Regulatory Burden Rising

By Christoffer Koch

U.S. commercial banks face growing regulatory requirements and complexity, especially with the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, which was intended to rein in excesses of the largest banks. The nation would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks.

The regulatory requirements for U.S. commercial banks have increased over time, most recently with the Dodd–Frank Act, which seeks to curb excesses primarily committed by the largest banks. By comparison, smaller community banks incurred much lower loan-loss rates and posed less of a threat to financial system stability (see "Community Banks Withstand the Storm"). The benefits of increased community bank regulation, it would appear, are limited, especially relative to the added costs.

Tighter regulation and supervision impose heavy burdens on smaller-scale and more-labor-intensive community banks. These institutions to a great extent focus on making and monitoring smaller loans and maintaining individual customer relationships. By undermining their competitiveness, recent regulatory reform may have the unintended consequences of bolstering banking industry concentration while weakening an industry segment posing comparatively little threat to financial stability.

More Paperwork

Over the past half-century, the level of detail in regulatory filings required from commercial banks has expanded.[1] One telling measure is the number of pages, excluding instructions, needed to complete what is known as the quarterly Report of Condition and Income, or Call Report for short. What began as a four-page filing in the late 1950s grew into a 30- to 40-page document in the 1980s and 1990s, and most recently to a 71-page report (*Chart 1*).

Preparing the Call Report may not be tremendously burdensome, but the document's increased heft is indicative of regulators' probing into more areas. The number of potential items to be reported quarterly increased from 241 in 1960 to 1,955 in 2012 (*Chart 2*). Initially, banks reported information taken from basic income statements and balance sheets. Over the past two decades, the reporting has grown more granular and complex, bringing in numerous off-balance-sheet and memoranda items.

The length of financial laws reveals further evidence of mounting regulatory complexity. The Glass–Steagall Act (1933), which governed U.S. financial intermediaries until its partial repeal in 1999, was 37 pages; the Dodd–Frank Act is more than 800 pages (*Chart 3*). Likewise, international agreements on banking supervision have grown in scope and complexity. The number of pages in the third version of the international Basel capital accord has mushroomed to 20 times the length of the first one.

Expansive Rules

Although long-term regulatory trends reflect a number of evolutionary factors in financial intermediation and practices, rapid acceleration of U.S. reporting requirements over the past four years is partially a response to the recent financial crisis and recession.

Community banks will benefit from some parts of the Dodd–Frank Act—for example, basing deposit insurance premiums on assets rather than deposits. Some of the act's main features, such as enhanced prudential standards and greater regulatory oversight, will apply only to the largest, systemically important institutions.

(Continued from Financial Stability: Traditional Banks Pave the Way - Regulatory Burden Rising)

Nevertheless, other provisions have largely been applied to big and small banks alike, not fully compensating for the differences in these institutions' business models—to the detriment of small banks. A community bank's knowledge of a small business, once sufficient for a loan, now may not satisfy regulation, rendering the lender unable to provide credit. A template-driven definition of qualified residential mortgages might prevent community banks from using their local real-estate market knowledge. Community banks will also be burdened with provisions covering escrow accounts for higher-priced mortgages, even though most subprime problems originated from the largest banks' securitizations—the bundling of such risky notes into mortgage-backed securities—rather than residential loans held on community bank balance sheets.

Cost Imbalance

Some allowances for community banks have been made in the Dodd–Frank Act, but the cost of implementing the act's regulations on smaller institutions appears high relative to the benefits.[2]

The number of employees per dollar of loans is depicted in *Chart 4* by bank size. Notably higher ratios for smaller banks indicate they are much more labor intensive than larger institutions, reflecting their focus on smaller loans and individualized products and services. The traditional, relationship-based model followed by community banks requires its own regulatory framework, one more streamlined than the increasingly complex and formulaic rules being applied to larger, more transaction-oriented banks. Such a streamlined framework should include flexibility to account for the diversity among community banks, as reflected in their customized approaches to individual customer needs and preferences.

Additionally, smaller banks cannot easily absorb the cost of new regulation. More complicated regulatory compliance will force community banks to increase staff relative to assets to a greater degree than at large banks, further undermining competitiveness. Adjustments to new, complex regulatory requirements represent costs that, spread over fewer assets, are more burdensome for smaller institutions.

Recent changes in bank regulations have focused on curbing excessive risk taking that contributed to a deepening recession and more difficult financial crisis. Associated lending losses were concentrated at larger, and often very large, banks that engaged in highly complex and risky activities. They became "too big to fail." By comparison, community banks were better able to avoid losses, and their practices did not justify greater regulation. They filled an important niche in financial intermediation. As a result, financial reform appears to have imposed high costs on community banks relative to any benefits of curbing micro- and macroprudential risk.

By unduly imposing greater regulations on the smaller institutions, recent regulatory reform will drive additional community bank consolidation. The country would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks. Some recent proposals call for further efforts to ensure that community banks are overseen differently than are larger and more complex operations.[3] The proposals have merit and deserve serious consideration.

(Continued from Financial Stability: Traditional Banks Pave the Way - Regulatory Burden Rising)

Notes

1. See "The Dog and the Frisbee," by Andrew G. Haldane and Vasileios Madouros, Bank of England, paper presented at "The Changing Policy Landscape" symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 30–Sept. 1, 2012, www.kansascityfed.org/publicat/sympos/2012/ah.pdf.

2. For more details on the merits and risks of individual provisions of the Dodd–Frank Act, see "Community Banks and Credit Unions: Impact of Dodd–Frank Act Depends Largely on Future Rule Makings," Government Accountability Office, September 2012.

3. See "Community Banks and Mortgage Lending," speech by Elizabeth A. Duke, Board of Governors of the Federal Reserve System, at the Community Bankers Symposium, Chicago, Nov. 9, 2012, www.federalreserve.gov/newsevents/speech/duke20121109a.pdf.

About the Author

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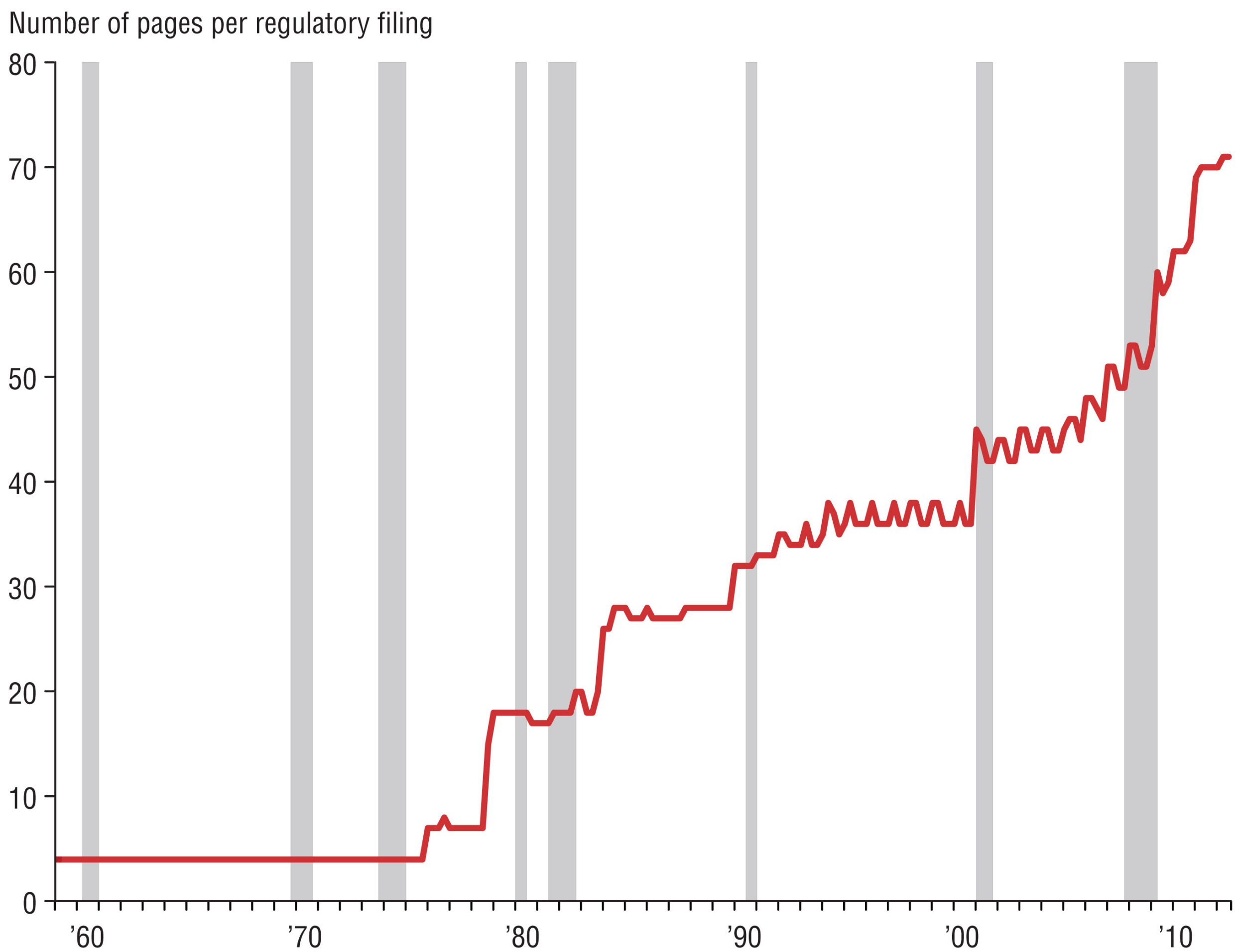
Chart 1

Pages in U.S. Regulatory Filings Rapidly Increase



NOTES: Gray bars indicate recessions. Maximum number of report pages for domestic banks only.
1959:Q4–1983:Q4: Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
1984:Q1–2000:Q4: Forms FFIEC 032, FFIEC 033, FFIEC 034.
2001:Q1–present: Form FFIEC 041.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

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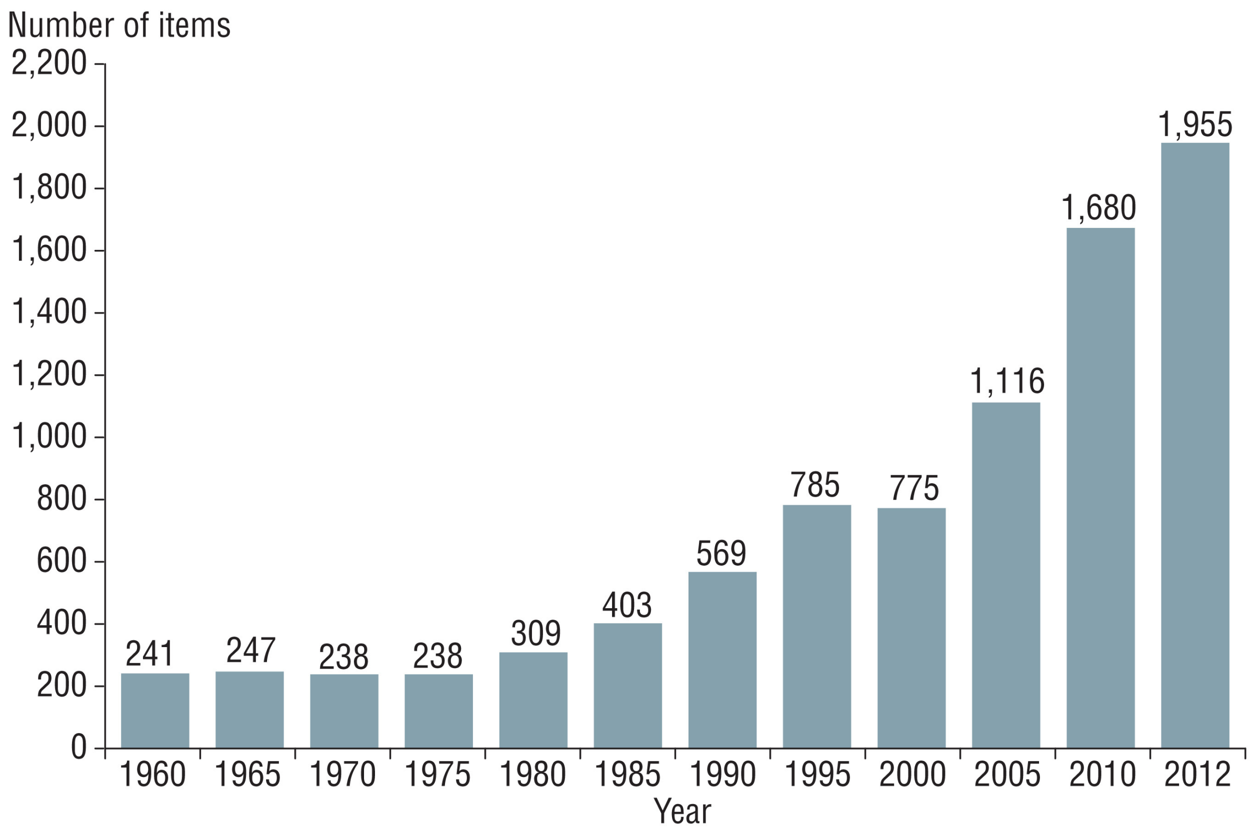
Chart 2

Items per Filing Rise as Complexity Increases



NOTES: Maximum number of reporting items for domestic banks only. Q4 of each year.
1960:Q4–1980:Q4: Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
1985:Q4–2000:Q4: Forms FFIEC 032, FFIEC 033, FFIEC 034.
2005:Q4–present: Form FFIEC 041.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

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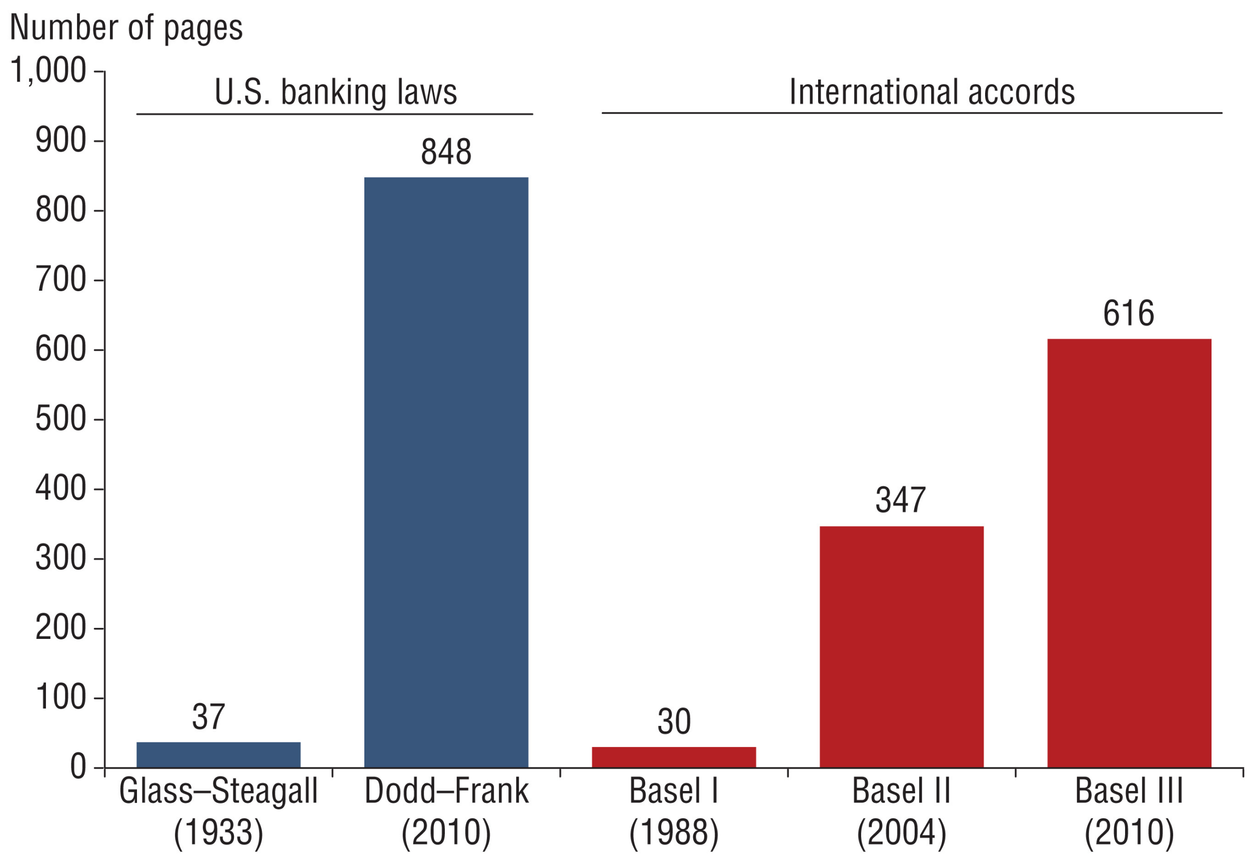
Chart 3
Rising Page Count Mirrors Heightened Oversight



DATA SOURCE: "The Dog and the Frisbee," by Andrew G. Haldane and Vasileios Madouros, Bank of England, paper presented at "The Changing Policy Landscape" symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 30–Sept. 1, 2012.

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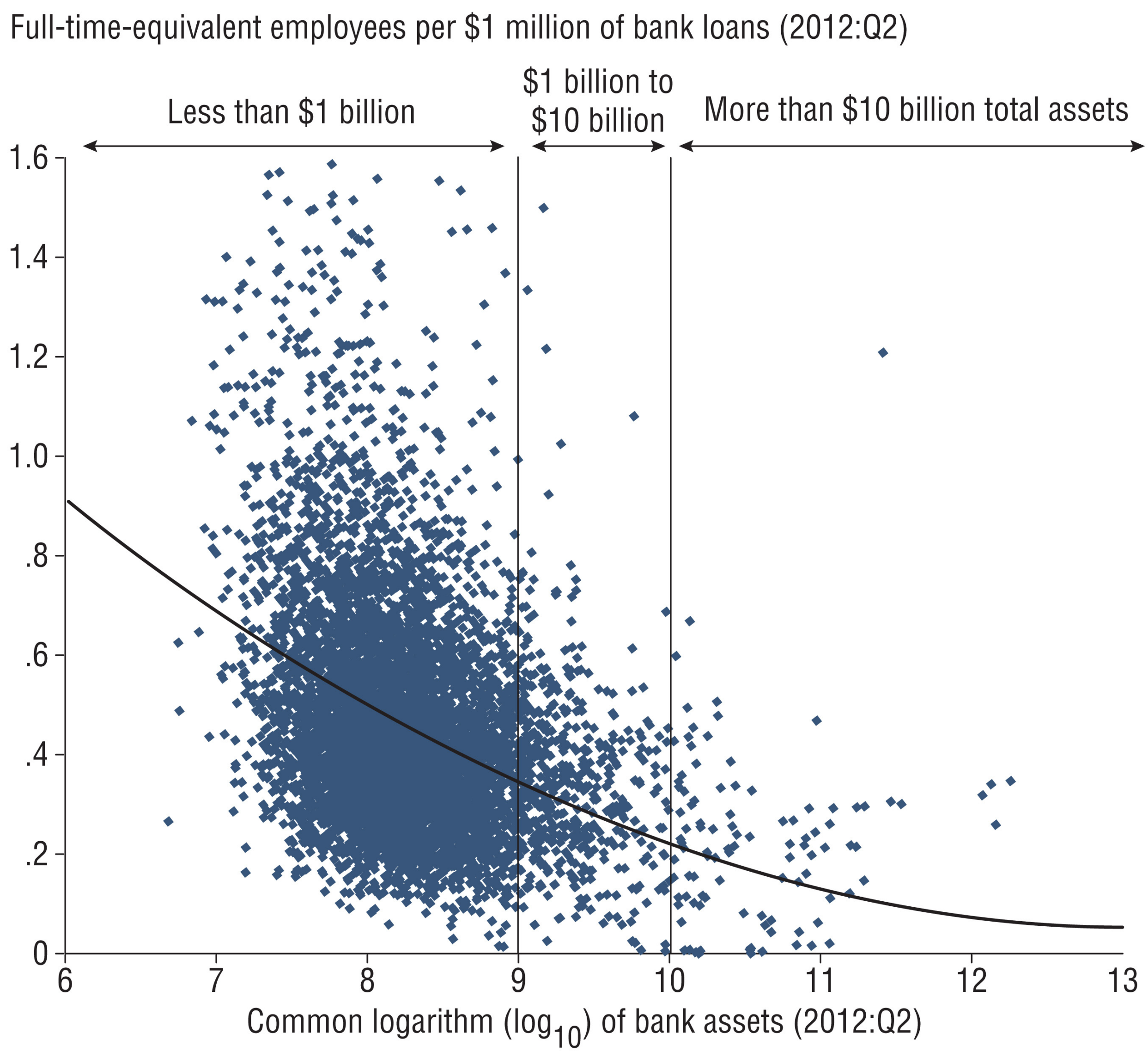
Chart 4
Smaller Banks Require Relatively More Personnel



NOTE: A few outliers with above 1.6 FTE/$1 million loans fall outside plot area.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.