"Too Small to Succeed"
The Impact of the Dodd-Frank Act on Community Banks

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History of Bank Regulation

- National Bank Act (1864)
- Federal Reserve Act (1913)
- The Great Depression (1929-39)
- New Deal Legislation
- FDIC/FRB/HOLA

BROOKLYN DAILY EAGLE

And Complete Long Island News

LATE NEWS

NEW YORK CITY, THURSDAY, OCTOBER 24, 1929.

32 PAGES

THREE CENTS

WALL ST. IN PANIC AS STOCKS CRASH

Attempt Made to Kill Italy's Crown Prince

STOCKS CRASH IN RUSH TO SELL; BILLIONS LOST

ASSASSIN CAUGHT IN BRUSSELS MOB; PRINCE UNHURT

Hollywood Fire Destroys Films Worth Millions

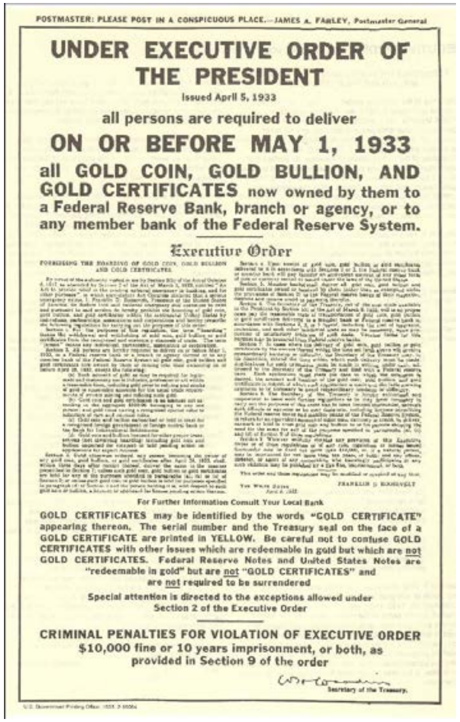
FEAR 52 PERISHED IN LAKE MICHIGAN; FERRY IS MISSING

PIECE OF PLANE LIKE DITEMAN'S IS FOUND AT SEA

High Duty Group Gave $700,000 to Coolidge Drive

Substantive Bank Regulation

- Banking Act of 1933- Glass-Steagall Act
  - Prohibits banks from engaging in investment business
  - Separates banks from investment banks
  - Established FDIC & Insurance of Accounts ($5,000 per account holder)
- Homeowners' Loan Act of 1933
- Federal Deposit Insurance Act -1950— Re-codified from Federal Reserve Act
- Graham Leach Bliley Act of 1999—repealed two provisions of Glass Steagall that restricted affiliations between commercial banks and securities firms – created "financial holding company" status



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Issued April 5, 1933

all persons are required to deliver

ON OR BEFORE MAY 1, 1933

all GOLD COIN, GOLD BULLION, AND GOLD CERTIFICATES now owned by them to a Federal Reserve Bank, branch or agency, or to any member bank of the Federal Reserve System.

Executive Order

For Further Information Consult Your Local Bank

GOLD CERTIFICATES may be identified by the words "GOLD CERTIFICATE" appearing thereon. The serial number and the Treasury seal on the face of a GOLD CERTIFICATE are printed in YELLOW. Be careful not to confuse GOLD CERTIFICATES with other issues which are redeemable in gold but which are not GOLD CERTIFICATES. Federal Reserve Notes and United States Notes are "redeemable in gold" but are not "GOLD CERTIFICATES" and are not required to be surrendered

Special attention is directed to the exceptions allowed under Section 2 of the Executive Order

CRIMINAL PENALTIES FOR VIOLATION OF EXECUTIVE ORDER
$10,000 fine or 10 years imprisonment, or both, as provided in Section 9 of the order

Substantive Bank Regulation

- Dodd-Frank Wall Street Reform and Consumer Protection Act
  - Enacted July 21, 2010 in response to the Great Recession
  - Most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression
  - Made changes in the American financial regulatory environment that affect all federal financial regulatory agencies and almost every part of the nation's financial services industry

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Is Dodd-Frank Crushing Community Banks?

- The increasing regulatory burden of Dodd-Frank is landing disproportionally on smaller community banks, despite the fact that community banks by and large had nothing to do with the financial crisis of 2008.

- Until recently, bankers often talk about the $10 billion in total assets as the critical threshold for managing regulatory compliance costs.

- Now, banks below that level are increasingly reporting similar burdens.

- Example: Regulators are now requesting “stress tests,” historically the province of only large banks, from small banks (i.e., under $10 billion total assets).

Impact of Dodd-Frank on Community Banks

- Banks as small as $3 billion in total assets have been asked to develop stress tests. And some banks of that size and smaller have actually been subjected to stress testing already.

- Regulators are now demanding that banks under $10 billion invest in compliance before crossing the magic threshold.

- Mission creep?

Comprehensive Capital Analysis and Review

- Stress test is an analysis or simulation designed to determine the ability of a financial institution to deal with an economic crisis and ensure adequate capital allocation levels to cover potential losses incurred during extreme, but plausible, events -- Stress tests are designed to help assess capital adequacy levels during hypothetical severely adverse economic conditions -- Comprehensive Capital Analysis and Review (CCAR).
- In 2012, federal regulators began recommending CCAR stress testing as a sound risk management practice for community banks or institutions that were too small to fall under Dodd-Frank's requirements.
- Starting in 2014, mid-sized firms (i.e., those with $10–50 billion in assets) were required to conduct Dodd-Frank CCAR Stress Testing.
- The Federal Reserve has continued to advance their expectations and adopt more complex scenarios in bank stress testing (i.e., making it harder).
- April 2016: 5 of 8 largest banks in US failed stress test -- would need to be rescued in a financial crisis like the Great Recession.

GAO Report to Congress

December 2015 GAO Report to Congress: "Dodd-Frank Regulations – Impacts on Community Banks, Credit Unions and Systemically Important Institutions"

- Federal financial agencies conducted required regulatory analyses for rules issued pursuant to Dodd-Frank Act and conducted cost-benefit analyses.
- Rules likely to result in an annual impact on the economy of $100 million or more, among other things.
- Dodd-Frank Act rules have increased the compliance burden on community banks.
- This included increases in staff, training, and time allocation for regulatory compliance and updates to compliance systems.
- Industry reported a decline in specific business activities, such as loans that are not qualified mortgages, due to fear of litigation or not being able to sell those loans to secondary markets.
- The full impact of the Dodd-Frank Act remains uncertain because many of its rules have yet to be implemented and insufficient time has passed to evaluate others.

Dodd-Frank Requirements -- Highlights

- Higher Capital Requirements for Bank/Thrift Holding Companies – same as depository institution subsidiaries
  - Tier 1 Capital of Holding Companies restricted to same capital instruments as bank subs – Holding companies under $1 billion exempted in 2014

- Capital Conservation Buffer – 2.5% -- limitations on dividends and discretionary compensation

- Lending Limitations
  - Qualified Mortgage Rule – can no longer make loans with negative amortization, interest only payments, balloon payments, terms greater than 30 years, loan fees in excess of 3%, debt/income ratio > 43%
  - Ability to Repay – income and assets verified and documented
    - Safe Harbor Protection – borrowers can defend against foreclosure
    - Seeking exemption for portfolio loans
    - Hurts community banks the most – can't make loans in rural areas

Dodd-Frank Requirements -- Highlights

- Broader FDIC Insurance Assessment Base – higher cost for FDIC insurance
- Corporate Governance and Executive Compensation Limitations
    - Say on Pay /Frequency of Pay Proposals
    - Claw-backs for restatements of financial statements
    - Pay Ratio Disclosure
    - Made it easier for Shareholder Nominees for Directors to be included in proxy materials
    - Required disclosure of structural aspects of corporate governance
- Volker Rule – limitations on proprietary trading by big banks
- Many more provisions to come from delayed effectiveness and to be adopted implementing regulations

Consumer Financial Protection Bureau

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB)

- A new Federal agency with broad powers to supervise and enforce consumer protection laws
  - Broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions and all other financial companies operating in the U.S.
    - Credit Unions, Mortgage Lenders, Debt Collectors, Securities Firms, Check Cashers, Insurance Firms, Pay Day Lenders, Pawn Shops, Payment Systems, Credit Cards
  - Authority to prohibit unfair, deceptive or abusive acts and practices
  - Examination and enforcement authority of all banks and savings institutions > $10 billion in total assets
  - Trickle down for institutions under $10 billion which continue to be examined by banking regulators

Is the Consumer Financial Protection Bureau Unconstitutional?

The U.S. Constitution establishes three branches of government, granting the legislative branch the power to pass laws, tasking the executive branch with administering and enforcing those laws, and making the judicial branch responsible for resolving conflicts arising in connection with those laws. Thus, it provides a separation of the powers of government, with each branch obligated to check the encroachments of another.

- The CFPB is in a category of its own, however: Congress delegated each of these distinct powers to the Bureau's Director (Richard Cordray).

- <u>PHH Mortgage</u> <u>v</u>. <u>Consumer Financial Protection Bureau</u> – US Court of Appeals DC Circuit
  - The CFPB first initiated an administrative action against PHH in June 2014, saying reinsurance payments received by PHH from mortgage insurers either were not for services actually performed or that they "grossly exceeded" the value of the reinsurance services.

Is the Consumer Financial Protection Bureau Unconstitutional?

- Richard Cordray: “Although PHH claimed to be giving its borrowers a choice, the supposed choice was entirely illusory — if the borrower selected a mortgage insurer that was not a party to a captive reinsurance agreement, PHH would not approve the loan.”
- Cordray disagrees with ALJ’s ruling of $6.5 million penalty and orders PHH to pay $109 million in disgorgement to the CFPB within 30 days for RESPA violations.
- PHH asked the D.C. Circuit to stay the CFPB's action, calling Cordray's ruling “a radical new interpretation” of RESPA.
- The D.C. Circuit granted the stay in August 2015, saying PHH met the “stringent requirements” for such requests.
- Of particular significance is Cordray's decision to hike the disgorgement amount which could be interpreted as a message by the CFPB not to challenge agency enforcement actions.

Is the Consumer Financial Protection Bureau Unconstitutional?

> "The [CFPB]Director is not answerable to the President, as he is removable <u>only for cause</u>. Nor is Congress able to rein in the Director using its power over the purse, as he has the sole power to fund his agency from the Federal Reserve System's operating expenses, and Congress is prohibited from reviewing the Director's budget determinations. The Director is not checked by the deliberative decision-making process of a multi-member commission structure, nor is he checked by a short tenure, as he serves a fixed five-year term. And far from a limited scope of power, the Director wields vast authority under eighteen statutes previously enforced by seven different agencies. Never before has so much power been accumulated in the hands of one individual so thoroughly shielded from democratic accountability. The combination of these unprecedented structural features violates the separation of powers."*

- Oral arguments held in April 2016– case is pending – many observers believe PHH will be successful – would be a major blow to one of President Obama's signature achievements.

**PHH Petitioner's Brief*

Impact of Dodd-Frank on Community Banks

"The 2010 Dodd-Frank law is squeezing small financial firms and crimping access to credit for Main Street, all in the name of protecting the country from another financial crisis." --- *Wall St. Journal Oct 2015*

- Harvard University Study – small banks lost 6% of their share of industry assets during the financial crisis and 12% since the passage of Dodd-Frank – the study suggests Dodd-Frank is to blame: "Consolidation is likely driven by regulatory economies of scale – larger banks are better suited to handle heightened regulatory burdens than are smaller banks, causing the average cost of community banks to be higher."

  - The study found that community banks were required to hire additional staffers to interpret and comply with new regulations. These compliance costs disproportionately hurt community banks which are smaller and gave them a reason to consolidate with larger institutions.

Impact of Dodd-Frank on Community Banks

- Commentators, community bankers, and regulators have also expressed fear or produced research showing that Dodd-Frank has exacerbated the pre-existing trend of banking consolidation by piling up regulatory costs on institutions that neither pose systemic risks nor have the diversified businesses to support such costs. *Forbes*

- A small community bank in North Carolina told the *Wall Street Journal*, "When they created too big to fail, they also created too small to succeed."

- "While Dodd-Frank was meant to protect consumers from predatory lending, it has ended up hurting community bankers who didn't cause the crisis." *Rep. Tim Huelskampt (R-Kan.), American Banker, June 13, 2016*

- From 2007 through 2013, the number of independent commercial banks shrank by 14 percent—more than 800 institutions. Most of this decrease was due to the dwindling number of community banks. *Federal Reserve Bank of Richmond*

Impact of Dodd-Frank on Community Banks

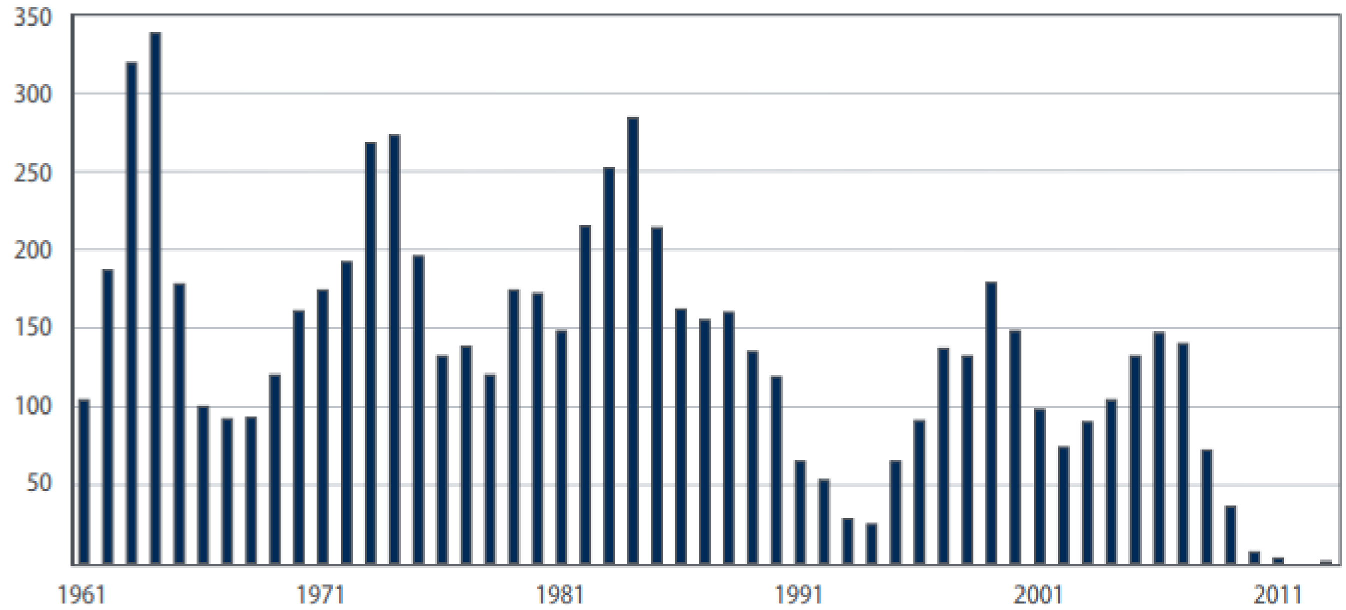
- Is Dodd-Frank solely to blame for the declining number of community banks?
  - Note that there were approximately 13,000 banks as recently as 1980. There are approximately 6,500 today.
- Is the decline in the number of banks a 36-year trend? Has this trend been accelerated by Dodd-Frank?
  - Yes and Yes. To explain this, you must look specifically at the decline in only community banks during the past 8 years.
- The consolidation of the banking industry that occurred from 1980-2000 was industry wide meaning much of consolidation took place among the money-center banks, super-regional banks and middle market banks.
- The reduction of 800 banks in the past 8 years has been primarily smaller community banks because they do not have the scale to absorb the increased compliance costs imposed by Dodd-Frank and the persistent low interest rate environment.

Impact of Dodd-Frank on Community Banks
New Bank Formations

The number of banking institutions in the U.S. has dwindled to its lowest level since the Great Depression.

Normally, periods of consolidation in the banking industry have been immediately followed by periods of de novo banking.

Figure 3: Numbers of Newly Created Banks (*De Novos*)



Impact of Dodd-Frank on Community Banks
New Bank Formations

- From 2002–2008, new bank formations averaged more than 100 per year. Contrast that with the period from 2011 through 2013; there were only four de novo banks in total chartered in the U.S.
- According to the FRB, if this change persists, it will have a large impact on the composition of the banking sector as well as the flow of credit in the economy.
- Is Dodd-Frank to blame for the lack of de novo bank formations?
- Not surprisingly, there are a number of factors that correlate with bank entry. Research has found that entry is more likely in fast-growing, profitable markets.
- Weak economic conditions during the recession of 2007–09 and the subsequent recovery reduced incentives for new banks to enter the system -- profitability. Net interest margin or spread between deposit rates and lending rates.
- Is Dodd-Frank responsible for the lack or profitability or net interest margin?
- The Fed's policy of keeping the federal funds rate near zero since 2008 has pushed lending rates down, which has kept the net interest margin relatively small. The low interest rate environment, coupled with weak demand for banking services, accounts for as much as 80 percent of the decline in bank entry in recent years.

Impact of Dodd-Frank on Community Banks
New Bank Formations

Is that the whole story behind the decline in new bank formations?

- Recent studies have shown that even if the net interest margin and economic conditions recovered to 2006 levels, there still would be almost no new bank entry. This suggests that other factors are also important for explaining the recent decline.
  - Dodd-Frank?
- Indeed, the net interest margin in the current period may not differ significantly from previous recoveries.
- Kansas City Fed compared net interest income—the revenue from interest on loans after factoring out expenses—in the recent recovery to previous recoveries. It found that while net interest income is at historically low levels, it is similar to net interest income observed during the recovery from the 2001 recession, and it is actually higher than during the recovery from the 1981–82 recession. Even so, entry rates were much higher during each of these earlier recoveries.
- Banking scholars have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations are particularly burdensome for small banks that are just getting started.

Impact of Dodd-Frank on Community Banks
New Bank Formations

- George Mason University's Mercatus Center surveyed community bankers and found that the median compliance staff for respondents doubled from one to two in the three years following enactment of Dodd-Frank.
- Survey respondents cited devoting more time and resources to compliance, and more than 80 percent estimated that such costs had risen more than 5 percent since 2010.
- Some of the costs related to regulatory burdens may be specific to starting a de novo bank. For example, in 2009 the Federal Deposit Insurance Corporation increased the length of time—from three to seven years—during which newly insured depository institutions are subject to higher capital requirements and more frequent examinations. April 6, 2016, the FDIC announced a return to three years.
- Additionally, anecdotal evidence suggests that the application process for new banks may have become more rigorous following the 2007–09 recession. Organizers of the only de novo bank in 2013 reported that the process was significantly longer and more intensive than it had been in the past.

Conclusion

The reasons for the decrease in community banks during the past 8 years is due to several equally important factors:

- Burdensome and expensive regulatory and compliance requirements imposed by Dodd-Frank which fall disproportionately hard on community banks because of their size.

- The monetary policy of the Federal Reserve Board which has imposed a sustained near zero interest rate environment significantly adversely impacting net interest margin and profitability of community banks.

- The lack of de novo bank formations and industry consolidation resulting from these factors.

- Dodd-Frank (higher costs), coupled with the low interest rate environment (reduced profitability), has accelerated the trend with respect to community banks.