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Reforming the Regulation of Community

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Reforming the Regulation of Community Banks After Dodd-Frank

TANYA D. MARSH*

The regulatory framework for financial institutions in the United States imposes significant costs on community banks without providing benefits to consumers or the economy that justify those costs. The Dodd-Frank Wall Street Reform and Consumer Protection Act builds on decades of “one-size-fits-all” regulation of financial institutions, an ill-conceived regulatory strategy that puts community banks at a competitive disadvantage as compared with their larger, more complex competitors. The imposition of regulatory burdens on community banks without attendant benefits ultimately harms both consumers and the economy by (1) forcing community banks to consolidate or go out of business, furthering the concentration of assets in a small number of megafinancial institutions; and (2) encouraging standardization of financial products, leaving millions of vulnerable borrowers without meaningful access to credit. Neither of these outcomes will protect consumers, the financial system, or the recovery of the American economy. Instead, radical reform of the existing regulatory structure is necessary to ensure the future of community banks.

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INTRODUCTION

A cascade of financial institution failures in September 2008 marked the beginning of the worst financial crisis since the Great Depression.¹ In his memoir,

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1. See Andrew Ross Sorkin, *A Bailout Above the Law*, N.Y. TIMES, Sept. 23, 2008, at C1.

Timothy Geithner² used the metaphor of a neighborhood on fire to describe both the 2008 financial crisis and the policy response to it. He noted that some critics objected to the perceived bailout of “troubled firms” because they thought that bailouts “rewarded the arsonists who set the system on fire.”³ Indeed, those who were concerned about moral hazard reasoned that “[i]f you rescue pyromaniacs, you’ll end up with more fires.”⁴ Although Geithner conceded that those were “valid concerns,” he argued that “the truly moral thing to do during a raging financial inferno is to put it out. The goal should be to protect the innocent, even if some of the arsonists escape their full measure of justice.”⁵ He referred to President Obama’s argument that you “shouldn’t refuse to deploy fire engines to a burning neighborhood in order to highlight the dangers of smoking in bed.”⁶

If the 2008 financial crisis was a burning neighborhood, with homes representing banks and other financial institutions, then there were a handful of homeowners who surrounded themselves with kindling and then fell asleep holding a burning cigarette⁷—Lehman Brothers, Countrywide Financial, Bear Stearns, Merrill Lynch, Fannie Mae and Freddie Mac, American International Group (AIG), Citigroup, and Bank of America.⁸ Secretary Geithner and other leading policy makers in the Bush and Obama administrations worried that the failure of any of these “huge, far-flung, overleveraged institutions” could “spark . . . global panic.”⁹ The “first responder” solution, adopted just a month after Lehman Brothers filed for bankruptcy protection, was to prevent these institutions from failing through disbursements from the \$700 billion Troubled Asset Relief Program (TARP).¹⁰ Armed with TARP, policy makers drove to the burning neighborhood with lights and sirens on, intending to stop the spread of the flames and reassure the populace that the entire community would not burn to the ground.¹¹

2. Geithner was president of the Federal Reserve Bank of New York from November 17, 2003, to January 26, 2009, and secretary of the Treasury from January 26, 2009, to January 25, 2013. *Timothy Geithner Fast Facts*, CNN.COM (Aug. 19, 2014, 11:56 AM), <http://www.cnn.com/2013/02/25/us/timothy-geithner-fast-facts/>.

3. TIMOTHY F. GEITHNER, *STRESS TEST: REFLECTIONS ON FINANCIAL CRISES* 9 (2014).

4. *Id.*

5. *Id.*

6. *Id.*

7. Note the rhetorical shifts in the metaphor: those concerned with moral hazard characterize the troubled firms as “pyromaniacs,” and Secretary Geithner refers to them as “arsonists,” while President Obama describes them as careless smokers. *See id.* This Article is concerned not with ascribing blame for the 2008 financial crisis but with describing and understanding the impact. For that reason, it will utilize President Obama’s characterization.

8. GEITHNER, *supra* note 3, at 4–5, 122–27, 147–52, 181.

9. *Id.* at 4.

10. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

11. TARP was not the only emergency program put in place by the federal government. The Federal Reserve System, Department of Treasury, and Federal Deposit Insurance Corporation (FDIC) introduced a number of temporary programs to stabilize financial institutions, including the Federal Reserve’s Term Auction Facility (TAF), Treasury’s Capital Purchase Program (CPP), and the FDIC’s Temporary Liquidity Guarantee Program (TLGP), among others. *See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-14-18, GOVERNMENT SUPPORT FOR BANK HOLDING COMPANIES: STATUTORY CHANGES TO LIMIT*

The “neighborhood” in 2008 consisted of 7284 “homes.”¹² The average value of the homes was \$1.5 million,¹³ but that is a very misleading figure because it does not reflect the diversity of the neighborhood. Indeed, the “neighborhood” was divided into several distinct regions. One segment consisted of 3066 working class homes, each worth an average of \$53,000.¹⁴ The next segment of 3705 homes was much larger, each worth an average of \$286,000.¹⁵ There were 509 mansions, each worth an average of \$10.6 million.¹⁶ At the epicenter of the neighborhood was an ultraexclusive, gated community with only four megamansions. Those megamansions were worth an average of \$1.1 billion.¹⁷ It should also be noted that approximately a quarter of the residents of the neighborhood were homeless or living in substandard housing.¹⁸

FUTURE SUPPORT ARE NOT YET FULLY IMPLEMENTED 13 (2013) [hereinafter GAO-14-18], available at <http://www.gao.gov/assets/660/659004.pdf>. The federal government also provided “extraordinary support” to several individual financial institutions, including a \$30 billion loan from the Federal Reserve Board to facilitate JPMorgan’s acquisition of Bear Stearns, the placement of Fannie Mae and Freddie Mac into conservatorship and subsequent investments of \$187.4 billion in the institutions through the Treasury’s Senior Preferred Stock Purchase Agreements program, over \$182 billion in assistance to AIG by the Federal Reserve Board and Treasury, and additional assistance to Citigroup and Bank of America. *Id.* at 37–40.

12. The numbers in this paragraph describe the universe of commercial banks as of December 31, 2007. *Statistics on Depository Institutions—Compare Banks*, FDIC.GOV, <https://www2.fdic.gov/SDI/> [hereinafter *FDIC Statistics Report*]. Readers who wish to review the statistics in this section should launch the URL, click “Retrieve Reports,” run Standard Report #1, and then select the appropriate parameters. Alternatively, readers can go to <https://www2.fdic.gov/SDI/SOB/>, select “Commercial Banks,” “National,” “Asset Size,” the appropriate report date, and “Assets and Liabilities” before clicking “Run Report.” Readers can click through to a number of data sets to find the component parts of each data set and can view statistics on commercial banks in sum, as well as those with assets less than \$100 million, between \$100 million and \$1 billion, and more than \$1 billion. Data can also be saved to Excel.

13. For the purposes of this metaphor, the average asset value of commercial banks on December 31, 2007, has been expressed in ‘000s. For example, the average commercial bank had an asset value of \$1.5 trillion, which translates to \$1.5 million.

14. There were 3066 commercial banks with assets less than \$100 million. They each held an average of \$53 million in assets.

15. There were 3705 commercial banks with assets more than \$100 million and less than \$1 billion. They each held an average of \$286 million in assets.

16. There were 513 commercial banks with assets more than \$1 billion. Subtracting the four largest commercial banks, the remaining 509 each held an average of \$10.6 billion in assets.

17. The four largest commercial banks in the United States held an average of \$1.1 trillion in assets as of December 31, 2007. They were JPMorgan Chase Bank (\$1.3 trillion in consolidated assets), Bank of America (\$1.3 trillion), Citibank (\$1.2 trillion), and Wachovia Bank (\$653 billion). FED. RESERVE SYS., INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE (2007), available at http://www.federalreserve.gov/Releases/Lbr/20071231/lrg_bnk_1st.pdf.

18. The most contemporary data provided by the FDIC regarding the number of “unbanked” and “underbanked” households in the United States dates to a 2012 report discussing the results of a 2011 survey. In 2011, approximately 21.7% of American households were underbanked, meaning that they conducted some of their financial transactions outside the mainstream banking system, relying to varying degrees on alternative financial-service providers like payday loan services, prepaid cards, nonbank-provided money orders, nonbank check cashing, rent-to-own stores, and pawnshops

The fire started in the four megamansions, but as policy makers focused their attentions there, they failed to appreciate that thousands of other homes were lit aflame by drifting embers.¹⁹ Those burning structures were too small, even in the aggregate, to attract the attention of the panicking public or anxious policy makers. Those working-class and upper middle-class homes, numerically the vast majority of homes in the neighborhood, were the community banks.²⁰ The mansions and megamansions were saved, but the configuration of the neighborhood changed in significant ways. Over 322 homes burned to the ground during and in the immediate aftermath of the 2008 financial crisis.²¹

After the flames were doused, policy makers endeavored to ensure that homeowners could never fall asleep with a lit cigarette in bed again. That second-wave response was the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).²² But the major, lingering deficiency of the Dodd-Frank strategy was that it once again failed to account for the fundamental differences in size and business strategy that separate community banks from larger financial institutions. The authors of Dodd-Frank believed the fundamental problem that led to the 2008 financial crisis was that the megamansions were too big, too flammable, and built too close to one another, so

(i.e., “slumlords”). In 2011, 7.3% of American households were unbanked, meaning that they did not utilize mainstream financial services at all (i.e., “the homeless”). The unbanked and underbanked generally incur much greater costs for financial services and face many barriers to full participation in American economic life. See FDIC, NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 10 (2012), available at https://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf.

19.

At the end of 2008, program use—measured for each institution as the percentage of total assets supported by the programs—was higher on average for banks and bank holding companies with \$50 billion or more in total assets than for smaller firms. The six largest bank holding companies were significant participants in several emergency programs

GAO-14-18, *supra* note 11.

20. There are a number of definitions of “community banks” used by policy makers and scholars. The FDIC introduces the most nuanced definition in its 2012 Community Banking Study. See FDIC, COMMUNITY BANKING STUDY 1-1 (2012) [hereinafter FDIC COMMUNITY BANKING STUDY], available at <https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf>. For the broad purposes of this Article, the term “community banks” refers to commercial banks with assets of less than \$1 billion.

21. Between January 1, 2007, and December 31, 2010, a total of 318 commercial banks and savings institutions failed. David C. Wheelock, *Have Acquisitions of Failed Banks Increased the Concentration of U.S. Banking Markets?*, 93 FED. RES. BANK ST. LOUIS REV. 155, 155 (2011), available at <http://research.stlouisfed.org/publications/review/11/05/155-168Wheelock.pdf>. The vast majority were community banks. The most significant failure was Washington Mutual Bank, which was organized as a thrift rather than a commercial bank. Washington Mutual was placed in receivership by the FDIC on September 25, 2008, and acquired by JPMorgan Chase Bank on the same day for \$1.9 billion. Before its receivership, Washington Mutual was the sixth largest bank in the United States with approximately \$307 billion in total assets. Eric Dash & Andrew Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at A1.

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

that once the fire started, it quickly spread.²³ But Dodd-Frank ultimately did nothing to reduce the size of those structures or their interconnectedness.²⁴ Instead, the majority of its provisions apply to every structure in the neighborhood, regardless of size, flammability, or whether the occupants even have matches on the premises. In essence, the smaller homeowners were forced to extinguish the fires caused by others without the subsidy of emergency assistance and are now required to bear the cost of complying with extensive new regulations intended to prevent behavior that they never engaged in. Six years later, the result of the policy responses to the 2008 financial crisis is a neighborhood with far fewer homes,²⁵ more homeless people,²⁶ and a handful of even larger megamansions where the homeowners still smoke in bed.²⁷

23. See, e.g., 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.”). Of course, not everyone agrees with this narrative of the 2008 financial crisis. See, e.g., FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 441 (2009) [hereinafter FINANCIAL CRISIS INQUIRY REPORT] (dissenting statement of Peter J. Wallison), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

24. See *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the H. Comm. on Fin. Servs.*, 113th Cong. 13 (2013) (statement of Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond) (“The problem known as too-big-to-fail consists of two mutually reinforcing expectations. First, some financial institution creditors feel protected by an implicit government commitment of support should the institution face financial distress. . . . Second, policymakers at times believe that the failure of a large financial firm with a high reliance on short-term funding would result in undesirable disruptions of financial markets and economic activity. . . . [With Dodd-Frank, w]e appear to have replicated the two mutually reinforcing expectations that define too-big-to-fail.”).

25. Between January 1, 2008, and December 31, 2013, a total of 1408 commercial banks disappeared. During the same timeframe, nearly five hundred FDIC-insured financial institutions failed. *Failures and Assistance Transactions*, FDIC.GOV, <https://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?begYear=2008&endYear=2013&state=1&Print=Y> (noting that 489 FDIC-insured institutions failed during this six-year period).

26. The percentage of American households which are underbanked increased from 18.2% in 2009 to 20.1% in 2011, while the unbanked increased from 7.6% in 2009 to 8.2% in 2011. More than one in four American households were either unbanked or underbanked in 2011. FDIC, *supra* note 18, at 4.

27. See, e.g., Peter Eavis & Michael Corkery, *Bank Finds a Mistake: \$4 Billion Less Capital*, N.Y. TIMES, April 29, 2014, at B1 (“There are signs that controls are not as tight as they need to be,” said Mike Mayo, an analyst at CLSA. “It’s a bank. It needs to get the numbers right.”); John A. Allison, *The Financial Crisis and the Free Market Cure*, Federalist Society Practice Group Teleforum Conference Call (Jan. 10, 2013), in ENGAGE, July 2013, at 43, 45 (“A lot of banks made large mistakes, and I would have allowed those banks to fail. In fact, it’s frustrating to me that Citigroup has been saved three times in my career, and every time, they get bigger and worse. And I believe as long as the government

Since Dodd-Frank was signed into law, various congressional committees and federal regulators have held hearings on the potential unintended consequences of Dodd-Frank, particularly the impact on small financial institutions and small businesses. Community bankers have offered consistent testimony reflecting three themes.²⁸

First, as will be discussed in Part I, 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, as discussed in Part I.C, community banks did not cause the 2008 financial crisis.²⁹ They did not engage in subprime residential lending.³⁰ They did not package and sell securitized mortgages. They did not participate in the opaque and risky derivatives markets.³¹

Third, while Dodd-Frank roughly distinguishes between banks on the basis of size, excluding financial institutions with assets of less than \$10 billion from some

continues to bail what I call 'crony capitalist institutions' out, like Citigroup, they will get bigger and worse, because if you have an implicit government guarantee, then you are going to take a lot of risk in the good times.").

28. See, e.g., *On The Record: Community Bankers Speak Out On the Impact of Dodd-Frank Regulations*, HOUSE FIN. SERVICES COMMITTEE (Oct. 17, 2011), <http://financialservices.house.gov/blog/?postid=264807> [hereinafter *On the Record*].

29. See Jerome H. Powell, Member, Bd. of Governors of the Fed. Reserve Sys., Community Banking: Connecting Research and Policy, Remarks at the Federal Reserve/Conference of State Bank Supervisors Community Banking Research Conference 1 (Oct. 3, 2013), available at <http://www.federalreserve.gov/newsevents/speech/powell20131003a.pdf> ("Community banks have faced significant challenges in recent years, as our nation has endured a major financial crisis and recession, followed by a painfully slow recovery. To make matters worse, *community bankers, who played no part in causing the financial crisis*, have been forced to fight to ensure that they are not swept up in a torrent of costly new regulations that were intended to address problems at those very large banks that did contribute to the crisis." (emphasis added)).

30. Community banks may have made residential loans to borrowers with poor or limited credit history, known as "subprime" loans, but they generally kept those loans on their books rather than selling them into the secondary market. There is nothing intrinsically wrong with making a subprime loan. Traditionally, the self-employed and farmers have been borrowers of subprime loans because they lack salary histories. Subprime loans at community banks are not understood to be a precipitating cause of the 2008 financial crisis—these banks had every incentive to originate good loans that would be repaid. See, e.g., Elizabeth A. Duke, Member, Bd. of Governors of the Fed. Reserve Sys., Community Banks and Mortgage Lending, Remarks at the Community Bankers Symposium 13 (Nov. 9, 2012), available at <http://www.federalreserve.gov/newsevents/speech/duke20121109a.pdf> ("Community bankers argue that they never engaged in the sort of lending practices that led to the financial crisis. And I think that in most cases, the evidence supports their claims. . . . [O]ver the last several years, on average, mortgages held by community banks outperformed even fixed-rate, prime loans, the best performing mortgage category. I think this statistic by itself is a strong testament to the responsible lending practices of community banks.").

31. See, e.g., Xuan (Shelly) Shen & Valentina Hartarska, Financial Derivatives at Community Banks (Oct. 2, 2013) (unpublished manuscript), available at http://www.stlouisfed.org/banking/community-banking-conference/PDF/Financial_Derivatives_Community_Banks_%20XS_and_VH.pdf (concluding that community banks primarily used derivatives to hedge interest-rate risk rather than to substitute for capital or manage credit risk).

rules, it is still expected to have a significant adverse impact on community banks by increasing compliance costs and promoting the standardization of financial products. 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.

Ironically, Dodd-Frank exacerbates “too big to fail” because it is leading to greater asset concentration in a smaller number of financial institutions.³² For the past several decades, bank consolidation and asset concentration have increased dramatically in the American banking sector.³³ Between 1980 and year-end 2013, the total number of bank and thrift charters in the United States dropped from approximately 20,000 to 6812.³⁴ About 2900 institutions failed during that time period, fully 84% of all financial-institution failures since the creation of the FDIC in 1934.³⁵ Except during the period following the savings-and-loan crisis of the late 1980s and early 1990s and the years since the 2008 financial crisis, bank failures have been relatively rare.³⁶ Mergers, acquisitions, and consolidations within organizations have been much more common.³⁷

In the five-year period from 2008–13, the number of commercial banks in the United States decreased from 7284 to 5876, a reduction of nearly 20%.³⁸ Thirty-five percent of that decrease is attributable to bank failures,³⁹ and the remainder is attributable to voluntary dissolution and mergers.

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

32. Allison, *supra* note 27, at 47 (“[O]ne of the ironies is that it’s very clear that the long-term policy of “too big to fail” . . . has caused consolidation in the industry. . . . [If we had a functioning private market,] Citigroup wouldn’t be here. We wouldn’t be worrying about this. They would have been broken up by the market long, long ago. . . . [T]he incentive for institutions to stay large is very powerful when you have an implicit government guarantee.”).

33. Benjamin R. Backup & Richard A. Brown, *Community Banks Remain Resilient Amid Industry Consolidation*, 8 FDIC Q., no. 2, 2014, at 33, 33 (“Consolidation . . . has been a defining trend in the U.S. banking industry since around 1980.”).

34. *Id.* There are many reasons for this consolidation. “One of the most important factors driving voluntary consolidation during this period was the relaxation of restrictions on intrastate branching and interstate banking that took place in the 1980s and early 1990s. Based largely in state law, these long-standing restrictions had the effect of artificially inflating the number of banking charters, and their removal was bound to result in consolidation.” FDIC COMMUNITY BANKING STUDY, *supra* note 20, at II. In fact, nearly 5000 banks were consolidated within organizations from 1984 to 2011. *Id.* at 2-1.

35. *Failures and Assistance Transactions*, FDIC.GOV, <https://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30&Header=1>.

36. *See id.*

37. Since 1990, there have been 6.5 mergers for every one bank failure. Bob Solomon, *The Fall (and Rise?) of Community Banking: The Continued Importance of Local Institutions*, 2 U.C. IRVINE L. REV. 945, 947 (2012).

38. *See FDIC Statistics Report*, *supra* note 12.

39. *See Failed Bank List*, FDIC.GOV, <http://www.fdic.gov/bank/individual/failed/banklist.html> [hereinafter *FDIC Failed Bank List*].

tripled over the same period.⁴⁰ Meanwhile, the concentration of capital in those large banks increased. At year-end 2013, the four largest commercial banks in the United States—JPMorgan Chase, Bank of America, Wells Fargo, and Citibank—held total assets of \$6.1 trillion.⁴¹ JPMorgan Chase alone held nearly \$2 trillion in total assets—14% of the total assets of all commercial banks combined—and the others each held \$1.3 to \$1.4 trillion. The “Big Four” banks held 44.6% of total commercial-bank assets at year-end 2013.⁴²

There is a meaningful size differential between the “Big Four” and other large banks. The fifth-largest commercial bank, U.S. Bank, held \$360 billion in total assets at year-end 2013.⁴³ At year-end 2013, 5876 commercial banks held \$13.7 trillion in total assets.⁴⁴ The “Big Four” alone held 44.6% of that sum, while the twenty largest commercial banks held \$9.1 trillion, or 66.4%.⁴⁵

At year-end 2013, there were 540 commercial banks in the United States that each held total assets in excess of \$1 billion.⁴⁶ Collectively, these “noncommunity banks” held 91.2% of total commercial banking assets.⁴⁷ Conversely, community banks constituted 90.8% of all commercial banks⁴⁸ yet held only 8.4% of total commercial bank assets.⁴⁹

To better understand the consolidation of the American commercial banking sector, it is useful to compare year-end 2001 to year-end 2013. This temporal snapshot captures the period when securitization began to gain steam, as well as the 2008 financial crisis itself and the subsequent recovery.

The concentration of assets in the “Big Four” commercial banks naturally increased during the heyday of securitization⁵⁰ and the housing bubble, from 27.1% at

40. RICHARD A. BROWN, CHIEF ECONOMIST, FDIC, COMMUNITY BANKING BY THE NUMBERS: THE FDIC COMMUNITY BANKING RESEARCH PROJECT 3 (2012), available at https://www.fdic.gov/news/conferences/communitybanking/community_banking_by_the_numbers_clean.pdf. There were 13,631 institutions with less than \$100 million in assets in 1985, and 2625 in 2010. There were thirty-six institutions with more than \$10 billion in assets in 1985 and 107 in 2010. *Id.*

41. See FED. RESERVE SYS., INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE (2013) [hereinafter 2013 STATISTICAL RELEASE], available at http://www.federalreserve.gov/Releases/Lbr/20131231/lrg_bnk_1st.pdf. For the purposes of the FDIC’s Statistics on Depository Institutions Report, “total assets” means “[t]he sum of all assets owned by the institution including cash, loans, securities, bank premises and other assets [but not including] off-balance-sheet accounts.” *Definitions*, FDIC.GOV, https://www2.fdic.gov/SDI/sitemap_rpt.asp?DRSLineLevel=10.

42. See 2013 STATISTICAL RELEASE, *supra* note 41; see also FDIC *Statistics Report*, *supra* note 12. In contrast, the four largest commercial banks held 27.1% of total assets at year-end 2001 and 40.6% of total assets at year-end 2007.

43. See 2013 STATISTICAL RELEASE, *supra* note 41.

44. See FDIC *Statistics Report*, *supra* note 12.

45. See 2013 STATISTICAL RELEASE, *supra* note 41.

46. FDIC *Statistics Report*, *supra* note 12.

47. See *id.*

48. Calculated by dividing 5336 community banks by 5876 commercial banks. See *id.*

49. Calculated by dividing approximately \$1.1 trillion by approximately \$13.7 trillion. See *id.*

50. See Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial*

year-end 2001 to 33.6% at year-end 2004.⁵¹ Perhaps more surprisingly, total asset concentration became more pronounced during the 2008 financial crisis and the subsequent recovery period, increasing to and stabilizing at 41%–45% since 2008.⁵²

The total consolidated assets held by American commercial banks increased from \$6.55 trillion at year-end 2001 to \$13.67 trillion at year-end 2013, an increase of 109%.⁵³ But a rising tide does not necessarily lift all boats equally. During that period, the total assets in the four largest commercial banks increased by 244%, nearly ten times the aggregate increase enjoyed by the community banks.⁵⁴ The top twenty commercial banks also disproportionately benefitted from this period of growth—recognizing a 183% increase in their total assets from year-end 2001 to year-end 2013.⁵⁵

Many policy makers in the early 1990s argued that industry consolidation would improve the “efficiency, safety, and profitability of the banking industry,” a line of reasoning that culminated in the Riegle-Neal Act of 1994.⁵⁶ However, scholars like Arthur Wilmarth, Jr. have long argued that a “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 ha[s] long existed in the United States.”⁵⁷

That decentralized banking system is governed by a regime of regulation by accretion—the result of legislative responses to particular crises from the Civil War

Conglomerates and the Origins of the Subprime Financial Crisis, 41 CONN. L. REV. 963, 963–64 (2009) (noting that seventeen large, complex financial institutions “dominated domestic and global markets for securities underwriting, syndicated lending, asset-backed securities (ABS), over-the-counter (OTC) derivatives, and collateralized debt obligations (CDOs)” and used an “originate to distribute” strategy to “maximize their fee income, reduce their capital charges, and transfer to investors the risks associated with securitized loans”).

51. Compare FED. RESERVE SYS., INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$100 MILLION OR MORE (2001), available at http://www.federalreserve.gov/Releases/Lbr/20011231/lrg_bnk_lst.pdf [hereinafter 2001 STATISTICAL RELEASE], with FED. RESERVE SYS., INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE (2004), available at http://www.federalreserve.gov/Releases/Lbr/20041231/lrg_bnk_lst.pdf.

52. See FED. RESERVE SYS., INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE (2008), available at http://www.federalreserve.gov/Releases/Lbr/20081231/lrg_bnk_lst.pdf.

53. Compare 2001 STATISTICAL RELEASE, *supra* note 51, with 2013 STATISTICAL RELEASE, *supra* note 41.

54. Compare 2001 STATISTICAL RELEASE, *supra* note 51, with 2013 STATISTICAL RELEASE, *supra* note 41. Total deposits increased by 137% during this time period. For banks with assets in excess of \$1 billion, total deposits increased by 167%, while total deposits only increased by 32% in community banks. For the purposes of the FDIC’s *Statistics on Depository Institutions Report*, “total deposits” is defined as “[t]he sum of all deposits including demand deposits, money market deposits, other savings deposits, time deposits and deposits in foreign offices.” *Definitions*, *supra* note 41.

55. Compare 2001 STATISTICAL RELEASE, *supra* note 51, with 2013 STATISTICAL RELEASE, *supra* note 41.

56. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (permitting interstate bank mergers and authorizing adequately capitalized bank holding companies to acquire banks in any state).

57. 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).

to the 2008 financial crisis.⁵⁸ Each of these legislative efforts was a well-meaning attempt to deal with the perceived problems that led to each crisis, but the overall strategy is flawed and the cumulative regulatory burden exacerbates market distortions. Between 1990 and 2005, “more than 800 new regulations [were] imposed on banks.”⁵⁹ The net effect is a federal regulatory system for banking that is unnecessarily inefficient and expensive and that imposes unintended negative consequences on community banks, consumers, and the economy. It is, as one banker put it, a system of “misregulation.”⁶⁰

The fundamental flaw of the current regulatory approach is that it assumes the word “bank” can be used to describe market participants that engage in similar activities and pose similar risks to economic stability and consumers. That premise is false. The average size of the top four banks is \$1.5 trillion.⁶¹ The average size of the next sixteen banks is \$188 billion.⁶² In stark contrast, the average community bank holds \$206 million in assets,⁶³ and 1814 community banks hold less than \$100 million in assets each, with an average size of \$58 million.⁶⁴

Over time, the differences between the largest commercial banks and the community banks have grown more pronounced. In 1984, the average noncommunity bank was twelve times larger than the average community bank.⁶⁵ In 2011, the average noncommunity bank was seventy-four times larger.⁶⁶ At the margins, of course, those differences are much more pronounced. Just *one* of the “Big Four” commercial banks is larger than the 5000+ community banks combined.⁶⁷ The twentieth largest bank is comparable in asset size to the 1814 smallest community banks combined.⁶⁸

58. 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.”); see also Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221 (2000).

59. Stephanie E. Dreyer & Peter G. Weinstock, *Less Is More: Changing the Regulator’s Role To Prevent Excess in Consumer Disclosure*, 123 BANKING L.J. 99, 103 (2006).

60. Allison, *supra* note 27, at 48.

61. Calculated by dividing approximately \$6 trillion in total assets across four banks. See 2013 STATISTICAL RELEASE, *supra* note 41.

62. Calculated by dividing approximately \$3 trillion in total assets across sixteen banks. See *id.*

63. Calculated by dividing \$1.1 trillion in total assets across 5336 community banks. See *FDIC Statistics Report*, *supra* note 12.

64. See *id.*

65. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 2-9.

66. *Id.*

67. The smallest of the Big Four, Citibank, holds \$1.3 trillion in total assets, compared to \$1.1 trillion held by the community banks. See 2013 STATISTICAL RELEASE, *supra* note 41.

68. The 1814 smallest community banks have combined total assets of \$106 billion, compared to \$103 billion in total assets for Northern Trust Corporation, the twentieth largest commercial bank as of December 31, 2013. Compare *FDIC Statistics Report*, *supra* note 12

The market participants that we broadly label “banks” have such different business models that they are barely in the same industry. Community banks and noncommunity banks both take deposits and make loans, but the similarities end there. Since the 1999 Gramm-Leach-Bliley Act,⁶⁹ which reduced barriers between depository banks and investment banks, the large, complex financial institutions have diversified far afield of traditional banking activities, and federal regulatory activity has struggled to adapt to the creativity and entrepreneurship employed by those large institutions.⁷⁰

The neighborhood fire that sparked in 2008 has been extinguished, but damage has been done. The working-class homes have been decimated, and slumlords are moving into the empty parcels.⁷¹ The four megamansions have grown even larger, but Dodd-Frank did not erect a firewall around them. Instead, it instituted new requirements that seek to fireproof all of the homes, at a cost that the more modest homeowners, still reeling from their unsubsidized cleanup efforts, struggle to absorb.

The American economy has long benefited from a healthy, diverse, and competitive marketplace in banking and financial services. That marketplace is steadily becoming less competitive and less diverse *because of* misguided regulation. The role of regulators should be, at a minimum, like physicians—first, do no harm. Instead, the American one-size-fits-all regulatory approach is paradoxically advantaging the very institutions that policy makers have labeled as the most dangerous. The unintended consequences of these flawed policies are hastening consolidation and reducing competition. We need to take a step back and fundamentally rethink our regulatory approach to banking—to target our resources toward real risks to the American consumer and the American economy in order to reverse these trends.

I. WHY COMMUNITY BANKS MATTER

Before examining the impact of Dodd-Frank on community banks, it is useful to define what community banks are, to understand their importance to the American

(aggregating commercial banks with assets up to \$1B), with 2013 STATISTICAL RELEASE, *supra* note 41 (ranking largest banks, including Northern Trust).

69. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

70. See generally Russell J. Funk & Daniel Hirschman, *Derivatives and Deregulation: Financial Innovation and the Demise of Glass-Steagall*, 59 ADMIN. SCI. Q. 669 (2014).

71. See, e.g., U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 743 tbl.1194 (2012), available at <https://www.census.gov/compendia/statab/2012/tables/12s1194.pdf> (“Mortgage Originations and Delinquency and Foreclosure Rates: 1990 to 2010”). Note that the percentage of residential loans in foreclosure rose from 2.0% in 2007 to 4.6% in 2010, while the percentage of subprime conventional loans in foreclosure increased from 8.7% to 14.5% during the same period. Over a quarter of subprime conventional loans were delinquent at the end of 2010. See also OLIVER CHANG, VISHWANATH TIRUPATTUR & JAMES EGAN, MORGAN STANLEY, HOUSING MARKET INSIGHTS: A RENTERSHIP SOCIETY 1 (2011), available at <http://www.morganstanleyfa.com/public/projectfiles/5bee89b1-94ce-45b5-b4b6-09f0ffdc626a.pdf> (“The demand for shelter is growing, but the lack of mortgage credit will drive this demand to the rental market at the expense of the owner-occupied market. As household formations grow and distressed liquidations continue, the demand for both multi-family and single-family rental units will likely increase.”).

economy, and to discuss the role that they played in the precipitating event to Dodd-Frank—the 2008 financial crisis.

*A. Who Are the Community Banks?*⁷²

The landscape of the American banking industry is distinct from other Western countries because it has traditionally been decentralized and dominated by a large number of small, local depository institutions. The term “community bank” has been used in recent decades to describe institutions that “focus on providing traditional banking services in their local communities.”⁷³ 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.⁷⁴

Federal regulators employ various definitions of community banks,⁷⁵ but as Mr. Reinhart’s testimony suggests, community banks generally differ from other

72. This subpart draws heavily on the contributions Joseph W. Norman made to a joint project with this author. See TANYA D. MARSH & JOSEPH W. NORMAN, AM. ENTER. INST., THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS (2013), available at http://www.aei.org/files/2013/05/06/-the-impact-of-doddfrank-on-community-banks_164334553537.pdf.

73. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 1-1; see also BENJAMIN M. LAWSKY, N.Y. DEP’T OF FIN. SERVS., COMMUNITY BANKING REPORT 1 (2013), available at http://www.dfs.ny.gov/reportpub/comm_bank_rpt_2013_02.pdf (“At its essence, community banking is based on a simple and traditional business model. Community banks focus on gathering deposits from the communities they serve and exclusively lending back to those communities.”).

74. *Regulatory Reform: Examining How New Regulations Are Impacting Financial Institutions, Small Businesses, and Consumers: Field Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. app. at 58 (2011) [hereinafter *Regulatory Reform Hearing*] (prepared statement of Marty Reinhart, President, Heritage Bank, Spencer, Wisconsin).

75. Among the banking industry’s three primary regulators—the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and 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. Duke, *supra* note 30, at 5. The OCC defines community banks as banking organizations with less than \$1 billion in total assets. See OFFICE 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>. And, lastly, the FDIC

commercial banks with respect to (1) their size, (2) their location, and (3) their methods of processing information.⁷⁶

1. Size

The simplest and crudest way to define community banks is as commercial banks with assets of less than \$1 billion.⁷⁷ By any definition, community banks make up the vast majority of American commercial banks. As of December 31, 2013, commercial banks with less than \$1 billion in total assets constituted 91% of all commercial banks.⁷⁸ Although numerically dominant, community banks held only 8.4% of total commercial-bank assets.⁷⁹ Thirty-one percent of commercial banks held assets less than \$100 million, while 60% held assets between \$100 million and \$1 billion.⁸⁰ There are important differences between a \$100 million bank and a \$1 billion bank, but they have more in common with each other than with the large, complex financial institutions.

2. Location

Community banks tend to operate in limited geographic areas—82% of community banks operated within three or fewer counties in 2011, while 37% of noncommunity banks operated within three or fewer counties.⁸¹

Although many community banks are located in suburban and urban counties, one of the most important ways that community banks contribute to the American economy is through their service to rural areas that would otherwise go without banking access.⁸² Rural areas make a significant contribution to the American

formerly defined community banks as banking organizations with less than \$1 billion in assets but recently revised its definition by moving to a more inclusive, multicriteria approach. *See infra* note 77.

76. There are other depository institutions that are not classified as commercial banks but that are functionally similar to community banks, including credit unions, thrifts, and mutual-savings institutions. Because this Article generally relies on FDIC data pertaining to commercial banks, the calculations do not include those other institutions unless specifically noted.

77. The FDIC has developed a far more nuanced approach to defining community banks, noting that

[o]ne problem with defining community banks using a fixed size limit is that any dollar-based yardstick must be adjusted over time to account for factors such as inflation, economic growth, and the size of the banking industry itself.

According to any of these measures, \$1 billion is not what it used to be.

FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 1-1. Despite the wisdom of the FDIC's observation, for the sake of simplicity, this Article will use the straightforward size limit.

78. *See FDIC Statistics Report, supra* note 12.

79. *See id.*

80. *See id.*

81. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 3-3.

82. Note that when this Article uses the term "rural," it does so somewhat colloquially. The FDIC uses the term to describe one category of nonmetropolitan counties, the other category being micropolitan. 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 *id.* at 3-4.

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 nonmetropolitan areas contribute over 12% of U.S. economic activity.⁸³ These rural—and productive—areas are also highly dependent on community banks to provide credit and other necessary financial services.

Community banks are much more likely than larger banks to operate in small towns and sparsely populated regions,⁸⁴ making up more than 70% of banking offices in rural areas.⁸⁵

As a result, while most metro areas tend to be well-served by institutions with a variety of business models, many nonmetro (and a surprising number of metro) areas tend to rely much more heavily on community banks as their lifeline to mainstream financial services. In 2011, there were 629 U.S. counties, with just over 6 million in population, where community banks operated offices, but where no noncommunity banking offices were present. . . . There were another 639 counties where community banks operated offices but where fewer than three noncommunity banking offices were present. . . . Taken together, these data point to more than 1,200 counties (out of a total of 3,238), encompassing 16.3 million people, who would have limited physical access to mainstream banking services without the presence of community banks.⁸⁶

The relationship between community banks and rural communities is a source of both strength and weakness to community banks. Between 1980 and 2010, the population of the United States increased by more than 36%, but more than half of all rural counties lost population.⁸⁷ Community banks located in depopulating areas have proven resilient but face challenges to future growth. For example, the Great Plains states face the most severe depopulation: 86% of those rural counties lost population from 1980 to 2010.⁸⁸ With aggregate assets of \$174.6 billion, the 836 community banks headquartered in Great Plains states may be a blip on the balance sheet of a megabank, but their presence and stability is vital to the future of the communities that they serve.⁸⁹ The success of a closely held rural community bank should be measured with different metrics than a publicly traded, large, complex financial institution. Community banks warrant a broader focus on social utility than growth or profitability.

83. *Id.*

84. Studies show that community banks are four times more likely than large banks to have an office in rural counties. *Id.*

85. *Id.* at 3-5.

86. *Id.*

87. John M. Anderlik & Richard D. Cofer Jr., *Long-Term Trends in Rural Depopulation and Their Implications for Community Banks*, 8 FDIC Q., no. 2, 2014, at 44, 44.

88. *Id.* at 48.

89. *Id.* at 51 tbl.4.

3. Methods of Processing Information

Perhaps the most 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 as “transactional banking.”⁹⁰

Transactional banking involves highly standardized products that “require little human input to manage and involve information that is generally easily available and reliable. Thus, in transactional banking hard information drives performance.”⁹¹ Financial institutions that utilize transactional banking rely heavily on mechanical processes such as credit scoring, which involves incorporating hard data into quantitative computer models to make underwriting decisions.⁹² 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.⁹³

Large banks serve both commercial and retail customers but tend to focus on those who are easily and cheaply processed through the transactional-banking model. These banks are interested in commodity banking (i.e., large-volume credit cards), large commercial customers, and international customers.⁹⁴ Large banks rely more on purchased liabilities to fund lending, while community banks rely on core deposits.⁹⁵

Community banks deploy those deposits into loans through the relationship-banking model, which builds on longstanding customer relationships that give the banks richer access to “soft information” about their customers.⁹⁶ Computer models may be used to enhance underwriting, but more authority is given to community bank employees to make lending decisions.⁹⁷ Soft information, by its nature, is not generally available and is difficult to quantify.⁹⁸ It is more expensive to acquire and process.⁹⁹ However, studies have shown that many borrowers, particularly small businesses, farmers, and individuals, are better served by relationship banking than by the transactional-banking model.¹⁰⁰ For example, the president of a \$250 million bank in the upper Midwest explained that his customers face challenges that larger

90. Scott E. Hein, Timothy W. Koch & S. Scott Macdonald, *On the Uniqueness of Community Banks*, 90 FED. RES. BANK ATLANTA ECON. REV., no. 1, 2005, at 15, 17–18.

91. *Id.* at 18.

92. *Id.* at 19.

93. *Id.*

94. *Id.* at 25.

95. *Id.*

96. *Id.* at 18.

97. *Id.* at 19.

98. *Id.*

99. *See id.* at 20.

100. *See id.* at 17, 19. These borrowers are sometimes called “informationally opaque.” Tim Critchfield, Tyler Davis, Lee Davison, Heather Gratton, George Hanc & Katherine Samolyk, *Community Banks: Their Recent Past, Current Performance, and Future Prospects*, 16 FDIC BANKING REV., no. 3, 2004, at 1, 4.

banks unfamiliar with the area would not understand.¹⁰¹ 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.¹⁰²

Another value of the relationship-banking model is that it includes a broader range of services than the simple provision of funds. “In the case of a relationship loan, the lender many times adds real value by providing accounting, business planning, and tax planning expertise.”¹⁰³

The relationship-banking model benefits the American economy in two main ways. First, relationship banking results in loans that are more likely to be repaid than those issued through transactional banking.¹⁰⁴ In every individual and commercial loan category, community banks had lower average net charge-off rates than noncommunity banks from 1991 to 2011.¹⁰⁵ During real-estate downturns, “loan loss rates were much higher at noncommunity banks than at community banks.”¹⁰⁶ 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 that exploit consumers.¹⁰⁷

Although transactional banking theoretically allows banks to process loans at a lower cost than does relationship banking, Federal Reserve data consistently shows

101. Telephone interview with Noah Wilcox, President & Chief Executive Officer, Grand Rapids State Bank, Grand Rapids, Minn. (Feb. 2, 2013) (notes on file with author).

102. Duke, *supra* note 30, at 6 (“Community banks have long been a source of loans that, for a variety of reasons, do not fit the parameters of conforming government-sponsored enterprise loans or eligibility for government-guaranteed programs.”).

103. Hein et al., *supra* note 90, at 18–19.

104. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at III (“Community banks have almost always incurred lower credit losses than noncommunity banks.”); Esther L. George, President and CEO, Fed. Reserve Bank of Kan. City, Can Community Banks Still Compete? Remarks at the 2012 Community Banking Conference 4 (Nov. 2, 2012), available at <http://www.kc.frb.org/publicat/speeches/2012-George-KansasCity-CommunityBanking-11-02.pdf> (“While many now claim that the value of customer relationships is declining with credit scoring and credit risk models, a recent study at our Bank found that there is real value in relationship lending and in the soft personal information on customers that community bankers typically have.”).

105. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 4-6 tbl.4.4.

106. *Id.* at 4-6.

107. 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.” *An Examination of the Challenges Facing Community Financial Institutions in Texas: Field Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 6–7 (2012) [hereinafter *Texas Community Banks Hearing*] (statement of George H. Hansard, President and CEO, The Pecos County State Bank, Fort Stockton, Texas).

that large banks charge higher fees than community banks and have increased their fees more over time.¹⁰⁸

B. The Role of Community Banks in the American Economy

In recent decades, noncommunity banks have demonstrated that they are generally more profitable than community banks.¹⁰⁹ However, the 2012 *FDIC Community Banking Study* concluded that community banks actually *outperform* noncommunity banks in generating net interest income and yields on earning assets and in reducing credit losses and noninterest expenses—core banking services.¹¹⁰ Nevertheless, noncommunity banks generate a higher return on assets because they have multiple lines of business that support “their ability to generate much higher volumes of noninterest income.”¹¹¹ In contrast, community banks 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.¹¹²

Traditionally, banks have been understood to exist because there are significant barriers between borrowers and lenders, and banks that take deposits and make loans serve an intermediary role that is essential to a functioning economy.¹¹³ It has been noted that in recent decades, the barriers between borrowers and lenders in the United States have been reduced, technology has improved, and competition from alternative intermediaries has grown, including peer-to-peer lending, private equity, pension funds, and securitization.¹¹⁴ These forces, combined with the consolidation within the banking industry, have caused community banks to lose ground in both deposits and lending.¹¹⁵

Despite these challenges, community banks remain important to consumers who prefer the relationship-banking model to the transactional-banking model. In addition, community banks are vital to the American economy because they provide financial services and credit to customers who are less attractive to larger financial institutions by virtue of their location or the profitability of the financial products they need.¹¹⁶ Community banks are particularly important to small businesses, farmers, commercial real-estate owners, and individuals.

108. Hein et al., *supra* note 90, at 17 n.2.

109. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 4-1.

110. *Id.* at 4-3 to 4-7.

111. *Id.* at 4-2.

112. *Id.* (“Because of their heavy dependence on lending as a source of income, community banks have been disproportionately affected by the long-term trend toward lower net interest margins.”).

113. See Franklin Allen & Anthony M. Santomero, *What Do Financial Intermediaries Do?*, 25 J. BANKING & FIN. 271, 289 (2001).

114. *Id.* at 274–78.

115. Noncommunity banks have been able to “shift[] from traditional intermediation functions to fee-producing activities” and therefore increase noninterest income. *Id.* at 279.

116. See, e.g., George, *supra* note 104, at 5 (“[C]ommunity banks fulfill a very important function in establishing close relationships and directing credit to customers whose needs might otherwise go unserved.”).

1. Small-Business Lending

Small businesses drive the American economy.¹¹⁷ Small businesses accounted for 63% of the net new jobs created between 1993 and mid-2013.¹¹⁸ Policy makers 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.¹¹⁹

Small businesses depend on community banks for basic financial services and for the credit to fuel their investment and job-creation efforts. Community banks provide banking services to small businesses—such as deposit taking, checking accounts, and payroll services—while also functioning as a funding source for working capital, expansion loans, and even start-up costs.¹²⁰

At year-end 2013, U.S. commercial banks had \$269 billion in outstanding small-business loans, which were secured by nonfarm, nonresidential properties with an original amount of \$1 million or less.¹²¹ Community banks held 38.2% of

117. As of 2008, small businesses accounted for 46% of private, nonfarm gross domestic product (GDP), meaning that almost half of all production in the United States came from small businesses. KATHRYN KOBE, U.S. SMALL BUS. ADMIN., SMALL BUSINESS GDP: UPDATE 2002–2010 (2012), *available at* http://www.sba.gov/sites/default/files/rs390_1.pdf. Small businesses also provide half of all employment in the United States and 43% of total U.S. payroll spending. *See Historical Data Tabulations by Enterprise Size–2010*, U.S. CENSUS BUREAU, <http://www.census.gov/econ/susb/data/susb2010.html>.

118. The Small Business Administration Office of Advocacy defines a “small business” as an independent business with fewer than five hundred employees. In 2011, there were 28.2 million small businesses and 17,700 firms with five hundred employees or more. OFFICE OF ADVOCACY, SMALL BUS. ADMIN., FREQUENTLY ASKED QUESTIONS (2014), *available at* http://www.sba.gov/sites/default/files/FAQ_March_2014_0.pdf.

119. Christine Lagorio-Chafkin, *Cory Booker: Start-Ups Will Define America’s Future*, INC.COM (Mar. 21, 2013), <http://www.inc.com/christine-lagorio/cory-booker-sxsw-start-ups-and-the-future.html> (observation by Newark’s then-Mayor Cory Booker); *see also* Letter from John Boehner, Republican Leader, Eric Cantor, Republican Whip, Mike Pence, Republican Conference Chairman & Dave Camp, Ways & Means Ranking Member, U.S. House of Representatives, to Barack Obama, President of the U.S. (Dec. 9, 2009), *available at* http://kingston.house.gov/uploadedfiles/gop_solutions_for_america_jobs.pdf (“The truth of the matter is that small business, not government, is the engine of job creation in America.”).

120. *See* WILLIAM J. DENNIS, JR., NFIB RESEARCH FOUND., FINANCING SMALL BUSINESSES: SMALL BUSINESS AND CREDIT ACCESS 20 (2011), *available at* <http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-Access-NFIB.pdf> (“The best predictor of a small employer’s success obtaining a new credit line is the firm’s credit score. . . . A second predictor is whether the small employer considers a \$100 billion bank his principal financial institution. If the owner does, the chances that he will be successful, all factors equal, are only one-quarter of that had his primary bank been smaller or he did not have one.” (citation omitted)).

121. *See FDIC Statistics Report*, *supra* note 12. To review the statistics discussed in this subpart, launch the URL, click “Custom Download,” and select the relevant field—such as “Small Business Loans” or “Net Loans and Leases”—from the drop-down box. Select the reports you are interested in via the checkboxes, click “Next,” and then proceed to enter your delimiting factors on the “Download Selection” screen. After that, click “Find”: you can then download a customized spreadsheet containing the data you’ve requested.

that sum on their books.¹²²

Community banks hold a small-business loan portfolio over four times their relative size in terms of assets.¹²³ With respect to small-business loans with original principal amounts of less than \$100,000, their participation is even more striking—61.7%, or 7.3 times their share of total assets.¹²⁴ It is not surprising that community banks dominate small-business lending, because the informationally opaque nature of small businesses makes them a natural fit for relationship banking.

2. Farm and Farmland Lending

Community banks are absolutely vital to the economic health of rural America and to the agricultural economy.¹²⁵ Farmers rely on community banks as sources of both short-term credit for crop production (farm loans) and long-term financing secured by mortgages on agricultural real estate (farmland loans). As of year-end 2013, community banks held 60.8% of all farmland loans.¹²⁶ These holdings included 74.3% of farmland loans less than \$500,000 and 80.5% of farmland loans less than \$100,000.¹²⁷ Community banks also held 54.9% of farm loans, including 75.9% of all farm loans less than \$500,000 and 78.5% of farm loans less than \$100,000.¹²⁸ In other words, community banks had 7 to 9.5 times the level of investment in loans to farmers as their relative asset size.

The disproportionate share of farm and farmland lending held by community banks suggests that they are particularly adept at serving the needs of farming families. Lack of substitutes for the banking services provided to rural areas further emphasizes the important role of community banks in farm lending.¹²⁹ With less than a 30% share of banking offices in rural areas, larger banks tend to be more geographically distant from farming operations.¹³⁰ As a result, large banks incur more monitoring costs when lending to smaller borrowers such as farms and rural small businesses.¹³¹ Because farm loans are more costly to larger banks, these banks

122. Community banks held \$103 billion. *See id.*

123. Community banks held 8.4% of total assets, compared to 38% of small-business loans. *See id.*

124. Community banks held \$9.3 billion of \$15 billion in total loans in this category. *See id.*

125. *See, e.g.,* LAWSKY, *supra* note 73, at 4 (“New York’s farms, which have little or no access to large banks, rely heavily on community banks for loans and other financial services.”).

126. *See FDIC Statistics Report, supra* note 12. “Farmland loans” are described in the FDIC reports as “[l]oans secured by farmland held in domestic offices.”

127. *See id.*

128. *See id.* “Farm loans” are described in the FDIC reports as “[l]oans to finance agricultural production and other loans to farmers.”

129. *See* William Keeton, Jim Harvey & Paul Willis, *The Role of Community Banks in the U.S. Economy*, 88 FED. RES. BANK KAN. CITY ECON. REV., no. 2, 2003, at 15, 26–27.

130. *See* FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 3–6 tbl.3.5.

131. Agricultural financing can be an underwriting-intensive operation where local knowledge and understanding of the market can be expensive to duplicate. Lenders use both quantitative data points, such as debt-to-asset ratio and profit margin, and qualitative factors to assess risk. *See, e.g.,* Steven C. Blank, *Financing Agricultural Operations: The Loan Process in California*, U. CAL. COOPERATIVE EXTENSION, http://sfp.ucdavis.edu/pubs/SFNews/Aug-Sept97/finance_510/ (last updated June 15, 2012) (“The qualitative

are less willing to extend credit. Consequently, there is little evidence that larger banks would be willing or able to substitute for the local-farm lending practiced by smaller community banks, particularly with respect to low-balance loans.¹³²

3. Commercial Real-Estate Lending

At year-end 2013, U.S. commercial banks carried \$1.01 trillion in commercial real-estate (CRE) loans on their books.¹³³ CRE includes nonfarm, nonresidential property types such as offices, retail shopping centers, industrial and warehouse buildings, and multifamily residential properties. Community banks held \$227 billion, or 22.4% of those loans.¹³⁴

The composition of loan portfolios held by community banks has changed significantly over the past quarter decade. Approximately 75% of loans on the books of community banks at year-end 2013 were primarily secured by real estate.¹³⁵ It is important to note that not all loans secured by CRE are for the acquisition or development of income-producing CRE 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.¹³⁶

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

factors considered in loan analysis were reported to be management ability, character, reputation, credit history, risk factors, appearance of the farm, good records and financial data, asset quality, analysis of the industry, and a farmer's knowledge of his business. Obviously, the factors on this list are not mutually exclusive. When asked to elaborate on what to look for when judging management ability, the lenders again mentioned the appearance of the farm, the borrower's knowledge, the quality of financial data submitted as well as production and financial history. . . . Seventy-five percent of the lenders said 'yes' when asked whether the riskiness of the commodities produced by the borrower alters the loan process. They reported that risk could make a difference because underwriting standards (especially the loan-to-value ratio) can become stricter on risky commodities.”)

132. See AM. BANKERS ASS'N, 2013 FARM BANK PERFORMANCE REPORT 4, available at <http://www.aba.com/Press/Documents/2013FarmBankPerformancereport.pdf> (describing the performance of 2152 “farm banks,” banks whose “ratio of domestic farm loans to total domestic loans [is] greater than or equal to the industry average”). The figure cited by the ABA includes thirty-eight banks with assets greater than \$1 billion, but the median-sized farm bank has \$102 million in assets. *Id.*

133. See *FDIC Statistics Report*, *supra* note 12. CRE loans are defined as nonresidential loans secured by real estate, excluding farm loans.

134. See *id.*

135. See *id.*

136. These “fixed asset” loans are particularly useful to small businesses that are less transparent or difficult to underwrite because the principal data source used by the lender is the value of the real estate pledged as collateral. Allen N. Berger & Lamont K. Black, *Bank Size, Lending Technologies, and Small Business Finance*, 35 J. BANKING & FIN. 724, 726 (2011).

most densely populated regions.¹³⁷ But small CRE properties make up the lion's share of U.S. CRE, and they are primarily financed by community banks.¹³⁸

The kind of CRE that community banks support with credit is integral to the success of small businesses. From the perspective of tenants, the CRE sector is a financing mechanism of equal importance to a line of credit.¹³⁹ 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.

4. Residential Mortgage Lending

Home ownership is an essential element of 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.¹⁴⁰ The prevailing policy theory is 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 are 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.¹⁴¹

Community banks have historically been an important source of credit for residential homebuyers. In 1984, residential real-estate loans represented 61% of all loans at community banks.¹⁴² But the rise of mortgage securitization and the tightening of consumer protections related to residential real-estate lending have dramatically decreased the involvement of community banks in residential real-estate lending. By year-end 2013, residential real-estate loans had dropped to 26% of all community-bank loans.¹⁴³ The ratio of residential real-estate loans held

137. Tanya D. Marsh, *Too Big To Fail vs. Too Small To Notice: Addressing the Commercial Real Estate Debt Crisis*, 63 ALA. L. REV. 321, 343 (2012).

138. *Id.* at 354.

139. See *Commercial Real Estate's Impact on Bank Stability: Hearing Before the Cong. Oversight Panel*, 112th Cong. 38 (2011) (prepared statement of Sandra Thompson, Director, Division of Supervision and Consumer Protection, FDIC) ("Small businesses rely heavily on commercial real estate to collateralize borrowings for working capital and other needs.").

140. See, e.g., Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233 (2010) (discussing housing-related tax subsidies defended on homeownership grounds as early as the 1950s); Robert B. Avery, Neil Bhutta, Kenneth P. Brevoort & Glenn B. Canner, *The Mortgage Market in 2010: Highlights from the Data Reported Under the Home Mortgage Disclosures Act*, FED. RES. BULL. (Fed. Reserve Sys., D.C.), Dec. 30, 2011, at 11 (indicating that nearly 50% of home-purchase loans in 2010 were government backed).

141. Mark Doms & Meryl Motika, *The Rise in Homeownership*, FRBSF ECON. LETTER (Fed. Reserve Bank of S.F.), Nov. 3, 2006, at 1, available at <http://www.frbsf.org/economic-research/publications/economic-letter/2006/november/the-rise-in-homeownership/el2006-30.pdf>.

142. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 5-1.

143. See *FDIC Statistics Report*, *supra* note 12.

by community banks compared to all commercial banks has also markedly declined, from 33% in 1993 to 14% in 2003 and 9% in 2013.¹⁴⁴

At the same time, residential real-estate loans held by community banks were more likely to be secured by first-mortgage liens than the riskier second-mortgage liens, also known as home-equity loans. Community banks held 10.3% of residential mortgages secured by a first lien, but only 4.8% of home-equity loans.¹⁴⁵ The reluctance to make home-equity loans is reflected in the very low levels of community bank unsecured lending to individuals (i.e., credit cards)—community banks held only 2.7% of such loans held by commercial banks at year-end 2013.¹⁴⁶

In 2012, Federal Reserve Governor Elizabeth Duke expressed concern that “new mortgage lending regulations might . . . seriously impair the ability of community banks to continue to offer their traditional mortgage products.”¹⁴⁷ She argued that a simpler regulatory structure should be adopted with respect to community-bank mortgage lending,¹⁴⁸ noting that community banks had proved to be much more reliable underwriters than larger banks:

Over the last several years as mortgage delinquencies reached record levels, the serious delinquency rate of mortgages held by community banks did not go much over 4 percent, far lower than the serious delinquency rates that climbed to almost 22 percent for subprime, fixed-rate loans and more than 46 percent for subprime, variable-rate loans. In fact, over the last several years, on average, mortgages held by community banks outperformed even fixed-rate, prime loans, the best performing mortgage category. I think this statistic by itself is a strong testament to the responsible lending practices of community banks.¹⁴⁹

Governor Duke concluded that “crafting a regulatory approach that is effective in preventing abuse but that leaves room for traditional community bank lending is challenging.”¹⁵⁰

5. Retail Deposit Services

Retail deposit services are vital to the economy on several levels. First, consumers and small businesses use deposit accounts to manage cash. Second, deposits are low-cost, reliable sources of capital for banks.¹⁵¹ By virtue of their emphasis on core banking services, it is not surprising that community banks are strong providers of retail deposit services. Retail deposits include transaction accounts, such as checking accounts, and nontransaction accounts like savings

144. *See id.*

145. *See id.*

146. *See id.*

147. Duke, *supra* note 30, at 5.

148. *Id.* at 15.

149. *Id.* at 13.

150. *Id.* at 14.

151. Timothy Clark, Astrid Dick, Beverly Hirtle, Kevin J. Stiroh & Robard Williams, *The Role of Retail Banking in the U.S. Banking Industry: Risk, Return, and Industry Structure*, FED. RES. BANK N.Y. ECON. POL'Y REV., Dec. 2007, at 39, 42.

accounts and certificates of deposit.¹⁵² 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.¹⁵³

At year-end 2013, U.S. commercial banks held approximately \$8 trillion in retail deposits.¹⁵⁴ Community banks held approximately \$893 billion of those retail deposits, representing an 11% share.¹⁵⁵ In rural areas, where customers have fewer brick-and-mortar banking options, community banks hold 70% of retail deposits, or 8.3 times their relative share of total assets.¹⁵⁶

Community banks also play a significant relative role in deposit accounts held by states and other political subdivisions (other than the federal government), holding 18% of such deposits.¹⁵⁷ Community banks also held 16.6% of transaction accounts held by individuals, partnerships, and corporations.¹⁵⁸

To summarize, community banks held only 8.4% of total commercial-bank assets as of December 31, 2013, but they represented an outsized share of certain important categories of financial services:

- 38% of small-business loans
- 62% of small-business loans less than \$100,000
- 61% of farmland loans
- 55% of farm loans
- 22% of commercial real-estate loans
- 10.3% of first-mortgage residential real-estate loans
- 18% of deposit accounts for state and other political subdivisions
- 17% of transaction accounts for individuals, partnerships, and corporations
- 11% of core (retail) deposits¹⁵⁹

C. Community Banks and the 2008 Financial Crisis

Congress enacted Dodd-Frank on January 5, 2010, and President Obama signed it into law on July 21, 2010.¹⁶⁰ Passed during the worst economic recession since

152. *Id.*

153. *Id.*

154. See *FDIC Statistics Report*, *supra* note 12. Here, retail deposits are defined as core deposits held domestically, excluding time deposits (CDs) of more than \$250,000 and brokered deposits of \$250,000 or less.

155. *See id.*

156. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 3-5.

157. See *FDIC Statistics Report*, *supra* note 12.

158. *See id.*

159. *See id.*

160. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); DAVIS POLK & WARDWELL LLP, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, at i (2010), available at http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.

the Great Depression, the legislation was intended to remedy problems in the financial-services sector that the Democratic majority in Congress believed caused the 2008 financial crisis. There is compelling evidence that community banks did not participate in subprime lending, securitization, or derivatives trading¹⁶¹—three of the primary causes of the 2008 financial crisis, according to the authors of Dodd-Frank.¹⁶² Many provisions of the Act, however, apply to both large, complex financial institutions and community banks.

1. Subprime Lending

Community banks participate in the U.S. residential mortgage market through their role as relationship bankers. At the end of 2013, community banks held about 9% of loans secured by mortgages on single-family residences—about the same proportion as total banking assets held.¹⁶³ Many customers obtain mortgage loans from banks that satisfy their other financial 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 Small Town and the Small Town bankers understand that customer's personal financial circumstances. Because of this personal familiarity, a small, informationally opaque borrower may also be more likely to obtain 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.¹⁶⁴ Entire ancillary, and heretofore nonexistent, industries sprung up around the housing market as a result. To get as many U.S. consumers into homes as possible, some mortgage originators used innovative and risky loan arrangements.¹⁶⁵ Prior to the housing bubble, most mortgage lending was performed similar to the way community banks practice relationship banking. That is, lenders wanted to know their customer, know their customer's creditworthiness, and ensure that mortgages held on the lenders' 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.¹⁶⁶

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

162. See FINANCIAL CRISIS INQUIRY REPORT, *supra* note 23, at xvii.

163. See FDIC Statistics Report, *supra* note 12; see also *supra* notes 49, 144 and accompanying text.

164. U.S. DEP'T OF HOUS. & URBAN DEV., URBAN POLICY BRIEF: HOMEOWNERSHIP AND ITS BENEFITS (1995), available at <http://www.huduser.org/publications/txt/hdbrf2.txt>.

165. See Press Release, Consumer Fin. Prot. Bureau, Consumer Financial Protection Bureau Issues Rule To Protect Consumers from Irresponsible Mortgage Lending (Jan. 10, 2013), available at <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-issues-rule-to-protect-consumers-from-irresponsible-mortgage-lending/>.

166. FIN. CRISIS INQUIRY COMM'N, PRELIMINARY STAFF REPORT: SECURITIZATION AND THE

The authors of Dodd-Frank cited residential subprime mortgage lending as a precipitating cause of the 2008 financial crisis.¹⁶⁷ 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.¹⁶⁸ Popular references to “subprime lending” typically include alt-A loans.¹⁶⁹ These loans are generally made to borrowers with strong credit scores but have other characteristics that make the loans riskier.¹⁷⁰ 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.¹⁷¹ Alt-A loans once made up 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 are 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.¹⁷²

In 1990, subprime loans totaled \$37 billion, or 9% of residential mortgage originations.¹⁷³ 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.¹⁷⁴ In 2006, alt-A and subprime loans combined to constitute 40% of all origination activity.¹⁷⁵ This origination volume was made possible because the vast majority of these loans were quickly pooled into mortgage-backed securities (MBS) and repooled into collateralized-debt obligations (CDOs), and the default risk was transferred from the originators to securities investors.¹⁷⁶

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 abilities to repay obtained mortgages.¹⁷⁷ When home values stopped rising, however, homeowners began to default at unprecedented numbers—curtailing the cash flow underlying many MBS

MORTGAGE CRISIS 19 (2010) [hereinafter SECURITIZATION PRELIMINARY REPORT], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-Preliminary_Staff_Report_-_Securitization_and_the_Mortgage_Crisis.pdf.

167. FINANCIAL CRISIS INQUIRY REPORT, *supra* note 23, at xxiii–xxiv.

168. FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT: THE MORTGAGE CRISIS 5 (2010) [hereinafter MORTGAGE CRISIS PRELIMINARY REPORT], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0407-PSR_-_The_Mortgage_Crisis.pdf.

169. *Id.* at 6.

170. *Id.*

171. *Id.*

172. Consumer Fin. Prot. Bureau, *What Is a Subprime Mortgage?*, CONSUMERFINANCE.GOV (Mar. 22, 2012), <http://www.consumerfinance.gov/askcfpb/110/what-is-a-subprime-mortgage.html>.

173. MORTGAGE CRISIS PRELIMINARY REPORT, *supra* note 168, at 8.

174. *Id.*

175. *Id.*

176. See SECURITIZATION PRELIMINARY REPORT, *supra* note 166, at 19.

177. See FINANCIAL CRISIS INQUIRY REPORT, *supra* note 23, at xxvi.

and related CDOs, and creating a cascade of defaults throughout the financial system.¹⁷⁸

The origination of subprime mortgage loans for securitization, with underwriting decoupled from credit risk, was clearly a significant problem that fueled the housing bubble and destroyed much household wealth. However, it is equally clear that community banks did not participate in that activity.¹⁷⁹

Community banks did make loans that are technically “subprime,” but the existence of subprime loans themselves was not the problem; subprime loans, when properly underwritten, can still perform. Community banks have stronger incentives to effectively underwrite loans than do originators of loans destined for the secondary market for several reasons:

When savers, borrowers, and lenders all live in the same community, lenders don’t write loans that amount to financial crack. They know their business depends on their good reputation. Similarly, borrowers, who prize the good opinion of their neighbors, don’t easily walk away from their loans.

In small-scale banking . . . borrowers and lenders can effectively see one another. They’re rich with what Federal Reserve Chairman Ben Bernanke calls “informational capital,” and this has a stabilizing influence.¹⁸⁰

Between 1996 and 2006, residential mortgages originated and held by community banks outperformed residential mortgages in general. The net charge-off rate at community banks was only 0.06%.¹⁸¹ The same rate at noncommunity banks was 0.11–0.12%.¹⁸²

Remarkably, this trend is magnified when comparing net charge-off rates at community and noncommunity banks for the period from 2006 to 2010, when mortgage defaults ballooned. During that period, charge-off rates averaged 0.35% at community banks versus 1.16% at noncommunity banks.¹⁸³ That is, the charge-off rate was 3.3 times higher for noncommunity banks than for community banks during that period.¹⁸⁴

178. *Id.* at 27.

179. In fact, loans that promoted the financial crisis were “primarily being made outside the regular banking system.” Joseph R. Mason, Robert Kulick & Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 791 (2010) (quoting Barney Frank, Chairman, House Comm. on Fin. Servs., The “Loan Arrangers” Will Not Ride Again, Speech Before the National Press Club (July 27, 2009)). Treasury research determined that 94% of “high-priced loans” to “lower income borrowers” were originated by nonbank entities. *Id.* (quoting DEP’T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 69–70 (2009), available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf).

180. Phillip Longman & T.A. Frank, *Too Small To Fail*, WASH. MONTHLY, Nov.–Dec. 2008, at 14, 16.

181. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 4–6.

182. *Id.*

183. *Id.*

184. The backlog in foreclosures and mortgage workouts is well known. CoreLogic, an

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 2008 financial crisis. Although community banks do extend residential mortgages that may meet some of the characteristics of subprime loans, they tend to hold those loans on their books and retain the risk.¹⁸⁵

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.¹⁸⁶ The resulting securities are generally known as “asset-backed securities,” although sponsors typically focus a particular security on a specific type of collateral.¹⁸⁷ Banks and financial institutions safely engaged in securitization prior to the 2008 financial crisis. Securitization is not inherently risky; rather, it is a valuable tool for mitigating risk and supplying additional credit into the economy.¹⁸⁸ Prior to the 2008 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 2008 financial crisis, however, it became clear 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.

analytics firm, estimates that a \$246 billion shadow inventory remained in the housing market as of August 2012. Agustino Fontevecchia, *What Housing Recovery? Distressed Sales Still High, Shadow Inventory Massive*, FORBES (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/>.

185. Duke, *supra* note 30, at 6–7 (“Community banks have long been a source of loans that, for a variety of reasons, do not fit the parameters of conforming government-sponsored enterprise loans or eligibility for government-guaranteed programs. Community banks typically hold these loans on their own balance sheets. They use higher interest rates to compensate for the lack of liquidity in these loans or to cover higher processing costs because community banks lack economies of scale, and they use balloon payments as a simple way to limit their interest-rate risk.”).

186. See SECURITIZATION PRELIMINARY REPORT, *supra* note 166, at 4.

187. Nonmortgage asset-backed securities fall into four main categories, based on the type of collateral that secures the loans: consumer ABS (student loans, credit card receivables, and auto loans); corporate ABS (corporate debt, collateralized-bond obligations, collateralized-debt obligations, etc.); commercial ABS (trade receivables, etc.); and whole-business ABS (franchise royalties, billboard leases, etc.). The best-known type of asset-backed security is the mortgage-backed security. See GUGGENHEIM PARTNERS, LLC, *THE ABCS OF ABS: IDENTIFYING OPPORTUNITIES IN ASSET-BACKED SECURITIES 3* (2013), available at <http://guggenheimpartners.com/GP/media/pdf/The-ABCs-of-ABS.pdf>.

188. Richard M. Hynes, *Securitization, Agency Costs, and the Subprime Crisis*, 4 VA. L. & BUS. REV. 231, 236 (2009) (“If properly regulated, securitization may actually help address two other possible causes of our recent housing troubles: the formation of market bubbles and the moral hazard created by the ability of lenders to shift losses to taxpayers.”).

Securitization is a process that is tailor-made for commodified, transactional banking. As a result, a small number of institutions dominate originations. A 2011 study determined that 96% of all residential mortgage originations in 2006 were carried out by forty lenders, and ten lenders were responsible for 65% of mortgage originations.¹⁸⁹

[B]ased on available estimates, approximately \$25 trillion of structured-finance securities and related derivatives were outstanding in the U.S. financial markets at the peak of the credit boom in 2007. Eighteen giant [financial institutions], including ten U.S. and eight foreign financial institutions, originated the lion's share of those complex instruments. Structured-finance securities and related derivatives not only financed but also far exceeded about \$9 trillion of risky private-sector debt that was outstanding in U.S. financial markets when the credit crisis broke out.¹⁹⁰

The growth of securitization has also allowed the largest banks to generate significant fee income through various financial-intermediary roles.¹⁹¹ 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 noncommunity banks.¹⁹²

3. Derivatives

According to the narrative adopted by the authors of Dodd-Frank, over-the-counter trading of credit derivatives contributed to the 2008 financial crisis in three primary ways.¹⁹³ First, credit default swaps were marketed as insurance against MBS loan losses, which encouraged investors to take more risk without offsetting the risk.¹⁹⁴ Second, the structure of a synthetic CDO—which involves taking a speculative bet on the performance of MBS without actually

189. Richard Stanton, Johan Walden & Nancy Wallace, *The Industrial Organization of the U.S. Residential Mortgage Market*, 6 ANN. REV. FIN. ECON. (forthcoming 2014) (manuscript at 16), available at http://faculty.haas.berkeley.edu/walden/HaasWebpage/18_mortgageio.pdf. The top ten lenders in 2006 were Countrywide Financial, Wells Fargo Home Mortgage, Washington Mutual, CitiMortgage Inc., Chase Home Finance, Bank of America Mortgage & Affiliates, Wachovia Corporation, Residential Capital Group, IndyMac, and GMAC Residential Holding Corporation. With the exception of GMAC, all of these entities were either banks or thrifts. *Id.*

190. Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951, 966 (2011) (footnotes omitted).

191. See FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 4-2; Katherine Samolyk, *The Future of Banking in America: The Evolving Role of Commercial Banks in U.S. Credit Markets*, 16 FDIC BANKING REV., no. 2, 2004, at 29, 30.

192. FDIC COMMUNITY BANKING STUDY, *supra* note 20, at 4-3.

193. See generally FINANCIAL CRISIS INQUIRY REPORT, *supra* note 23, at 38-51, 127-55.

194. *Id.* at 50.

owning any mortgages—requires the use of a credit default swap.¹⁹⁵ Synthetic CDOs allowed investors to multiply the number of bets on the same underlying MBS, thereby exponentially increasing systemic credit exposure.¹⁹⁶ Third, because many different investors 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.¹⁹⁷ 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.¹⁹⁸

Even if we accept this narrative as correct, community banks were irrelevant to the kinds of derivatives markets implicated in the 2008 financial crisis. Small banks should be more likely to use derivatives to hedge risk, particularly interest-rate risk.¹⁹⁹ Prior to the enactment of Gramm-Leach-Bliley in 2001, community banks were deterred from using derivatives to hedge because of their cost.²⁰⁰ Call reports from 1999 show that less than one percent of community banks used derivatives that year.²⁰¹ Use of derivatives by small banks increased after 2001. In 2012, about eighteen percent of community banks were active derivatives users.²⁰² Moreover, the interest-rate swaps used by some community banks are wholly unlike the derivatives traded by large banks participating in the greater derivatives market.²⁰³ At no point between 2003 and 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 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 2010.²⁰⁴ Moreover, community banks engaged in an insignificant amount of credit-derivatives trading. Community banks held just 0.003% of all credit derivatives held by banking institutions between 2003 and 2010.²⁰⁵

195. *Id.* 142; Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 IND. L.J. 213, 262 (2013) (“Synthetic CDOs provided investors with similar risk exposures but did not actually fund any new mortgages. Rather than purchase MBS and thereby fund mortgages, synthetic CDOs used credit default swaps to enable investors to make side bets on the performance of existing MBS or CDOs.”)

196. FINANCIAL CRISIS INQUIRY REPORT, *supra* note 23, at 145–46.

197. *Id.* at 226–28, 386.

198. *Id.* at 386.

199. Shen & Hartarska, *supra* note 31, at 2.

200. *Id.*

201. *Id.*

202. *Id.* at 3.

203. *Id.* at 7–8 (explaining that speculative derivatives increased riskiness at banks, but hedging derivatives, like interest-rate swaps, reduced risk).

204. See *FDIC Statistics Report*, *supra* note 12. This figure represents the sum of the following: interest-rate contracts (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).

205. See *id.*

Community banks were not responsible for the causes of the 2008 financial crisis as understood 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. Richard Cordray, the director of the Consumer Financial Protection Bureau (CFPB), agreed with this analysis, telling a group of community bankers that although community banks did not cause the 2008 financial crisis, these banks must “unfortunately” deal with regulations to prevent another crisis.²⁰⁶

II. THE REGULATION OF COMMUNITY BANKS

A. Regulatory Structure

The American banking system and regulatory regime are significantly different from those of other Western countries.²⁰⁷ The American 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.²⁰⁸ Hamilton favored a federal bank and the establishment of a national currency.²⁰⁹ Jefferson advocated for a decentralized system in which the states chartered banks.²¹⁰ 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.²¹¹ At the same time, the first Bank of the United States was chartered by Congress in 1791.²¹² A bill to recharter the bank failed in 1811.²¹³ As every lawyer who has taken constitutional law knows, the Second Bank of the United States was chartered in 1816 by Congress.²¹⁴ The State of Maryland, in an effort to protect its own state-chartered banks, imposed a tax on the Second Bank of the United States and challenged its right to exist under the Federal Constitution. In *M'Culloch v. Maryland*,²¹⁵ the Supreme Court struck down the tax

206. CMTY. BANKERS ASS'N OF ILL., CFPB DIRECTOR RICHARD CORDRAY MEETS WITH CBAI BANKERS (2012), available at https://www.cbai.com/downloads/CFPB_Roundtable_%20CBAI_E-News_12-21-2012.pdf.

207. 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.”).

208. MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION 4 (3d ed. 2011).

209. *Id.* at 3.

210. 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).

211. LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 10 (4th ed. 2011) (North Carolina was the last of the original thirteen states to establish a state-chartering system, in 1804).

212. *Id.*

213. *Id.*

214. *Id.* at 11.

215. 17 U.S. (4 Wheat.) 316, 425, 436 (1819).

and 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 reestablish its charter.²¹⁶ “The Jeffersonian and Jacksonian struggles against the First and Second Banks reflected a deeply rooted popular hostility 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.”²¹⁷

Following the demise of the Second Bank of the United States, a period known as the Free Banking Era began. By 1860, nearly 1600 state-chartered banks were in operation, each issuing its own paper currency.²¹⁸

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.²¹⁹ The next year, this legislation was replaced by the National Bank Act, which began the process of establishing regulations for federally chartered banks.²²⁰ Although these acts created a uniform national currency and limited the issuance of bank notes to federally chartered banks, they 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.

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.²²¹ 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.²²² The Federal Reserve Act also prohibited national banks from distributing their own currency, and it restricted the issuance of notes to the Federal Reserve banks.²²³

In response to the Depression and the resulting widespread failure of banks, the Banking Act of 1933 created a system of federal deposit insurance supported by the FDIC.²²⁴ Also in 1933, the Glass-Steagall Act required the separation of investment banks and commercial banks.²²⁵ In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act allowed banks to establish nationwide interstate banking for the first time.²²⁶ This was the enabling step in the rise of large, complex

216. BROOME & MARKHAM, *supra* note 211, at 11, 14–15.

217. Wilmarth, *supra* note 210, at 971.

218. BROOME & MARKHAM, *supra* note 211, at 15.

219. *Id.* at 22.

220. *Id.* at 23.

221. Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.).

222. BROOME & MARKHAM, *supra* note 211, at 32.

223. *Id.* at 33.

224. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.); *see also* BROOME & MARKHAM, *supra* note 211, at 38.

225. BROOME & MARKHAM, *supra* note 211, at 42–44.

226. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified as amended in scattered sections of 12 U.S.C.); *see also* BROOME & MARKHAM, *supra* note 211, at 54–55.

financial institutions. In 1999, the Gramm-Leach-Bliley Act repealed portions of the Glass-Steagall Act and allowed bank holding companies to own both investment banks and commercial banks.²²⁷ The PATRIOT Act,²²⁸ a response to the September 11, 2001, terrorist attacks, and the 2002 Sarbanes-Oxley Act,²²⁹ 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.²³⁰

This brief history of the American system of banking regulation illustrates the legislative pattern of regulation by accretion. Following major 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 2008 financial crisis, major changes have taken place in the regulatory structure. This has led to a highly fractured system of banking regulation.

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.²³¹ 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.²³²

There are four main federal regulatory agencies for financial institutions: the OCC, which is part of the Department of the Treasury; the Federal Reserve; the FDIC; and the National Credit Union Administration.²³³ 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 that are members of the Federal Reserve. State banks that are not members of the Fed are primarily supervised by the FDIC.²³⁴ National banks are primarily supervised by the OCC.²³⁵ In addition, Dodd-Frank created the CFPB, which has concurrent supervisory authority over banks with more than \$10 billion in assets.²³⁶

American banks are therefore subject to regulation, supervision, and inspection by a variety of state and federal agencies. Banking regulations generally fall into

227. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

228. Uniting and Strengthening America by Providing Appropriate Tools Required To Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

229. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

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

231. Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 677 (1988).

232. BROOME & MARKHAM, *supra* note 211, at 185.

233. MALLOY, *supra* note 208, at 28-42.

234. BROOME & MARKHAM, *supra* note 211, at 185.

235. MALLOY, *supra* note 208, at 28, 31, 36.

236. BROOME & MARKHAM, *supra* note 211, at 66, 370.

four categories.²³⁷ First, regulators are concerned with protecting the safety and soundness of deposits.²³⁸ This is the primary concern of the FDIC, although other regulatory agencies are also concerned with safety and soundness.²³⁹ Second, regulators are concerned with reducing systemic risk, that is, the risk of disruption to the financial system and the broader economy as a result of one or more major bank failures.²⁴⁰ 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.²⁴¹ 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.²⁴² Another primary goal of Dodd-Frank was to promote consumer protection, and much legislation over the past thirty years has focused on similar issues.²⁴³

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 December 31, 2013, Federal Reserve regulations A through YY had been established.²⁴⁴ Each of these regulations imposes detailed requirements on banks, and there is a significant compliance cost associated with understanding and implementing the banks' 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

237. See generally KENNETH SPONG, *BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS* (5th ed. 2000), available at <http://www.kansascityfed.org/publicat/bankingregulation/RegsBook2000.pdf>.

238. See generally *id.* at 6–7, 63–144.

239. *Id.* at 56.

240. *Id.* at 7–8.

241. See, e.g., Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1114.

242. SPONG, *supra* note 237, at 10–11, 201–52.

243. See, e.g., Truth in Savings Act, Pub. L. No. 102-242, §§ 261–74, 105 Stat. 2236, 2334–43 (1991) (codified as amended at 12 U.S.C. §§ 4301–13 (2012)); Expedited Funds Availability Act, Pub. L. No. 100-86, §§ 601–613, 101 Stat. 552, 635–52 (1987) (codified as amended at 12 U.S.C. §§ 4001–4010 (2012)); Electronic Fund Transfer Act, Pub. L. No. 95-630, §§ 901–921, 92 Stat. 3641, 3728–41 (1978) (codified as amended at 15 U.S.C. §§ 1693–1693r (2012)); Community Reinvestment Act of 1977, Pub. L. No. 95-128, §§ 801–806, 91 Stat. 1111, 1147–48 (codified as amended at 12 U.S.C. §§ 2901–2905 (2012)); Fair Debt Collection Practices Act, Pub. L. No. 95-109, 91 Stat. 874 (1977) (codified as amended at 15 U.S.C. §§ 1692–1692o (2012)); Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, §§ 301–310, 89 Stat. 1124, 1125–28 (codified as amended at 12 U.S.C. §§ 2801–2809 (2012)); Equal Credit Opportunity Act, Pub. L. No. 93-495, §§ 701–707, 88 Stat. 1500, 1521–25 (1974) (codified as amended at 15 U.S.C. §§ 1691–1691e (2012)); Fair Credit Reporting Act, Pub. L. No. 91-508, §§ 601–622, 84 Stat. 1114, 1128–36 (1970); Truth in Lending Act, Pub. L. No. 90-321, §§ 101–145, 82 Stat. 146, 146–59 (1968) (codified as amended in scattered sections of 15 U.S.C.).

244. *Regulations*, BOARD GOVERNORS FED. RES. SYS., <http://www.federalreserve.gov/bankinforeg/reglisting.htm>.

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 typical American community banks, which engage in traditional banking activities in a limited geographic area, many of these costs are disproportionate to 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.

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.²⁴⁵ 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.²⁴⁶

Residential lending provides a good example. To obtain a first-mortgage residential home loan at a community bank in Florida,²⁴⁷ a customer must first fill out a seventy-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 (revised 6/09)
- (2) A three-page “Good Faith Estimate” form developed by the U.S. Department of Housing and Urban Development (HUD)
- (3) A one-page document detailing the “Good Faith Addendum Lock-In Agreement and Application Fees”
- (4) A one-page “Truth-in-Lending Disclosure”
- (5) A one-page disclosure of the “Itemization of Amount Financed”
- (6) A one-page “Hazard Insurance Closing Requirements Advance Notice”
- (7) A one-page document containing “Certifications, Disclosures, and Notices” acknowledging that the applicant is aware of the Equal Credit Opportunity Act, the Fair Credit Reporting Act, anticoercion requirements under state and federal law, and the Right to Financial Privacy Act of 1978
- (8) A one-page disclosure informing the customer that she has a right to

245. Congress specifically empowered the CFPB with ensuring that consumer disclosures are “fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service” 12 U.S.C. § 5532(a) (2012).

246. Jean Braucher, *Form and Substance in Consumer Financial Protection*, 7 BROOK. J. CORP. FIN. & COM. L. 107, 124 (2012) (“[R]egulation 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.” (footnote omitted)).

247. The documents described in this subpart were provided to the author by Eddie Creamer, president and CEO of Prosperity Bank in St. Augustine, Florida.

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's 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 forty-eight-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 fourteen times and theoretically read seventy pages of disclosures, warnings, and references to dozens of laws.

If the customer is approved for the loan, then she receives a sixty-eight-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 thirteen-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 disclosure of the "Itemization of Amount Financed"
- (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 disclosure of "Real Estate Tax Information"
- (17) The customer's four-page "Uniform Residential Loan Application"

so the customer can recertify 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) A second copy of IRS Form 4506-T “Request for Transcript of Tax Return”
- (24) A one-page “Compliance Agreement”

In the sixty-eight-page closing packet, the customer is required to sign seventeen 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.²⁴⁸ The consumer presented with this imposing package likely suffers from disclosure fatigue and obtains little benefit.²⁴⁹

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

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 “naive consumer” for whom the disclosure is intended to protect, may not receive any

248. It was reported that Judge Richard Posner of the Seventh 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*, A.B.A. J. (June 23, 2010, 1:37 PM), http://www.abajournal.com/news/article/judge_posner_admits_he_didnt_read_boilerplate_for_home_equity_loan/.

249. Senator Elizabeth Warren argues that one of the purposes of the CFPB 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., Apr. 2011, at 10.

meaningful benefit from the information provided. Yet there is no doubt that all consumers are paying their share of the cost.²⁵⁰

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 is a particularly 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 providers is a bad idea.²⁵¹ Consumers should be aware of the Equal Credit Opportunity Act, the Fair Credit Reporting Act, anticoercion 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, RESPA, and the Housing Financial Discrimination Act of 1977. But if it seems unlikely that consumers will (1) absorb all of this information and (2) use this information to make better borrowing decisions, then we must consider the cost this regulatory approach inflicts on banks and, ultimately, consumers.²⁵²

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 twenty-four documents in the typical residential closing packet with the documents in a typical closing packet for a multimillion 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.

250. Dreyer & Weinstock, *supra* note 59, at 100–01.

251. 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, 160 (2006) (footnote omitted) (quoting Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 516 n.5 (2005)).

252. See Dreyer & Weinstock, *supra* note 59, 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.”).

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.²⁵³ However, 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 mortgage loans during that time period.²⁵⁴ Even before Dodd-Frank, there was a disconnect between the regulation imposed on community banks, the significant cost ultimately passed on to consumers by virtue of that regulation, and the minimal 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 2008 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.²⁵⁵ 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.²⁵⁶ 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 institution could set off a cascade of stress and failures throughout the American economy.²⁵⁷ In order to prevent conflagration across the entire financial industry, the federal government and the

253. See, e.g., Todd Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 GEO. WASH. L. REV. 856, 900 (2013) ("The architects of the CFPB were correct that the substantive consumer financial protection rules were suboptimal. For example, the impenetrable thicket of paperwork surrounding mortgage originations did little to dispel consumer confusion or protect them from fraud.")

254. See *supra* Part I.C.1.

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

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

257. 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.").

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 narrative—largely adopted by the Obama administration, the congressional majority in the 111th Congress, 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.²⁵⁸ That intervention came in January 2010 when Congress passed Dodd-Frank.²⁵⁹ Sponsors explained that Dodd-Frank was designed to “address the numerous failures that led to the near collapse of our financial system.”²⁶⁰ Specifically, sponsors highlighted the following Dodd-Frank regulations²⁶¹: (a) creation of the Financial Stability Oversight Council to monitor potential threats to the financial system; (b) provision for 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 CFPB; (d) increased transparency for the over-the-counter derivatives market; and (e) mortgage reform. Drafters intended all of these policies to correct the perceived “inefficiencies and failures” in the financial system that led to the 2008 financial crisis.²⁶²

As the GAO noted in a September 2012 report, although Dodd-Frank was primarily aimed at large, systemically important financial institutions, seven of the Act’s sixteen titles are expected to have an effect on community banks.²⁶³ Four years after Congress passed Dodd-Frank, it 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.²⁶⁴ Some of those

258. Of course, not everyone agrees with this narrative of the financial crisis. *See, e.g.*, FINANCIAL CRISIS INQUIRY REPORT, *supra* note 23, at 441 (dissenting statement of Peter J. Wallison).

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

260. 155 CONG. REC. 30, 816 (2009) (testimony of Rep. Edwin Perlmutter).

261. *See* COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, U.S. SENATE, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://www.banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

262. Although Dodd-Frank itself does not recite a clearly stated goal, the Financial Stability Oversight Council, the new supercommittee created by the Act, has stated that the purpose of the Act is to “build a stronger, more resilient financial system—less vulnerable to crisis, more efficient in allocating financial resources, and less vulnerable to fraud and abuse.” FIN. STABILITY OVERSIGHT COUNCIL, 2011 ANNUAL REPORT, at i (2011), *available at* <http://www.treasury.gov/initiatives/fsoc/documents/FSOCAR2011.pdf>.

263. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-881, COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF THE DODD-FRANK ACT DEPENDS LARGELY ON FUTURE RULE MAKINGS 19 (2012) [hereinafter GAO-12-881], *available at* <http://www.gao.gov/assets/650/648210.pdf>.

264. DAVIS POLK & WARDWELL LLP, DODD-FRANK PROGRESS REPORT 2 (2014), *available at* http://www.davispolk.com/sites/default/files/October2014_Dodd.Frank_Progress.Report.pdf.

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.²⁶⁵ Some of the most significant discretion, for the purposes of this Article, is the discretion granted to regulatory agencies to determine whether or not a particular rule should be applied to a set of financial institutions.²⁶⁶ 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.²⁶⁷

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.²⁶⁸ 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.²⁶⁹ For example, section 1075 requires the Federal Reserve to limit interchange fees to a level that is “reasonable” and “proportional.”²⁷⁰ The Act does not define either of those words. 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.²⁷¹ However, Congress did not define “incremental cost,” and there is no generally accepted definition of the term.

265. See HESTER PEIRCE, INCREASING THE EFFECTIVENESS OF THE BUREAU OF CONSUMER FINANCIAL PROTECTION IN PROTECTING CONSUMERS 5 (2014), available at <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba15-wstate-hpeirce-20140521.pdf> (testimony before the Financial Institutions and Consumer Credit Subcommittee of the House Committee on Financial Services) (“Dodd-Frank’s grant of authority to the Bureau allows the agency considerable discretion.”).

266. See GAO-12-881, *supra* note 263, at 6–7.

267. See PEIRCE, *supra* note 265, at 4 (“An even more troubling practice is the Bureau’s intentional perpetuation of statutory ambiguities in order to allow further clarification through enforcement actions. The most notorious example of this is the Bureau’s decision not to define the unclear jurisdictional term introduced by Dodd-Frank—“abusive” act or practice—and choosing instead to retain the option of defining it through enforcement actions.”).

268. § 1075, 124 Stat. at 2068.

269. *Understanding the Federal Reserve’s Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 2 (2011) [hereinafter *Raskin Statement*] (statement of Sarah Bloom Raskin, Governor, Federal Reserve System).

270. § 1075(a)(2), 124 Stat. at 2068.

271. *Id.* at 2069.

Governor Raskin testified that it “was a little bit hard to translate [that term] into something workable”²⁷² and that, in general, “there are quite a number of provisions in this set of directives that have been difficult to interpret.”²⁷³ 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 billion, from the cap on interchange fees.²⁷⁴ 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.²⁷⁵ In other words, the law may have expressly exempted community banks, but basic economic theory suggests that approach would have been unsuccessful. When asked about the economic impact of the Durbin Amendment on small banks, Governor Raskin testified: “Whether or not [small issuers] still are able to make a profit is going to depend on the market dynamics on how this all looks in the end.”²⁷⁶ 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 going to happen”²⁷⁷

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

272. *Raskin Statement, supra* note 269, at 7.

273. *Id.* at 22.

274. § 1075(a)(2), 124 Stat. at 2070.

275. Letter from Indep. Cmty. Bankers of Am. & Credit Union Nat’l Ass’n to Members of the U.S. Senate (May 5, 2010), *available at* http://www.cuna.org/Grassroots-And-Political-Action/DownLoads/congress_letter_050510a/ (“Splitting up a system that works because it is currently *not* bifurcated will place our members and their customers at a significant disadvantage: with government price controls on debit cards issued by big banks, no market mechanism will be in place to prevent merchants from discriminating against consumers who carry the now artificially more expensive debit cards from credit unions and community banks.” (emphasis in original)).

276. *Raskin Statement, supra* note 269, at 11.

277. *Id.* at 27–28.

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 October 1, 2014, slightly more than one-half of the 398 rulemaking requirements in Dodd-Frank had been satisfied with finalized rules.²⁷⁸ Rules have been proposed to meet an additional 21%, while over 20% of the required rulemakings have not yet been addressed.²⁷⁹

It is beyond the scope of this Article to comprehensively analyze the complete impact of the 838-page Dodd-Frank Act on community banks.²⁸⁰ The two provisions of Dodd-Frank which are most concerning 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 CFPB.²⁸¹ The CFPB has been granted broad powers to “regulate the offering and provision of consumer financial products or services.”²⁸² The limit to those powers, and how those powers may be implemented to impact community banks, remains uncertain and represents 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.²⁸³

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.²⁸⁴ 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 authorized to collect additional data from all financial

278. DAVIS POLK & WARDWELL LLP, *supra* note 264, at 2.

279. *Id.*

280. For a more comprehensive analysis, see MARSH & NORMAN, *supra* note 72.

281. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1011, 124 Stat. 1376, 1964 (2010).

282. § 1011(a), 124 Stat. at 1964. Section 1022 transferred existing rulemaking authority to the CFPB.

283. Michael J. Aiello & 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.”).

284. § 1026(b), 124 Stat. at 1993.

institutions related to small businesses and residential mortgages.²⁸⁵ 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.

Section 1031 grants the CFPB broad authority to define and prevent “unfair, deceptive, or abusive acts or practices.”²⁸⁶ 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 commerce,” the term “abusive” is new and undefined.²⁸⁷ 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 the 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.²⁸⁸

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 before 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.²⁸⁹

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

285. *See, e.g.*, § 1071, 124 Stat. at 2056 (requiring lenders to collect and report small-business loan data); § 1094, 124 Stat. at 2097 (amending the Home Mortgage Disclosure Act to require lenders to collect and report an applicant’s credit score); *see also* U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-14-758, CONSUMER FINANCIAL PROTECTION BUREAU: SOME PRIVACY AND SECURITY PROCEDURES FOR DATA COLLECTIONS SHOULD CONTINUE BEING ENHANCED (2014), available at <http://www.gao.gov/assets/670/666000.pdf> (“To carry out its statutory responsibilities, the Consumer Financial Protection Bureau (CFPB) has collected consumer financial data on credit card accounts, mortgage loans, and other products through one-time or ongoing collections.”).

286. § 1031(b), 124 Stat. at 2005–06.

287. John T. Adams, *Consumer Financial Protection and Community Banks*, 35 U. ARK. LITTLE ROCK L. REV. 227, 239 (2013) (quoting 15 U.S.C. § 45(a) (2006)).

288. § 1031(d), 124 Stat. at 2006.

289. Adams, *supra* note 287, at 240 (alterations in original) (footnotes omitted).

regulators and by the market as protective of 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.²⁹⁰ 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 but may still reasonably be judged to be good credit risks by a lender with a fuller picture of the individual borrower and the local economy.²⁹¹

The admirable goal of the CFPB is to protect consumers. During the run-up to the 2008 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 began taking advantage of its customers, word would spread quickly, and it would soon be out of business. Even if the CFPB is necessary or advisable to protect consumers from large financial institutions and nonbank financial-service 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 Subtitle B (“Minimum Standards for Mortgages”), section 1411 (“Ability to repay”).²⁹² 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.”²⁹³ This intention of the provision is clear. As CFPB Director Richard Cordray 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

290. See Zywicki, *supra* note 253, at 917–23.

291. The uncertainty posed by the new “abusive” standard may also spur standardization by “increas[ing] the risks of offering customized products.” Adams, *supra* note 287, at 241.

292. § 1411, 124 Stat. at 2142.

293. *Id.*

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.²⁹⁴

While Cordray'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.²⁹⁵ Far fewer community-bank residential mortgage loans are sold. The standard practice of community banks is to make loans and keep those loans on their books until maturity or earlier repayment. The banks bear the risk that their underwriting was insufficient—that a borrower lacks the ability to repay a loan. In other words, again, the business model of community banks precludes them from participating in the sins that Title XIV 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 that the borrower had the ability to repay as of the time of disbursement, 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.²⁹⁶

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.²⁹⁷ 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) monthly payment on the covered transaction; (4) monthly payment on any simultaneous loan; (5) monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) monthly debt-to-income ratio; and (8) credit history.²⁹⁸ The rule includes additional guidance on how lenders should interpret and weigh each factor.

The “qualified mortgage” term is new to financial regulation, 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

294. Richard Cordray, CFPB, *Assuring Consumers Have Access to Mortgages They Can Trust*, CONSUMERFINANCE.GOV (Jan. 10, 2013) <http://www.consumerfinance.gov/blog/assuring-consumers-have-access-to-mortgages-they-can-trust/>.

295. *See supra* Part I.C.1.

296. A violation of TILA gives rise to liability for statutory damages, including actual damages incurred by the debtor plus a civil penalty. 15 U.S.C. § 1640(a)(1)–(2)(A)(i) (2012). A violation of TILA may also permit a borrower to rescind a loan, including a rescission of the security interest that the lender has in the borrower's principal residence. 15 U.S.C. § 1635(a) (2012). The borrower may also have the right to equitable modification under § 1635(b).

297. § 1412, 124 Stat. at 2145.

298. 12 C.F.R. § 1026.43 (2014).

themselves from mistakes that could lead to costly litigation. Beyond changing their processes for originating and underwriting residential mortgages, they will likely be compelled to hire additional compliance staff or outside consultants. On July 15, 2014, the Independent Community Bankers of America and a number of other organizations representing community banks wrote to Richard Cordray, urging the CFPB to revise the ability-to-repay / qualified mortgage rules “to allow community bank loans held in portfolio for the life of the loan to receive automatic [qualified-mortgage] safe harbor status and an exemption from the escrow requirements if the loans are higher priced.”²⁹⁹ The letter reiterated that the purpose of the qualified mortgage rule was to prevent predatory lending and that market forces already protected the customers of community banks:

Community banks operate under a completely different business model than that of the larger financial institutions and mortgage companies. They underwrite based on firsthand knowledge of their customers and communities, and thrive on the strength of their reputations. As such, community banks have every incentive to make fair, safe, and affordable loans.

. . . Therefore, additional underwriting and escrow requirements only function as unnecessary regulatory burdens that stifle community banks’ ability to provide solid loan products to consumers so they can achieve the American dream of home ownership. This reality seems inconsistent with the CFPB’s mission which is “to make markets for consumer financial products and services work for Americans.”³⁰⁰

III. REFORMING THE REGULATION OF COMMUNITY BANKS

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 Part examines two specific impacts of Dodd-Frank on community banks: increased compliance costs and increased standardization. The proper response to these impacts, 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 2008 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 goal requires the application of

299. Letter from Cmty. Banking Orgs. to Richard Cordray, Dir., CFPB 1 (July 15, 2014), available at <http://www.icba.org/files/ICBASites/PDFs/cl071514.pdf>.

300. *Id.*

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 sufficiently protect consumers. Community banks have far different incentives in underwriting solid loans than do 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. 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 the chief challenge facing community bankers—they must plan for a future in which the rules are largely unknown.³⁰¹

The most likely impacts of Dodd-Frank are twofold. First, community banks will incur significant compliance costs that will place them at a further competitive disadvantage as compared with 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 CFPB 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,³⁰² concluded that it is impossible at this time to quantify the costs that community banks will incur as a result of Dodd-Frank. This problem is due to two main factors.

First, there is considerable uncertainty regarding the content of roughly half of the rules mandated by the Act.³⁰³ 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.³⁰⁴

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 (e.g., 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

301. *Texas Community Banks Hearing*, *supra* note 107, at 13–14 (statement of Ignacio Urrabazo, Jr., President, Commerce Bank, Laredo, Texas) (“Community bankers are frustrated with the unknown . . .”).

302. See GAO-12-881, *supra* note 263; FDIC COMMUNITY BANKING STUDY, *supra* note 20.

303. See *supra* notes 278–79 and accompanying text.

304. See *supra* note 301 and accompanying text.

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

A 2013 Economic Policy Paper from the Federal Reserve Bank in Minneapolis attempted to quantify the cost of the increased regulatory burden.³⁰⁵ It did so by “modeling the impact of new regulatory costs as the hiring of additional staff, resulting in higher total compensation and lower profitability.”³⁰⁶ The analysis concluded that

the impact on profitability is most significant for the smallest institutions. The median bank with assets below \$50 million would experience a drop in [return on assets] of nearly 23 basis points, while the median firms in the larger size cohorts would encounter a decline of 11 basis points or less.³⁰⁷

As a result:

Nearly 60 percent of the total number of banks that would become unprofitable due to the regulatory change are in the smallest cohort using data from 2012. Moreover, 13 percent of the banks with assets less than \$50 million would become unprofitable, compared with roughly 2 percent or less of the other size groups.³⁰⁸

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.”³⁰⁹ 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.³¹⁰ He testified that four to five years ago, his bank had “maybe 7” people in compliance. In 2012, that number had ballooned to

305. RON FELDMAN, KEN HEINECKE & JASON SCHMIDT, FED. RESERVE BANK OF MINNEAPOLIS, QUANTIFYING THE COSTS OF ADDITIONAL REGULATION ON COMMUNITY BANKS (2013), available at https://www.minneapolisfed.org/pubs/eppapers/13-3/epp_13-3_community_banks.pdf.

306. *Id.* at 1.

307. *Id.* at 6.

308. *Id.* at 8.

309. Dreyer & Weinstock, *supra* note 59, at 100 (citing *Cutting Through the Red Tape: Regulatory Relief for America’s Community Based Banks: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 108th Cong. 32 (2004)).

310. *Texas Community Banks Hearing*, *supra* note 107, at 22 (testimony of Ignacio Urrabazo, Jr., President, Commerce Bank, Laredo, Texas).

48.³¹¹ The president of a \$177 million, thirty-seven-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.³¹²

The president of an eighty-year-old, \$150 million community bank located in Fort Stockton, Texas (population 8000), and Sanderson, Texas (population 750), testified that during the eleven 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 Frank-Dodd [sic], that will constitute 10 percent of my entire staff.”³¹³

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 data gathering and reporting mandated by the CFPB³¹⁴ and new requirements for underwriting residential mortgages.³¹⁵ 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].”³¹⁶

Community banks, particularly small institutions located in rural areas, may have difficulty recruiting and retaining qualified compliance officers. 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.³¹⁷

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 by 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

311. *Id.*

312. *Id.* (testimony of Lester Leonidas Parker, Chairman, President, and Chief Executive Officer, United Bank of El Paso Del Norte, El Paso, Texas).

313. *Id.* at 6–7 (statement of George H. Hansard, President and CEO, The Pecos County State Bank, Fort Stockton, Texas).

314. See Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring Under Dodd-Frank?* 46–48 (George Mason Univ. Mercatus Ctr., Working Paper No. 14-05, 2014).

315. *Id.* at 49–52.

316. *On the Record*, *supra* note 28.

317. *Texas Community Banks Hearing*, *supra* note 107 (statement of Cliff McCauley, Senior Executive Vice President, Frost Bank, San Antonio, Texas).

extending residential mortgage loans because of the increased costs.³¹⁸ 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.³¹⁹ “[It] makes no economic sense for us,” Mr. Purcell said.³²⁰

Community bankers have consistently expressed concern about the creeping regulatory-compliance burden.³²¹ Greg Ohlendorf, president of the \$150 million First Community Bank and Trust in Beecher, Illinois, put the new Dodd-Frank compliance costs in perspective:

What we have to understand is we’re already overburdened with regulation. We have significant numbers of regs that we need to comply with today, and it seems like just one more isn’t going to change the deck a whole lot, but the consistent piling on of additional regulation is very, very stunning. It’s punishing.³²²

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 compliance³²³

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

318. John Adams, *Dodd-Frank Rules Are IT-Cost Prohibitive for Some Banks*, AM. BANKER (January 14, 2013, 3:34 PM), http://www.americanbanker.com/issues/178_10/some-lenders-new-rules-are-it-cost-prohibitive-1055840-1.html.

319. *Id.*

320. *Id.*

321. *Regulatory Reform Hearing*, *supra* note 74 app. at 59 (prepared statement of Marty Reinhart, President, Heritage Bank, Spencer, Wisconsin) (“[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 & Weinstock, *supra* note 59, 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. Without the resources of larger institutions, smaller banks are likely to be overwhelmed.” (footnotes omitted)).

322. *On the Record*, *supra* note 28.

323. *Texas Community Banks Hearing*, *supra* note 107, at 6 (statement of George H. Hansard, President and CEO, The Pecos County State Bank, Fort Stockton, Texas).

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.³²⁴

The rising costs of regulatory compliance put a more significant relative burden on community banks than their larger cousins.³²⁵ For example, JPMorgan Chase estimates that its cost to comply with Dodd-Frank will be approximately \$3 billion over the next few years.³²⁶ In comparison, JPMorgan Chase lost \$6.25 billion in 2012 from losses incurred by a single credit-derivative trader known as the “London Whale.”³²⁷ Jamie Dimon referred to that loss as a “sideshow” and a “complete tempest in a teapot.”³²⁸ Despite the loss, JPMorgan Chase posted a record net income in 2012 of \$21.3 billion on total revenues of \$99.9 billion.³²⁹

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.³³⁰ A 1998 study by Federal Reserve staff found evidence that smaller banks are at a cost disadvantage compared to larger banks.³³¹ That cost disadvantage will intensify with further investments in compliance staff, technology, lawyers, and consultants.

324. *Id.* at 12–13 (statement of Lester Leonidas Parker, Chairman, President, and Chief Executive Officer, United Bank of El Paso Del Norte, El Paso, Texas).

325. *Regulatory Reform Hearing*, *supra* note 74, at 14 (statement 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.”).

326. Letter from Jamie Dimon, Chairman & Chief Executive Officer, JPMorgan Chase, to JPMorgan Chase Shareholders 17 (Mar. 30, 2012), *available at* <http://online.wsj.com/public/resources/documents/dimon.pdf>.

327. Jessica Silver-Greenberg, *Mortgage Lending Helps JPMorgan Profit Rise 34%*, N.Y. TIMES, Oct. 13, 2012, at B1.

328. Poly Lesova, *Dimon: London Whale Issues “Tempest in a Teapot,”* MARKETWATCH (Apr. 13, 2012, 9:37 AM), <http://www.marketwatch.com/story/dimon-london-whale-issues-tempest-in-a-teapot-2012-04-13-937450>.

329. Press Release, JPMorgan Chase & Co., JPMorgan Chase Reports Fourth-Quarter 2012 Net Income of \$5.7 Billion, or \$1.39 Per Share, on Revenue of \$24.4 Billion (Jan. 16, 2013), *available at* http://files.shareholder.com/downloads/ONE/3462396563x0x628657/e9bf2070-50c9-4a9d-a842-4f45812989fe/JPM_4Q12_EPR_FINAL.pdf.

330. Zywicki, *supra* note 253, at 885 (“It is well established that certain types of regulatory compliance costs, such as paperwork and other oversight costs, are largely invariant to the size or output of a firm, and thus fall proportionately harder on smaller firms in an industry. It is unsurprising, therefore, that community banks and credit unions have expressed grave concerns about Dodd-Frank’s and the CFPB’s punishing regulatory compliance costs.” (footnote omitted)).

331. Gregory Elliehausen, *The Cost of Banking Regulation: A Review of the Evidence*, FED. RES. BOARD STAFF STUD., Apr. 1998, at 1, *available at* <http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss171.pdf>.

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” impose a more significant relative burden on smaller banks due to economies of scale.³³² “As a result, smaller banks face higher average regulator [sic] compliance costs than larger banks, especially in connection with these start-up activities.”³³³

B. Standardization

A recurring theme in Dodd-Frank, particularly with respect to the CFPB, is that the standardization of financial products and forms will protect consumers. This is implicitly a reaction to the narrative that one of the causes of the 2008 financial crisis was the inability of parties to understand and appreciate the risks of innovative financial products.³³⁴ But the focus on standardization of consumer financial products, like home loans and checking accounts, fails to recognize the value to consumers of the community-banking model, which emphasizes relationship banking, personalized underwriting, and customization of financial products to meet the specific needs of customers and communities.³³⁵ One of the chief advantages of community banks is their ability to successfully lend to borrowers who are “informationally opaque” because they do not have the deep credit history necessary for the model-based lending used by large financial institutions.³³⁶

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.³³⁷ Esther George, president and CEO of the Federal Reserve Bank of Kansas City, expressed concern in 2012:

332. Adams, *supra* note 287, at 242 (citing Ellichausen, *supra* note 331, at 16–19).

333. *Id.*

334. See Zywicki, *supra* note 253, at 901 (“Elizabeth Warren has pined for a return to a supposed golden age of simple consumer credit products and has argued that the only reason for increased complexity in credit card agreements is to create ‘tricks and traps’ for consumers. Yet nearly everything consumers purchase is too complex for them to understand all the details, features, and dangers of those purchases—whether the product is a car, computer, or medical service. Yet it would be absurd to argue that the only reason that sellers have replaced typewriters with computers is *because* computers are more complex and bewildering than typewriters, thereby enabling computer sellers to trick and harm consumers more easily by selling them computers when consumers would prefer typewriters. . . . Thus, while simplification is a useful goal, it cannot be a transcendent goal in itself—at least not without considering functionality and the role of consumer choice.” (emphasis in original) (footnote omitted)).

335. See *supra* Part I.B.

336. See *supra* text accompanying note 163.

337. See Wilmarth, *supra* note 57, at 39 (“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

[T]he Consumer Financial Protection Bureau will be rewriting many of the key regulations related to mortgage lending.

This approach of specifying how residential mortgage loans should be structured and underwritten will undoubtedly leave community bankers with far less flexibility and authority to tailor such lending to the characteristics of their communities and customers. . . . [I]t is not uncommon to hear community bankers say that they may be forced to cut back substantially on their home lending activities or even eliminate them entirely. Such unintended consequences are costly and impede mortgage lending at a time when housing markets are weak.³³⁸

In addition, due to their higher operating costs relative to larger banks based on economies of scale, if community banks are forced through standardization into small versions of large financial institutions, they will be at a severe competitive disadvantage.³³⁹

C. Four 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.³⁴⁰

many lines of business and broad geographical areas. It is, therefore, 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.”).

338. George, *supra* note 104, at 6.

339. Zywicki, *supra* note 253, at 885–56 (“[S]maller banks compete by providing more personalized services, such as designing products specifically tailored to individual needs. Dodd-Frank and the CFPB, however, push toward making consumer credit more like a standardized commodity rather than permitting banks to tailor their consumer credit products to the needs of particular borrowers.”); Letter from Craig G. Blunden, Chairman, President & CEO, Provident Sav. Bank, David A Bochnowski, Chairman & CEO, Peoples Bank, Thomas L. Hoy, Chairman, President & CEO, Arrow Fin. Corp., Robert R. Jones, III, President & CEO, United Bank, Robert V. Macklin, President & CEO, The Milford Bank & Julieann M. Thurlow, President & CEO, Reading Co-operative Bank, to Timothy F. Geithner, Sec’y of the Treasury, U.S. Dep’t of the Treasury, at 2 (Aug. 18, 2009), available at 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.”).

340. Without the additional burdens imposed by misregulation, community banks face “factors and circumstances” that

argue against the long-term success of community banks: excessive concentration of risk in lending; competitive pressures from deregulation and new technologies; and limitations on market power, brand recognition, and

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 hazards posed by each to prudential risk, consumers, and systemic risk are fundamentally different. With this principle in mind, I endorse four major reforms.

1. Narrow Banking

Congress should adopt a narrow-banking regulatory approach that would tightly limit the activities banks can engage in. A number of scholars have endorsed narrow-banking proposals.³⁴¹ Essentially, narrow banking means creating a two-tiered system of bank regulation that would restrict traditional banking organizations to traditional activities like deposit taking, lending, fiduciary services, and other activities that are “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.³⁴² 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.³⁴³ 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.”³⁴⁴ 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.”³⁴⁵ As the 2008 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.”³⁴⁶ As Amar Bhidé argues, “Without

technological investment. Their size presumably prevents smaller banks from adequately diversifying credit risk and prevents management from investing sufficiently in new technologies to compete effectively.

Hein et al., *supra* note 90, at 16–17 (footnote omitted).

341. See 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* (pt. 1), BANKING & FIN. SERVICES POL’Y REP., Mar. 2012, at 1 [hereinafter Wilmarth, *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* (pt. 2), BANKING & FIN. SERVICES POL’Y REP., Apr. 2012, at 1; Wilmarth, *supra* note 57, at 77–88.

342. Wilmarth, *Narrow Banking*, *supra* note 341, at 1.

343. *Id.* at 5.

344. *Id.*

345. Amar Bhidé, *In Praise of More Primitive Finance*, ECONOMISTS’ VOICE, Feb. 2009, at 1, 3.

346. *Id.* at 4.

deposit insurance—and the reassurance of state supervision—most depositors, even sophisticated ones, would shun banks that traded futures. Paltry passbook rates simply wouldn't compensate for the risks."³⁴⁷

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 that 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 that “investors do not price the true, intrinsic ability of a [big] bank to repay its debts, but instead price implicit government support for the bank.”³⁴⁸ The authors of the study also concluded that “[t]he passage of Dodd-Frank in the summer of 2010 did not significantly alter investors’ expectations of government support.”³⁴⁹ 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.³⁵⁰ The best way to eliminate the implicit too-big-to-fail subsidy is to adopt a regulatory approach that separates traditional banks.

2. Limit Standardization

As the description of the typical residential real-estate loan package in Part 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 CFPB 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 CFPB, 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 agree on whether banks should be chartered by the states or the federal government.³⁵¹ More than two

347. *Id.* at 3.

348. Wilmarth, *Narrow Banking*, *supra* note 341, at 4 (alteration in original); *see also* Viral V. Acharya, Deniz Anginer & A. Joseph Warburton, *The End of Market Discipline? Investor Expectations of Implicit Government Guarantees* (June 2014) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961656.

349. Acharya et al., *supra* note 348, at 29.

350. In fact, as Professor Arthur E. Wilmarth has noted, “Dodd-Frank does not completely shut the door to future government bailouts for creditors of SIFIs.” Wilmarth, *Narrow Banking*, *supra* note 341, at 1–2.

351. *See supra* notes 208–10 and accompanying text.

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.”³⁵² 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?³⁵³

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.”³⁵⁴ Felsenfeld and Bilali also concede that “fierce resistance” could be expected from the “state banking authorities (and perhaps the national authority too).”³⁵⁵ 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 anticonsumer practices. Community banks depend on 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 than a 168-page residential real-estate lending packet does. With this in mind, we should ask whether there should be safe harbors from certain reporting and disclosure requirements for community banks below a certain size.

We should also question whether consumer protection belongs in the province of federal or state law. One observer argued that federal preemption of state consumer-protection laws before the 2008 financial crisis created a “race to the bottom,” which permitted the predatory lending and abusive practices in subprime lending.³⁵⁶ This pattern of preemption continued in Section 1044 of Dodd-Frank.³⁵⁷ 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.

352. Felsenfeld & Bilali, *supra* note 207, at 80.

353. *See* Butler & Macey, *supra* note 231, at 680 (“[U]nder the current FDIC insurance system, there is no legitimate role for state regulation of bank activities.”).

354. Felsenfeld & Bilali, *supra* note 207, at 79.

355. *Id.*

356. 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).

357. *Id.*

CONCLUSION

The purpose of Dodd-Frank was to protect consumers and the stability of the financial system. Community banks provide vital services to millions of Americans, many of whom would be underserved if the community-bank model were broken or if community banks were to 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 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 be better able 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 toward protecting the relationship-banking model and reversing the trend of asset consolidation in a small number of large, complex financial institutions.

