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Thanks to Dodd-Frank, Community Banks Are Too Small to Survive

By: Louise Bennetts - NOVEMBER 9th, 2012

Politicians may wax lyrical on the importance of community banks to local economies and regulators may claim the focus of their efforts is on institutions that are "too big to fail," but the facts tell a different story.

The Dodd-Frank Act, sold to the public as the tamer of the "Wall Street Titans," may well end up having a disproportionate impact on smaller institutions, thanks to the costs of capital implications of being "*not* too big to fail" and the advent of the Consumer Financial Protection Bureau.

And things are really bad when even the regulators begin to notice. Comptroller Thomas Curry stated in his speech to the Florida Bankers Association last month that Dodd-Frank contained "a number of provisions that… many in the industry thought would not apply to community institutions." In particular, the move away from institutional reliance on credit ratings agencies will have a profound impact on community banks, which lack the institutional structures and analytical resources to undertake independent due diligence.

Granted, a retreat from the largely fictitious ratings system that continues to dominate the capital markets and lending practices is not a bad thing, even if it puts smaller banks at a disadvantage in the market. Nor is encouraging banks to undertake some diligence on their clients.

More problematic is the implicit government guarantee that underpinned the 2008 bailouts – and which, despite claims to the contrary, lives on in the Dodd-Frank systemic risk regime. Prior to the crisis, community banks were mostly subject to lower funding costs, being largely deposit-taking institutions that avoided the costly debt-financing

activities of larger institutions. As of the second quarter and using the cost of funding earning assets as a proxy for the cost of capital, banks with in excess of $1 billion in assets have almost half (0.39%) the cost of capital of institutions with less than $1 billion (0.74%), according to the FDIC's latest Quarterly Banking Profile. This puts smaller banks at a distinct disadvantage unrelated to their activities and financial health.

Furthermore, the rules and regulations developed by the CFPB will affect all commercial banks, regardless of size, and will have a disproportionate impact on community banks (even though, in theory, the agency should supervise only financial institutions with assets in excess of $10 billion).

The largest banks, in particular those that operate in the more complex capital markets arena, are unlikely to regard the CFPB as anything other than additional red tape, in part because they serve a different market. Large corporates are unlikely to run to the CFPB if they feel underserved by a Goldman or a Citigroup.

In contrast, if public statements are anything to go by, the CFPB is clearly targeting its efforts at the consumers who use community banks. The CFPB's website highlights the bureau's focus on groups such as pensioners, students and consumers who lack financial literacy. And that means significant compliance costs that community banks will find harder to absorb.

And community banks face challenges beyond the unseen small-bank implications of Dodd-Frank. The Fed's artificially low interest rate environment means the traditional business of lending is not especially lucrative and the disincentive to save makes deposits harder to come by. So the banks will need to focus on generating other types of fee-based revenue, which will hurt consumers who will need to pay more for loans and basic banking services, or quit the market.

All of these factors are also coupled with distinct unwillingness on the part of federal regulators to approve new bank charters. In 2006, they approved over 170 new national bank charters, excluding conversions and the purchase of assets of failed banks. In 2011, the OCC approved a single *de novo* national bank charter.

It wasn't always so. For decades, community and regional banks received special protection from state banking laws and the implicit guarantee provided by federal deposit insurance. Despite the many community bank failures during and in the aftermath of the 2008 financial crisis, the U.S. still has more than 7,000 banks – more than any other country.

It is questionable whether this structure would ever have developed without the protections afforded to smaller banks before the crisis, and whether the U.S. market needs quite so many banks. International experience suggests not. The Canadian and South African banking systems – the world's "soundest"according to the World Economic Forum's 2012 Global Competitiveness Report – are both extremely concentrated.

Though some consolidation – particularly outside of the largest few – is probably a good thing, it should be driven by the market, independent of regulatory and short-term interest rate considerations and regulators should give new, innovative firms sufficient space and flexibility to survive. Crippling community banks under a heavy regulatory weight is not the way to bring about structural change.