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Recommended Citation
Heidi Mandanis Schooner, Regulating Angels, 50 GA. L. REV. 143 (2015).

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REGULATING ANGELS

*Heidi Mandanis Schooner**

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I. INTRODUCTION

Since the Financial Crisis, a common narrative casts the largest, too-big-to-fail (TBTF) banks as villains[1] and community banks[2] as darlings.[3] On the one hand is the image of the infamous mega banks that brought the economy to its knees and continue to profit while the rest of society sputters, and on the other hand is the angelic community banker (think Jimmy Stewart in *It's a Wonderful Life*) working tirelessly to provide the last bastion of hope for small, job-creating, businesses and other worthy borrowers. Advocates for these innocent small banks point to the crushing regulatory burden imposed on institutions that had nothing to do with the crisis.[4] Accordingly, the considerable political power of community banks[5] has been harnessed in a press for regulatory relief.[6] These advocates predict the demise of

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[1] *See, e.g.*, *The Origins of the Financial Crisis: Crash Course*, ECONOMIST (Sept. 7, 2013), http://www.economist.com/node/21584534/print (arguing that financiers at big banks caused the Financial Crisis by issuing an abundance of irresponsible home loans, turning them into pools of securitizing, and transferring them to large banks where the securitized mortgages eventually set off a negative chain reaction when United States housing prices tumbled).

[2] This Article generally uses the term "community bank" in a non-technical sense, i.e., to refer to smaller institutions that are distinguishable from larger regional and multinational banks. Part II includes a brief discussion of various technical definitions for community banks. This Article does not seek to discover or explain the line-drawing involved in determining whether a small or smaller institution is, in fact, a community bank.

[3] *See, e.g.*, *Lessons Learned from the Financial Crisis Regarding Community Banks: Hearing on Examining the Major Trends Affecting Community Banks and Lessons Learned from Community Bank Failures During the Financial Crisis Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. 1 (2013) (Statement of Sen. Tim Johnson, Chair, S. Comm. on Banking, Hous. & Urban Affairs) ("We know that community banks did not cause the financial crisis, but many were casualties of the Great Recession that followed.").

[4] *See* Stephen Moore, Editorial, *The Demise of the Small American Bank*, WALL ST. J. (July 31, 2015, 8:32 PM), http://www.wsj.com/articles/the-demise-of-the-small-american-bank-1438382060 ("The [regulatory] burdens get so intense that it is destroying the small[-] and medium-size banks in America." (internal quotation marks omitted)).

[5] *See* BARNEY FRANK, FRANK: A LIFE IN POLITICS FROM THE GREAT SOCIETY TO SAME-SEX MARRIAGE 314 (2015) (discussing the political power of grassroots organizations like community banks).

[6] *See* Robert Blackwell, *The Easy Legislative Fix that Could Save Community Banks*, AM. BANKER (Feb. 23, 2015, 2:26 PM), http://www.americanbanker.com/news/law-regulation/the-easy-legislative-fix-that-could-save-community-banks-1072855-1.html?zkPrintable=true ("Small banks are currently lobbying Congress for regulatory relief . . . .").

community and other small banks if the regulatory burden is not lifted.[7] Some view such predictions with a more skeptical eye and suggest that the interests of large banks are behind community bank reform proposals. These critics claim that the big banks are attempting to slip under the community bank halo with the hope of less regulation for all banks—big and small.[8]

Even if much of the hand-wringing on behalf of community banks is a disguise for big banks' efforts at deregulation, reason for concern regarding the state of community banks remains. Small banks have been disappearing for quite some time.[9] The demise of community banks is troubling because of the unique services they provide to certain borrowers and communities.[10] Therefore, efforts to promote and preserve community banks are well-founded. Yet, community banks pose many of the same extrinsic risks to the economy as their larger counterparts (albeit on a much smaller scale). For example, the failure of savings and loan associations in the 1980s was the source of the larger banking crisis that

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[7] *See* Moore, *supra* note 4 (arguing that "community banks are disappearing" as a result of regulatory burden).

[8] Senator Elizabeth Warren made this observation at a Senate Banking Committee hearing on regulatory reform: "We should be very skeptical of regulatory relief bills that are promoted as helping small banks but are pushed by ABA lobbyists for the big banks." Kevin Cirilli, *Warren: Community Banks Thriving under Dodd-Frank*, THE HILL (Feb. 12, 2015, 1:25 PM) (internal quotation marks omitted), https://thehill.com/policy/finance/banking-financial-institutions/232637-warren-community-banks-thriving-under-dodd. Dennis Kelleher, President and CEO of Better Markets, Inc., recently observed: "The cornerstone of the industry's PR strategy is to claim that their megabanks are just like all the other banks in the United States, and that those who support reducing Wall Street's dangerous practices are 'bank bashing', 'beating up on the industry', or 'hammering the banks.'" Dennis M. Kelleher, *Why Presidential Candidates Are Talking About the Unique Threat Posed by Wall Street's Megabanks*, HUFFINGTON POST (June 16, 2015, 5:36 PM), http://www.huffingtonpost.com/dennis-m-kelleher/why-presidential-candidates_b_7587056.html.

[9] Various statistics support this claim. For example, from 1984 to 2011, "the number of banks with assets less than $25 million declined by 96 percent." FDIC, COMMUNITY BANKING STUDY, at I (2012) [hereinafter FDIC COMMUNITY BANKING STUDY], https://www.fdic.gov/regulations/resources/cbi/study.html. From 1985 to 2010, "the number of banks under $10 billion in assets and credit unions declined by over 50 percent . . . ." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-881, COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF THE DODD-FRANK ACT DEPENDS LARGELY ON FUTURE RULE MAKINGS (2012), *available at* http://www.gao.gov/assets/650/648210.pdf.

[10] *See infra* notes 23–26 and accompanying text.

followed.[11] In any financial crisis, smaller institutions often fail and their failure triggers government support.[12] While they are not important enough to the overall economy to justify the headline bailouts available to large financial institutions, community banks suffer from many of the same conditions that contribute to the instability of TBTF institutions. For example, community banks' balance sheets exhibit the same sort of precariousness as those of the large institutions.[13] Moreover, community banks are highly leveraged and their assets have longer maturities than their liabilities. The justification for extensive regulation of community banks rests on a recognition of the financial fragility of institutions that play an important role in the communities they serve.

Thus, calls for scaling back the regulatory burden imposed on community banks do not offer ready solutions. This Article examines the current calls for deregulation and balances those ideas against the long history of community bank regulation, insolvency, and government support. Part II discusses the benefits offered by community banks and the current status of the industry. Part III outlines the justification for community bank regulation and the availability of the government safety net to support these institutions. Part IV addresses the solvency risk of community banks—their rates of failure and the causes of their failure. Part V addresses the reaction by community banks and their supporters to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[14] and links those discussions to the broad and continuing purpose for the regulation of community banks.

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[11] *See* George Kaufman, *The U.S. Banking Debacle of the 1980s: A Lesson in Government Mismanagement*, *Freeman*, FOUND. ECON. EDUC. (Apr. 1, 1995), http://fee.org/freeman/the-us-banking-debacle-of-the-1980s-a-lesson-in-government-mismangement/ (noting the costs of bank failures in the 1980s including the failure of savings and loan associations, which imposed high costs on the surviving financial institutions, including large banks).

[12] *See, e.g., id.* (noting how the federal government responded to the failure of small savings and loan associations in 1991 by enacting the FDIC Improvement Act).

[13] *See infra* Part III (discussing balance sheet fragility).

[14] Pub. L. No. 113-203, 124 Stat. 1376 (2010).

II. WHAT ARE COMMUNITY BANKS AND WHY DO THEY MATTER?

Community banks are often identified by and praised for their distinctive business model.[15] As discussed below, they utilize a relationship approach as opposed to the transactional approach favored by larger institutions. Community banks are also often identified by their asset size. One billion dollars or less in assets has been used to define community banks.[16] More recently, ten billion dollars or less in assets has served as the benchmark.[17] Of course, designations based on asset size have many limitations, not the least of which is that such definitions do not capture the activities associated with community banking.[18] In its 2012 *Community Banking Study*, the Federal Deposit Insurance Corporation (FDIC)[19] utilized a comprehensive approach toward defining community banks which incorporated not only asset size but also a consideration of asset type (e.g., banks that specialize in credit card lending are excluded) and whether the bank engages in traditional lending and deposit-taking.[20] The FDIC's definition also includes geographic limitations to serve as a proxy for relationship banking.[21] Using its definition, the FDIC reported that 94% of the 6,914 United States banking organizations in 2010 were community banks.[22]

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[15] *See* FDIC COMMUNITY BANKING STUDY, *supra* note 9, at I ("The value of community banks has always been associated with the unique combination of services they provide to their customers, as well as the manner in which they do business.").

[16] *See id.*

[17] *See id.* at 1-1.

[18] *See id.* at 1-2.

[19] The FDIC is the primary federal regulator for most community banks. It also provides deposit insurance for all banks. The other federal bank regulators are the Office of the Comptroller of the Currency (OCC) and the Board of Governors for the Federal Reserve System (Federal Reserve).

[20] *See* FDIC COMMUNITY BANKING STUDY, *supra* note 9, at 1-1 to 1-5 (detailing the FDIC's approach to determining what constitutes a community bank).

[21] The study explains: "This [geographic] limitation of scope is used as a proxy measure for a bank's relationship approach to banking. Banks that operate within a limited market area have more ease in managing relationships at a personal level." *Id.* at 1-3.

[22] *Id.*

The societal benefits of community banks are well-documented.[23] The relationship approach allows community banks to effectively lend to customers on the basis of confidential or opaque information that does not stand up to the credit score or other modeling approaches of larger institutions.[24] This means that community banks offer lending services that are not always available elsewhere. In their study of community banks, Marsh and Norman found:

> Community banks are more focused than larger banks on core financial services, demonstrated in their disproportionate involvement in key activities. . . . [C]ommunity banks hold only 14.2 percent of total

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[23] *See* CONFERENCE OF STATE BANK SUPERVISORS, U.S. FED. RESERVE SYS., COMMUNITY BANKING IN THE 21ST CENTURY: OPPORTUNITIES, CHALLENGES AND PERSPECTIVES 5 (2013), *available at* https://www.stlouisfed.org/~/media/Fiels/PDFs/Banking/CBRC-2013/town-hall.pdf ("Community banks are a critical component of our country's financial system and economy. They creatively meet a diverse array of consumer and commercial credit needs and are important partners in the economic stability of their communities."); TANYA D. MARSH & JOSEPH W. NORMAN, AM. ENTER. INST., THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 1 (2013), *available at* https://www.aei.org/wp-content/uploads/201/05/the-impact-of-doddfrank-on-community-banks_164334553537.pdf ("Community banks play a vital role in this nation's economy, particularly with respect to small businesses and rural communities, and their continued health and vitality is central to the nation's economic recovery."); Arthur E. Wilmarth, Jr., *A Two-Tiered System of Regulation Is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks*, 2015 MICH. ST. L. REV. 249, 289 ("Community banks have a superior ability to assess and monitor local firms because their managers and loan officers generally have long tenures in their positions and are deeply involved in the life of their communities."); Marshall Lux & Robert Greene, *The State and Fate of Community Banking* 4–5 (Mossavar-Rahmani Ctr. for Bus. and Gov't, Harv. Kennedy Sch., Assoc. Working Paper No. 37, 2015), *available at* http://www.hks.harvard.edu/content/download/74695/1687293/version/1/file/Final_State_and_Fate_Lux_Greene.pdf (noting that community banks are better than large banks at serving small businesses in rural areas because they heavily rely on personal relationships with lenders to make lending decisions); Hester Pierce et al., *How are Small Banks Faring Under Dodd-Frank?* 11 (Mercatus Ctr., George Mason Univ., Working Paper No. 14-05, 2014), *available at* http://mercatus.org/sites/default/files/Peirce-SmallBankSurvey_v1.pdf ("[S]mall banks are particularly important as agricultural lenders and small-business lenders." (internal quotations omitted)).

[24] For a discussion of relationship banking, see U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-71, FINANCIAL INSTITUTIONS: CAUSES AND CONSEQUENCES OF RECENT BANK FAILURES 8 (2012), *available at* http://www.gao.gov/assets/660/651154.pdf; Arnoud W.A. Boot, *Relationship Banking: What Do We Know?*, 9 J. FIN. INTERMEDIATION 7 (2000).

> bank assets, but they provide 48.1 percent of small business lending, 43.8 percent of farm loans, 42.8 percent of farmland loans, 34.7 percent of commercial real estate lending, and 15.7 percent of residential mortgage loans and hold 20.1 percent of retail deposits.[25]

Marsh and Norman also illustrate the importance of community banks in providing banking services to certain rural areas. They found that community banks were the only banks offering services in one-third of the underserved counties in the United States.[26]

Given the significant benefits offered by community banks, the dramatic decrease in their number is a matter of concern. The number of community banks has fallen from 14,408 in 1984 to 6,356 in 2011.[27] The traditional reasons cited for this sharp decline include mergers, consolidations, and failures.[28] More recently, focus has turned to the impact of new and existing regulations. In the post-Financial Crisis environment, observers have pointed to an increased cost of compliance coupled with low interest rates as the reason for the dearth of new bank charters.[29] As reported in a recent Federal Reserve Board study, from 1990 to 2008, over 2,000 new banks were formed.[30] Yet, from 2009 to 2013, only seven new banks received charters.[31] This study considered the impact of new regulations since the Financial Crisis and whether the burden of such regulation was the cause of the decline in new bank charters. The study concluded that the weak

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[25] MARSH & NORMAN, *supra* note 23, at 20.

[26] *Id.*

[27] FDIC COMMUNITY BANKING STUDY, *supra* note 9, at 2-6.

[28] *See id.* at I–II (discussing trends in banking consolidation, including the role of bank failures and mergers).

[29] Thomas Heath, *The Long Odds of Starting a Local Bank: Recession, Interest Rates Deplete Ranks*, WASH. POST (Mar. 27, 2015), *available at* http://www.washingtonpost.com/business/capitalbusiness/the-long-odds-of-starting-a-local-bank-recession-interest-rates-deplete-ranks/2015/03/27/fedd2194-d729-11e4-a62f-ee745911a455_story.htm.

[30] Robert M. Adams & Jacob P. Gramlich, *Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation* 1 (Fin. & Econ. Discussion Series, Fed. Reserve Bd., Working Paper No. 2014-113, 2014).

[31] *Id.*

economy and low interest rate environment are primarily to blame and that the decrease in new charters would have occurred without an increase in regulatory burden.[32]

Whether or not an increase in regulation has depressed the rate of new bank-chartering, the regulatory burden on community banks is an important consideration. Complying with regulations and submitting to prudential supervision is costly.[33] Such costs could strain the community bank's profitability and, therefore, viability. Therefore, the purpose and nature of community bank regulation can appropriately be scrutinized.

III. WHY REGULATE COMMUNITY BANKS?

With all the focus on large "systemically important" financial institutions in the wake of the Financial Crisis, the reasons for regulating small, not systemically important financial institutions can sometimes get lost in the shuffle. Long before the terms TBTF or systemically important were ever coined, we had a system of prudential regulation (also known as "safety and soundness" regulation) for banks—large and small.[34] Prudential regulation of banks seeks to protect banks from failure, and the rationale for such regulation was and remains based on the importance of banks to the overall economy, coupled with their inherent fragility. The importance of banks derives from the services they provide customers in the form of both payments and liquidity.[35] The fragility of banks stems from the maturity transformation that

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[32] *See id.*

[33] *See* FDIC COMMUNITY BANKING STUDY, *supra* note 9, at B-1 to B-3 (describing interviews with nine community bankers detailing the cost of complying with regulation supervision).

[34] *See* Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOY. CONSUMER L. REV. 43, 53 (2005) (discussing prudential regulation in the United States, which was primarily developed through Depression-Era laws). The first federal bank regulator, the Office of the Comptroller of the Currency, was established in 1863. *History: 150 Years of the OCC*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, http://www.occ.treas.gov/about/what-we-do/history/index-history.html (last visited Sept. 14, 2015).

[35] For the classic exploration of banks' special role in the economy, see FED. RESERVE BANK OF MINN., ANNUAL REPORT 1982: ARE BANKS SPECIAL? (1982), *available at* https://www.minneapolisfed.org/publications/annual-reports/ar/annual-report-1982-complete-text.

they provide, i.e., banks transform short-term liabilities (e.g., bank deposits) into long-term assets (e.g., mortgage loans). Importantly, the prudential regulation of banks can be distinguished from other types of financial regulation such as those regulations that are meant to protect bank customers. In fact, one of the rationales for creating a separate federal agency, the Consumer Financial Protection Bureau (CFPB), to administer consumer protection regulation was the recognition that consumer protection is different from prudential regulation (although they can overlap).[36]

As discussed, the focus of prudential regulation is to limit the costliness of bank failure. In the context of community banks, there are good reasons to conclude that the failure of even small banks can be damaging to a local economy (i.e., decreased credit availability and loss of jobs).[37] At the same time, there are also reasons to suspect that the consequences of the failure of a community bank may be relatively minimal. As noted by Kandrac in a recent study, FDIC deposit insurance, bank resolution by purchase and assumption, and the rise of technology that replaces the advantages of geography might all lead to the conclusion that community bank failures are not so worrisome.[38] Despite this hypothesis, Kandrac's study supports the traditional conclusion that the failure of small banks is highly disruptive to communities. In a study of bank failures from 2008 to 2010, Kandrac found that such failures "lead to lower income and compensation growth, higher poverty rates, and lower employment."[39] Moreover, Wilmarth discusses the less obvious negative impact on nonprofit and other service organizations when community banks fail.[40]

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[36] For a general and comprehensive discussion of the foundations for consumer protection versus prudential regulation and a discussion of assignment of regulatory responsibilities among federal agencies, see Schooner, *supra* note 34.

[37] *See supra* notes 25–26 and accompanying text.

[38] John Kandrac, *Bank Failure, Relationship Lending, and Local Economic Performance* 2 (Fin. & Econ. Discussion Series, Fed. Reserve Bd., Working Paper No. 2014-41, 2014).

[39] *Id.* at 1.

[40] *See* Wilmarth, *supra* note 23, at 290 n.153 (providing an overview of the import to service organization of community banks).

In 2013, the Government Accountability Office (GAO) also studied the impact of small bank failures on local communities.[41] The GAO reported that "[a]ccording to banks in urban and rural areas in the three states that we interviewed, acquisitions of failed small banks mitigated some potential negative effects on the cost and availability of credit and on philanthropic contributions in these communities."[42] The GAO also found that "the impact of bank failures on a state's economy is most likely to appear in the real estate sector and are [sic] less likely to appear in the overall labor market or in the broader economy."[43]

In addition to the potential harm caused to communities by the failure of a small bank, consideration must be given to the access of small banks to the government safety net. While community and other small banks are not, by definition, TBTF, they do receive considerable government support. All banks in the United States benefit from the availability of federal deposit insurance, and the expansion of deposit insurance under Dodd-Frank from the general coverage limit of $100,000 in deposits to $250,000 certainly benefited community banks.[44] In addition, all banks enjoy borrowing privileges at the Federal Reserve's discount window.[45] Finally, and perhaps most important in the post-Financial Crisis narrative, many community banks received tax-appropriated government support through the Troubled Asset Relief Program (TARP) during the Financial Crisis.[46]

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[41] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 24.

[42] *Id.* at 51.

[43] *Id.* at 55.

[44] *See* Press Release, FDIC, Basic FDIC Insurance Coverage Permanently Increased to $250,000 Per Depositor (July 21, 2010), https://www.fdic.gov/news/news/press/2010/pr10161.html (noting the expansion of federal deposit insurance).

[45] Regulation A sets forth eligibility for borrowing from the Federal Reserve. 12 C.F.R. § 201 (2015).

[46] For a discussion of community banks' participation in TARP and their challenges exiting that program, see SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, TARP AND SBLF: IMPACT ON COMMUNITY BANKS (2012), https://www.sigtarp.gov/Audit%20Reports/TARP_SBLF_Special_Section.pdf.

IV. WHY COMMUNITY BANKS FAIL

Given the importance of community banks' operations and access to government support, an examination of the reasons for their insolvency is important to any regulatory discussion. The United States has a longstanding and highly cyclical experience with bank failure. The United States has experienced periods of significant failures. In the five-year period after the FDIC was created, 1934 to 1938, 252 banks failed.[47] From 1987 to 1991, 1,629 banks failed.[48] Recently, from 2009 to 2013, 464 banks failed.[49] The United States has also seen periods of very low incidents of bank failure. In 2005 and 2006, no banks failed.[50] And, in 1945, 1946, 1957, 1960, 1962, and 1997, only one bank failed during each of those years.[51] Bank failures can result in significant losses to the FDIC's deposit insurance fund. Even after the worst years of the Financial Crisis had passed, the FDIC's annual losses ran in the billions of dollars, and all such recent failures involved small depository institutions.[52]

The FDIC's Community Banking Study points to data on bank failures as a measure of community banks' resiliency. Community banks failed at the same rate as noncommunity banks in the

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[47] FDIC, FAILURES AND ASSISTANCE TRANSACTIONS: NUMBER OF INSTITUTIONS, US AND OTHER AREAS, 1934–1938, https://www5.fdic.gov/hsob/ (follow "Failures and Assistance Transactions" hyperlink; then search "1934" and "1938" as "Effective Date(s)").

[48] FDIC, FAILURES AND ASSISTANCE TRANSACTIONS: NUMBER OF INSTITUTIONS, US AND OTHER AREAS, 1987–1991, https://www5.fdic.gov/hsob/ (follow "Failures and Assistance Transactions" hyperlink; then search "1987" and "1991" as "Effective Date(s)").

[49] FDIC, FAILURES AND ASSISTANCE TRANSACTIONS: NUMBER OF INSTITUTIONS, US AND OTHER AREAS, 2009–2013, https://www5.fdic.gov/hsob/ (follow "Failures and Assistance Transactions" hyperlink; then search "2009" and "2013" as "Effective Date(s)").

[50] FDIC, FAILURES AND ASSISTANCE TRANSACTIONS: NUMBER OF INSTITUTIONS US AND OTHER AREAS 2005–2006, https://www5.fdic.gov/hsob/ (follow "Failures and Assistance Transactions" hyperlink; then search "2005" and "2006" as "Effective Date(s)").

[51] FDIC, FAILURES AND ASSISTANCE TRANSACTIONS: NUMBER OF INSTITUTIONS US AND OTHER AREAS 1945–1997, https://www5.fdic.gov/hsob/ (follow "Failures and Assistance Transactions" hyperlink; then search "1945" and "1997" as "Effective Date(s)").

[52] Losses to the deposit insurance fund in recent years were as follows: $.4 billion in 2014; $1.2 billion in 2013; $2.7 billion in 2012; and $7.9 billion in 2011. *See* 2014 FDIC ANN. REP. 19; 2013 FDIC ANN. REP. 14; 2012 FDIC ANN. REP. 14; 2011 FDIC ANN. REP. 11, https://www.fdic.gov/about/strategic/report/.

period studied by the FDIC, 1984 to 2011.[53] The FDIC also considered banks' failure index, which compares the frequency of failure within one group of banks with the failure of all banks in a given period.[54] Considering the failure index in five-year periods from 1986 to 2011, community banks had a lower failure index for all five-year periods except the period of 1986–1990.[55] During that period, community banks had a failure index of 1.05 and noncommunity banks had a significantly lower failure index of 0.71.[56]

The GAO studied bank failures in the ten states with ten or more bank failures during 2008 to 2011.[57] The GAO found that the failure of small- and medium-sized banks was primarily driven by high concentrations of commercial real estate (CRE) loans, in particular acquisition, development, and construction loans (ADC).[58] Small banks that did not fail in that period had slower growth of ADC loans.[59] Concentrations of CRE loans in failed institutions also correlated to poor risk management (e.g., poor oversight, weak underwriting, and inadequate allowances for loan losses) and risky funding sources (e.g., brokered deposits).[60] The FDIC Inspector General's study, covering 2008 to 2011, found: "The majority of community banks failed as a result of aggressive growth, asset concentrations, poor underwriting, and deficient credit administration coupled with declining real estate values."[61]

A significant number of banks have failed since the FDIC and the GAO's study of bank failures. In 2012, 51 banks failed; in 2013, 24 banks failed; and, in 2014, 18 banks failed.[62] Federal law

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[53] FDIC COMMUNITY BANKING STUDY, *supra* note 9, at 2-11.

[54] *Id.*

[55] *Id.* at 2-10 tbl.2.5, 2-11.

[56] *Id.* at 2-10 tbl.2.5.

[57] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 24.

[58] *Id.* at 15, 18–25.

[59] *Id.* at 18.

[60] *Id.* at 19–21.

[61] OFFICE OF INSPECTOR GEN., FDIC, EVAL-13-002, REPORT TO THE CONGRESS: COMPREHENSIVE STUDY ON THE IMPACT OF THE FAILURE OF INSURED DEPOSITORY INSTITUTIONS, at iii (2013), https://www.fdicig.gov/reports13/13-002EV.pdf.

[62] *Failed Bank List*, FDIC, https://www.fdic.gov/bank/individual/failed/backlist.html (last visited Sept. 13, 2015).

requires an ex post review of any bank failure that results in a material loss to the FDIC's deposit insurance fund, called material loss review (MLR).[63] MLRs are conducted by the Inspector General (IG) of the appropriate federal banking agency.[64] The MLRs for Tennessee Commerce Bank (TCB), a bank with $1 billion in assets that closed on January 27, 2012,[65] and for First State Bank (FSB), a bank with $528.7 million in assets that closed on January 20, 2012,[66] provide interesting case studies. According the FDIC's IG report, the failure of FSB is consistent with the GAO study discussed above. FSB failed because its management failed to effectively manage its high concentration of CRE loan portfolio, in particular, residential ADC projects.[67] The story of TCB, however, is another matter. TCB employed a non-traditional banking business model; it was a "business bank" without branches or branching services.[68] The bank financed its operations with Internet and brokered deposits and with capital from its holding company.[69] The bank's lending activities were significantly concentrated in the transportation industry, including loans to leasing companies and lease brokers for the financing of commercial use vehicles.[70] The FDIC's IG concluded that TCB failed because of ineffective risk management of "large and complex borrowing relationships" and reliance on "non-core

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[63] *See* 12 U.S.C. § 1831o(k) (2012) (explaining when material loss occurs, MLR is triggered). Originally, the statute defined a material loss to the deposit insurance fund as the greater of $25 million or 2% of the bank's total assets. 12 U.S.C. § 18310(k)(B) (2006). The statute was amended to define material loss for the period from January 1, 2010 to December 31, 2011 as greater than $200 million; for January 1, 2012 to December 31, 2013 as greater than $150 million; and on or after January 1, 2014, as greater than $50 million. *Id.* § 1831o(k)(2)(B).

[64] 12 U.S.C. § 1831o(k)(1) (2012).

[65] OFFICE OF AUDITS AND EVALUATIONS, OFFICE OF THE INSPECTOR GEN., FDIC AUD-12-014, MATERIAL LOSS REVIEW OF TENNESSEE COMMERCE BANK, FRANKLIN, TENNESSEE, at I-2 (2012) [hereinafter TCB], https://www.fdicig.gov/reports12%5C12-014AUD.pdf.

[66] OFFICE OF AUDITS AND EVALUATIONS, OFFICE OF THE INSPECTOR GEN., FDIC, AUD-12-013, MATERIAL LOSS REVIEW OF THE FIRST STATE BANK, STOCKBRIDGE, GEORGIA, at I-1 (2012), https://www.fdicig.gov/reports12%5C12-013AUD.pdf.

[67] *Id.* at I-3.

[68] TCB, *supra* note 65, at I-3.

[69] *Id.* at I-5.

[70] *Id.*

funding sources."[71] TCB caused a $416.8 million loss to the FDIC insurance fund.[72] TCB provides an example of a bank that, while relatively small in asset size, chose the kinds of operations that are more often found in larger institutions. Apparently, because TCB failed to manage those operations appropriately, the FDIC was left with significant losses when the bank was closed. The experience of an institution like TCB forms the background for discussions of regulatory relief for smaller banks.

V. DODD-FRANK AND CALLS FOR REFORM

It comes as no surprise that Dodd-Frank is unpopular with the financial services industry. Certainly among community bankers, this sentiment runs deep and has led to calls for reform. A 2013 joint study by the Federal Reserve and the Conference of State Bank Supervisors identified regulation as a frequently cited challenge.[73] That study found:

> Many bankers felt that the move toward standardized products and a "one-size-fits-all" supervisory approach were taking away one of the strongest advantages of community banks: the ability to tailor products to fit individualized needs. . . . Bankers also noted increased regulatory scrutiny and costs . . . .[74]

Other studies support the need for regulatory reform. Lux and Greene conclude: "Our findings appear to validate concerns that an increasingly complex and uncoordinated regulatory system has created an uneven regulatory playing field that is accelerating consolidation for the wrong reasons."[75]

Congress demonstrated sensitivity to the regulatory burden on smaller institutions in the passage of Dodd-Frank. In discussions leading to the creation of the new Consumer Financial Protection

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[71] *Id.* at I-6.
[72] *Id.* at I-2.
[73] FED. RESERVE & CONFERENCE OF STATE BANK SUPERVISORS, *supra* note 23, at 15.
[74] *Id.*
[75] Lux & Greene, *supra* note 23, at 3.

Bureau (CFPB) in 2010, community bankers expressed dismay over the addition of a federal regulator that would subject them to periodic examination.[76] Congress responded to such complaints by excluding banks with assets of $10 billion or less from CFPB supervision (although small banks are still subject to the CFPB's rules).[77] In addition, the enhanced supervisory regime established by Congress under Dodd-Frank only applies to bank holding companies with assets of $50 billion or more.[78] Moreover, Dodd-Frank's annual stress test requirement only applies to institutions with more than $10 billion in assets.[79]

Since the passage of Dodd-Frank, regulatory agencies have also demonstrated willingness to consider the particular situation of community and small banks in promulgating new rules. The CFPB exempted banks with assets of $2 billion or less from its ability-to-repay (ATR) and qualifying mortgage (QM) rules.[80] The Federal Reserve Board excluded banks with assets of less than $10 billion from the new liquidity coverage ratio.[81] In addition to specific exemptions for smaller banks, bank regulators have made

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[76] *See* Damian Paletta, *Fight Over Consumer Agency Looms as Overhaul Is Signed*, WALL ST. J. (updated July 22, 2010, 12:01 AM), http://www.wsj.com/articles/SB10001424052748704746804575367502836650966 (noting that many bankers opposed the creation of a financial consumer protection agency).

[77] 12 U.S.C. §§ 5515–5516 (2012).

[78] *Id.* § 5365(a).

[79] *Id.* § 5365(i)(2). At the same time, bank regulators encourage community banks to utilize stress testing as part of their sound risk management practices. OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, BULLETIN 2012–33, COMMUNITY BANK STRESS TESTING (2012), http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-33.html; *see also* BD. OF GOVERNORS OF FED. RESERVE SYS., FDIC & OFFICE OF THE COMPTROLLER OF THE CURRENCY, STATEMENT TO CLARIFY SUPERVISORY EXPECTATIONS FOR STRESS TESTING BY COMMUNITY BANKS (2012), https://www.fdic.gov/news/news/press/2012/pr12054a.pdf ("[C]ommunity banks are not required or expect to conduct [certain stress tests] . . . [but] all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition.").

[80] *See* Press Release, CFPB, *CFPB Finalizes Amendments to Ability to Pay Rule* (May 29, 2013), http://www.consumerfinance.gov/newsroom/cfpb-finalizes-amendments-to-ability-to-repay-rule/. The ATR/QM rules generally require a lender to make a reasonable, good faith determination that the customer can repay the loan prior to extending credit. *See Ability to Repay & Qualified Mortgages*, FDIC, https://www.fdic.gov/regulations/resources/director/technical/atr.html.

[81] 12 C.F.R. § 329.1(b)(iii) (2012).

a demonstrative effort to ease the compliance burden on community banks by providing resources tailored to such institutions. For example, the Federal Reserve, FDIC, and the OCC published a "Community Bank Guide" outlining changes in capital rules. The purpose of the guide is "to help small, non-complex community banking organizations understand the sections of the [new] capital rule . . . most relevant to their operations."[82] More broadly, the FDIC has produced a program of videos, available on their website and the FDIC's YouTube channel, to assist in the education of bank officers, directors, and employees in many areas of regulation and supervision.[83]

Of course, despite this apparent sensitivity to regulatory burden, new regulations imposed by Dodd-Frank added to an existing and heavy regulatory burden. For this reason, proposals for reform to ease the burden on community banks have proliferated. While this Article makes no attempt to canvas all reform proposals, the following lists some of the more recent and visible ones. Not surprisingly, the Independent Community Bankers of America (ICBA) has published a comprehensive list of reform proposals.[84] A well-known, bipartisan bill introduced by Senators Sherrod Brown and David Vitter to eliminate TBTF policies also includes various forms of regulatory relief for community banks.[85] The OCC[86] has submitted proposals to Congress for reform to address regulatory burdens on community

[82] BD. OF GOVERNORS OF FED. RESERVE SYS., FDIC & OCC, NEW CAPITAL RULE: COMMUNITY BANK GUIDE 1 (2013), http://www.occ.gov/news-issuances/news-releases/2013/2013-110b.pdf.

[83] *Technical Assistance Video Program*, https://www.fdic.gov/regulations/resources/director/video.html (last updated Nov. 4, 2015).

[84] ICBA, PLAN FOR PROSPERITY: A REGULATORY RELIEF AGENDA TO EMPOWER LOCAL COMMUNITIES (2013). The ICBA plan includes proposals for relief from mortgage rules, reform of bank examinations, and many other proposals. *Id.* at 1–2.

[85] *See* Terminating Bailouts for Taxpayer Fairness Act of 2013, S. 798, 113th Cong. § 6 (2013) (including provisions intended to reduce the regulatory burden for smaller financial institutions).

[86] The OCC is the primary federal regulator for all federally chartered banks. *About the OCC*, OCC, http://www.occ.gov/about/what-we-do/mission/index-about.html (last visited Nov. 6, 2015).

banks, including limitations to the scope of the Volcker rule,[87] revisions to examination schedules, and changes to permissible activities for federal savings associations.[88] Federal Reserve Board Governor Daniel K. Tarullo has also suggested consideration of amendments to the Volcker rule in favor of community banks.[89] Finally, former FDIC Chair Sheila Bair offered a broad legislative proposal that would "giv[e] [bank] regulators the power to exempt institutions with less than $10 billion of assets from existing or new regulations."[90]

These reform proposals are worthy of serious and careful consideration. This Article does not attempt to weight the costs and benefits of any particular proposal. Rather, the discussion that follows highlights the importance of emphasizing the underlying purpose of prudential regulation of community banks in discussions regarding regulatory relief.

Not all financial regulations serve the same purpose. As discussed in Part III, financial regulation can be roughly lumped into two categories: regulations that protect customers (consumer protection regulations) and regulations that protect the institutions' solvency (prudential regulations).[91] The distinction is

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[87] Congress enacted the Volcker Rule under Section 619 of Dodd-Frank, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010) (codified at 12 U.S.C. § 1851 (2012)). The Volcker rule prohibits banking entities from engaging in proprietary trading and from certain relationships with hedge funds and private equity funds. 12 U.S.C. § 1851(a)(1) (2012). The purpose of the Volcker Rule, among other things, is to restrict banks from engaging in highly profitable and yet highly risky activities while at the same time enjoying access to the federal safety net. A Senate Report found: "The prohibitions in section 619 therefore will reduce potential taxpayer losses at institutions protected by the federal safety net, and reduce threats to financial stability, by lowering their exposure to risk." S. REP. NO. 111-176, at 8 (2010).

[88] For a discussion of these legislative proposals and other issues relevant to community banks, see *Regulatory Relief for Community Banks and Credit Unions: Hearing Before the S. Comm. on Banking, Hous. And Urban Affairs*, 114th Cong. (2015) (statement of Toney Bland, Sr. Dep'y Comptroller for Midsize and Comm'y Bank Supervision, Office of the Comptroller of the Currency).

[89] *See* Daniel K. Tarullo, Member, Bd. of Governors of Fed. Reserve Sys., Remarks at the Community Bankers Symposium: A Tiered Approach to Regulation and Supervision of Community Banks (Nov. 7, 2014), *available at* http://www.federareserve.gov/newsevents/speech/turullo20141107a.pdf.

[90] Blackwell, *supra* note 6.

[91] Of course, there is plenty of overlap between these categories.

relevant because of the distinct harms addressed by these different regulatory regimes. A consumer protection regulation that is appropriate but only serves to protect a very small group of hypothetical bank customers may not be worth the cost of compliance, whereas a costly prudential regulation may be justified because its purpose is to protect the broader economy. Of course, the reverse is also potentially true. Some consumer protection rules protect vast numbers of bank customers and some prudential rules may have only a minor positive impact on bank solvency. The point is that careful consideration must be given to the underlying purpose of the regulation.

Perhaps most importantly, reform proposals geared toward community banks sometimes lose sight of the justifications for prudential regulation of such institutions. Objections to the application of the Volcker Rule to community banks provide a useful example. Community banks[92] have complained about the application of the Volcker Rule, which as discussed limits proprietary trading and certain relationships with hedge funds and private equity funds.[93] While it is likely that the Volcker Rule does not apply to most community banks' operations,[94] opponents of the rule claim that it nevertheless imposes a

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[92] It is worth noting that larger banks do not like the Volcker Rule either. And, sometimes, commentators confuse complaints from larger institutions with those of smaller ones. An article in the *New Republic* about objections to the Volcker Rule ran the following headline: "A Small Bank in Utah Has Launched Wall Street's War on the Volcker Rule." David Dayen, *A Small Bank in Utah Has Launched Wall Street's War on the Volcker Rule*, NEW REPUBLIC (Dec. 30, 2013), http://www.newrepublic.com/article/116054/Volcker-rule-lawsuit-small-banks-sue-undo-financial-regulation. The bank covered in the article is Zions Bancorp, a regional bank with operations based in Salt Lake City. *Id.* Zions Bancorp is only a "small" bank when compared with the top few extremely large institutions, e.g., Bank of America, JP Morgan, etc., but Zions Bancorp has approximately $50 billion in assets and is therefore very unlikely, under any definition, to be considered a small or community bank. *See ZION Company Financials*, NASDAQ, http://www.nasdaq.com/symbol/zion/financeials?query=balance-sheet (last visited Nov. 6, 2015).

[93] *See supra* note 87 and accompanying text.

[94] *See* BD. OF GOVERNORS OF FED. RESERVE, FDIC & OCC, THE VOLCKER RULE: COMMUNITY BANK APPLICABILITY 1 (2013), http://www.federalreserve.gov/aboutthefed/boardmeetings/Volcker-rule-community-bank-20131210.pdf ("The vast majority of . . . community banks have little or no involvement in prohibited proprietary trading or investment activities in covered funds.").

significant compliance burden.[95] While it is tempting to dismiss such complaints as overblown (should not community banks know whether or not, for example, they are engaged in proprietary trading?), compliance with highly complex regulations can turn even the determination that a regulation does not apply into a costly exercise. Therefore, consideration of the short- and long-term costs of the Volcker Rule are certainly worthy discussions. Yet, such discussions should not distract from the overall purpose of the rule. Congress adopted the Volcker Rule to prevent FDIC insured banks (and their affiliates) from engaging in activities that, while highly profitable, could pose risks to the government safety net.[96] While it may be true that most community banks are not engaged in such activities, if they were, there is no reason why they should be exempt from the rule. The Volcker Rule prevents banks from using cheap, government-subsidized funding (FDIC insured deposits) for their own profit (as opposed to the gain of bank customers).[97] If that rule prevents large banks from reaping such profits, it seems that it should apply equally to smaller institutions.

While reform discussions at times lose sight of the underlying purpose of the prudential regulation of community banks (i.e., the insolvency risk of community banks), such discussions have not often accounted for the different risks posed by community banks (i.e., not all community banks pose the same solvency risk). In other words, discussions of lower regulatory burden have not adequately considered the differences among community banks by distinguishing between those that will and will not be likely to require government support. As a point of reference, consider that when Congress enacted the Gramm-Leach-Bliley Act of 1999 (GLB),[98] it devised a system that enabled certain bank holding companies to engage in expanded, non-bank financial activities (e.g., securities and insurance activities) if an institution was

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[95] *See supra* notes 87–90 and accompanying text.
[96] *See supra* note 87.
[97] *See supra* note 87 and accompanying text.
[98] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

deemed "well managed" and "well capitalized."[99] While these particular provisions of GLB benefit primarily larger institutions with more sophisticated operations, the same sort of regime might be applied to reduce the regulatory burden of community banks. Along the lines of Sheila Bair's proposal referenced above,[100] it might be useful to consider a regime in which bank regulators are granted the authority to exempt smaller institutions from certain regulations upon determination that such institutions were well managed and well capitalized. Such exemptive authority would balance the need for reduced regulatory burden against the need to protect the federal safety net.

VI. CONCLUSION

Community banks offer many important services to our communities. The declining numbers of such institutions should not be ignored. While community banks will hopefully thrive as the economy continues to improve, lawmakers should continue efforts to reduce overreaching regulation. Yet, the justification for the prudential regulation of community banks remains even in an era in which very large institutions demand greater attention. Like larger financial institutions, community banks are highly leveraged institutions with significant access to the government safety net. Therefore, reform proposals must be balanced against the need to limit community banks' failure and, thereby, their access to government support.

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[99] *See id.* at sec. 103, § (l)(1), 13 Stat. at 1346 (codified at 12 U.S.C. § 1843(l)(1) (2012)); *see also id.* § 121(a)(2), 113 Stat. at 1373 (codified at 12 U.S.C. § 24(a)(2)(C) (2012)) (providing similar restrictions on expanded activities for national banks).

[100] *See supra* note 90 and accompanying text.