22 (testimony of Lester Leonidas Parker, Chairman, President, and Chief Executive Officer, United Bank of El Paso Del Norte, El Paso, Tex.).

178. *Id.* (testimony of George Hansard, President/CEO, The Pecos County State Bank, Fort Stockton, Tex.).

179. ON THE RECORD, *supra* note 12.

average for all occupations.[180] 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.[181]

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," Mr. Purcell said.[182]

Community bankers have consistently expressed concern about the creeping regulatory compliance burden.[183] Greg Ohlendorf,

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180. U.S. DEPARTMENT OF LABOR, OCCUPATIONAL OUTLOOK HANDBOOK, 2012-13 EDITION,
on the Internet at http://www.bls.gov/ooh/business-and-financial/financial-examiners.htm.

181. *An Examination of the Challenges Facing Community Financial Institutions in Texas: Field Hearing before H. Subcommittee on Financial Institutions and Consumer Credit of the Com. on Financial Services*, 112th Cong. 22 (2012) (testimony of Cliff McCauley, Senior Executive Vice President, Frost Bank, San Antonio, Tex.).

182. John Adams, *Dodd-Frank Rules Are IT-Cost Prohibitive for Some Banks*, AM. BANKER, January 14, 2013.

183. *Regulatory Reform: Examining How New Regulations are Impacting Financial Institutions, Small Businesses, and Consumers: Field Hearing before H. Subcommittee on Financial Institutions and Consumer Credit of the Com. on Financial Services*, 112th Cong. 79 (2011) (testimony of Marty Reinhart, President, Heritage Bank, Spencer, Wis.) ("[W]ith regulatory and paperwork requirements, both new and old, there continues to be a disproportionate burden placed on community banks due to their more limited resources, diminishing their profitability and ability to attract capital and support their customers, including small businesses."); Dreyer and Weinstock, *supra* note __ at 104 ("Although the cost of compliance is significant for all banks, it weighs heaviest on smaller, community banks. Smaller, community banks do not benefit from the economies of scale enjoyed by their larger counterparts.

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.[184]

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.[185]

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.[186]

The rising costs of regulatory compliance put a more significant relevant burden on community banks than their larger cousins.[187] For example, JPMorgan Chase estimates that its cost to comply

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Without the resources of larger institutions, smaller banks are likely to be overwhelmed.")

184. ON THE RECORD, *supra* note 12.

185. Statement of George Hansard, *supra* note 34.

186. Statement of Lester Leonidas Parker, *supra* note 104.

187. *Regulatory Reform: Examining How New Regulations are Impacting Financial Institutions, Small Businesses, and Consumers: Field Hearing before H. Subcommittee on Financial Institutions and Consumer Credit of the Com. on Financial Services*, 112th Cong. 79 (2011) (testimony of Patricia Wesenberg, President and Chief Executive Officer, Central City Credit Union) ("For a large financial institution, the compliance costs, even if large, are just a very small slice of their total costs. For smaller institutions … they represent a huge increase in relative costs.")

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."[188] Jamie Dimon referred to that loss as a "sideshow" and a "complete tempest in a teapot."[189] Despite the loss, in 2012 JPMorgan Chase posted a record net income of $21.3 billion on total revenues of $99.9 billion.[190] 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% of the bank's 2012 revenue.

While the regulatory costs associated with Dodd-Frank will annoy the large banks, they will constitute a blip on the balance sheet. They will have a far greater impact on community banks. There is evidence that smaller banks are disproportionately affected by the costs of regulatory compliance. A 1998 study by Federal Reserve staff found evidence that smaller banks are at a cost disadvantage compared to larger banks.[191] That cost disadvantage will intensify with further investments in compliance staff, technology, lawyers, and consultants. Of special concern, regulatory "start-up costs" such as "learning the requirements of a regulation, reviewing and redesigning credit applications, changing data processing systems and revising credit evaluation models" imposes a more significant relative burden on smaller banks due to economies of scale.[192] "As a result, smaller banks face higher average regulator compliance costs than larger banks, especially in connection with these start-up activities."

*B. 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

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188. Jessica Silver-Greenberg, *Mortgage Lending Helps JPMorgan Profit Rise 34%,* N.Y. TIMES, Oct. 12, 2012), *available* at http://dealbook.nytimes.com/2012/10/12/jpmorgan-quarterly-profit-rises-34/.

189. Polya Lesova, *Dimon: London Whale issues "tempest in a teapot,"* WALL ST. J., Apr. 13, 2012, *available* at http://articles.marketwatch.com/2012-04-13/industries/31335210_1_london-whale-tempest-jamie-dimon.

190. 4th Quarter 2012 Earnings Press Release, *supra* note 9.

191. Gregory Elliehausen, *The Cost of Banking Regulation: A Review of the Evidence*, 171 FED. RESERVE BD.STAFF STUDIES (1998).

192. Adams, *supra* note ___ at 242, citing Elliehausen at 16-19.

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 "informally 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. [193] In addition, due to 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.[194]

### *C. Five Modest Proposals for Regulatory Reform*

The purpose of this Article is not to argue that repealing Dodd-Frank would benefit community banks. Dodd-Frank is impacting and will continue to impact community banks by increasing their compliance costs and promoting standardization that undermines the relationship banking model. But the regulatory problem facing community banks is much bigger than Dodd-Frank. To save community banks, more radical action is required.

The basic principle that should inform any efforts to regulate the American banking sector is that community banks are different from large, complex financial institutions, and that the risks posed by each to prudential risk, consumers, and systemic risk are fundamentally different. With this principle in mind, we propose five major reforms.

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193. Wilmarth, supra note ___ at 39 [Stanford] ("Cost factors appear to be the primary reason for the relative lack of interest among big banks in providing credit to small firms. Compared with syndicated loans to large corporate borrowers, it is much more costly (on a per-loan dollar basis) for big banks to make loans to small businesses whose creditworthiness cannot be evaluated according to fixed numerical standards such as net worth, liquidity, and debt-to-equity ratios. Senior managers of large banks are typically responsible for overseeing many lines of business and broad geographical areas. It is, herefore, more difficult and expensive for those managers (compared with community bank executives) to ensure that loan officers properly evaluate and monitor small firm borrowers. In addition, a large bank generally experiences (through rotation, promotion, and attrition) a frequent turnover of its lending personnel at any particular branch. In contrast, community bank loan officers are usually long-term residents of the bank's home community and therefore are more familiar with the small businesses in that community.")

194. Letter from Craig G. Blunden, Chair, Pres. & CEO, Provident Savs. Bank, et al., to Timothy F. Geithner, Secretary, U.S. Dept. of the Treasury 2 (Aug. 18, 2009), http://www.aba.com/aba/pdf/gr/CFPA_Geithner_081809.pdf ("Commoditization, contrary to the administration's assertions, will favor large institutions with economies of scale and larger advertising budgets.").

*1. Narrow Banking.*

Congress should adopt a narrow banking regulatory approach that would tightly limit the activities that banks can engage in. A number of scholars have endorsed narrow banking proposals.[195] Essentially, narrow banking means creating a two–tiered system of bank regulation which would restrict traditional banking organizations to traditional activities like deposit taking, lending, fiduciary services, and other activities that are quote "closely related" to banking. The large, complex financial institutions would be required to spin off their traditional banking units or segregate them from their other financial activities. This approach would have a number of benefits for community banks.

It would reduce the size of too big to fail or, in Dodd-Frank parlance, systemically important financial institutions (SIFIs) by reducing the "[too big to fail] subsidies" provided by joining investment banks with depository institutions.[196] Scholars have noted that large, complex financial institutions have pursued "aggressive growth strategies" since the 1999 Gramm-Leach-Bliley Act in order to reach a size at which they would be considered to be too big to fail.[197] They have been motivated both by explicit safety net subsidies including federal deposit insurance and access to the Federal Reserve's liquidity assistance, and their "implicit [too big to fail] subsidy by using lower–cost funds to finance high–risk activities."[198] Advocates of narrow banking argue that large, complex financial institutions have been exploiting federal deposit insurance for years by using the "regulatory canopy to undertake more complex and dangerous innovations."[199] As the Financial Crisis demonstrated, this "proliferation of financial products increased risks substantially. Futures and swaps were used not just to hedge risks, but increasingly to take large bets with little money down."[200] As Amar Bhide argues, "[w]ithout deposit insurance–and the reassurances state supervision–most depositors, even sophisticated ones, would shun banks that traded futures. Paltry passbook rates simply wouldn't compensate for the risks."[201]

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195. Wilmarth, *supra* note ___ at 77-88 [Stanford]; Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform that Could Solve the Too-Big-To-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates*, 31 No. 3 BANKING & FIN. SERVICES POL'Y REP. 1 (2012) [hereinafter "Narrow Banking"]; Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform that Could Solve the Too-Big-To-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates (Part II)*, 31 No. 4 BANKING & FIN. SERVICES POL'Y REP. 1 (2012)

196. Narrow Banking, *supra* note ___ at 1.

197. Narrow Banking, *supra* note ___ at 5-6

198. Narrow Banking, *supra* note ___ at 4.

199. Amar Bhide, *In Praise of More Primitive Finance*, ECONOMISTS' VOICE (2009)

200. Bhide at 4.

201. Bhide at 3.

Community banks face many hurdles when attempting to compete with large, complex financial institutions. Larger banks benefit from economies of scale. Transactional banking is more efficient and cost-effective than relationship banking. These are market realities. Regulation which is not appropriately aligned to systemic and consumer risk should not increase the competitive advantage that large banks have over small banks. The "implicit subsidy" of too big to fail has been confirmed by a recent study that concluded "investors did not price the true, intrinsic ability of a [big] bank to repay its debts, but instead price implicit government support of the bank."[202] The authors of the study also concluded that "[t]he passage of Dodd-Frank in July of 2010 did not eliminate investors expectation of government support. In fact, expectations of government support rose in 2010 [compared to 2009]."[203] Although the authors of Dodd-Frank made it very clear that the federal government will not bail out SIFIs in the future, the market is equally clear that it does not believe this to be true.[204] The best way to eliminate the implicit too big to fail subsidy is to adopt a regulatory approach which separates traditional banks.

*2. Limit Standardization.*

As the description of the typical residential real estate loan package in Section II(B) illustrated, there is already significant standardization of the documentation used in consumer loans. The promissory note and mortgage are on forms created by Fannie Mae and/or Freddie Mac. The settlement statement and good faith estimate are provided on forms developed by HUD. It is likely that the consumer financial protection Bureau will promulgate additional standard disclosure forms to be used in residential real estate lending.

In other words, a move toward standardization of financial products has been developing for decades. But the regulators who create these forms, in particular the consumer financial protection Bureau, should take care that they do not ultimately undermine consumers and their access to credit by undermining the relationship banking model.

*3. Revisit Dual Banking.*

America has a unique and inefficient dual banking system in part because Alexander Hamilton and Thomas Jefferson could not

202. Narrow Banking, *supra* note ___ at 4 citing A. Joseph Warburton & Daniz Anginer, "The End of Market Discipline? Investor Expectations of Implicit State Guarantees" (Nov.
18, 2011), available at http://ssrn.com/abstract=1961656.

203. Id.

204. In fact, as Professor Arthur E. Wilmarth has noted, "[D]odd Frank does not completely shut the door to future government bailouts for creditors of SIFIs." Narrow Banking, *supra* note __ at 1-2.

agree on whether banks should be chartered by the states or the federal government. Their disagreement stemmed from a conflict between urban mercantile interests, which Jefferson believed would be promoted by the national banks, and a dispersed agrarian population, whose interests were represented by the state banks. More than two centuries later, that tension remains, but we should ask whether there is continued benefit to this compromise system. Critics contend that the "dual banking system is an illusion" that is "both expensive and useless."[205] The federal government regulates the safety and soundness of state-chartered banks through the FDIC, preempts state consumer protection laws, and regulates systemic risk through the Federal Reserve. In light of this level of federal activity, what meaningful role is left for state government?[206]

We should also ask whether the continued regulatory cost is worth it. Felsenfeld and Bilali argue that eliminating the dual banking system would result in streamlined and less costly regulation: "Bankers complain regularly about the unnecessary complexity of the regulatory system but do not seem to appreciate that turning the so-called dual system into a single regulatory approach to banking can yield obvious simplifications the price for which has already been spent."[207] Felsenfeld and Bilali also concede that "fierce resistance" could be expected from the "state banking authorities (and perhaps the national authority too)."[208] At the very least, we should go further than Dodd-Frank in terms of achieving uniformity of primary supervisors and ensuring a consistent approach in supervision and examination.

*4. Revisit Consumer Protection Laws.*

Although consumer protection laws are well-intentioned and address real problems, we should evaluate whether those laws need to be uniformly applied to all banks and whether the laws as they currently exist do more than cause "disclosure fatigue." There is little evidence that community bankers engage in predatory lending or other anti-consumer practices. Community banks are dependent upon the goodwill of their customers and their continued good reputation in their communities. In other words, market forces do much to protect the customers of community banks. It is certainly arguable that market forces do more to protect the customers of community banks then a 168 page residential real estate lending packet does. With this in mind, we should ask whether there should

205. Carl Felsenfeld & Genci Bilali, *Is There a Dual Banking System?*, 2 J. BUS. ENTREPRENEURSHIP & L. 30, 80 (2008)

206. *See* Jonathan, *supra* note ___ at 680 ("[U]nder the current FDIC insurance system, there is no legitimate role for state regulation of bank activities.")

207. Felsenfeld and Biali, *supra* note ___ at 79.

208. Id.

be safe harbors from certain reporting and disclosure requirements for community banks below certain size.

We should also question whether consumer protection laws should be federal rather than state. One observer argued that federal preemption of state consumer protection laws before the Financial Crisis created a "race to the bottom," which permitted the predatory lending and abusive practices in subprime lending.[209] This pattern of preemption continued in Section 1044 of Dodd-Frank.[210] Federal rather than state consumer protection statutes favor large banks, which need consistency for their interstate operations, over small banks, which generally operate in a single state.

*5. Resize Examinations.*

Examinations of small banks to determine their prudential risk impose significant compliance costs. We should consider whether there are appropriate trade-offs that could ensure the safety and soundness of smaller banks while reducing those costs. For example, perhaps community banks could agree to hold larger capital reserves in exchange for less intrusive examinations.

## 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 abandon lines of service.

If the patterns of consolidation continue and community banks are forced to merge, consolidate, or go out of business because of the cumulative regulatory burden, 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

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209. Danyeale L. Hensley, *Section 1044 of Dodd-Frank: When Will State Laws Be Preempted Under the OCC's Revised Regulations?*, 16 N.C. BANKING INST. 161, 162 (2012)

210. Id.

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. The unique challenges that they pose to the stability of the financial system could be more appropriately and efficiently addressed by the staff of existing regulatory agencies if the burden on community banks were lessened.

None of the proposed reforms would be easily accomplished. Indeed, it is quixotic to even suggest most of them. But they would have a significant and beneficial impact on community banks and could go a long way towards protecting the relationship banking model and reversing the trend of consolidation of assets in a small number of large, complex financial institutions.