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Written Testimony of

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Subcommittee on Financial Institutions and Consumer Credit

"Rising Regulatory Compliance Costs and Their Impact on the Health of Small Financial Institutions"

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Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation. Professor Levitin has previously served as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP) and as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony, and he is not testifying on behalf of any organization.

Ms. Chairman Capito, Ranking Member Maloney, Members of the Subcommittee:

Good morning. My name is Adam Levitin. I am a Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in financial regulation. I have also previously served as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP).

I am here this morning to urge the Subcommittee to be cognizant of the regulatory burdens on small financial institutions, but also to take a targeted, nuanced approach in considering any changes to the current regulatory regime. While there are areas in which regulatory burdens on smaller financial institutions can and should be reduced, it should be a surgical operation and not serve as cover for a broader ideological agenda of financial deregulation was a significant cause of the financial crisis in 2008.

In particular, it bears emphasis that the problems of smaller financial institutions are not the product of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Dodd-Frank Act itself did little to affect the regulatory burden of small banks. Moreover, part of the Act, the Durbin interchange amendment, actually makes small banks more competitive in a core product market—the deposit account. The Durbin interchange amendment is arguably the single best legislative development for small banks in the past two decades.

Pointing the finger at "overregulation" avoids discussion of the real problems in the small bank business model in a world of megabanks. Going back to where we were before the financial crisis in terms of regulation will not stem the decline in the number of small banks and credit unions.

DOES DODD-FRANK AFFECT SMALL BANKS' REGULATORY BURDENS?

There is no doubt that the 849 pages of the Dodd-Frank Act plus its numerous implementing regulations will add to the regulatory burdens of financial institutions. This is not entirely a bad thing. Some of these increased burdens are misguided or wishful regulation, such as the Orderly Liquidation Authority in title II of the Act. Other provisions, however, are important and necessary safeguards to protect the U.S. economy from excessive risk-taking by financial institutions seeking to maximize their short-term profits such as we saw during the housing bubble from 2003-2008.

The 2008 financial crisis was driven primarily by the behavior of large banks, not small. Small banks and credit unions were generally victims, not perpetrators of this crisis. Accordingly, it would be unfair if small banks bore the brunt of the regulatory response. As it happens, however, few of the regulatory burdens of the Dodd-Frank Act actually fall on small banks and credit unions. Most of the burdens fall on the large banks and their investment affiliates.

While the financial institution lobbying associations testifying today are all concerned about regulatory burdens, it is simply hard to identify much in the Dodd-Frank Act that has already affected small banks' and credit unions' regulatory burdens. This is not to say that there are not significantly regulatory burdens that come with the privilege of a banking charter or that these burdens affect small banks more because they lack their larger competitors' economies of scale. But the problems facing small banks are not the product of the Dodd-Frank Act. Instead, it is simply increasingly difficult for smaller financial institutions to compete with larger banks that can leverage economies of scale and more diversified lending bases to their advantage in terms of funding, hiring, technology, and compliance. This challenge is all the greater in a period of high unemployment, foreclosures, and underwater mortgages.

If Congress is looking to help make small banks more competitive, then rolling back the Dodd-Frank Act is hardly the way to go. The solution is not so much reducing regulatory burdens on small banks as increasing them on the too-big-to-fail megabanks so as to truly end our too-big-to-fail problem. Put another way, if we want to slim down our biggest banks, the solution is not to make smallness marginally cheaper, but to make bigness more expensive so that we do not have too-big-to-fail megabanks.

Turning to the Dodd-Frank Act itself, I can only identify a handful of provisions that meaningfully affect small banks' regulatory compliance burdens. Dodd-Frank has sixteen titles. Thirteen of the sixteen have no or the most indirect bearing whatsoever on small banks and credit unions: Titles I (financial stability), II (orderly liquidation authority), III (changes to bank regulators), IV (investment advisors for hedge funds), V (insurance), VII (swaps), VIII (clearinghouses), IX (securities investor protection), XI (Federal Reserve system changes), XII (authorizing grants for experimental small dollar loan programs) XIII (TARP fund repayment), XV (miscellaneous issues like conflicts minerals, and XVI (section 1256 contracts). That leaves only titles VI, X, and XIV to be addressed. An examination of these titles indicates that none of them have yet to increase small banks' regulatory burdens and that they could in fact help to *decrease* them in some instances.

Title VI

Title VI of Dodd-Frank makes changes to the regulation of bank holding companies. By and large these changes are incremental; they do not add major new compliance costs. Instead, title VI does things like expand the limitation on loans to insiders to include derivative transactions that may be economically equivalent to a loan exposure.[1] While there is some increased compliance cost to determining if a derivative transaction with an insider qualifies, this is not a likely scenario for small banks.

Title X

Title X of Dodd-Frank creates the Consumer Financial Protection Bureau (CFPB). While the CFPB has been the focus of a great deal of angst from the financial services industry, it has not materialized as the boogeyman that was feared. To date, the CFPB has not undertaken any action that would warrant alarm except from those opposed to consumer protection as an ideological matter.

The CFPB has also had little effect on small banks thus far. First, the CFPB does not have examination authority over small banks.[2] That authority remains with the small banks' prudential regulators. Second, other than a rulemaking on remittances required by Dodd-Frank,[3] the CFPB has not yet engaged in a rulemaking under a power created by Dodd-Frank. *All other CFPB rulemaking activity has been under pre-existing federal consumer protection laws that were merely transferred to CFPB as part of Dodd-Frank*. Therefore, it is hard to point to Dodd-Frank as having already created additional regulatory burdens for small banks via the CFPB,

[1] Dodd-Frank Act § 611, *codified at* 12 U.S.C. §1828(y).
[2] Dodd-Frank Act § 1026, *codified at* 12 U.S.C. § 5516.
[3] Dodd-Frank Act § 1073, *codified at* 15 U.S.C. § 1693o-1.

with one exception: section 1071's requirement that the CFPB collect data on small business loans.[4]

A. Section 1071 (Small Business Data Collection)

Section 1071's small business loan data collection requirement (not yet implemented via regulation) will add to small banks' regulatory burden. The real burden, however, is fairly minimal. It should not take a lot of effort to obtain and record some very basic information about a borrower and to keep it separate from the loan underwriting process: the date of the loan application, the type and purpose of the loan being applied for, the amount of credit applied for and approved, the bank's action on the loan (grant, deny, etc.), the census tract of the residence of the applicant's principal place of business (the FFIEC website enables free conversion of street addresses to census tracts[5]), the applicant's gross annual income in the preceding year, and the applicant's race, sex, and ethnicity. This is less than a page of information to be requested from a borrower. Obtaining it, recording it into an electronic record, and storing that record so that it cannot be accessed by underwriters involves some minor initial costs and then *de minimis* on-going compliance costs.

There is also good reason, however, to mandate this data collection. First, financial regulators know shockingly little about lending. It may surprise members of this Subcommittee, but federal regulators do not know basic things like the number of mortgages in the United States (estimated to be between 50-60 million), the amount of credit card debt (the Federal Reserve's statistics lump together credit card debt with overdraft and other revolving consumer debt), or the amount of student loan debt (simply estimated). Likewise, we are told that community banks are the major source of credit for small businesses. I have no reason to doubt it, but I am unaware of any hard data supporting the claim. It's hard to craft good regulatory policy without good data; absent data, regulators are flying blind.

Second, the small business lending data collection requirement is meant to facilitate the application of the Equal Credit Opportunity Act, particularly to protect women-owned and minority-owned small businesses from discriminatory lending. The simple collection of the data may itself help to ensure against discriminatory lending, but without the data it is difficult to determine if such discriminatory lending does in fact exist. If we value fair, equal, non-discriminatory access to credit as a society, then this data collection is the price to pay for it.

Other than section 1071, however, title X of Dodd-Frank does not in and of itself add to small banks' regulatory burdens. If and when the CFPB starts to use its Dodd-Frank rulemaking powers other than under the "enumerated consumer laws" transferred to the agency, this situation may change, but until that point, it is premature to point to title X or the CFPB as a source of increased regulatory burdens. The CFPB has not yet materialized as the boogeyman of over-regulation. Indeed, the transfer of existing federal consumer laws to the CFPB actually added a layer of additional protection from undue regulation for small banks. The CFPB, unlike other federal financial regulators, is required to submit its rulemakings to small business panels for preliminary review under the Small Business Regulatory Fairness Act. Thus, the transfer of existing federal laws to the CFPB is likely to reduce, rather than increase regulatory burdens as the result of rulemaking activity.

[4] Dodd-Frank Act § 1071, *codified at* 15 U.S.C. § 1691o-2.

[5] http://www.ffiec.gov/Geocode/default.aspx.

B. Section 1075 (Durbin Amendment)

Title X of the Dodd-Frank Act also includes the Durbin Interchange Amendment (section 1075 of the Act).[6] While many small banks and credit unions opposed the Durbin Amendment, it has thus far proven to be a competitive boon for them, as I and others predicted.[7] The Durbin Amendment is the single best piece of legislation for small banks in the past two decades.

Statistics released by the Federal Reserve Board this month indicate that the Durbin Amendment has resulted in two-tiered interchange fee pricing that is very favorable to smaller banks and credit unions, which are making on average 50 basis points or 19 cents more than large banks on every debit card transaction.[8] Small banks feared that there would not be two-tiered pricing, but there is every reason for the payment card networks to have two-tiered pricing as they compete for small banks' business.

The Federal Reserve statistics also show that small banks' share of the debit card payment market increased slightly,[9] perhaps as a result of consumers shifting their accounts away from large banks that have tried, unsuccessfully to make up for reduced interchange revenue by raising consumer fees. In other words, the Durbin Amendment has helped level the playing field for small banks to compete for payments, where they face disadvantages because they lack the large banks' economies of scale. By making small banks more competitive with deposit accounts—the gateway financial product—they are more competitive in general because of greater cross-selling opportunities. In any event, the Durbin Amendment creates no real regulatory burdens for small banks; its burdens fall on payment card networks.

Title XIV & Escrow Requirements

Title XIV of the Dodd-Frank Act, the Mortgage Reform and Anti-Predatory Lending Act, creates a range of new requirements for mortgage lending. The CFPB has been charged with implementing title XIV via regulations. To date the CFPB has not promulgated any regulations under title XIV.

Most of the prohibitions in title XIV have limited impact on small banks; the prohibitions are aimed at the most exotic and aggressive mortgage products, namely those that fueled the housing bubble. These products were not generally part of small depositaries' offering. (They were frequently offered by small finance companies.)

Title XIV actually offers an opening for *reducing* compliance costs for small banks. A major pre-Dodd-Frank Act compliance cost for small banks was the Reg Z escrow requirement for high-cost Home Ownership and Equity Protection Act of 1994 (HOEPA) loans.[10] In July 2008, the Federal Reserve promulgated its first rulemaking under HOEPA. The rulemaking required that borrowers have the ability to repay, prohibiting some prepayment penalties, and

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[6] Dodd-Frank Act § 1075, codified at 15 U.S.C. § 1693o-2.

[7] *See, e.g.*, Adam J. Levitin, *Interchange Regulation: Implications for Credit Unions*, Filene Research Institute, Issue Brief 224 (Nov. 2010), at 37-39, *at* http://www.law.georgetown.edu/faculty/levitin/documents/LevitinFileneInterchangeBrief.pdf.

[8] *See* Board of Governors of the Federal Reserve System, Average Debit Card Interchange Fee by Payment Card Network, *at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120501a1.pdf. *See also*, accompanying data release, *at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120501a2.xls.

[9] *Id.*

[10] 12 C.F.R. § 226.35(b)(3).

requiring escrowing of taxes and insurance.[11] The escrow provision did not go into effect until April 2010, in response to community bank concerns about the difficulties and costs in setting up escrows.[12]

The reach of the escrow requirement is quite broad in a low interest rate environment. Higher priced loans are currently defined as those with APRs at least 1.5 percentage points higher than the prime rate for loans within the GSE conforming loan limit or at least 2.5 percentage points higher than the prime rate for loans larger than the conforming loan limit.[13] In today's low-rate environment, this means a 5.26% APR loan could require an escrow.

Section 1461 of the Dodd-Frank Act authorizes the CFPB to exempt small originators or those in rural and underserved areas from escrow requirements.[14] While an understanding of the particular cost problems involved in escrowing would seem essential to any rulemaking,[15] it seems reasonable for the CFPB to exercise its authority to exempt some depositaries from the escrow requirement. The CFPB has not yet passed regulations under title XIV or on HOEPA loans, but it is important to recognize that CFPB regulatory action can *decrease* as well as increase regulatory burdens.

SMALL BANKS' REGULATORY BURDENS

While many small banks and credit unions believe that their regulatory burden is too great, it has little to do with the Dodd-Frank Act. Therefore, concerns about the regulatory burdens on small banks do not provide a good justification for altering or repealing provisions of the Dodd-Frank Act. If there is a problem with the burdens created by specific regulations, then by all means, we should reexamine those regulations and decide if they make sense.

There are unquestionably financial regulations that do little other than add to regulatory burdens. For example, the Gramm-Leach-Bliley Act/Reg P privacy disclosures create an on-going regulatory burden for financial institutions, which have to craft their privacy policies and send annual disclosures to consumers, irrespective of whether there have been changes to the policies.[16] Yet the benefits from these disclosures are at best small and likely non-existent or negative; few consumers read the policies, and they cannot be negotiated. Gramm-Leach-Bliley Act privacy disclosures instead substitute for meaningful substantive privacy protections. While I would urge Congress to consider more substantive privacy protections rather than mere disclosure that there are few protections, I would also urge the elimination of the entire Gramm-Leach-Bliley Act privacy disclosure requirement even if there is no substantive replacement, and, at the very least, eliminate the requirement of an annual disclosure when there has been no change to the policy.

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[11] 73 Fed. Reg. 44522-44614 (July 30, 2008). If the Federal Reserve Board had acted on its regulatory authority between 1994 and 2008 rather than deliberately refraining from regulation because of an ideological antipathy toward regulation, the housing bubble and ensuring financial crisis would have been much less severe.

[12] 73 Fed. Reg. 44562 (July 30, 2008).

[13] 15 U.S.C. § 1639d(b)(3)(A)-(B).

[14] Dodd-Frank Act § 1461, *codified at* 15 U.S.C. § 1639d(c).

[15] In the original HOEPA rulemaking, the Federal Reserve Board noted that "A few small lenders commented that the costs of setting up escrow accounts are prohibitively expensive but did not disclose what such costs are." 73 Fed. Reg. 44597 (July 30, 2008). Fact-based rulemaking requires a close analytic look at regulatory costs, rather than blithe acceptance of statements of interested parties.

[16] 15 U.S.C. § 6803; 12 C.F.R. § 216.5.

In considering the regulatory burdens on small banks, it is important not to lose sight of something very fundamental: banks exist first and foremost to serve the public and only secondarily for their shareholders. Banks are not like ordinary businesses. Entry into banking is limited. It is a privilege, not a right, and banks have duties and responsibilities that no other businesses have because of their special role in the national economy. Banks' right to make a profit is always subject to their safe and fair provision of financial intermediation services.

There's a rough market barometer of whether we are overregulating the banking industry, namely whether banking is attracting sufficient private risk capital to meet America's financial intermediation needs. Putting aside the long-standing problem of provision of financial services to rural or poor urban communities (situations in which small depositaries are especially important), there is nothing that that regulation is driving out public risk capital by depressing bank profitability to the point that a bank is an unattractive investment. As it is, the size of the US banking sector has been growing, not shrinking.[17] (The number of banks has been shrinking,[18] but that is a separate issue about real and perceived economies of scale in financial services.)

CONCLUSION

There's a lot to like about small depositaries—they're community-based, the service is better, and they generally don't try to ensnare their customers—their neighbors—with tricks and traps. Their business model is built on relationships and loyalty. Yet, it's not clear whether the small bank business model is long-term viable against large banks in an age of interstate and international branch banking any more than the corner green grocer can survive against Wal-Mart.

Unfortunately, there's a temptation for small banks to point the finger at overregulation because they believe they are more likely to accomplish changes there than by pushing against too-big-to-fail, and this lets small banks' business model problems be hijacked for ideological deregulatory agendas. But does anyone really believe that repealing regulations like the requirement that ATMs have signage merely noting that fees may apply will fundamentally affect the position of small banks?[19]

If we truly value small banks, the best way to help them is not to chip away at their marginal regulatory burdens and pretend that it will fix everything. The strains on the small banking business model should not provide cover for deregulatory agendas. Instead, to help small banks, we need to focus on eliminating too-big-to-fail institutions that put the entire economy at risk.

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[17] FDIC Statistics on Depositary Institutions (Total Assets, All Institutions—National) (showing annual growth every year since 1992 with the exception of decline from 2008-2009).

[18] FDIC Statistics on Depositary Institutions (Number of Institutions Reporting, All Institutions—National).

[19] *See* Letter from ICBA to CFPB, dated Mar. 5, 2012, *at* http://www.icba.org/files/ICBASites/PDFs/ICBA%20Comment%20Letter%20CFPB%202011%200039.pdf (urging the repeal of ATM signage requirement of 12 C.F.R. § 205.16(c)).