



# BANKING TRENDS

## How Dodd–Frank Affects Small Bank Costs

Do stricter regulations enacted since the financial crisis pose a significant burden?

BY JAMES DISALVO AND RYAN JOHNSTON

*“With respect to supervisory regulations and policies, we recognize that the cost of compliance can have a disproportionate impact on smaller banks, as they have fewer staff members available to help comply with additional regulations.”*

— Federal Reserve Chair Janet Yellen

New regulations imposed on banks since the financial crisis and Great Recession are primarily directed toward large banks, especially banks that regulators deem systemically important. However, small banks have argued that the stricter regulations are excessively costly for them. Often they have identified the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 as the main culprit, and this charge has been taken up by politicians who have cited the higher regulatory burden on small banks as a reason that various parts of Dodd–Frank ought to be repealed. Small banks have also complained that new capital requirements under the international Basel III accord have been unduly burdensome. Recently, some regulators have made proposals to lower regulatory costs for small banks.<sup>1</sup>

We examine the effects of regulatory changes since the Great Recession on banks with assets below \$10 billion, which we refer to as small banks.<sup>2</sup> We show that new home mortgage lending rules imposed by the Consumer Financial Protection Bureau likely significantly affected small banks, despite a wide range of exemptions that limit the effects of new regulations. Another important line of business for small banks, commercial real estate lending, may also be significantly affected by new risk-based capital requirements. However, regulations on debit card transaction fees do not appear to have hurt small banks, despite complaints from bankers.

Because direct measures of regulatory costs are not

available, we mainly use a rough indicator of regulatory burden: the share of bank portfolios potentially affected by new regulations. Apart from these measures of bank activity that might be affected, regulatory compliance costs — in particular, the standardized reports required to qualify for the exemptions — may hit small banks disproportionately hard, as Chair Yellen has argued. These costs are largely anecdotal and hard to measure, but we report some estimates from economists at the Minneapolis Fed.<sup>3</sup>

In this article, we examine only the costs imposed on small banks without factoring in some new regulations that reduce their costs such as lower FDIC assessments.<sup>4</sup> Nor do we discuss the intended benefits of the new regulations. We focus on the three regulatory changes that have elicited the most complaints from small bankers and their representatives: the qualified mortgage rule, Basel III capital standards, and the Durbin Amendment.

### QUALIFIED MORTGAGE RULE

This rule mandated by Dodd–Frank is designed to force banks to maintain higher lending standards for home mortgages. It imposes rigorous standards of proof that a loan is not high risk. Notably, banks must document that a borrower has the ability to repay the loan and that the mortgage has no nonstandard contract structures, such as balloon payments. A mortgage that meets these conditions is called a *qualified mortgage*.<sup>5</sup> Mortgages are presumed to be qualified mortgages if they are guaranteed by a

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government entity such as the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) or meet the standards of a government-sponsored enterprise (GSE) such as Fannie Mae.

For the small bank, the key benefit of making qualified mortgages is that it then has protection against lawsuits by borrowers and against attempts by borrowers to avoid foreclosure.<sup>6</sup> The legal protections are even stronger for qualified mortgages that are not *high priced*. A high-priced loan is one with an interest rate that exceeds the average prime rate by more than 1.5 percentage points for a loan secured by a first lien or by 3.5 percentage points for a junior lien. In recent surveys conducted by Fannie Mae and the Fed, small bankers report higher lending costs and lower approval rates because of the new qualified mortgage requirement.<sup>7</sup>

We can estimate the fraction of small bank portfolios affected by the qualified mortgage rule by examining the share of mortgages that would not have qualified for legal protections in the year before the new requirements were imposed. We use 2013 numbers because the economy had substantially recovered from the Great Recession by 2013 and because the rule was imposed in 2014.<sup>8</sup> Unfortunately, Home Mortgage Disclosure Act (HMDA) data do not include enough information about each loan to know for certain whether a loan is a qualified mortgage or whether it is high priced, but we construct a rough approximation. First, the data do indicate whether a loan is FHA or VA insured, so those loans are automatically qualified mortgages. Our proxy for whether a loan conforms to GSE standards is that the face value of the loan is lower than the conforming loan limit for the geographic area of the property for which the loan was made.<sup>9</sup> We also construct a proxy for high-priced loans.<sup>10</sup> Our conservative measure of loans affected by the qualified mortgage rule adds nonconforming loans and conforming loans that are high priced. We call these loans *affected loans*.

Figure 1a illustrates that the median share — think of it as the measure for the “typical” bank — of affected loans by *number* of loans was approximately 10 percent for banks with less than \$100 million in assets, dropping to under 5 percent for banks with assets of \$2 billion to \$10 billion. The average number of affected loans was about 22 percent for the smallest banks, dropping to 9 percent for the largest category (Figure 1b). (The median share of affected loans by *dollar value* is somewhat higher than the share by number, ranging from 9 percent to 13 percent for different size banks, while the averages ranged from about 26 percent for the smallest banks to 17 percent for the largest.) The difference

FIGURE 1a

### Qualifying Mortgage Rule Affects Small Bank Mortgage Lending

Median share of affected and unaffected mortgages by number of loans, 2013.

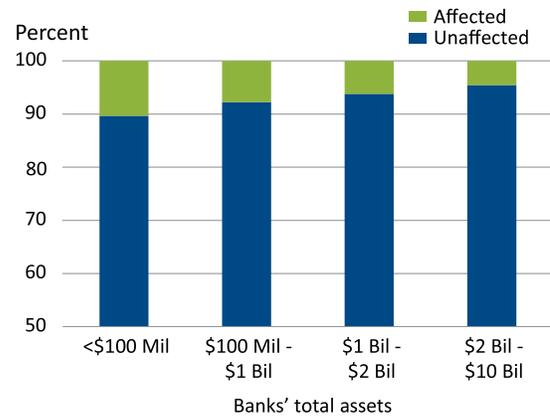
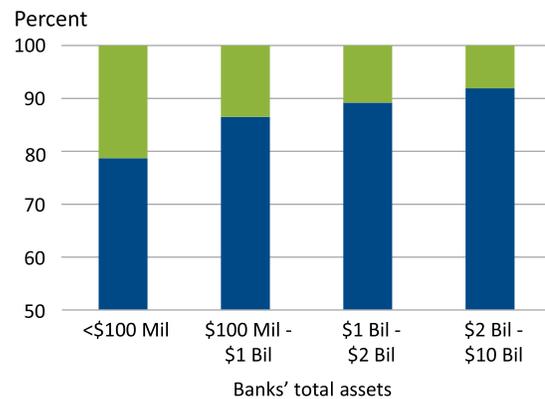


FIGURE 1b

Average share of affected and unaffected mortgages by number of loans, 2013.



Source: Home Mortgage Disclosure Act data.

Note: Affected mortgages include nonconforming loans and conforming loans that are high priced. Unaffected mortgages include FHA insured loans, VA insured loans, and conforming loans that are not high priced.

between the median and average values indicates that some banks in each size class specialized in lending mortgages that are affected by the qualified mortgage rule, but a closer examination of individual banks shows that the higher average values were not driven by a small number of banks with high concentrations of nonexempt mortgage lending. No less than 20 percent of the banks in each size class dedicated at least 10 percent of their portfolios to affected loans.

The number of loans is probably most relevant for thinking about compliance costs, which must be borne regardless of loan size. The dollar value is more relevant for

thinking about lost profits should small banks make fewer affected loans.

To sum up, the qualified mortgage rule affects a significant share of mortgage lending by small banks, and by some measures, the effect appears to be greatest for the smallest banks.<sup>11</sup>

## BASEL CAPITAL STANDARDS

While not directly the result of Dodd–Frank, capital requirements for banks have been raised and the risk weights on some classes of assets have risen significantly since the Great Recession.<sup>12</sup> The rise in total capital requirements primarily affects large banks, especially systemically risky banks.<sup>13</sup> But the rise in the risk weights on certain types of commercial real estate (CRE) may have disproportionately affected small banks because they invest relatively heavily in commercial real estate. Indeed, CRE represents approximately 50 percent of small bank loan portfolios, compared with just over 25 percent of large bank portfolios. Raising the cost of making CRE loans could reduce small banks' competitiveness because detailed knowledge of local real estate markets is probably a significant source of comparative advantage for small banks.

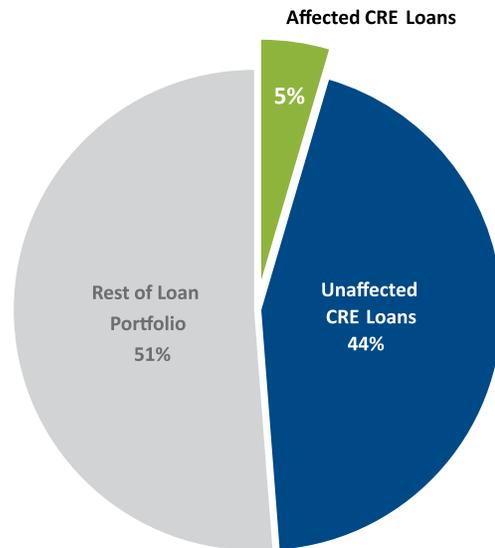
Specifically, the new capital requirements impose a 150 percent risk weight on particularly risky CRE loans known as high-volatility commercial real estate.<sup>14</sup> For the purpose of determining a bank's capital requirements, this means that each dollar lent through such loans raises the value of bank assets by \$1.50.<sup>15</sup> Previously, the risk weights on CRE had not exceeded 100 percent. Apart from concerns about the higher risk weight, bankers have also argued that the rules for determining whether a particular deal is a high-volatility loan are flawed.

While we can't directly determine the share of high-volatility CRE in small bank loan portfolios, we can get an upper-bound estimate of the share that could be classified as high-volatility CRE.<sup>16</sup> First, the 89 percent of commercial banks with assets of less than \$1 billion are exempt from the higher capital requirement. For the remaining small banks, while CRE is a large component of small bank lending, neither mortgages for multifamily housing nor construction loans for one- to four-family housing — detached single-family homes plus attached homes of two to four units — can be classified as high-volatility CRE under the new capital standards. Figure 2 shows that the construction loans that might be so classified represent approximately 5 percent of total loans (2 percent of total assets) for the median commercial

FIGURE 2

## New Requirements Affect Modest Portion of Small Bank Portfolios

Affected and unaffected commercial real estate loans as share of total loans, 2013.



Source: Federal Financial Institutions Examination Council Call Reports.

Notes: Affected CRE loans are defined as all construction loans for purposes other than constructing one- to four-family residential properties, all land development loans, and all other land loans. Total CRE loans include construction and land development loans, real estate loans secured by farmland, real estate loans secured by multifamily (five or more) residential properties, and real estate loans secured by nonfarm nonresidential properties.

bank with total assets below \$10 billion, while the average values are slightly larger.<sup>17</sup> While this is an upper bound on the share of CRE loans actually subject to the higher capital requirements, it may be the appropriate measure for judging higher compliance costs. Even if a loan doesn't qualify as high-volatility CRE, the bank must provide adequate documentation to demonstrate that to examiners.<sup>18</sup>

In summary, the new capital requirements potentially affect a modest, but certainly not insignificant, portion of small banks' CRE portfolios.

## THE DURBIN AMENDMENT

The Durbin Amendment of Dodd–Frank, which the Federal Reserve implemented as Regulation II in 2011 and amended in 2012,<sup>19</sup> requires regulators to impose a ceiling on the *interchange fees* that covered banks charge for debit card transactions.<sup>20</sup> Each time a customer buys something with a debit card, the bank that issued the card charges the merchant's bank an interchange fee. All banks with assets below \$10 billion are exempt from the regulation. But

according to the American Bankers Association, “Interchange is one of the most important sources of non-interest income for community banks, and the severe reductions in debit-card interchange income that would result from the implementation of Durbin would be a major hit to the overall earnings of community banks.”<sup>21</sup>

Since the regulation imposes a ceiling on interchange fees only on banks with assets of more than \$10 billion, how would that affect small banks? Small bankers have argued that competition between large card issuers and small issuers would effectively impose the ceiling on small banks. What does the evidence say?

There is substantial evidence that the ceiling did lower interchange fees collected by banks with assets above \$10 billion, from around 44 cents to about 22 cents per transaction.<sup>22</sup> But there was no such decline for small banks. Furthermore, after the ceiling was imposed, the volume of transactions conducted with cards issued by exempt banks grew faster than it did for large banks.<sup>23</sup> Finally, Zhu Wang shows that interchange revenue fell substantially at large banks after the fee ceiling was imposed but continued rising for small banks.<sup>24</sup>

In sum, the evidence does not support the claim that competitive forces have effectively imposed the interchange fee ceiling on small banks, although it is possible that longer-term competitive effects might yet put small banks at a disadvantage.

## COMPLIANCE COSTS

Regulations can impose significant costs if they increase regulatory reporting and compliance requirements. For example, the information required to document for regulators that a particular commercial real estate loan is not a high-volatility loan might be more costly to acquire than the information that the bank would routinely collect as part of its own due diligence and monitoring efforts. And to the extent that these costs are not divisible — for example, if the bank must hire a lawyer to ensure its regulatory compliance — then the small bank may be at a competitive disadvantage compared with a large bank that already has a legal department.

To date, reports of the costs of regulatory compliance have been largely anecdotal. But economists at the Minne-

apolis Fed have developed a simple methodology for estimating compliance costs for very small banks, measured by the cost of adding an employee dedicated solely to managing regulatory compliance. They estimate that 40 basis points is the minimum return on assets that investors require of a small bank.<sup>25</sup> They find that nearly 18 percent of banks with less than \$50 million in assets would fall below this minimum return if they had to hire an additional full-time employee, while 2.5 percent of banks with assets of \$500 million to \$1 billion would fall below the minimum.

While it is plausible that the fixed costs of hiring another employee impose a larger burden on small banks, it should be kept in mind that many small banks use consultants and vendors to handle regulatory compliance. These outside contractors spread their own fixed employment costs across their many small bank clients. Ultimately, the magnitude of the rise in regulatory costs due to Dodd–Frank and the accompanying regulatory changes since the Great Recession is an empirical question that will require more time and analysis to determine. However, even with years of data in hand, it will remain difficult to disentangle regulatory costs from other factors that affect small banks’ cost structures.

## CONCLUSION

The inconclusive nature of the evidence notwithstanding, we note one interesting proposal from Federal Reserve Governor Daniel Tarullo, echoing a more detailed proposal by FDIC Vice Chairman Thomas Hoenig, designed to reduce regulatory costs for small banks. It offers small banks a trade. In exchange for maintaining a somewhat higher capital level than the minimum, small banks that do not engage in nontraditional activities would be permitted to use much simpler risk-based capital requirements similar to those of Basel I, which required only elementary distinctions between assets according to risk. For example, in exchange for holding a higher capital level, small banks would not be subject to the Basel III requirements for CRE.<sup>26</sup> This proposal might significantly reduce record keeping and compliance costs without posing a significantly higher risk to safety and soundness. ■

## NOTES

<sup>1</sup> Concern about the impact of regulatory costs on small banks has two main rationales. First, as shown in our third quarter 2015 issue of *Banking Trends*, small banks play an outsized role in small business lending in the U.S. Second, small bank failures do not pose the same risks to financial stability as do large bank failures.

<sup>2</sup> In this article, we do not address the effects of the new regulations on large banks.

<sup>3</sup> Bankers have also complained about overzealous and inconsistent examiners, but these costs have little to do with Dodd–Frank and are difficult to verify or quantify.

<sup>4</sup> See Jim Fuchs and Andrew Meyer’s estimates.

<sup>5</sup> A bank can make a qualified mortgage by documenting certain facts about the borrower: income or assets, employment, credit history, monthly mortgage payment, other monthly payments associated with the property, other monthly obligations associated with the mortgage, and other debt. Also, a borrower’s debt-to-income ratio must be 43 percent or less; the bank cannot charge more than 3 percent in points and fees; and the loan cannot have a special structure such as balloon payments, negative amortization, interest-only payments, or terms beyond 30 years. For more information on the qualified mortgage rule for small banks, see the Consumer Financial Protection Board’s *Ability-to-Repay and Qualified Mortgage Rule Small Entity Compliance Guide*.

<sup>6</sup> Nonqualified loans are also significantly more costly to securitize — that is, to package along with other mortgages into a security that can be sold to investors. This cost is very important for large banks, less so for small banks, which generally retain more of their mortgage loans in their own portfolios.

<sup>7</sup> While 67 percent of respondents to the Fed’s July 14, 2014, Senior Loan Officer Opinion Survey reported that the qualified mortgage requirements had no effect on their lending standards, those respondents reporting a decline in making nonqualified mortgages were more likely to be from smaller banks. Fannie Mae reported similar results, finding that most lenders had experienced or expected a rise in compliance costs.

<sup>8</sup> In fact, the numbers are similar for 2013 and 2014. It is possible that banks were adapting to the impending regulation ahead of its enactment. Furthermore, most observers agree that bank credit standards for mortgage loans have been quite tight even as the economy recovered, so we might expect the new regulations to bind more tightly in future years.

<sup>9</sup> We exclude home improvement loans because they would typically be below the conforming loan limit.

<sup>10</sup> We define a high-priced loan as one in which the annual percentage rate is more than 1.5 percent higher than the average prime offer rate for loans secured by first liens and 3.5 percent higher for loans secured by junior liens. Still, some high-priced loans by our measure may meet GSE standards.

<sup>11</sup> Consumer Financial Protection Bureau regulations reduce the reporting burden for banks with less than \$2 billion in assets that made fewer than 2,000 mortgage loans in the previous year. This is a potentially large source of regulatory relief. We do not adjust our numbers to take this potential into

account because the extent to which a bank actually has a legal safe harbor if it takes advantage of the less stringent requirements is not yet clear. Nonetheless, we think of our portfolio measure as an upper bound.

<sup>12</sup> The Bank for International Settlements concisely describes the Basel agenda, [www.bis.org/bcbs/basel3.htm](http://www.bis.org/bcbs/basel3.htm).

<sup>13</sup> See Ronel Elul’s article for a description and discussion of capital regulation from pre-Basel to Basel III.

<sup>14</sup> High-volatility commercial real estate includes all acquisition, development, and construction (ADC) commercial real estate loans except one- to four-family residential ADC loans and commercial real estate ADC loans that meet regulatory requirements imposing a maximum loan-to-value ratio both at the outset and throughout the life of the loan.

<sup>15</sup> Joseph Rubin, Stephan Giczewski, and Matt Olson discuss the possible effects of the new CRE capital standards.

<sup>16</sup> Banks began reporting high-volatility CRE only in 2015.

<sup>17</sup> Unlike for the HMDA data, the Call Reports provide no information about the number of CRE loans, only their total outstanding dollar value.

<sup>18</sup> Bankers have also complained about the added complexity of the Basel III risk-weighted capital rules. This is difficult to quantify. Below, we briefly discuss a proposal to lessen this burden.

<sup>19</sup> For more on Regulation II, see [www.federalreserve.gov/paymentsystems/regii-faqs.htm](http://www.federalreserve.gov/paymentsystems/regii-faqs.htm).

<sup>20</sup> We will focus on the ceiling on interchange fees because this has been the primary source of complaints from bankers. Durbin also mandates that merchants be permitted to route debit card transactions through whichever networks are least costly for them.

<sup>21</sup> Letter from Stephen Wilson to Sheila Bair.

<sup>22</sup> See the report from the Board of Governors and the paper by Benjamin Kay, Mark Manuszak, and Cindy Vojtech.

<sup>23</sup> See the report on interchange fees by the Board of Governors.

<sup>24</sup> The Call Report lumps together interchange fees from debit cards and credit cards, so the different responses for large and small banks might, in principle, be due to a change in credit card fees rather than the result of the imposition of ceilings for debit cards. Wang addresses this issue by dropping all monoline credit card banks and finds identical results.

<sup>25</sup> This is the historical return on assets for a de novo bank after five years.

<sup>26</sup> Note that this would not address the qualified mortgage rule. The American Bankers Association has proposed that loans kept on balance sheets be exempt from the rule. To evaluate this proposal, we would need to address concerns about consumer protection and financial stability that underlie the rule.

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