

The Dodd-Frank Bill Has Enormous Consequences for Community Banks

The Dodd-Frank Act will dramatically and negatively affect *all* banks – *large and small*. Some industry trade groups have said that community banks are relatively better off in the Dodd-Frank Act. So why doesn't it feel that way? There is plenty of pain to go around and long-term unintended consequences are inevitable. Some provisions will have a direct negative impact, such as the sheer volume of new regulations and new reporting burdens, many of which will flow from the new rules set by the Consumer Financial Protection Bureau (CFPB). There are other provisions which ostensibly provide some relief for community banks, but market competition and other unintended consequences are expected to quickly reverse any "static" or "initial" savings. These include the loss of interchange income (despite an exemption from mandated, below market pricing for debit transactions) and the increased competition for deposits resulting from the rise in cost of funding using *non*-deposit liabilities which will now be subject to FDIC assessments. Here are some things to consider:

➤ ***5,000 Pages Of New Regulations***

Congress consistently underestimates the complexity and volume of the regulations resulting from new laws. Based on the number of pages of regulations resulting from previous laws, the Dodd-Frank Act will result in more than 5,000 pages of new regulation for traditional banks. This is in addition to the 50 new or expanded regulations affecting banks over the last two years.

➤ ***Consumer Financial Protection Bureau Rules Apply to All Banks***

All banks – *large and small* – will be required to comply with rules and regulations set by the CFPB, including rules that identify what the bureau considers to be "unfair, deceptive, or abusive." The CFPB can require community banks to submit whatever information it decides it needs and the ***CFPB can examine community banks*** at its discretion on a "sampling basis." Thus, the new legislation will result in enormous new compliance burdens for community banks and a new regulator looking over their shoulders.

➤ ***Pre-emption Weakened and State Attorneys General Given More Power***

The standard for preemption is modified for national banks and changed significantly for federal thrifts. ***This will create uncertainty, lead to years of litigation, and place banks at greater risk of having to comply with a patchwork of state laws.*** All banks will be affected, including state-chartered banks that benefit from state wild-card statutes. State attorneys general will have greater authority to enforce rules and regulations, specifically including those promulgated by the CFPB.

➤ ***Significant New Disclosures and Reporting Requirements***

All banks, regardless of size, will have to comply with extensive new disclosure and reporting requirements created by the bill. For instance, the CFPB is given sweeping authority to require whatever disclosures it thinks are necessary to permit consumers to understand "the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances." All banks will have to ask a business customer whether it is a women-owned, minority-owned, or small business, maintain records of the responses, and submit the information to the CFPB each year. The Dodd-Frank Act also requires 20 new HMDA reporting obligations. These and other reporting requirements will add considerable compliance costs to every bank's bottom line.

➤ ***Loss of Interchange Income on Debit Transactions***

Small banks have an exemption from the rules the Fed will set for large banks, but market share will always flow to the lowest priced product, even if those lower prices are mandated. We expect that retailers in the market will seek to reduce their costs which will compress rates overall. It also means a loss of revenue that supports free transactions and other valuable services, or both.

➤ ***New Capital Standards***

All banks with over \$500 million in assets will be prohibited from using trust preferred securities to raise Tier 1 capital at their holding companies going forward. This will eliminate a popular source of capital that often is downstreamed to a bank. In addition, the agencies will be imposing more onerous capital rules on banks, large and small, and will force all banks to maintain higher levels of capital than expected in the past.

➤ ***The Savings From the Broadened Assessment Base May Be Short-lived***

By expanding the assessment base (from total domestic deposits to total assets less tangible capital) the cost of non-deposit funding rises. The banks that face the higher assessments will change their business plans, which will inevitably lead to a shift away from non-deposit funding sources toward deposit funding. Competition for deposits is likely to intensify, pushing deposit rates higher. Should that competition lead to a mere 5 basis point rise in deposit rates, the “static” savings for the typical community bank disappears. It also affects the availability and pricing of home loan bank advances as these are now subject to FDIC assessments. Thus, while the appeal of this change is understandable, the unintended consequences have the very real potential to lower or even eliminate the promised savings.

➤ ***No Limit on Size of FDIC Insurance Fund***

The Dodd-Frank Act **eliminates dividends** whenever the deposit insurance fund (DIF) exceeds 1.35 percent of insured deposits and **eliminates the hard cap** (of 1.50 percent) on the size of the fund. It also gives the FDIC **unrestricted authority** to set a new “designated reserve ratio” or long-term target ratio **above** 1.50 percent. The bill **raises the minimum** level for DIF to 1.35 percent, and does benefit banks under \$10 billion by requiring larger banks to make up the gap from the old minimum of 1.15 percent to the new minimum of 1.35 percent. Smaller banks would continue to pay premiums, however, and how this provision will be implemented is unknown. All banks would be required to keep the fund above the minimum and at the new designated reserve ratio wherever that is set.

➤ ***Additional Cost of Higher Insurance Limits***

The Dodd-Frank Act does increase permanently the insurance limit to \$250,000 and does extend the Transaction Account Guarantee (TAG) for two years. The permanent increase in the \$250,000 coverage level, however, means that the reserve ratio of the fund (which is equal to the fund divided by insured deposits) is lower. Thus, the cost to attain even the old minimum of 1.15 percent is greater and the pace of the recapitalization is longer (unless the FDIC raises all premium rates to maintain the same schedule). The Congressional Budget Office “scored” this increase in premium income at \$8.8 billion. How the FDIC will price the TAG program (which protects depositors in all institutions) is also unknown.

➤ ***Precedent for using the FDIC as a Government Revenue Raiser***

Both the increase in the insurance coverage levels and the last minute provision to raise the minimum level of DIF to 1.35 percent were used as a way to **increase federal government revenues and meet the “pay-go” requirements**. Pay-go (or pay-as-you-go) rules require that any new spending must be offset by new sources of revenue so that there is no addition to the federal budget deficit. Premiums paid to FDIC are considered revenue to the federal government as FDIC is “on-budget.” **Thus, the actions set a precedent to use premiums as a revenue raiser to support other government spending programs**. It also undermines the integrity of the insurance assessment process and could ultimately undermine depositor confidence in the FDIC, as the fund will be seen as a political fund to be used for other purposes. Such an approach, in terms of its impact, is a tax on bank capital, and every dollar of bank capital serves as the basis for making loans of eight dollars or more.