Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Public Policy Conflict*

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This is a short note describing what appears to be a bit of a puzzle in the bank regulatory sector of our economy. The note offers no solutions.

The issue is best framed by the persistent voice given to those who argue that lesser regulation is beneficial for the economy when it is applied to smaller banks. Smaller banks, the argument goes, should not go the way of the corner drugstore, and if the increasing burden of regulations continues, it will cause them to be unable to make their hurdle rates, which, in turn, will led to consolidation throughout the sector of community banks. The numbers and the services they provide will be reduced.

If they do vanish (to continue the argument), or are consolidated, with the surviving institution growing in size, the prospects for small entrepreneurial businesses to be funded will diminish dramatically, and since the new jobs in the economy frequently come from such businesses, the economy, in turn, will be harmed.

The answer recommended by those who make that argument is relaxation or elimination of certain regulations. As phrased by Richard Parson in a recent American Banker article:

Congress, in its capacity as maker of laws, should ask federal and state bank supervisors to conduct a full accounting of all bank regulations borne by small community banks, with the intention of eliminating everything that is not critical to the safety and soundness of the U.S. banking system, and the long-term vitality of community banks.

If [Congress] seeks a risk-free banking system for social-engineering and quasi-policing purposes, legislators must recognize that such a system comes at the expense of another presumed public policy goal: the preservation of a banking system with healthy, profitable community banks.[1]

It is becoming accepted lore that community banks are being crippled by a variety of issues, including lack of succession possibilities, increased competition, lowered margins, difficulty in finding acceptable directors in the cyber age, and most of all — a crushing burden of bank regulations.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] "Two Policy Changes That Could Help Save Community Banks," Richard J. Parsons, American Banker, May 1, 2014. The author explains his thinking further in his book, Broke: The American Banking System — Common Sense Ideas to Fix Banking in America , Risk Management Association, 2013.

The solution proposed — relaxation of social-engineering and policing regulations and focus on safety and soundness — would make some of those problems less imposing, and would probably extend the life of a few thousand of the 7,000 or so community banks remaining in the country.[2] Most likely that would be beneficial to a number of small businesses and useful for the U.S. economy.

Congress and the regulators are paying some attention to these pleas. For example, there are special rules on stress testing so that community banks are not obliged to engage the resources to conduct such tests, even though one could argue that this particular rule is designed strictly for safety and soundness purposes. Smaller institutions are exempt from certain Ability to Repay rules on their residential mortgages, if they don't make too many of them. Community banks are specifically exempted from the enhanced risk management rules recently published by the OCC. The CFPB does not have authority to examine community banks. Community banks do not have caps on interchange fees on debit cards.

But other rules have not been relaxed. For example, community banks are currently feeling a rush of regulatory pressure on loans directly or indirectly to payday lenders and similar businesses that the Administration believes should be eliminated, i.e., the notorious "Chokepoint" approach to regulation, notwithstanding that many of them seem to be operating legally under state laws.[3] The pressure to ensure tight compliance with the Bank Secrecy Act continues, including the need to have separate staff and to prepare major documentation to show compliance. Fair Lending rules have not been relaxed and the aggressive interpretation of those laws embedded in the disparate impact theory of discrimination applies to community banks.

It is difficult to conclude that community banks were providing the same protections to their customers before passage of the Dodd-Frank Act (and the implementing regulations) as the Act and its regulations require. It is likewise difficult to convincingly argue that all of the non-safety and soundness rules should be ignored for any group of customers simply because they happen to be served by a bank that is not too large.

There is another perspective to this problem faced by community banks, however, though it is somewhat concealed. If community banks could be a better engine for our economy if the rules under which they operate were limited to safety and soundness rules, wouldn't that be true for larger banks also?

If banks between $10 billion and $50 billion, for example, were required only to operate in a safe and prudent manner, their compliance costs would be reduced, just how much would be dependent upon an analysis of how much compliance time and resources are devoted to non-safety and soundness compliance.[4] But it would be a significant number.

The same would be true for banks over $50 billion in size, although since the share of the economy occupied by those banks is so much larger than that of community banks, the impetus to the economy would be significantly larger.

Viewed another way, if consumers who are customers of community banks are not injured by not being covered in some of their dealings with community banks, then why would they be injured if they were not

[2] For reference regarding consolidation pressures, there were over 11,000 community banks 20 years ago, and over 9,000 just 10 years ago.

[3] While there is some mystery around the origination and goals of this Justice Department/bank regulators operation, it seems to be targeted on a variety of activities that the FDIC, in 2011, said created high-risk to bankers who loaned them funds. Those activities include such businesses as coin dealers, dating services, lottery sales, money transfer networks, payday loans, pharmaceutical sales, gun sales, fireworks sales, surveillance equipment, tobacco sales and travel clubs. It lists 30 in all.

[4] There is an argument that the consumer protection laws are, at the end of the day, safety and soundness laws because they prevent litigation costs and possible reputation risks.

covered in some of their dealings with banks of $10 billion and above? Or from another perspective, if they are injured by not being covered in some of their dealings with community banks, what is the public policy that supports that?

In other words, there would appear to be some public policy that requires that consumers, (to take one customer group), wherever they may be located, to have the benefits of equal protection under consumer laws. To exclude some because they selected a smaller bank for its services, would suggest that the laws may be designed for purposes other than the protection of consumers.[5]

In summary, it does appear to be the case that increases in regulatory burden are making the continued existence of some community banks a doubtful probability, and if the arguments are correct, that will damage our economy. A logical extension of the arguments is that that same regulation will be damaging to the economy even if the banks against whom it is applied are larger and may not fail or merge as a result of the regulatory burden. It will be expensive and will be reflected in less vigorous economic performance because of increased prices to consumers, fewer products and services offered, etc.

At the same time, purely because of specific governmental decisions, some customers will be treated unequally simply because of the kind of institution they choose to do business with, regardless of which institution actually provides better service to the customer.

The difficulty in following this train of thought too far is that elimination of the protections for all customers so that the economy can get a boost minimizes the importance of the protections that have been provided by DFA and its regulations, especially for consumers. Those protections were only put in place following the discovery of some extremely shoddy practices driven by the iconic image of the manager in the sales room with the baseball bat, pounding on desks and saying — get those option ARMs, those no docs, those no income loans, those loans full of false statements out the door. No one wants that environment to have a chance of reviving.

But it is a dilemma for policy makers, since there is a lack of protection provided each time an exception is made based on the size of the bank the customer is using. Why that customer and not the one next door who is using a larger bank?

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[5]At the end of the day, that may be Parson's point — namely, preserving the community bank franchise may be more important than providing their consumers protections from the practices the consumer protection laws are designed to give.