COMMUNITY BANKS AND CREDIT UNIONS

Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings

Why GAO Did This Study

The Dodd-Frank Act includes numerous reforms to strengthen oversight of financial services firms and consolidate certain consumer protection responsibilities within CFPB. To help minimize its regulatory burden on small institutions, including community banks and credit unions, the act exempts such institutions from several of its provisions. However, the act also contains provisions that impose additional requirements on small institutions. Although no commonly accepted definition of a community bank exists, the term often is associated with smaller banks. Historically, community banks and credit unions have played an important role in providing credit to small businesses and other local customers.

This report examines (1) the significant changes community banks and credit unions have undergone in the past decade and the factors that have contributed to such changes, and (2) Dodd-Frank Act provisions that regulators, industry associations, and others expect to impact community banks and credit unions, including their small business lending. GAO analyzed regulatory and other data on community banks and credit unions; reviewed academic and other relevant studies; and interviewed federal regulators, community banks, credit unions, state regulatory and industry associations, academics, and others.

CFPB, federal banking regulators, and the Securities and Exchange Commission provided technical comments on this report, which GAO incorporated as appropriate. CFPB and the National Credit Union Administration generally agreed with the report.

What GAO Found

While the number of community banks and credit unions has declined in recent years, they have remained important lenders to small businesses and other local customers. From 1985 through 2010, the number of banks under $10 billion in assets and credit unions declined by over 50 percent to 7,551 and 7,339, respectively. The decline resulted largely from consolidations, which were facilitated by changes in federal law that made it easier for banks and credit unions to expand geographically. Another factor that may have contributed to consolidations is economies of scale, which refer to how an institution’s size is related to its costs. Although the existence of economies of scale in banking has been subject to debate, some recent research suggests that banks can save costs by expanding. Despite the decline in their number, community banks and credit unions have maintained their relationship-banking model, relying on their relationships with customers and local knowledge to make loans.

Community banks and credit unions also play an important role in rural areas, using relationship-based lending to serve customers with limited credit histories.

Although the Dodd-Frank Wall Street Reform and Consumer Protection Act’s (Dodd-Frank Act) reforms are directed primarily at large, complex U.S. financial institutions, regulators, industry officials, and others collectively identified provisions within 7 of the act’s 16 titles that they expect to have positive and negative impacts on community banks and credit unions. Industry officials told us that it is difficult to know for sure which provisions will impact community banks and credit unions, because the outcome largely depends on how agencies implement certain provisions through their rules, and many of the rules implementing the act have not been finalized. Thus, regulators and industry officials also have noted that the full impact of the Dodd-Frank Act on these institutions is uncertain. Nonetheless, some regulators and industry officials expect some of the act’s provisions to benefit community banks and credit unions and other provisions to impose additional requirements on community banks and credit unions that could affect them disproportionately relative to larger banks. GAO analyzed a number of the Dodd-Frank Act provisions that regulators, industry officials, and others expect to impact community banks and credit unions. Several of the act’s provisions, including its deposit insurance reforms, exemption from Section 404(b) of the Sarbanes-Oxley Act, and the Bureau of Consumer Financial Protection’s (CFPB) supervision of certain nonbanks, could reduce costs and/or help level the playing field for community banks and credit unions. Other provisions, such as the act’s mortgage reforms, may impose additional requirements and, thus, costs on generally all banks and credit unions, but their impact will depend on, among other things, how the provisions are implemented. Finally, industry officials generally told us that it is too soon to determine the Dodd-Frank Act’s overall impact on small business lending and identified only one provision that contains a data collection and reporting requirement as potentially having a direct impact on such lending.

For more information, contact Lawrance Evans at (202) 512-8678 or evansl@gao.gov.
Table 6: Dodd-Frank Act Provisions Expected by Federal Regulators, State Regulatory Associations, and Industry Associations to Impact Community Banks and Credit Unions

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Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Name</th>
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<tbody>
<tr>
<td>CFPB</td>
<td>Bureau of Consumer Financial Protection</td>
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<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
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<td>DIF</td>
<td>Deposit Insurance Fund</td>
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<tr>
<td>Dodd-Frank Act</td>
<td>Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
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<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<tr>
<td>Federal Reserve</td>
<td>Board of Governors of the Federal Reserve System</td>
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<tr>
<td>FHFA</td>
<td>Federal Housing Finance Agency</td>
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<tr>
<td>HMDA</td>
<td>Home Mortgage Disclosure Act</td>
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<tr>
<td>JOBS Act</td>
<td>Jumpstart Our Business Startups Act</td>
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<tr>
<td>NCUA</td>
<td>National Credit Union Administration</td>
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<tr>
<td>OCC</td>
<td>Office of the Comptroller of the Currency</td>
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<tr>
<td>OTC</td>
<td>over-the-counter</td>
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<tr>
<td>OTS</td>
<td>Office of Thrift Supervision</td>
</tr>
<tr>
<td>QM</td>
<td>qualified mortgage</td>
</tr>
<tr>
<td>QRM</td>
<td>qualified residential mortgage</td>
</tr>
<tr>
<td>RMBS</td>
<td>residential mortgage-backed securities</td>
</tr>
<tr>
<td>SBA</td>
<td>Small Business Administration</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>TILA</td>
<td>Truth in Lending Act</td>
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September 13, 2012

The Honorable Olympia Snowe
Ranking Member
Committee on Small Business and Entrepreneurship
United States Senate

The Honorable Mark Kirk
United States Senate

In 2008, the U.S. financial system and broader economy faced the most severe financial crisis since the Great Depression. The crisis threatened the stability of the financial system and contributed to the failure of numerous financial institutions, including some large, complex financial institutions. For example, 414 banks and 90 credit unions failed between 2008 and 2011, with such failures peaking in 2010. In response to the crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which became law on July 21, 2010.\(^1\) The act includes numerous reforms to strengthen oversight of financial services firms and consolidate certain consumer protection responsibilities within the Bureau of Consumer Financial Protection, commonly known as the Consumer Financial Protection Bureau (CFPB).\(^2\)

Although the Dodd-Frank Act exempts small institutions, such as community banks and credit unions, from several of its provisions, and authorizes federal regulators to provide small institutions with relief from certain regulations, it also contains provisions that will impose additional restrictions and compliance costs on these institutions.\(^3\) Historically,


\(^2\)Title X of the Dodd-Frank Act, also called the Consumer Financial Protection Act of 2010, creates CFPB as a new executive agency to enforce certain existing federal consumer protection laws and promulgate new rules regarding federal consumer financial laws.

\(^3\)Although no commonly accepted definition of a community bank exists, the term often is associated with smaller banks (e.g., under $1 billion in assets) that provide relationship banking services to the local community and have management and board members who reside in the local community. In this report, we generally define community banks as banks (insured depository institutions that are not credit unions) with under $10 billion in total assets. We also include in our analysis federally insured credit unions with under $10 billion in total assets. We use under $10 billion in total assets as our criterion because the Dodd-Frank Act exempts small institutions from a number of its provisions based on that threshold.
community banks and credit unions have played an important role in serving their local customers, including providing credit to small businesses.

This report examines

- the significant changes community banks and credit unions have undergone in the past decade, and the factors that have contributed to such changes; and

- Dodd-Frank Act provisions that regulators, industry associations, and others expect to impact community banks and credit unions, including their small business lending.

To examine changes in community banks and credit unions, we analyzed data from SNL Financial, a private financial database that contains publicly filed and financial reports, including Consolidated Reports on Condition and Income (Call Reports) submitted to the Federal Deposit Insurance Corporation (FDIC), Thrift Financial Reports submitted to the Office of Thrift Supervision (OTS), and 5300 Call Reports (Call Reports) submitted to the National Credit Union Administration (NCUA). We used SNL Financial data to identify changes in the total number, profitability, lending activities, expenses, and other metrics of community banks and credit unions from 2002 through 2011. We reviewed the SNL Financial data and found the data to be sufficiently reliable for our purposes. We

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4The Dodd-Frank Act eliminated OTS, which chartered and supervised federally chartered savings institutions and savings and loan companies. Rule-making authority previously vested in OTS was transferred to the Office of the Comptroller of the Currency (OCC) for savings associations and to the Board of Governors of the Federal Reserve System (Federal Reserve) for savings and loan holding companies. Supervisory authority was transferred to OCC for federal savings associations, to FDIC for state savings associations, and to the Federal Reserve for savings and loan holding companies and their subsidiaries, other than depository institutions. The transfer of these powers was completed on July 21, 2011, and OTS was officially dissolved 90 days later (Oct. 19, 2011).

5Call Reports are a primary source of financial data used for the supervision and regulation of banks and credit unions. They consist of a balance sheet, an income statement, and supporting schedules. Every national bank, state member bank, insured state nonmember bank, and federally insured credit union is required to file a consolidated Call Report, normally as of the close of business on the last calendar day of each calendar quarter. The specific reporting requirements depend on the size of the institution and whether it has any foreign offices. As of March 31, 2012, savings associations no longer filed Thrift Financial Reports and instead were required to file Call Reports.
also reviewed and analyzed relevant academic, regulatory, and industry studies. We interviewed officials from FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and NCUA, and the Small Business Administration (SBA); officials from two state regulatory associations (Conference of State Bank Supervisors and National Association of State Credit Union Supervisors); representatives of industry associations, including the American Bankers Association, Credit Union National Association, Independent Community Bankers of America, and National Association of Federal Credit Unions; and academics to obtain their perspectives on industry changes.

To assess the Dodd-Frank Act’s impact on community banks and credit unions, we reviewed the act and related materials, including relevant congressional hearings; comment letters on proposed rules; and studies and analyses prepared by federal and state regulators, industry associations, law firms, and academics. We used Call Report and other data compiled by SNL Financial to assess the extent to which community banks and credit unions may be subject to or otherwise impacted by various Dodd-Frank Act provisions. We reviewed the SNL Financial data and found the data to be sufficiently reliable for our purposes. To help identify Dodd-Frank Act provisions applicable to community banks and credit unions and assess their impact on those institutions, we interviewed the federal agencies, state regulatory and industry associations, and others identified above, and CFPB. We discussed public comments that some regulators received about proposed rules, but regulators generally do not disclose how they will respond to such comments until after the rules are finalized. In addition, based on demographic factors, we interviewed four state banking and credit union associations, and we randomly selected and interviewed 12 community banks and credit unions to obtain information on the Dodd-Frank Act’s provisions. Our interviews with this small sample of institutions provided further insights on the expected impact of the Dodd-Frank Act, but the responses are not generalizable to the population of community banks and credit unions. Although we analyzed the impact of a number of specific Dodd-Frank Act provisions on community banks and credit unions, assessing the extent to which these provisions or their related regulations should apply to such institutions was beyond the scope of our work. Appendix I contains additional information on our scope and methodology.

We conducted this performance audit between February and September 2012, in accordance with generally accepted government auditing
standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

**Background**

In the banking industry, the specific regulatory configuration for a banking institution depends on the type of charter the institution chooses. Depository institution charter types include:

- commercial banks, which originally focused on the banking needs of businesses but over time have broadened their services;

- thrifts, which include savings banks, savings associations, and savings and loans, and were originally created to serve the needs—particularly the mortgage needs—of those not typically served by commercial banks; and

- credit unions, which are member-owned cooperatives run by member-elected boards with an historical emphasis on serving people of modest means.

These charters may be obtained at the state or federal level. State regulators charter institutions and participate in their oversight, but all institutions that offer federal deposit insurance have a prudential regulator. The prudential regulators—which generally may issue regulations for and take enforcement actions against industry participants within their jurisdiction—are identified in table 1.
Table 1: Prudential Regulators and Their Basic Functions

<table>
<thead>
<tr>
<th>Agency</th>
<th>Basic function</th>
</tr>
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<tbody>
<tr>
<td>Office of the Comptroller of the Currency</td>
<td>Charters and supervises national banks and federal thrifts</td>
</tr>
<tr>
<td>Board of Governors of the Federal Reserve System</td>
<td>Supervises state-chartered banks that opt to be members of the Federal Reserve System, bank holding companies, thrift holding companies, and the nondepository institution subsidiaries of those institutions</td>
</tr>
<tr>
<td>Federal Deposit Insurance Corporation</td>
<td>Supervises FDIC-insured state-chartered banks that are not members of the Federal Reserve System, as well as federally insured state savings banks and thrifts; insures the deposits of all banks and thrifts that are approved for federal deposit insurance; and resolves all failed insured banks and thrifts and certain nonbank financial companies</td>
</tr>
<tr>
<td>National Credit Union Administration</td>
<td>Charters and supervises federally chartered credit unions and insures savings in federal and most state-chartered credit unions</td>
</tr>
</tbody>
</table>

Source: GAO.

As shown in table 2, almost 7,400 (about 99 percent) of all banks had less than $10 billion in assets in 2011 and thus fell within our definition of a community bank. The majority of community banks have $250 million or less in total assets. Although community banks comprise the vast majority of all banks, they held in aggregate about 20 percent of the industry’s total assets (about $2.8 trillion) in 2011.

Table 2: Numbers of Banks by Asset Class, 2011

<table>
<thead>
<tr>
<th>Asset size</th>
<th>Number of banks</th>
<th>Percentage of total banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Community Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt; $100 million</td>
<td>2,504</td>
<td>33%</td>
</tr>
<tr>
<td>$100 - $250 million</td>
<td>2,418</td>
<td>32</td>
</tr>
<tr>
<td>$250 million - $1 billion</td>
<td>1,907</td>
<td>25</td>
</tr>
<tr>
<td>$1- $10 billion</td>
<td>556</td>
<td>7</td>
</tr>
<tr>
<td>Large Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; $10 billion</td>
<td>109</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>7,494</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: GAO analysis of SNL Financial data.

Note: Community banks can be defined based on a number of criteria, but for the purpose of this report, we use size (less than $10 billion in assets) as the sole criterion to distinguish community banks from their larger counterparts.

Similarly, table 3 shows that the vast majority of credit unions (over 99 percent) had $10 billion or less in total assets in 2011. Furthermore, around 80 percent of the credit unions had $100 million or less in total assets.
Table 3: Numbers of Credit Unions by Asset Class, 2011

<table>
<thead>
<tr>
<th>Asset size</th>
<th>Number of credit unions</th>
<th>Percentage of total credit unions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Small Credit Unions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt; $5 million</td>
<td>1,676</td>
<td>24%</td>
</tr>
<tr>
<td>$5 - $20 million</td>
<td>1,936</td>
<td>27%</td>
</tr>
<tr>
<td>$20 - $100 million</td>
<td>2,080</td>
<td>29%</td>
</tr>
<tr>
<td>$100 million - $1 billion</td>
<td>1,219</td>
<td>17%</td>
</tr>
<tr>
<td>$1- 10 billion</td>
<td>180</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Large Credit Unions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; $10 billion</td>
<td>3</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>7,094</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: GAO analysis of SNL Financial data.

Note: We use under $10 billion in total assets as our criteria for a small credit union, because the Dodd-Frank Act exempts small institutions from a number of its provisions based on that threshold.

The Dodd-Frank Act made important and fundamental changes to the structure of the U.S. financial system to strengthen safeguards for consumers and investors and to provide regulators with better tools for limiting risk in the major financial institutions and the financial markets. According to the Financial Stability Oversight Council, the core elements of the act are designed to build a stronger, more resilient financial system—less vulnerable to crisis, more efficient in allocating financial resources, and less vulnerable to fraud and abuse.6 Under the Dodd-Frank Act, federal financial regulatory agencies are directed or have the authority to issue hundreds of regulations to implement the act’s reforms. The Dodd-Frank Act directs agencies to adopt regulations to implement the act’s provisions and, in some cases, gives the agencies little or no discretion in deciding how to implement the provisions. However, other rule-making provisions in the act are discretionary in nature, stating that (1) certain agencies may issue rules to implement particular provisions or that the agencies may issue regulations that they decide are “necessary and appropriate,” or (2) agencies must issue regulations to implement particular provisions but have some level of discretion as to the substance of the regulations. As a result, the agencies may decide to promulgate

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rules for all, some, or none of the provisions, and often have broad
discretion to decide what these rules will contain. Many of the provisions
in the Dodd-Frank Act target the largest and most complex financial
institutions, and regulators have noted that much of the act is not meant
to apply to community banks. As such, the act directs regulators in a
number of areas to consider whether to exempt small banks and credit
unions. However, the act is comprehensive and far-reaching and will
impact smaller institutions, specifically those that undertake activities
thought to be precipitating factors in the 2007 through 2009 financial
crisis.

Community Banks
and Credit Unions
Have Declined in
Number but Remain
Important for Small
Businesses and
Agriculture

The number of community banks and credit unions has declined in recent
decades, as smaller institutions have expanded, merged with, or been
purchased by larger institutions. The trend of consolidation in banks and
credit unions has been facilitated by statutory and regulatory changes and
may have resulted, in part, from advantages in efficiency at larger
institutions. However, community banks and credit unions still play an
important role in the economy. Community banks and credit unions
allocate more of their lending to small businesses and rural areas than
large banks, which research suggests is due to their focus on
relationship-based lending.

Changes in Regulation and
Other Factors Have Led to
the Consolidation of Many
Community Banks and
Credit Unions

The number of community banks and credit unions has continued to
decline significantly since at least the mid-1980s. According to FDIC
research presented in 2012, the number of banks with less than $10
billion in assets declined from 17,997 to 7,551, or by about 58 percent,
between 1985 and 2010.7 Similarly, according to NCUA annual reports,
the number of federally insured credit unions declined from 15,045 to
7,339, or by about 51 percent, between 1985 and 2010. Despite the
decline in the number of credit unions, our analysis of Census data found
that membership in credit unions doubled over the same period. Our
analysis of SNL Financial data shows that the number of community

7Richard Brown, Chief Economist, FDIC, “Community Banking by the Numbers” (paper
presented at FDIC’s Future of Community Banking Conference, Feb. 16, 2012). FDIC
plans to issue additional research on the community banking sector by the end of 2012.
banks and credit unions declined further in 2011, to 7,385 and 7,094, respectively.8

The decline in the number of community banks and credit unions has resulted largely from consolidations, in which two or more institutions generally merge into one larger institution. In their 2012 research, FDIC staff found that of the banks that exited the market between 1985 and 2010, 16 percent failed but 80 percent merged with another financial institution or consolidated within a single holding company. FDIC staff also found that the smallest banks (those with less than $100 million in assets) experienced the largest decline in number, decreasing by 81 percent. Consistent with a pattern of consolidation and expansion, the number of midsize banks (those with $250 million to $1 billion in assets) and large banks (those with over $10 billion in assets) increased by 47 percent and 197 percent, respectively.

Changes in Regulation

Two key statutory and regulatory changes have facilitated consolidation by removing regulatory barriers to geographic and membership expansion by banks and credit unions, respectively. First, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 authorized interstate mergers between banks starting in June 1997, regardless of whether the transaction would be prohibited by state law.9 Previously, most banks that wanted to operate across state lines had to establish a bank holding company and, with certain restrictions, acquire or charter a bank in each state in which they wanted to operate. With the advent of interstate branching, banks that previously were not permitted to expand across state lines could do so by acquiring existing banks, and some multistate bank holding companies could consolidate their operations into a single bank with multistate branches.10 Second, after the passage of the Credit Union Membership Access Act in 1998, NCUA revised its regulations to make it easier for federal credit unions to qualify for

8For this objective, our analysis of SNL Financial data includes commercial banks, savings banks, savings institutions, and credit unions.


10Section 613 of the Dodd-Frank Act further reduced restrictions on interstate branching. Before the passage of the Dodd-Frank Act, states could opt not to allow national banks and out-of-state banks to open new branches. The Dodd-Frank Act allows national and out-of-state banks to open branches in any state, only restricted by the laws that apply to in-state banks.
community charters that allowed people to qualify for membership in a
credit union based on their geographic location (e.g., such as a county)
rather than based on their employer or affiliation in an organization. As a
result, community-chartered credit unions were able to expand, according
to one expert we interviewed, by consolidating with other local credit
unions, whose members resided in their geographic area. As we
previously reported, the total number of federally chartered credit unions
decreased from 2000 through 2005, but the number of federal community-
chartered credit unions more than doubled.12

Another factor that may have contributed to consolidation is economies of
scale, which refer to how a bank’s or credit union’s scale of operations, or
size, is related to its costs. Increasing returns to scale are created when
an increase in size leads to a less than proportionate increase in cost
and, therefore, a decline in average cost. Banks and credit unions that
can take advantage of economies of scale can generate revenues at
lower costs by increasing their size through expansion and consolidation.
For example, a bank could reduce the average cost in its technology
investment by increasing the volume of its goods and services, and
thereby increase its profitability. Importantly, the existence of economies
of scale in banking has been subject to debate. Studies using data from
the 1980s failed to find scale economies beyond very small banks, but
later studies have found scale economies in various sized banks.13 For
example, a 2009 study covering all commercial banks from 1984 to 2006
found that banks had increasing returns to scale throughout the
distribution of banks, and the authors concluded that industry
consolidation had been driven, at least in part, by scale economies.14
Similarly, in a 2008 study of credit union consolidation presented at
FDIC’s Mergers and Acquisitions of Financial Institutions Conference,

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serve the general public.

12GAO, Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and
30, 2006).

13See, for example, Loretta J. Mester, “Optimal Industrial Structure in Banking,” Handbook

14David C. Wheelock and Paul W. Wilson, “Do Large Banks have Lower Costs? New
Reserve Bank of St. Louis, Revised (May 2011).
researchers found that smaller and less profitable credit unions were more likely to merge with other credit unions, and that the assets of a small credit union might be used more efficiently if the credit union were acquired and its assets were absorbed into a larger institution.  

The results of our analysis are consistent with research finding that larger banks generally are more profitable and efficient than smaller banks, which may reflect increasing returns to scale. For example, in a 2004 study that compared performance between smaller and larger banks, FDIC staff found that smaller banks earned more on their assets than larger banks but that the earnings did not translate into a higher return on assets because smaller institutions also had higher costs. Our analysis of SNL Financial data also found that community banks and credit unions generally have lower rates of return on their assets. As shown in figure 1, banks with more than $10 billion in assets had higher rates of return on their assets than community banks and credit unions from 2002 through 2006. However, returns on assets at large banks declined sharply in 2007 and turned negative in 2008 and 2009, coinciding with the financial crisis. During this period, returns on assets at community banks were higher than at large banks—declining but remaining positive. From 2010 through 2011, returns on assets increased more quickly at large banks than at community banks and credit unions. Returns on equity at community banks, credit unions, and large banks have followed a trend


16NCUA officials noted that while banks and credit unions often collect the same data, comparisons between the two are limited because of differences in organizational structure and regulation. Specifically, credit unions operate as not-for-profit institutions and have limited fields of membership.


18Return on assets and return on equity are both measures of bank profitability. Return on assets represents the income banks earned per dollar of loan or investment, while return on equity represents the income earned per dollar of capital. Differences between a bank’s return on equity and return on assets depend on the bank’s use of leverage, which can be measured by its capital ratio.

19We adjusted each bank’s and credit union’s total assets in each year for inflation to 2011 dollars using the U.S. gross domestic product deflator.
similar to that of returns on assets, with large bank earning higher returns on equity than small financial institutions from 2002 through 2006. Moreover, the gap in returns on equity between large and small financial institutions was greater than the gap in returns on assets before the financial crisis. In their 2004 study, FDIC staff also found that smaller institutions tend to have higher capital ratios than large banks, which also leads to lower returns on equity at a given level of earnings.\textsuperscript{20}

Our analysis also indicates that community banks and credit unions have generated revenues at higher average costs than large banks since

\textsuperscript{20}For a given return on assets, lower capital ratios imply higher returns on equity because leverage magnifies returns on equity.
As of the end of 2011, large banks earned $1.71 per dollar of operating costs, while community banks earned $1.27 and credit unions earned $1.09. We also found that larger community banks and credit unions were more efficient than smaller institutions by this measure, suggesting that those institutions may have benefited from some economies of scale. As shown in figure 2, the difference in efficiency between community banks and credit unions and large banks generally remained consistent between 2002 and 2010. However, recent declines in revenue per dollar of overhead cost at large banks, along with gains in efficiency at community banks, decreased the difference in 2011. Although community banks with less than $100 million in assets were the least efficient in each year between 2002 and 2011, they (unlike the other banks) experienced an overall increase in their efficiency over the period. These measures of efficiency and profitability also can be influenced by other factors outside of economies of scale, such as increased competition. In April 2011, an OCC official testified that declines in net interest margins have played a major role in decreasing community bank profits.

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21Operating expenses as a percentage of operating revenues is a standard measure of bank efficiency in the literature. For clarity, we have provided the inverse of this measure, operating revenues per dollar of operating costs, so that a higher number indicates greater efficiency.

Some research suggests that one area in which large banks are able to take advantage of economies of scale is regulatory compliance, which contributes to their advantage in terms of operational efficiency. Federal regulators and state regulatory association and industry officials that we interviewed stated that regulatory compliance costs are not regularly tracked in Call Reports, and these costs have not been studied recently in the research literature. Thus, information on economies of scale in this area is limited. However, in a 1998 study, Federal Reserve staff reviewed statistical studies that empirically examined possible economies of scale in regulatory compliance at banks, noting that “if regulatory costs exhibit economies of scale, smaller banks would face higher average costs in complying with regulations than larger banks.”23 The studies found

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statistical evidence that indicated economies of scale in compliance costs for several regulations, which suggested that smaller banks, relative to larger banks, have a cost disadvantage that may discourage the entry of new firms into banking, may stimulate consolidation of the industry into larger banks, and may inhibit competition among institutions in markets for specific financial products. Additionally, several experts that we spoke with said that smaller institutions are disproportionately affected by increased regulation, because they are less able to absorb additional costs.

Our analysis suggests that community banks have done more small business and agricultural lending as a percentage of their total lending than large banks over the past decade. To examine small business lending, we used business loans of $1 million or less as a proxy for small business loans at banks, though these loans were not necessarily made to small businesses. As shown in figure 3, our analysis of SNL Financial data found that about 18 percent of total lending at community banks was small business loans, compared to about 5 percent at larger banks in 2011. Figure 3 also shows that while the difference between small business lending at community banks and large banks has remained fairly consistent over the past decade, small business lending as a percentage of total lending declined at both community banks and large banks by about 2 percent from 2002 through 2011. Despite allocating less of their lending to small business loans, banks with more than $10 billion in assets still made about 45 percent of all small business loans in 2011, while accounting for about 1 percent of the total number of banks.
Community banks also have done significantly more agricultural lending as a percentage of total lending than large banks, with the smallest community banks allocating the highest percentage of lending to agricultural loans. Our analysis found that banks with less than $100 million in assets had allocated about 14 percent of their lending to agricultural loans on average from 2002 through 2011, while banks with over $10 billion in assets had allocated less than 1 percent of their loans to agriculture on average. In a 2003 study, Federal Reserve staff also found that community banks played an important role in rural areas generally, where they represented a much higher percent of branches and deposits than in urban areas. The study found that community banks represented nearly 58 percent of bank branches and 49 percent of

total deposits in rural areas, compared to 24 percent of branches and around 14 percent of deposits in urban areas.

Some credit unions also make small business and agricultural loans, but differences in regulation and structure make comparisons to banks difficult. We found that small business lending at credit unions with less than $10 billion in assets increased from about 2 percent to about 7 percent of their total lending from 2002 through 2011.25 A recent study conducted on behalf of SBA found that credit union lending may have offset some of the decrease in small business lending at banks.26 We recently reported that such loans can be risky for credit unions and have contributed to the failure of a number of credit unions.27 Specifically, we reported that our analysis of NCUA and its Office of Inspector General’s data indicated that member business loans contributed to 13 of the 85 credit union failures from January 2008 to June 2011. The Credit Union Membership and Access Act of 1998 contains a provision that limits business lending by credit unions to the lesser of 12.25 percent of total assets or 175 percent of net worth.28 Experts and credit union officials told us that smaller credit unions may not be able to engage profitably in small business lending due in part to the lending cap. To engage in such lending, these officials told us a credit union has to develop business lending expertise and resources and may need to hire additional staff, but the cap may not allow them to make the volume of loans needed to cover these costs. Larger credit unions are able to make more loans under the cap and thus are better able to develop the necessary resources. Our analysis found that small business lending increased much more.

25We used business lending data compiled by SNL Financial as a proxy for small business lending for credit unions. Business lending at credit unions is referred to as member business lending because credit unions are owned by their depositors, or members, and credit unions may extend credit only to their members. One expert noted that nearly all member business lending is done to small businesses.


28Credit unions designated as low income are exempt from the 12.25 percent statutory cap on member business loans. A low-income credit union is one that serves predominantly low-income members as defined in NCUA regulations. A recent NCUA initiative streamlined the process for federal credit unions to receive a low-income designation.
dramatically at credit unions with at least $100 million in assets from 2002 through 2011. Figure 4 shows that small business lending at these large credit unions increased from about 2 percent of total loans in 2002 to nearly 8 percent in 2011. While most credit unions do little or no agricultural lending, some credit unions have been chartered specifically to provide agricultural credit, and industry officials told us that these institutions play key roles in their communities.

Research has indicated that community banks and credit unions have advantages over larger banks in providing small business loans and loans in rural areas because of their direct relationships with and knowledge of individual customers. The 2003 study by Federal Reserve staff found that community banks have focused on “relationship banking,” basing lending decisions on personal knowledge of their customers and an understanding of their local economies. The study contrasted this approach to that of large banks, which often rely on data, credit scoring,
and centralized decision making. FDIC staff noted that relationship lending gives community banks the ability to lend to borrowers without long credit histories, because it allows them to use nonstandard information to make profitable loans to customers who are seen as high risk by large banks. Experts we spoke with noted that small businesses often do not have audited financial statements and other data that may be used by large banks in credit scoring models. One expert stated that loans to small business and rural residents tend to have nonstandard terms and require knowledge of the personal or professional history of the business or person seeking the loan. As shown in figure 5, we found that loans make up a slightly greater proportion of their total assets, which suggests that community banks and credit unions may be more focused on traditional lending services than large banks.

Figure 5: Loans as a Percentage of Total Assets at Banks and Credit Unions from 2002 through 2011

Loans as a percentage of total assets

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>Banks with $10 billion or more in assets</th>
<th>Banks with less than $10 billion in assets</th>
<th>Credit unions with less than $10 billion in assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td></td>
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<tr>
<td>2003</td>
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<td>2010</td>
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<tr>
<td>2011</td>
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</tbody>
</table>

Source: GAO analysis of SNL Financial data.
Many Dodd-Frank Act Provisions May Affect Community Banks and Credit Unions, but the Full Extent of Their Impact Is Uncertain

The Dodd-Frank Act’s reforms are directed primarily at large, complex U.S. financial institutions, and the act exempts small institutions, including community banks and credit unions, from several of its provisions. However, federal regulators, state regulatory associations, and industry associations collectively identified provisions within 7 of the act’s 16 titles that they expect to impact community banks and credit unions. (See app. II for the Dodd-Frank Act provisions identified by the above entities.) We analyzed the impact of a number of these Dodd-Frank Act provisions and, in brief, found that:

- some provisions, including the depository insurance reforms and CFPB supervision of nonbank providers of financial services and products, have benefited or may benefit community banks and credit unions;
- certain of the act’s mortgage reforms are expected to impose additional costs on community banks and credit unions, but their impact depends on future rule makings;
- the act’s risk retention provision for securitizations is expected to initially have a limited impact on community banks and credit unions; and
- other provisions, including those covering proprietary trading, remittance transfers, and executive compensation, are expected to impose additional requirements on community banks and credit unions, but their impact depends partly on future rule makings.

Industry officials told us that determining which provisions will affect small institutions is difficult, because the impact may depend on how agencies implement certain provisions through their rules, and many of the rules needed to implement the act have not been finalized. For the same reason, regulators and industry officials have noted that the full impact of the Dodd-Frank Act on community banks and credit unions is uncertain. Nonetheless, regulators and industry officials have noted that they expect that some of the act’s regulations will increase regulatory requirements on community banks and credit unions and disproportionately affect them

According to Davis Polk & Wardwell (a law firm that has been tracking the implementation of the Dodd-Frank Act), 119 of the 398 rulemakings required under the Dodd-Frank Act, about 30 percent, had been finalized as of July 2, 2012.
relative to larger banks because of their size. Moreover, some industry officials have expressed concern that the reforms targeting only large banks eventually will be applied to small institutions in varying degrees, for example, through industry best practices. In our interviews with officials from community banks and credit unions, several told us that they may reduce certain business activity or exit certain lines of business as a result of the new regulations. However, some also have cited benefits of particular provisions for smaller institutions.

As recognized by federal regulators, industry officials, and others, the Dodd-Frank Act contains several provisions to help minimize certain regulatory requirements on small institutions. For example, the act includes provisions that generally exempt (1) small bank holding companies from certain leverage and risk-based capital requirements, (2) small banks and credit unions from supervision by CFPB, (3) small debit card issuers from the debit interchange fee standards, and (4) small financial institutions from disclosure and reporting requirements for incentive-based compensation arrangements.\footnote{These exemptions are based on specific asset thresholds, and the exemptions do not use the same asset threshold. For example, the exemption from CFPB supervision applies to banks and credit unions with $10 billion or less in assets, and the exemption from disclosure and reporting requirements for incentive-based compensation arrangements applies to financial institutions with less than $1 billion in assets.} The Dodd-Frank Act also provides federal agencies with the authority to provide small institutions with relief from certain regulations. For example, the act and certain of the federal consumer financial laws provide CFPB with the authority to exempt covered persons or transactions from certain CFPB rules, and it directs the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to consider exempting small banks and credit unions from their swap clearing requirements.

CFPB, FDIC, the Federal Reserve, OCC, and NCUA have undertaken various efforts to reach out to community banks and credit unions outside of the examination process, in part to understand challenges being raised for them by the Dodd-Frank Act. Examples of such outreach efforts include the following:

- CFPB has created the Office of Small Business, Community Banks, and Credit Unions, to help it incorporate the perspectives of these institutions in its policy-making process, communicate relevant policy
initiatives to them, and work with them to identify areas for regulatory streamlining. According to CFPB officials, CFPB has convened three small business panels in conjunction with SBA's Chief Counsel for Advocacy and the Office of Management and Budget's Office of Information and Regulatory Affairs.\textsuperscript{31}

- FDIC has held roundtable discussions with community banks in each of its regions and a community bank conference. It is researching a variety of issues involving community banks and expects to issue its study by the end of 2012. In 2009, FDIC established the FDIC Advisory Committee on Community Banking to provide it with advice and guidance on policy issues affecting community banks, and the committee's meetings have included discussions of the Dodd-Frank Act.

- In October 2010, the Federal Reserve formed the Community Depository Institutions Advisory Council to provide the agency with direct insight and information from community bankers about supervisory matters and other issues of interest to community banks. In a recent testimony, a Federal Reserve official noted that the agency expects these ongoing discussions to provide a useful and relevant forum for improving its understanding of the effect of legislation, regulation, and examination activities on small banking organizations.\textsuperscript{32}

- OCC has conducted a variety of outreach activities, including Meet the Comptroller events, chief executive officer roundtables, and teleconferences on topical issues. In preparation for the transfer of federal savings associations to OCC supervision, OCC presented numerous programs for thrift executives around the country to provide information and perspective on OCC's approach to supervision and regulation. OCC also has chartered advisory committees for federal

\textsuperscript{31}Section 1100G of the Dodd-Frank Act requires CFPB to convene panels to seek direct input from small businesses before proposing certain rules.

\textsuperscript{32}The State of Community Banking: Opportunities and Challenges. Before the Subcommittee on Financial Institutions and Consumer Protection of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (2011) (statement of Maryann F. Hunter, Deputy Director of Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System).
savings associations with mutual charters and minority-owned institutions similar to those OTS had chartered.

- NCUA officials told us that to assist credit unions in complying with the Dodd-Frank Act, they have posted articles on their website, conducted a webinar with the CFPB director, and issued letters to credit unions on any rule changes.

As presented below, we analyzed a number of the Dodd-Frank Act provisions that regulators, industry officials, and others expect to impact community banks and credit unions. While several of these provisions have been implemented through finalized rules, most have not. The impact of those provisions will depend, in part, on how they are implemented by federal agencies through their regulations. As the act’s impact on individual banks and credit unions will depend on their organizational form, mix of activities, or other factors, our analysis focused on assessing, where data were available, which of these institutions may be subject to the selected provisions. As part of our analysis, we also document industry and other views on the potential impact of the provisions and the status of regulations needed to implement the provisions. As noted above, assessing whether such provisions or their related regulations should apply to community banks and credit unions was beyond the scope of our work.

Some Provisions Have Reduced Costs or Provided Other Benefits

##### Depository and Share Insurance Reforms

Some of the Dodd-Frank Act provisions that we analyzed have benefited or may benefit community banks or credit unions, such as by reducing costs.

The Dodd-Frank Act’s depository and share insurance reforms have reduced costs for community banks and increased consumer confidence to the benefit of community banks and credit unions. Title III of the Dodd-Frank Act includes several provisions reforming the Deposit Insurance Fund (DIF) and National Credit Union Share Insurance Fund. For example, section 331 revised the method used to calculate DIF assessments. Section 335 permanently increased the standard deposit

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33 DIF insures deposits at banks and the National Credit Union Share Insurance Fund insures deposits, referred to as shares, at credit unions.

34 DIF assessments are insurance assessments collected from its member depository institutions.
and share insurance coverage amount from $100,000 to $250,000. Section 343 provided temporary unlimited deposit and share insurance coverage for non-interest-bearing transaction accounts, such as consumer checking accounts.

Section 331 required FDIC to redefine the DIF assessment base, generally basing it on average consolidated total assets rather than domestic deposits, on which it was previously based. According to FDIC, the change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than smaller institutions, but without affecting the overall amount of assessment revenue collected. As shown in table 4, after the rule became effective on April 1, 2011, DIF assessments for community banks (those with less than $10 billion in assets) decreased in aggregate by $342 million, (33 percent) from the first to second quarter of 2011. According to FDIC, this rule has resulted in a sharing of the DIF assessment burden that better reflects each group’s share of industry assets. Officials from industry associations told us that they viewed this change as positive for community banks overall. In addition, officials from the two community bank state associations told us that assessments likely have decreased for their member institutions. Also, officials from five community banks told us that their assessments have either decreased or stayed about the same, but officials from three community banks told us that their assessments had increased (one of these banks has between $1 billion to $10 billion in assets).

Table 4: Change in Quarterly Insurance Assessments Primarily Due to the Change in the Assessment Base

<table>
<thead>
<tr>
<th>Asset size group</th>
<th>First quarter 2011 assessments</th>
<th>Second quarter 2011 assessments</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $100 million</td>
<td>$51</td>
<td>$33</td>
<td>-36</td>
</tr>
<tr>
<td>$100 million - $250 million</td>
<td>147</td>
<td>96</td>
<td>-35</td>
</tr>
<tr>
<td>$250 million - $500 million</td>
<td>160</td>
<td>104</td>
<td>-35</td>
</tr>
<tr>
<td>$500 million - $1 billion</td>
<td>180</td>
<td>123</td>
<td>-32</td>
</tr>
<tr>
<td>$1 billion - $10 billion</td>
<td>499</td>
<td>340</td>
<td>-32</td>
</tr>
<tr>
<td>Total of less than $10 billion</td>
<td>$1,037</td>
<td>$695</td>
<td>-33</td>
</tr>
<tr>
<td>Over $10 billion</td>
<td>2,423</td>
<td>2,836</td>
<td>17</td>
</tr>
<tr>
<td>Total of asset size groups</td>
<td>$3,460</td>
<td>$3,531</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: FDIC.

Note: According to FDIC officials, at the same time the new assessment base was implemented, other assessment changes also were implemented that had a minor effect on the quarterly change in total assessments and the distribution of assets (e.g., a new large bank pricing scorecard and changes in bank ratings, assets, and capital during the quarter).

Section 335 made permanent the temporary increase of the maximum deposit and share insurance amounts from $100,000 to $250,000. Beginning in October 2008, the deposit and share insurance coverage had been increased temporarily to $250,000 to help consumers maintain confidence in the banking system and the marketplace. These increases were made permanent and effective in August and September 2010, respectively. According to FDIC, the higher insurance coverage level should help community banks attract and retain core deposits. Industry associations and officials from the community banks and credit unions we spoke with generally viewed the increase in insurance coverage as beneficial to community banks and credit unions.


Section 343 provided temporary unlimited deposit and share insurance coverage for non-interest-bearing transaction accounts from December 31, 2010, through December 31, 2012. According to FDIC, the 10.7 percent increase in insured deposits during 2011 was primarily attributable to growth in non-interest-bearing transaction account balances receiving temporary coverage. However, according to an NCUA official, non-interest-bearing transaction accounts typically are held by businesses for payroll and accounts payable and, therefore, are less common at credit unions than at banks. Although this insurance program was designed to be a temporary response to financial instability, several industry associations representing banks are advocating for this provision to be extended. In addition, officials from two state associations representing community banks we spoke with said they expect the termination of the coverage to have a negative or very negative impact on their member institutions. In contrast, officials from the two state associations representing credit unions said they expect the termination would have no impact. But the responses from the individual community banks and credit unions were more mixed. Officials from five of the eight community banks and two of the four credit unions we spoke with said that they expect the termination of the coverage to have a negative or very negative impact on their institution. Officials from the other three community banks and two credit unions said that the termination would have no impact on their institution or it was too soon to determine the impact.

Section 989G of the Dodd-Frank Act eliminates an audit requirement for a number of small community banks and bank holding companies that are

Exemption from Section 404(b) of the Sarbanes-Oxley Act

Temporary unlimited insurance coverage for non-interest-bearing transaction accounts initially was provided for federally insured banks through FDIC’s Transaction Account Guarantee program. The temporary unlimited insurance coverage for non-interest-bearing transaction accounts differs from the Transaction Account Guarantee program in that it applies to all insured depository institutions with non-interest-bearing accounts, it does not cover low interest negotiable order of withdrawal accounts, and FDIC does not charge a separate assessment for the insurance of non-interest-bearing transaction accounts. The Transaction Account Guarantee program expired on December 31, 2010, and section 343 for federally insured banks became effective on that same date. Section 343 was effective for federally insured credit unions on July 21, 2010. 75 Fed. Reg. 69,577 (Nov. 15, 2010).

public companies.\textsuperscript{40} In response to numerous corporate failures arising from corporate mismanagement and fraud, Congress passed the Sarbanes-Oxley Act of 2002 to help protect investors, in part by improving the accuracy, reliability, and transparency of corporate financial reporting and disclosures.\textsuperscript{41} Specifically, section 404(a) of the Sarbanes-Oxley Act requires a public company’s management to assess and report on the effectiveness of its internal controls over financial reporting. In turn, section 404(b) requires an independent auditor to attest to and report on management’s assessment. Under SEC rules, non-accelerated filers (generally defined as public companies with a public float under $75 million) have been required to comply with section 404(a) for fiscal years ending on or after December 15, 2007.\textsuperscript{42} However, before the passage of the Dodd-Frank Act, these filers were not required to comply with section 404(b) for fiscal years ending before June 15, 2010. SEC had provided such issuers with several extensions to the compliance dates in response to concerns about compliance costs and management’s preparedness.

Section 989G of the Dodd-Frank Act amended the Sarbanes-Oxley Act to exempt non-accelerated filers from section 404(b).\textsuperscript{43} Using SNL Financial data, we found that around 630 publicly traded financial institutions, including community banks and bank holding companies, identified

\textsuperscript{40}Credit unions are member-owned cooperatives, rather than public companies, and so are not subject to section 404 of the Sarbanes-Oxley Act of 2002, which was amended by section 989G of the Dodd-Frank Act.


\textsuperscript{42}Although the term non-accelerated filer is not defined in SEC rules, it refers to a reporting company that does not meet the definition of either an “accelerated filer” or a “large accelerated filer” under Exchange Act Rule 12b–2. The public float is the aggregate market value of the issuer’s outstanding voting and nonvoting common equity held by nonaffiliates of the issuer. An accelerated filer generally is a public company that, among other things, had at least $75 million but less than $700 million in public float as of the last business day of its most recently completed second fiscal quarter, and filed at least one annual report with SEC. A large accelerated filer generally is a public company that, among other things, had a public float of $700 million or more as of the last business day of its most recently completed second fiscal quarter and filed at least one annual report with SEC.

\textsuperscript{43}SEC amended its rules and forms to conform them to section 404(c) of the Sarbanes-Oxley Act of 2002, as added by section 989G of the Dodd-Frank Act. Section 404(c) provides that section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b–2 under the Securities Exchange Act of 1934. See 75 Fed. Reg. 57,385 (Sept. 21, 2010).
Debit Interchange Fee Provision

Unlike large banks, community banks and credit unions generally have not, on average, experienced a significant decline in their debit interchange fees as a result of the Federal Reserve’s implementation of section 1075 of the Dodd-Frank Act. Debit cards can be used to make noncash purchases at merchants. When a consumer uses a debit card to make a purchase, the merchant does not receive the full purchase amount. Part of the amount (called the merchant discount fee) is deducted and distributed among the merchant’s bank, debit card issuer, and payment card network processing the transaction. Historically, the majority of the merchant discount fee was paid from the merchant’s bank to the debit card issuer in the form of an interchange fee. Debit card interchange fees are established by card networks and ultimately paid by merchants to debit card issuers for each electronic debit transaction.

44We also found other banks and bank holding companies that identified themselves as non-accelerated filers but were traded on the Over-the-Counter Pink market. We excluded these companies, because the data did not allow us to determine whether they were subject to reporting requirements under the federal securities laws.

45SEC, Office of Economic Analysis, Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements (Washington, D.C.: September 2009). The study noted that these companies voluntarily complied or were required to comply in the past as accelerated filers and must continue to do so because their float had not since dropped below $50 million. The study noted that to the extent that these factors affect companies’ experience with section 404(b) compliance, care should be taken when extrapolating the results to non-accelerated filers that had yet to comply.

46See GAO, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, GAO-06-361 (Washington, D.C.: Apr. 13, 2006). In addition, pursuant to section 989I of the Dodd-Frank Act, GAO is required to conduct a study on the impact of the section 404(b) amendments under the Dodd-Frank Act on smaller issuers and to submit a report not later than 3 years after the date of enactment of the act.
In July 2011, the Federal Reserve adopted Regulation II (Debit Card Interchange Fees and Routing) to implement section 1075 of the Dodd-Frank Act. Regulation II establishes standards for assessing whether debit card interchange fees received by issuers are reasonable and proportional to the costs incurred by issuers for electronic debit transactions. The rule sets a cap on the maximum permissible interchange fee that an issuer may receive for an electronic debit transaction at $0.21 per transaction, plus 5 basis points multiplied by the transaction’s value. The fee cap became effective on October 1, 2011. However, the rule exempts from the fee cap issuers that have, together with their affiliates, less than $10 billion in assets, and transactions made using debit cards issued pursuant to government-administered payment programs or certain reloadable prepaid cards. In addition, Regulation II prohibits issuers and card networks from restricting the number of networks over which electronic debit transactions may be processed to less than two unaffiliated networks. The rule further prohibits issuers and networks from inhibiting a merchant from directing the routing of an electronic debit transaction over any network allowed by the issuer.

Initial data collected by the Federal Reserve indicate that card networks largely have adopted a two-tiered interchange fee structure after the implementation of Regulation II, to the benefit of exempt issuers. According to the Federal Reserve, over 14,300 banks, credit unions, savings and loans, and savings banks qualified for an exemption from the debit card interchange fee cap during 2011. Data collected by the Federal Reserve from 16 card networks show that all but 1 network provided a higher interchange fee, on average, to exempt issuers than nonexempt issuers after the rule took effect. The data also show that the average interchange fee received by exempt issuers declined by $0.02, or around 5 percent, after the rule took effect—declining from $0.45 over

48 An issuer also is allowed to receive an upward adjustment of 1 cent to its interchange transaction fee, if the issuer, among other things, develops, implements, and updates policies and procedures reasonably designed to identify and prevent fraudulent electronic debit transactions. See 76 Fed. Reg. 43,478 (July 20, 2011).
49 The prohibition on network exclusivity, which applies to all issuers regardless of size, took effect on April 1, 2012, with respect to most types of debit cards.
50 Institutions that qualified for the exemption during 2011 were those institutions that had, together with affiliates, assets of less than $10 billion as of December 31, 2010.
the first three quarters of 2011 to $0.43 in the fourth quarter of 2011.\textsuperscript{51}

During the same period, the interchange fee as a percentage of the average transaction value for exempt issuers declined from 1.16 percent to 1.10 percent.\textsuperscript{52} In comparison, the average interchange fee received by issuers subject to the fee cap (nonexempt issuers) declined from $0.50 to $0.24, or by 52 percent, between the two periods. Our analysis of SNL Financial data shows that interchange fee income received by around 6,450 exempt banks increased, in aggregate, on a quarterly basis after the rule became effective, but the data do not allow us to determine why fee income increased, such as because of an increase in transaction volume. The aggregate interchange fee income reported quarterly by these banks from the second quarter of 2011 through the first quarter of 2012 was about $532 million, $547 million, $575 million, and $585 million, respectively.\textsuperscript{53}

Although Regulation II has had a limited impact on exempt issuers to date, concerns remain about the potential for their interchange fees or fee income to decline over the long term. For example, industry officials and others have noted that (1) some merchants may steer customers to lower-cost payment options, even if networks maintain a two-tiered fee structure, (2) the prohibition on network exclusivity and routing restrictions may lead networks to lower their interchange fees, in part to encourage merchants to route debit card transactions through their networks, or (3) economic forces may cause networks not to maintain a two-tiered fee structure that provides a meaningful differential between fees for exempt

\textsuperscript{51}The Federal Reserve collected data from 16 payment card networks. Eight networks reported a decline in their average interchange fee per transaction for exempt issuers—ranging from $0.01 to $0.04—after the rule took effect. Three networks reported no change in their average interchange fee for exempt issuers. Five networks reported an increase in their fee for exempt issuers—ranging from $0.01 to $0.03—after the rule took effect.

\textsuperscript{52}The interchange fee as a percentage of the average transaction value is calculated by dividing the total interchange fees by the value of settled purchase transactions.

\textsuperscript{53}The totals include both debit and credit card interchange fee income reported by banks that were exempt from the debit interchange fee cap. Credit card interchange fees are not subject to the Regulation II limitations. The reporting of bank card and credit card interchange fees in Call Reports is required only if that amount exceeds $25,000 or 3 percent of other noninterest income. As a result, not all banks report a value for this variable. In addition, savings institutions historically did not report interchange fee income in their Thrift Financial Reports. Finally, the totals exclude interchange fee income reported by credit unions. Although credit unions report their interchange fee income, they aggregate that income with other sources of operating income.
and other issuers. Some merchants and others have noted that major card networks have adopted a two-tiered fee structure and have an incentive to maintain that structure to attract exempt issuers.\(^{54}\) According to Federal Reserve officials, the agency plans to collect data annually that analyze the rule’s impact on exempt issuer fees. It also plans to survey exempt issuers in 2012 to determine how much it cost them to comply with the network exclusivity prohibition and whether any merchants are refusing to accept their debit cards.

<table>
<thead>
<tr>
<th>CFPB Provisions May Help Level the Regulatory Playing Field but also May Result in Additional Compliance Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>According to some regulators and industry officials, subjecting certain nonbank providers of financial services or products (nonbanks) to federal consumer protection laws and CFPB supervision may benefit community banks and credit unions by helping to level the regulatory playing field. Although community banks and small credit unions are not supervised by CFPB, they generally are subject to its regulations. CFPB’s implementation of the Dodd-Frank Act’s mortgage-related and other provisions are expected to impose additional requirements on community banks and credit unions. However, the impact of these regulations will depend on how CFPB implements such provisions and exercises its exemption authority. The Dodd-Frank Act established CFPB and authorized it to supervise certain nonbank financial companies and large banks and credit unions with over $10 billion in assets and their affiliates for consumer protection purposes. Before the Dodd-Frank Act, responsibility for administering and enforcing consumer financial laws for these entities was spread across several federal agencies. The act transferred supervisory and enforcement authority over a number of consumer financial institutions and services, as well as rule-making and...</td>
</tr>
</tbody>
</table>

\(^{54}\)A number of merchant associations have brought a lawsuit against the Federal Reserve, alleging that it failed to follow the intent of Congress regarding the amount of an interchange fee that an issuer could charge or receive.
enforcement authority (for those institutions it supervises) over many previously enacted consumer protection laws, to CFPB.55

To promote consistent enforcement of consumer protection laws, sections 1024, 1053, and 1054 of the Dodd-Frank Act provided CFPB with authority to supervise, examine, and take enforcement action against nonbanks, such as payday lenders and mortgage lenders and servicers.56

Before the passage of the Dodd-Frank Act, there was no federal program to supervise nonbanks for compliance with consumer financial protection laws. The Federal Trade Commission had enforcement authority, but did not have the supervisory authority to regularly examine these entities or impose reporting requirements on them with respect to consumer financial protection law.57 Nonbanks were primarily supervised by state regulators, whose authority and level of supervision varied. Under the Dodd-Frank Act, CFPB is authorized to supervise, based on statutory

55Section 1021 of the Dodd-Frank Act established the following goals for CFPB: (1) ensure that consumers have timely and understandable information to make responsible decisions about financial transactions, (2) protect consumers from unfair, deceptive, or abusive acts or practices, and from discrimination, (3) reduce unwarranted regulatory burdens due to outdated, unnecessary, or unduly burdensome regulations, (4) promote fair competition by enforcing the federal consumer financial laws consistently, and (5) ensure that markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

56Section 1024 of the Dodd-Frank Act authorizes CFPB to supervise certain entities and individuals that engage in offering or providing a consumer financial product or service and their service providers that are not covered by sections 1025 or 1026 of the act. Specifically, section 1024 applies to those entities and individuals who offer or provide mortgage-related products or services and payday and private student loans as well as larger participants of other consumer financial service or product markets as defined by a CFPB rule, among others, plus their service providers. Section 1025 authorizes CFPB to supervise, with respect to consumer finance laws, large insured depository institutions and credit unions with more than $10 billion in total assets and all their affiliates (including subsidiaries), as well as service providers for such entities. Under section 1026, CFPB has the authority to require reports, as necessary, from banks and credit unions under $10 billion, and CFPB, at its discretion, may include its examiners on a sampling basis in examinations conducted by their prudential regulator for these entities. Under sections 1026 and 1061(c), CFPB has supervisory authority over a service provider to a substantial number of smaller depository institutions.

57The Federal Trade Commission has enforcement authority over most nonbank entities for numerous consumer protection statutes, including, for example, the Truth in Lending Act, 15 U.S.C. §§ 1601-1666j and the privacy provisions of the Gramm-Leach Bliley Act, 15 U.S.C. §§ 6801-6809. The Commission generally retains its enforcement authority under the Dodd-Frank Act, although in some instances its authority may be concurrent with CFPB’s enforcement authority.
factors that focus on risk to consumers, nonbanks engaged in the residential mortgage industry, private education lending, and payday lending. For other financial services or product markets, CFPB’s authority applies only to a “larger participant.” CFPB’s supervisory authority also covers nonbanks that it has reasonable cause to determine are engaging, or have engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services. In January 2012, CFPB launched its nonbank supervision program, under which it examines such entities for, among other things, compliance with federal consumer financial laws. According to CFPB, nonbanks will be identified for examination based on risks to consumers, including consideration of the company’s asset size, volume of consumer financial transactions, extent of state oversight, and other relevant factors.

Regulators and industry representatives expect CFPB supervision of nonbanks to benefit community banks and credit unions by leveling the regulatory playing field. For example, in 2011, an FDIC official testified that CFPB will likely reduce the unfair competitive advantage that nonbanks have long enjoyed as under-regulated—and often unregulated and unsupervised—financial services providers. Industry officials have

58 In February 2012, CFPB issued a proposed rule defining a larger participant in certain consumer product and finance markets. 77 Fed. Reg. 9,592 (Feb. 17, 2012). In its proposal, CFPB proposed to define larger participants in the markets for consumer debt collection and consumer reporting. CFPB intended that this proposal and subsequent initial rule would be followed by a series of rule makings covering additional markets for consumer financial products and services. In July 2012, CFPB issued a final rule to define larger participants in a consumer reporting market as a nonbank-covered person with more than $7 million in annual receipts resulting from consumer reporting activities. 77 Fed. Reg. 42,874 (July 20, 2012).

59 In May 2012, CFPB proposed a rule establishing the procedures by which it may subject a nonbank to this authority. 77 Fed. Reg. 31,226 (May 25, 2012).

60 CFPB’s supervision program has two parts that operate under common procedures and shared staff. The large bank supervision program began operations in July 2011 and focuses on compliance at banks, thrifts, and credit unions with assets over $10 billion, their affiliates, and certain service providers.


testified that community banks and credit unions did not engage in abusive lending practices and were not the cause of the financial crisis, and urged CFPB to focus its efforts on regulating nonbanks as many of the problems that led to the financial crisis began outside the regulated banking industry.63 Officials from half of the 16 state associations, community banks, and credit unions we interviewed told us that they expect CFPB supervision of nonbanks to have a positive impact. Officials from three of these entities expect CFPB supervision to have no impact, three thought it was too soon to tell, and two thought it could have a negative impact.

The Dodd-Frank Act grants broad rule-making authority to CFPB, but requires it to coordinate with other federal agencies to ensure consistency in its regulation of consumer products and services. Although CFPB does not directly supervise community banks and small credit unions, its regulations generally apply to all banks and credit unions (and most nonbanks). According to CFPB, its rule-making activities have focused on two main areas: implementing protections required by the Dodd-Frank Act and streamlining inherited regulations. Pursuant to the Dodd-Frank Act, CFPB has proposed or finalized various regulations involving the mortgage market and international money transfers (discussed below). In December 2011, CFPB issued a notice requesting public comment on how to streamline existing regulations implementing federal consumer financial laws.64

Section 1022 of the Dodd-Frank Act permits CFPB to exempt any class of product or institution, including small institutions, from its regulations issued under Title X of the act. In issuing any such exemption, CFPB must take into account several factors, including the existing provisions of law applicable to the consumer financial product or service and the extent to which such provisions provide consumers with adequate protections. Furthermore, other federal consumer financial laws provided CFPB with

63 The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses, Before the House Committee on Financial Services, 112th Cong. (2011) (statements of Albert Kelly, Chairman and Chief Executive Officer, Spiritbank on Behalf of the American Bankers Association; James D. MacPhee, Chief Executive Officer, Kalamazoo County State Bank, on Behalf of the Independent Community Bankers of America; and John P. Buckley, Jr. President and Chief Executive Officer, Gerber Federal Credit Union, on behalf of the National Association of Federal Credit Unions).

varying degrees of exemption authority, generally with respect to classes of transactions where certain conditions are met. In a recent testimony, the CFPB Director said that when it is appropriate to treat smaller institutions differently from larger institutions, CFPB will consider doing so. Similarly, CFPB staff told us that they will need to determine how much regulatory relief the agency will provide small institutions on a rule-by-rule basis. For example, in early July 2012, pursuant to sections 1032(f), 1100A, and 1098 of the Dodd-Frank Act, CFPB proposed a rule to integrate mortgage disclosures required by two different mortgage-lending-related statutes into one form. In the proposed rule, CFPB is considering exempting small entities (including some banks and credit unions with $10 billion or less in assets) from electronic data retention requirements to reduce their burden. In addition, CFPB is seeking comment on how much time industry needs to make any changes required in implementing the rule and whether small entities should have more time.

While many consumer protection and mortgage reforms are not yet finalized, CFPB staff told us that they are in the process of proposing several additional regulations to provide guidance to the mortgage industry in implementing new reforms under the Dodd-Frank Act. As mandated by the statute, most of these rules are due in final form by January 21, 2013. However, industry representatives and others have expressed concern about the potential impact of CFPB regulations on community banks and credit unions. In congressional testimony and our interviews, industry representatives have said that they are hopeful that

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66 The Dodd-Frank Act also requires CFPB to comply with the Small Business Regulatory Enforcement Fairness Act panel process. This act requires CFPB to convene a Small Business Review Panel before proposing a rule that may have a significant economic impact on a substantial number of small entities. See Pub. L. No. 104-121, tit. II, 110 Stat. 847, 857 (1996) (as amended by Pub. L. No. 110-28, § 8302 (2007)).


68 Pursuant to the Small Business Regulatory Enforcement Fairness Act, CFPB must convene a panel to obtain feedback from small business representatives before proposing rules that may affect them. Throughout the proposed rule to integrate mortgage disclosures, CFPB discussed how it is addressing issues considered by this panel, including the timing of implementation.
CFPB will be able to consolidate and simplify rules for all financial institutions. They also have noted that CFPB has conducted outreach efforts to obtain input on CFPB’s activities. However, industry representatives expressed concern that the numerous new regulations from CFPB will impose additional regulatory burden and compliance costs on small institutions, potentially causing them to exit certain lines of business. Specifically, they cited concerns about the additional time, resources, and effort it would take their institutions to address new regulatory requirements. In particular, they were concerned about having to comply with numerous regulations issued around the same time by CFPB. Industry representatives also were concerned that the standardization of processes through CFPB regulations could reduce the ability of community banks and credit unions to offer differentiated products to better serve their communities. In congressional testimony and our interviews, community bank and credit union associations and representatives have emphasized that they believe these entities have a long history of serving customers fairly. Some commented that it is their opinion that CFPB regulations should not apply to them as they did not engage in the types of abuses that prompted the passage of the Dodd-Frank Act. Credit union representatives added that credit unions are owned by their members and, thus, have a strong incentive to treat their consumers well.

Mortgage Reforms Are Expected to Impose Additional Costs, but Their Impact Depends on Future Rule Makings

The Dodd-Frank Act’s mortgage reform provisions are expected to impose additional costs on a large percentage of community banks and credit unions. However, the full cost to these entities will depend on the extent to which CFPB (and other agencies where appropriate) exercises its authority, where available, to exempt small institutions from any of its regulations and how it implements specific provisions that provide more limited relief to small institutions, particularly those operating in rural or underserved communities. The act’s mortgage reforms include (1) additional origination and servicing requirements; (2) minimum standards for mortgage loans (including determining a borrower’s ability to repay the loan); (3) limits on charges for mortgage prepayments; (4) expanding the definition of “high-cost mortgages” and protections that apply to such loans; (5) new disclosure requirements; (6) establishing various appraisal standards; and (7) requiring additional data elements to be reported under the Home Mortgage Disclosure Act (HMDA) reporting.
requirements. The Dodd-Frank Act’s mortgage reforms generally seek to address substandard residential mortgage lending practices that contributed to spikes in foreclosures and the 2007 through 2009 financial crisis. A key challenge in implementing these reforms is balancing the goals of protecting consumers from abuse and maintaining broad access to credit. Authority for implementing these reforms generally was transferred from the Federal Reserve to CFPB in July 2011. CFPB has the rule-making authority for most of these regulations, and in other cases agencies are jointly responsible for rule making. While federal agencies have proposed a number of rules to implement the act’s mortgage reforms, most of the required rules have not been finalized.

The Dodd-Frank Act’s mortgage reforms could apply to and impact the vast majority of community banks and credit unions, given their involvement in mortgage lending. On the basis of our analysis of SNL Financial data, over 97 percent of community banks and over 70 percent of credit unions held residential mortgage loans in 2011. Over the past 5 years, community banks within different asset-sized categories generally dedicated about 30 percent of their lending portfolios to mortgage lending. However, mortgage lending by credit unions was more varied by asset size. As a percentage of a credit union’s total lending portfolio in 2011, mortgage lending comprised, on average, over 50 percent for credit unions holding more than $100 million in assets, about 44 percent for those with $20 million to $100 million in assets, about 26 percent for

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69 The Home Mortgage Disclosure Act of 1975 (HMDA), Pub. L. No. 94-200, 89 Stat. 1124, requires certain creditors to collect, disclose, and report data on the personal characteristics of mortgage borrowers and loan applicants (for example, their ethnicity, race, and gender), the type of loan or application (for example, if the loan is insured or guaranteed by a federal agency), and financial data such as the loan amount and borrowers’ incomes. Institutions that provide mortgage lending, have over $41 million in assets, and have a home office or branch office in a metropolitan statistical area must report HMDA data. The purposes in collecting these data are to aid in determining whether financial institutions are serving the housing needs of their communities, identifying areas where additional investment is needed, and identifying possible discriminatory lending patterns.

70 In July 2011, pursuant to the Dodd-Frank Act, rulemaking, supervision, and enforcement authority for consumer protection laws were generally transferred to CFPB. This includes responsibility for implementing the Truth in Lending Act (TILA) and the Home Ownership Equity Protection Act, which are among the primary federal laws governing consumer credit, including mortgage lending. TILA was intended to provide consumers with more information about the costs of credit, and the Home Ownership Equity Protection Act amended TILA to regulate and restrict certain “high cost” mortgage loans.
those with $5 million to $20 million in assets, and about 7 percent for those with less than $5 million in assets.

Although the Dodd-Frank Act’s mortgage reforms may affect the majority of community banks and credit unions, precisely how or to what extent the reforms will affect these institutions is uncertain. Many of the reforms have not yet been implemented; therefore, data do not exist to assess their impact. However, some regulators and industry representatives expect the potential cumulative effect of the mortgage reforms to increase the regulatory burden for smaller institutions, potentially leading them to decrease certain mortgage lending activities or, at the extreme, exit the mortgage business. In our interviews with state associations, community banks, and credit unions, officials from 9 of the 16 entities told us that they expected the act’s mortgage reforms to decrease their or their member institutions’ lending, but officials from seven of the entities told us it was too soon to determine the reforms’ potential impact. Some officials also told us that the mortgage reforms may reduce community banks’ and credit unions’ advantage not only in serving niche markets (e.g., rural communities) by standardizing mortgage terms but also in making loans based on “soft information” by increasing the cost of providing these loans. Evaluating these concerns is difficult, especially given the CFPB’s regulatory flexibility. As discussed in the previous section, the Dodd-Frank Act and federal consumer financial protection laws provide CFPB with varying amounts of exemptive authority with regard to particular transactions and circumstances. In addition, the Dodd-Frank Act’s provisions that establish minimum standards for mortgage underwriting (“ability-to-repay” provision), additional escrow requirements, and appraisal standards provide some exceptions and regulatory relief for small institutions. These particular provisions were identified by regulators and industry representatives as potentially having a significant impact on community banks and credit unions.

### Ability-to-Repay and Escrow Provisions

Sections 1411 and 1412 of Title XIV of the Dodd-Frank Act amended the Truth in Lending Act (TILA) by prohibiting creditors from making mortgage loans without regard to consumers’ ability to repay them and establishing standards for making a reasonable and good faith determination based on verified and documented information. This reform was enacted to address the loosening of underwriting standards, which was partly responsible for the dramatic increase in mortgage delinquencies and foreclosures beginning in 2006. A creditor can meet the ability-to-repay requirement by satisfying certain underwriting factors, or the creditor may also be presumed to have satisfied the ability-to-repay requirement and receive some protection from liability if it originates a “qualified mortgage”
(QM) as defined by criteria in the Dodd-Frank Act and implemented by CFPB. In other sections of subtitle B of Title XIV, the act sets steeper penalties for noncompliance with the requirements and allows consumers to cite ability-to-repay violations as a set off in foreclosures.

In a 2011 report, we examined five of the nine QM criteria specified in the Dodd-Frank Act for which sufficient data were available and generally found that most mortgages likely would have met the individual criteria for each year from 2001 through 2010. However, we noted that the impact of the full set of QM criteria was uncertain, partly because data limitations made analysis of the other four criteria difficult and partly because CFPB could establish different criteria in developing final regulations. Consumer and industry groups indicated that the criteria specified in the act would likely encourage sound underwriting, but could also restrict the availability of and raise the cost of mortgage credit for some homebuyers. Provisions in the act and proposed regulations attempt to address some of these issues, in part by providing exemptions for certain loan products in certain locales, such as rural areas.

Within subtitle E of Title XIV, sections 1461 and 1462 of the Dodd-Frank Act amended TILA to expand escrow requirements for certain types of mortgage loans to enhance consumer protection. Before the Dodd-Frank Act, regulations issued under TILA required that creditors establish escrow accounts for taxes and insurance for higher-priced residential mortgage loans. The Dodd-Frank Act substantially codified these

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72The act generally requires that mandatory escrow accounts be established for mortgages secured by a first lien on a customer’s primary residence if (1) the escrow account is required by federal or state law; (2) the mortgage is made, guaranteed, or insured by a state or federal government lending or insurance agency (e.g., the Federal Housing Administration or the Department of Veterans Affairs); or (3) the mortgage is a close-ended “higher priced” mortgage loan.

73On July 30, 2008, the Federal Reserve published a final rule amending Regulation Z (TILA) to establish new regulatory protections for consumers in the residential mortgage market. 73 Fed. Reg. 44,522 (July 30, 2008). Among other things, the final rule defined a class of higher-priced mortgage loans that are subject to additional protections, including mandatory escrow accounts for certain loans. Different aspects of the rule were to be effective as of October 2009 and April 2010; however, in August 2009 the Federal Reserve published a proposed rule to amend this Regulation Z requirement due to concerns about the rate used in determining whether a loan is higher-priced. No final action had been taken on this rule prior to the Dodd-Frank Act.
requirements and lengthened the time during which a mandatory escrow account established for a higher-priced mortgage loan must be maintained from 1 to 5 years. In addition, the act established additional disclosure requirements for escrow accounts.

Both the ability-to-repay and escrow provisions may provide some relief to creditors operating in predominantly rural or underserved communities. As discussed previously, smaller banks generally have higher levels of agricultural loans as a percentage of their total lending portfolios. In addition, some credit unions are chartered specifically to serve agricultural communities. Community banks and credit unions may make balloon loans to help ensure access to credit in rural or underserved communities where consumers may be able to obtain credit only from these institutions offering such loans and to hedge against interest rate risk. Section 1412 of the Dodd-Frank Act defines a balloon payment as a scheduled payment that is more than twice as large as the average of earlier scheduled payments. Under this provision, CFPB may by regulation allow some creditors, including those operating in predominantly "rural or underserved" areas, to make balloon-payment QMs that meet certain criteria. In other cases, balloon-payment loans may not be considered QMs, and creditors making these loans would not be protected from certain liabilities. The act provides a similar exemption from mandatory escrow requirements for similar types of creditors. To qualify for these exemptions, in both cases, creditors must operate in predominately rural or underserved areas, be under total annual asset and mortgage loan origination limits to be set by CFPB (initially set by the Federal Reserve, see following discussion), and retain their mortgage loans in their portfolios. The intent behind these exemptions is to preserve access to credit for consumers located in rural or underserved areas, where creditors may originate balloon loans to hedge against interest rate risk or higher-priced mortgages, but in volumes too small to justify the expense of establishing and maintaining escrow accounts for loans held in portfolio.

Before the transfer of rule-making authority for TILA to CFPB, the Federal Reserve proposed rules to implement both the ability-to-repay and escrow requirements. In May 2011, the Federal Reserve proposed regulations for compliance with the ability-to-repay provisions.74 Its

proposal provided a definition for a QM and, in accordance with the act, proposed that creditors with under $2 billion in assets operating predominantly in “rural or underserved” areas may make a balloon-payment QM that meets certain conditions. Due to the lack of available data, the agency requested comment on how to set a mortgage loan origination limit. In March 2011, the Federal Reserve proposed rules for implementing the act’s escrow requirements. With respect to the exemption, the agency proposed a threshold of no more than 100 total mortgage loan originations a year and chose not to propose an asset-size threshold. In both rules, the Federal Reserve defined “underserved” areas as counties where not more than two creditors may make five or more mortgages a year and “rural” areas as counties classified by the U.S. Department of Agriculture as representing the most remote rural areas—where access to the resources of more urban communities and mobility is limited.

In their comment letters on these proposed rules, community bank and credit union associations supported the intent of the reforms but were concerned about regulatory burden. One community bank association noted that the additional requirements could lead to an economic environment where only larger creditors would continue doing business, as they generally are better equipped to absorb increased regulatory costs. Industry representatives added that community banks and credit unions had not engaged in the abusive lending practices or substandard underwriting practices the mortgage provisions sought to address. For example, a community bank association noted that community banks have provided balloon loans in small communities for decades without problems and that these types of loans may be the only available credit

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75In its proposed rule, the Federal Reserve requested comment on whether the mortgage loan origination limit should be set by the aggregate principal amounts of relevant loans extended by the creditor and its affiliates or by the total number of such loans.

7676 Fed Reg. 11,598 (Mar. 2, 2011). On the same date, the Federal Reserve issued a final rule implementing part of section 1461 that amended Regulation Z to provide a separate, higher threshold for determining when the escrow requirement applies to higher-priced mortgage loans that exceed the maximum principal obligation eligible for purchase by Freddie Mac, or “jumbo” loans. The final rule was effective on April 1, 2011. 76 Fed. Reg. 11,319 (Mar. 2, 2011).

77The Economic Research Service of the U.S. Department of Agriculture maintains “urban influence codes” that reflect factors such as counties’ relative population sizes, degrees of urbanization, access to larger communities, and commuting patterns.
option for consumers in rural communities. They also noted that many balloon loans would fall under the definition of higher-priced loans and, therefore, would be covered by the mandatory escrow requirement. In our interviews with state associations, community banks, and credit unions, officials from 8 of the 16 entities expected the ability-to-repay provisions to decrease their or their member institutions’ mortgage lending, four thought the provisions would have no impact, and four thought it was too soon to tell.

For both of the proposed rules, a state regulatory association and several industry associations emphasized the importance of the exemptions for small institutions, but disagreed with how “underserved” and “rural” areas were defined and, in turn, proposed that their definitions be expanded. They said the proposed definitions were too narrow and complicated, and would exclude many community banks and credit unions that should be covered. A state regulatory association and industry associations also supported expanding these exemptions to cover all creditors holding loans in portfolio, maintaining that these institutions have an incentive to ensure higher standards of underwriting and retain the risk associated with consumers failing to pay taxes and insurance. With respect to the escrow requirements, industry representatives suggested increasing the proposed threshold of 100 loans.

As of August 2012, CFPB has not finalized either rule. In early June 2012, CFPB reopened the comment period for the proposed ability-to-repay rule. In particular, CFPB requested additional data on mortgage lending underwriting criteria and loan performance, as well as estimates of litigation costs and liability risks associated with claims alleging ability-to-repay requirement violations. CFPB expects to issue final rules for the ability-to-repay provisions and the escrow requirements by the end of this year. According to the Dodd-Frank Act, these provisions become effective 18 months after rule-making authority was transferred to CFPB (that is, January 21, 2013) if implementing regulations have not been issued. Where implementing regulations are issued by the deadline, the statutory provisions take effect when the rules take effect. In some cases, implementing rules must take effect within 12 months of issu ance.

Subtitle F of Title XIV established additional appraisal requirements for mortgage lending. Among other provisions, section 1471 establishes
additional requirements for “higher risk” mortgages. Section 1472 of the act amends TILA to require that appraisers be independent to reduce any conflicts of interests. It declared the Home Valuation Code of Conduct, the previous standard for appraisal independence for loans purchased by Fannie Mae and Freddie Mac (the enterprises), to no longer be in effect but codified several of the code’s provisions. The intent of section 1472 is to better ensure that real estate appraisals used to support creditors’ decisions are based on the appraiser’s independent judgment, free of any influence from parties that may have an interest in the transaction. Among other requirements, section 1472 (1) prohibits coercion and bribery to influence the value of an appraisal, (2) prohibits appraisers from having a financial interest in property they are appraising, (3) prohibits a creditor from extending credit if it knows that a violation of appraisal independence has occurred, (4) mandates that the parties involved in the transaction report appraiser misconduct to state appraiser licensing authorities, and (5) mandates the payment of reasonable and customary compensation for appraisals.

CFPB, FDIC, the Federal Reserve, the Federal Housing Finance Agency (FHFA), OCC, and NCUA are jointly responsible for implementing the act’s appraisal provisions. Section 1471 of the act provides the rule-making agencies discretion in exempting certain loans from its requirements. In their August 2012 proposed rule, the agencies sought

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78Section 1471 defines a “higher risk” mortgage as one that is not a “qualified mortgage” (to be defined by CFPB pursuant to section 1412) and whose annual percentage rate exceeds average rates (specified in the act) for a comparable transaction. This report section focuses primarily on section 1472. However, Subtitle F of Title XIV of the act includes other appraisal provisions. For example, section 1473 includes amendments relating to the Appraiser Subcommittee of the Federal Financial Institutions Examination Council, appraisal independence monitoring, appraisal management companies, automated valuation models, and broker price opinions. For additional GAO work relating to the Dodd-Frank Act appraisal provisions, see GAO, Residential Appraisals: Opportunities to Enhance Oversight of an Evolving Industry, GAO-11-653 (Washington, D.C.: July 13, 2011) and Real Estate Appraisals: Appraisal Subcommittee Needs to Improve Monitoring Procedures, GAO-12-147 (Washington, D.C.: Jan. 18, 2012).


80The act allowed rule-making agencies to jointly exempt, by rule, a class of loans from the requirements of this provision if the agencies determine that the exemption is in the public interest and promotes the safety and soundness of creditors.
comment on whether the final rule should provide an exemption for certain appraisal requirements for higher-risk mortgage loans made in rural areas.81 They also sought comment on whether the final rule should define “rural” areas as proposed in the ability-to-repay rule.82 In October 2010, the Federal Reserve issued an interim final rule implementing section 1472.83 The Federal Reserve included a safe harbor for compliance with prohibitions on conflicts of interest for employees and affiliates of creditors holding less than $250 million in assets. According to our analysis of SNL Financial data, about 65 percent of community banks and about 90 percent of credit unions held less than $250 million in assets in 2011. The agency noted that without allowances for staff and other limitations of smaller creditors, smaller creditors may decrease their lending, which could reduce credit availability and harm many consumers. Further, the agency stated that the federal banking agencies have long recognized that small institutions may be unable to achieve strict separation between valuation and loan underwriting staff, and the rule provides special guidance taking this limitation into account. Specifically, the interim final rule provides that the appraiser can be employed or affiliated with the creditor as long as (1) their compensation does not depend on the value of the appraisal and (2) the appraiser does not participate in the decision as to whether to make a loan or not.

In their comment letters on the interim final rule, several bank and credit union associations supported the intent and key aspects of the rule.84 However, both a banking and a credit union association suggested that the safe harbor be expanded to include institutions with less than $1 billion in assets and that hold their loans in portfolio. Specifically, they


82On August 15, 2012, the rule-making agencies issued a proposed rule for implementing section 1471. They sought comment as to whether higher-risk mortgage loans made in rural areas should be exempt from the requirement that creditors obtain two appraisals prior to extending a higher-risk mortgage loan to finance a consumer’s acquisition of property. In the proposed rule, the agencies requested any data to be submitted supporting whether exempting any classes of higher-risk mortgage loans from the additional appraisal requirement would be in the public interest and promote safety and soundness of creditors. Comments on the proposed rule are due in October 2012.


84One national credit union association did not support the rule due to its requirement that credit unions report violations of the rule, suggesting that the requirement would require credit unions to become experts in rules, laws, and standards regarding appraisers.
noted that many smaller community banks are predominately portfolio creditors and often make lending decisions based on long-term relationships and experience in their communities, which would extend to any valuation activity. CFPB, FDIC, the Federal Reserve, FHFA, OCC, and NCUA share responsibility for jointly issuing any further final rules on appraisal requirements under section 1472, as well as implementing section 1471 and other appraisal provisions.

Risk Retention Provision Initially May Have a Limited Impact  

The Dodd-Frank Act’s risk retention provision for securitizations, found in section 941 of the act, is expected to have a limited initial impact on community banks and credit unions largely because of the limited nature of their current involvement in securitizations. However, as we recently reported, the implications of section 941 with respect to residential mortgage lending will depend on a variety of regulatory decisions and potential changes in the mortgage market that could affect the availability and cost of mortgage credit and the viability of a private mortgage securitization market. In turn, such market changes could affect community banks and credit unions. As discussed in the previous section, our analysis of SNL Financial data found that over 97 percent of community banks and over 70 percent of credit unions held residential mortgage loans in 2011. To securitize residential mortgage loans, lenders may, in some cases, sell their loans to third parties, generating funds that they can use to make more loans. The third parties, or securitizers, bundle mortgages and sell them as investment products, called residential mortgage-backed securities (RMBS). Securitizers include investment banks, commercial banks, mortgage companies, and real estate investment trusts. Types of RMBS sold in the secondary market are (1) Ginnie Mae-RMBS backed by cash flows from federally insured or guaranteed mortgages, (2) enterprise RMBS backed by mortgages that meet the criteria for purchase by the enterprises, and (3) private-label RMBS, which are backed by mortgages that may not meet some aspect

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85See GAO-11-656.

86Real estate investment trusts are companies that own income-producing real estate and in some cases engage in the financing of real estate. To qualify as a real estate investment trust, a company must have most of its assets and income tied to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. For more detailed information on securitization processes, see GAO-11-656.
Section 941 of the Dodd-Frank Act requires, in part, that mortgage securitizers retain a financial exposure of no less than 5 percent of the credit risk of any securitized residential mortgage that is not a “qualified residential mortgage” (QRM)—that is, one that does not meet certain underwriting criteria to be defined by the rule-making agencies (FDIC, the Federal Reserve, OCC, SEC, FHFA, and the Department of Housing and Urban Development). The requirement mandates that securitizers of RMBS have an economic stake in the assets included in the securitizations they sponsor and, thus, an incentive to help ensure that lenders originate well-underwritten mortgages. In addition to the securitization of loans that meet the QRM criteria, the act exempts securitizations of government-insured or government-guaranteed mortgages (and certain other assets) from the risk retention requirement (excluding mortgages backed by the enterprises, which are currently in government conservatorship). Although the purpose and scope of the

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87 Government-insured or government-guaranteed mortgages primarily serve borrowers who may have difficulty qualifying for mortgages. The Federal Housing Administration and the Department of Veterans Affairs operate the two main federal programs that insure or guarantee mortgages. Fannie Mae and Freddie Mac (the enterprises) purchase mortgages that meet specified underwriting criteria from approved lenders. Most of the mortgages are made to prime borrowers with strong credit histories. The enterprises bundle the mortgages into securities and guarantee the timely payment of principal and interest to investors in the securities. On September 6, 2008, the enterprises were placed under federal conservatorship because of concern that their deteriorating financial condition and potential default on $5.4 trillion in outstanding financial obligations threatened the stability of financial markets.

88 The Dodd-Frank Act’s risk retention requirement also applies to securities backed by other asset classes, such as commercial loans, commercial real estate mortgage loans, credit cards, and automobile loans.

89 In addition to mortgages backed by the enterprises, this section of the act also does not apply the exemption for government-insured or government-guaranteed mortgages to mortgages backed by Federal Home Loan Banks, which form a system of regional cooperatives that support housing finance through advances and mortgage programs, among other activities.
QM and QRM provisions are somewhat different, they could be expected to work together by increasing lenders’ and securitizers’ exposure to the risks that are associated with mortgages whose features and terms may put borrowers at a higher risk of default and foreclosure.

Section 941 requires the rule-making agencies to jointly prescribe regulations for the risk retention requirement. The Dodd-Frank Act requires that in crafting the risk retention regulations, the rule-making agencies must specify, among other things,

- criteria for QRMs, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default;\(^90\)
- permissible forms of risk retention and the minimum duration for meeting the requirement;
- whether credit risk is to be allocated from securitizers to loan originators; and
- the possibility of permitting a lower risk retention requirement (less than 5 percent) for any non-QRM that meets underwriting standards that the agencies develop in regulations.

Federal banking and other agencies issued a proposed rule for the risk retention requirement in April 2011 but have not finalized the rule.\(^91\) In the proposed rule, the agencies established criteria for QRMs, including that the mortgage, if made in connection with a purchase, must have a loan-

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\(^90\)The Dodd-Frank Act specifies that the QRM definition cannot be broader than the QM definition described previously (i.e., the QRM criteria can be more restrictive than the QM criteria but not less restrictive).

\(^91\)76 Fed. Reg. 24,090 (Apr. 29, 2011). FDIC, the Federal Reserve, OCC, SEC and, in cases of residential mortgage assets, the Department of Housing and Urban Development and FHFA, are responsible for jointly prescribing the risk retention rules. The Chairperson of the Financial Stability Oversight Council is tasked with coordinating the risk retention rule-making effort.
to-value ratio of 80 percent or less.\textsuperscript{92} The agencies also proposed that the full guarantee provided by the enterprises would satisfy the risk retention requirement for securitizations sponsored by the enterprises while they are under conservatorship with the capital support of the U.S. Department of the Treasury. Although the Dodd-Frank Act places the responsibility for retaining risk on securitizers, it permits the agencies to require lenders to share the risk retention obligations. The proposed rule permits but does not require a securitizer to allocate a portion of its risk retention requirement to any lender that contributed at least 20 percent of the underlying assets to the asset pool underlying a securitization transaction.

In the proposed rule, the agencies, pursuant to the Regulatory Flexibility Act, estimated that the proposed requirement would not have a significant impact on a substantial number of small banking institutions (as defined by SBA as those with assets less than or equal to $175 million), at least under current market conditions.\textsuperscript{93} Based on their analysis of Call Report data for the third quarter of 2010, FDIC, the Federal Reserve, and OCC identified over 6,200 small banking organizations under their supervision, of which 329 originated loans for securitization.\textsuperscript{94} FDIC and OCC noted that they were aware of only six small banking organizations that sponsored securitizations. The regulators also noted that the small banks making securitized loans usually sell their loans to the enterprises, which retain credit risk through agency guarantees; thus, the banks would not be allocated credit risk under the proposed rule. In the proposed rule, for the purposes of their Regulatory Flexibility Act analysis, regulators estimated that most RMBS are collateralized by a pool of mortgages with

\textsuperscript{92}The proposed rule also established other QRM criteria, including: (1) the debt to income ratio must be 36 percent or less; (2) the loan term must not exceed 30 years; (3) the loan cannot include negative amortization or payment deferral features; (4) points and fees cannot exceed 3 percent of the total loan amount; (5) the borrower can neither be 30 or more days past due on any debt obligation at the time of the loan nor have been 60 or more days past due on any debt obligation within the preceding 24 months; and (6) the originator must incorporate into the mortgage documents certain requirements regarding policies and procedures for servicing the mortgage.

\textsuperscript{93}The Regulatory Flexibility Act generally requires that an agency, in connection with a notice of proposed rulemaking, prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of the proposed rule on small entities or certify that the rule will not have a significant economic impact on a substantial number of small entities (defined in regulations promulgated by SBA to include banking organizations with total assets of less than or equal to $175 million).

\textsuperscript{94}In its analysis, the Federal Reserve included over 2,400 small bank holding companies.
aggregated balances of at least $500 million. Accordingly, under the proposed rule, a securitizer could allocate a portion of the risk retention requirement to a small banking organization only if the bank originated at least 20 percent ($100 million based on the above estimate) of the securitized mortgages. According to the regulators, only one small banking organization reported an outstanding principal balance of over $100 million in assets sold and securitized as of September 30, 2010. Using SNL Financial data, we expanded this analysis to include banks with less than $10 billion in total assets (our definition of “community bank”) at year-end 2011. We found that over 890 of these banks originated loans for securitization, of which 9 reported an outstanding principal balance of over $100 million in assets sold and securitized, primarily residential mortgages.\textsuperscript{95} NCUA officials said that there is limited Call Report data on credit unions’ securitization of mortgage loans and stated that credit unions that do securitize mortgage loans usually sell their loans to the enterprises. Therefore, under the proposed rule, such credit unions would not be allocated credit risk because it has been transferred to the enterprises. Also, under the proposed rule, the enterprises would be required to retain the risk (and while under conservatorship, the enterprise guarantee would satisfy the risk retention requirement).

In our 2011 report, we reported that many industry stakeholders and consumer groups noted that the implications of the proposed risk retention rule depend on a variety of regulatory decisions and potential changes in the mortgage market.\textsuperscript{96} These include decisions on the characteristics of QRMs that would be exempt from the risk retention requirement, the forms of risk retention that would be allowed, the percentage that securitizers would be required to hold, and the risk-sharing arrangements between securitizers and lenders. They noted that these factors could affect the availability and cost of mortgage credit and

\textsuperscript{95} This analysis does not include data for thrift institutions. This finding assumes that no portion of the assets originated by these banks was sold to the enterprises or securitizations that qualify for an exemption from the risk retention requirements under the proposed rule. OCC officials commented that because no private-label RMBS transactions closed in 2011, none of the 2011 securitization activity would have been in residential mortgages sold to a securitizer, where the securitizer might have attempted to allocate the risk retention back to the lender. They noted that the residential mortgages were either government-insured mortgages or sold to the enterprises.

\textsuperscript{96} See GAO-11-656.
the future viability of the private-label RMBS market, which could impact all institutions involved in mortgage lending. In addition, several mortgage industry representatives indicated that smaller lenders, such as independent mortgage companies and small community banks, could lack sufficient capital resources to share risk retention obligations or hold non-QRMs that were not securitized on their balance sheets. As we reported, a few mortgage and securitization market participants told us that large lenders had the financial capacity to share risk retention obligations with securitizers or hold non-QRMs on their balance sheets, giving them an advantage over smaller lenders that could ultimately reduce competition in mortgage lending. Finally, a number of market participants noted that even if lenders were not required to share risk in the manner prescribed by the Dodd-Frank Act, securitizers could be expected to take steps to transfer the cost of risk exposure by paying lenders less for the mortgages they sold or requiring additional collateral to ensure the underwriting quality of the mortgages. But others noted that creditors would pass this cost on to borrowers and that the cost would likely be marginal.

In our interviews with state associations, community banks, and credit unions, officials from 8 of the 16 entities said that the QRM proposed rule would have a negative impact on community banks and credit unions and may cause them to decrease their mortgage lending. Five said that it was too soon to discern the impact of the proposed QRM rule, and three said the rule would have no impact. One bank noted that the risk retention requirement would likely curtail the availability of securitizers because of tighter guidelines for them and limit the bank’s potential market. Officials from several banks and credit unions said that the risk retention requirement would not have any impact on their institution because they did not securitize any of their mortgage loans. One bank official said that his bank sells its loans in the private market and that its portion of the securitization is less than 20 percent; thus, the bank would not be affected by the provision as proposed.

A number of provisions are expected to impose additional costs or other requirements on certain community banks or credit unions. However, the extent to which these small institutions will be affected is largely uncertain, in part because the rules implementing the provisions have not been finalized.
Prohibitions against Proprietary Trading and Ownership of Certain Funds

Few community banks may be directly affected by the Dodd-Frank Act’s proprietary trading prohibitions, but the federal regulators’ proposed rules implementing this provision would create additional compliance responsibilities for community banks. Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, amends the Bank Holding Company Act to prohibit banking entities from engaging in proprietary trading and having ownership interests in hedge funds and private equity funds (covered funds).

The provision’s prohibitions are designed to restrain risk-taking and reduce the potential for federal support of entities covered by the provision. To implement the provision, four agencies proposed a joint rule that was published in the Federal Register in November 2011.

The restrictions and prohibitions in section 619 were to be effective the earlier of either a year after the issuance of final rules or July 21, 2012. As final rules have not yet been issued, the prohibitions became effective on July 21, 2012. Banking and nonbank entities covered by the provision generally will have 2 years to bring existing activities into conformance.

The act defines proprietary trading as the purchase or sale of securities, derivatives, commodities futures, or options on these instruments (covered positions) for the trading account of a banking entity or nonbank financial entity, as opposed to on behalf of a customer. The act further defines a trading account as any account used principally with the intent to profit from short-term price movements. The proposed rule implements statutory exemptions from the prohibition on proprietary trading for certain government securities, and for hedging, market-making, and underwriting activities. The proposed rule also provides guidance on the types of

97 This section’s prohibitions apply to banking entities and do not apply to credit unions. The section does not prohibit nonbank financial companies supervised by the Federal Reserve from engaging in proprietary trading or having ownership interests in a covered fund. However, the provision allows the Federal Reserve or other agencies to impose additional capital charges and quantitative limits on nonbank financial companies supervised by the Federal Reserve that are engaged in those activities. OCC officials noted that no such nonbank entities have been designated as of August 13, 2012.

98 76 Fed. Reg. 68,846 (Nov. 7, 2011). The responsible rule-making agencies are OCC, the Federal Reserve, FDIC, and SEC. CFTC also has rule-making authority under section 619 of the Dodd-Frank Act and proposed a substantively similar rule in February 2012. The rules proposed by SEC and CFTC will not apply to community banks, as these agencies are not the primary financial regulatory agency for banks.

99 The Federal Reserve, Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 77 Fed. Reg. 33,949 (June 8, 2012). See also the Federal Reserve’s conformance period final rule, which was issued in February 14, 2011, 76 Fed. Reg. 8,265.
interests that are considered to be ownership interests in hedge funds, which commonly are understood to be investment vehicles that engage in active trading of securities and other financial contracts, and private equity funds, which commonly are understood to be funds that use leverage or other methods to invest in companies or other less-liquid investments.

Our analysis found that few community banks may be affected by the proposed rule’s prohibitions, but data on proprietary trading and involvement with covered funds at community banks are limited. Thus, the exact number of institutions that may be affected by the proposed rule is unknown. Using SNL Financial data, we found that about 1 percent of banks with more than $100 million and less than $10 billion in assets reported having financial instruments that may fall under the definition of a covered position in their trading accounts at the end of 2011. In previous analysis conducted on proprietary trading in July 2011, we found that most proprietary trading has been conducted by the largest bank holding companies. However, because banks with less than $100 million in total assets or less than $2 million in trading assets are not required to report their trading assets in Call Reports by the type of financial instrument, not all community banks involved in proprietary trading may be captured in the data. Further, Call Reports do not require banks to report ownership stakes in covered funds, so we could not estimate the number of community banks that may be affected by this prohibition.

Despite the small percentage of community banks that may be affected by the Dodd-Frank Act’s proprietary trading and covered fund prohibitions, the proposed rules could have an impact on community banks due to their compliance requirements. The proposed rules have a tiered compliance program, which was not expressly part of the act but could apply to all banks. Under the proposed rules, banks that do not engage in any covered trading or fund activities must ensure that their existing investment policies and procedures include measures that are


101Other banks that report total average trading assets of less than $2 million in each of the four preceding quarters also are not required to provide a breakdown of their trading assets by type of financial instruments.
designed to prevent them from becoming engaged in prohibited activities in the future, for example, by limiting their authorized investments to those exposures exempt from the prohibition. 102 Banks engaging in covered activities under the proposed rules must establish a six-part compliance framework to demonstrate that their activities are allowed by one of the rules’ exemptions. 103 Specific exemptions also have additional compliance requirements. For example, to use the exemption for risk-mitigating hedging, banks must be able to demonstrate that their hedging positions are reasonably correlated with specific risks. Our analysis of SNL Financial data on over-the-counter (OTC) derivatives found that about 15 percent of community banks held derivatives for purposes other than trading, such as hedging risk. The extent to which the risk mitigating hedging provision may affect community banks will depend on the requirements or standards that the regulators establish for demonstrating that a hedge is reasonably correlated with specific risks and whether such correlations must be on a transaction or portfolio basis. The proposed rule did not include any specific exemptions from the compliance requirements for small institutions, so if the proposed rules were adopted, these banks may have to expand their compliance frameworks to accommodate any additional hedging requirements imposed by the rule.

Although the impact of the proposed rules’ compliance requirements on community banks still is unknown, industry associations have expressed concern that the rules will impose an undue burden on small banks. As part of the proposed rules, the regulators considered the impact of the rules on small entities in accordance with the Regulatory Flexibility Act, and concluded that the compliance requirements in the proposed rule would not result in a significant economic impact on a substantial number of small entities. However, one industry association expressed concerns in its comment letter that the proposed rule will adversely affect

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102 Banks currently are required to have investment policies that identify acceptable instruments for purchase. The Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (63 Fed. Reg. 20,191 (Apr. 23, 1998)) specifies that banks should identify, measure, monitor, and control the risks of investment activities as a matter of sound banking practice. This includes maintaining policies that set limits on the purchase of securities and other investment vehicles. These policies can be used to identify instruments that the bank may purchase, such as U.S. Treasuries, municipal obligations, and Government Sponsored Enterprise debt, that are exempt from the proposed Volcker Rule.

103 Banks with more than $1 billion in covered positions or covered fund activities must also meet minimum standards in the compliance program.
community banks. The association noted that it would be costly for banks with no covered activities to amend their compliance policies and procedures, but did not estimate the anticipated increase in compliance costs for these institutions. The industry association also recommended that community banks that occasionally engage in interest rate swaps to hedge their interest rate risk be able to do so without meeting the compliance requirements for that exemption because these requirements are more extensive. However, the level of compliance burden may be relatively small for most community banks, given that the proprietary trading provisions do not apply to types of exposures that comprise the investment portfolio of most of the smaller community banks.

Swap Provisions

The Dodd-Frank Act’s swap provisions under Title VII may impose additional costs on the fraction of community banks currently using swaps, but CFTC and SEC have taken steps to help minimize the burden. A swap is a type of derivative that involves an ongoing exchange of one or more assets, liabilities, or payments for a specified period. Unlike exchange-traded derivatives, swaps traditionally have been traded in the OTC market and generally have not been cleared through clearinghouses. Financial and nonfinancial firms use swaps and other OTC derivatives to hedge risk, speculate, or for other purposes, but the market is dominated by a limited number of dealers. According to the Financial Stability Oversight Council, OTC derivatives, with the exception of credit risk transfer products, generally were not a central cause of the recent financial crisis but were a factor in the propagation of risks, as their complexity and opacity contributed to excessive risk taking and a lack of clarity about the ultimate distribution of risks.

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104 A derivative is a financial instrument created from, or whose value depends upon, the value of one or more separate assets or indexes of asset values.

105 A derivatives clearinghouse or similar organization enables each party to a derivatives transaction to substitute the credit of the clearinghouse for the credit of the parties, provides for the settlement or netting of obligations from the transaction, or otherwise provides services mutualizing or transferring the credit risk from the transaction.

106 Dealers participate in the derivatives market by quoting prices to, buying derivatives from, and selling derivatives to end users and other dealers.

Title VII of the Dodd-Frank Act establishes a new regulatory framework for swaps to reduce risk, increase transparency, and promote market integrity in the financial system. The act authorizes CFTC to regulate “swaps,” and SEC to regulate “security-based swaps” (hereafter collectively referred to as swaps). Among other things, Title VII (1) provides for the registration and regulation of swap dealers and major swap participants; (2) imposes clearing and trade execution requirements on swaps, subject to certain exceptions; and (3) creates record-keeping and real-time reporting regimes. CFTC and SEC are continuing to implement Title VII through their rule makings. According to Davis Polk, CFTC, SEC, and other regulators have finalized 43 of the 90 rules required under Title VII (as of July 2, 2012).

As shown in table 5, Call Report data aggregated by FDIC show that 1,101 of the 7,250 community banks (15 percent) held derivatives in 2011. According to industry officials, community banks typically use swaps to manage their exposure to interest rate risk or to help customers meet their risk management needs. Indeed, banks with $10 billion or less in total assets held nearly $88.8 million (notional amount) in derivatives at year-end 2011, of which $82.4, nearly 93 percent, was interest rate derivatives. Table 5 also shows that a considerably higher percentage of larger community banks hold derivatives than smaller community banks, but the use of derivatives within each asset-size class increased over the past 5 years. In 2011, for instance, over 50 percent of banks with over $1 billion to $10 billion held derivatives, but around 3 percent of banks with less than $100 million in assets held derivatives. In contrast to community banks, federally chartered credit unions have been prohibited by NCUA from engaging in derivatives, except through a pilot program. In view of the Dodd-Frank Act’s clearing requirements and its pilot program experience, NCUA is reconsidering whether to permit credit unions to engage in derivatives to hedge risk.

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108 Swaps include interest rate swaps, commodity-based swaps, and broad-based credit swaps. Security-based swaps include single-name and narrow-based credit swaps and equity-based swaps.

109 Although permitted by law, NCUA currently allows only a limited number of credit unions, on a case-by-case basis, to engage in such transactions under an investment pilot program.

Community bank and other industry officials have raised concerns about the potential for Title VII provisions or related regulations to impede the ability of community banks to use swaps. One concern is that community banks entering into swaps with customers could be required to register as swap dealers, unless they qualify for an exemption, and therefore be subject to capital, margin, business conduct, and other regulations. CFTC and SEC finalized their rule defining, among other things, a swap...
The final rule excludes persons engaged in a de minimis amount of swap-dealing activity from the definition of a swap dealer.\textsuperscript{111} Based on our analysis of SNL Financial data, we identified over 1,000 community banks that held OTC derivatives at year-end 2011. The data provided a snapshot of the notional amount of a bank’s derivatives activity, but did not indicate the value of derivatives entered into in the previous year, which is needed to determine whether any of the banks we analyzed met the definition of a swaps dealer. However, the bank with the highest notional amount of OTC derivatives held around $4.1 billion, which is considerably below the de minimis amounts set by CFTC and SEC for CFTC-regulated swaps and SEC-regulated credit default swaps. In addition, as directed by the Dodd-Frank Act, CFTC and SEC’s rule excludes from the swap dealer definition banks that enter into a swap with a customer in connection with originating a loan with that customer and meet other conditions specified under the rule.

Another concern raised by industry officials is that community banks, unless exempted, could be required to clear their swaps through a clearinghouse, which would impose additional costs on them. Title VII requires those swaps that CFTC or SEC determines must be cleared to be cleared through a clearinghouse, but provides an exception from the clearing requirement to end-users that are not financial entities and use these swaps to hedge or mitigate commercial risk. CFTC and SEC are required to consider whether to except, among others, small banks and credit unions from the definition of financial entity and thereby provide

\textsuperscript{111}\textsuperscript{112}See 77 Fed. Reg. 30,596 (May 23, 2012). The Dodd-Frank Act instructed CFTC and SEC to exempt from designation as a dealer a person that engages in a de minimis quantity of swap or security-based swap dealing in connection with transactions with or on behalf of his or her customers.

\textsuperscript{112}The rules provide for a phase-in of the de minimis thresholds to facilitate orderly implementation of swap dealer and security-based swap dealer requirements. The initial swap dealer and security-based swap dealer de minimis thresholds are, for the preceding year, no more than $8 billion in aggregate gross notional amount of dealing activity in CFTC-regulated swaps, $8 billion in notional amount of dealing activity for security-based swaps that are credit default swaps, and $400 million for other types of security-based swaps for security-based swap dealers. After the phase-in period ends and if CFTC or SEC have not otherwise determined to change the respective threshold amounts, the swap dealer de minimis threshold will be $3 billion in notional amount of dealing activity for all CFTC-regulated swaps, and the security-based swap dealer de minimis thresholds will be $3 billion in notional amount of dealing activity for security-based swaps that are credit default swaps, and $150 million in notional amount of dealing activity for other security-based swaps.
them with an exception from the mandatory requirement. In July 2012, CFTC adopted a final rule that exempts banks, savings associations, farm credit system institutions, and credit unions with total assets of $10 billion or less from the definition of “financial entity,” making such “small financial institutions” eligible for the end-user exception.\textsuperscript{113} As noted above, community banks’ derivatives activities are limited largely to interest rate derivatives, which are regulated by CFTC. In December 2010, SEC proposed rules that would allow small banks and credit unions to use the end-user exception from mandatory clearing created by the Dodd-Frank Act.\textsuperscript{114}

Even if community banks were provided with an exception from the mandatory swap clearing requirements, community bank officials are concerned that their noncleared swaps could be subject to margin requirements set by CFTC, SEC, or prudential regulators.\textsuperscript{115} According to an industry association, margin requirements could make it difficult or impossible for many community banks to continue using swaps. CFTC and the prudential regulators have issued proposed regulations for noncleared swaps.\textsuperscript{116} CFTC’s proposal would not impose margin requirements on nonfinancial entities.\textsuperscript{117} The prudential regulators’ proposal would impose margin requirements on nonfinancial entities but categorize them as lower-risk, requiring the dealer to collect margin from a nonfinancial entity only when the dealer’s exposure to the entity exceeded whatever credit limit the dealer has established for that

\textsuperscript{113}77 Fed. Reg. 42,560 (July 19, 2012).
\textsuperscript{114}75 Fed. Reg. 79,992 (Dec. 30, 2010).
\textsuperscript{115} Futures clearinghouses use initial and variation margin as a key part of their risk management programs. Initial margin serves as a performance bond against potential future losses. If a party fails to meet its obligation to pay variation margin, resulting in a default, the other party may use initial margin to cover most or all of any loss based on the need to replace the open position. Variation margin entails marking open positions to their current market value each day and transferring funds between the parties to reflect any change in value since the previous time the positions were marked. This process prevents losses from accumulating over time and thereby reduces both the chance of default and the size of any default should one occur.
\textsuperscript{116}CFTC has proposed regulations for noncleared swaps (see 76 Fed. Reg. 23,732 (Apr. 28, 2011)). Also, the prudential regulators have jointly proposed corollary noncleared margin rules (76 Fed. Reg. 27,564 (May 11, 2011)).
\textsuperscript{117} CFTC requested public comments on whether counterparties that are small financial institutions using derivatives to hedge their risks should be treated in the same manner as nonfinancial entities for purposes of the margin requirements.
According to FDIC staff, under long-standing banking agency guidance that predates the Dodd-Frank Act, a dealer bank engaging in an interest rate or other derivative with a community bank would not be expected to collect margin as long as the dealer bank’s exposure to the community bank was below the credit exposure limits that the dealer bank had established under its credit assessment processes and procedures. FDIC staff noted that the joint margin rule proposed by the prudential regulators reiterates this long-standing interagency safety and soundness guidance and that the proposed rule would effectively maintain the status quo with respect to commercial banks that are end-users of interest rate or other derivatives.\footnote{119}

Section 1073 of the Dodd-Frank Act imposes new requirements on remittance transfers (typically money transferred from consumers to their families or friends in other countries) that likely will increase costs for community banks and credit unions, but it also provides some temporary regulatory relief.\footnote{120} This provision established new consumer protections for remittance transfers, including most electronic wire transfers sent by consumers in the United States to individuals and businesses in other countries. In February 2012, CFPB issued a final rule to implement section 1073 and provided a 1-year implementation period, making the rule effective in February 2013.\footnote{121} The rule generally requires transfer providers to provide disclosures and receipts to consumers who provide the exact price of the remittance transfer, exchange rate, amount of currency to be delivered, and date of the funds’ availability. In addition, the rule generally provides that consumers have 30 minutes to cancel a

\footnote{118} The prudential regulators requested public comments on whether counterparties that are small financial institutions using derivatives to hedge their risks be treated in the same manner as nonfinancial end users for purposes of the margin requirements.

\footnote{119} Under the proposed rule, most community banks would fall under the category of “low-risk financial end users.” Under the proposal, such users would be required to post an initial margin only when the initial margin requirement, as calculated by the dealer, exceeds the lesser of $15 million or 0.1 percent of the dealer’s capital.

\footnote{120} Section 1073 of the act amended the Electronic Fund Transfer Act (15 U.S.C. 1693 et seq.).

\footnote{121} 77 Fed. Reg. 6,194, 6,208 (Feb. 7, 2012).
transaction after payment and the ability to dispute errors related to the transfer.\textsuperscript{122} NCUA analysis of Call Report data estimated that about 10 percent of all credit unions offered remittance services in the fourth quarter of 2011. Although comparable data on remittance services do not exist for community banks, a recent Federal Reserve study found that most U.S. depository institutions process international wire transfers on behalf of their customers.\textsuperscript{123}

Industry associations have questioned the ability of institutions that use open networks to make remittance transfers, such as community banks and credit unions, to continue to provide such services because of their difficulty in complying with the rule’s disclosure requirements.\textsuperscript{124} These associations suggested that open network transfer providers be given regulatory relief. In addition, two industry associations commented that the final rule does not level the playing field for consumer financial products, as it favors remittance transfer providers that use closed networks, such as nonbank institutions. In the February final rule, CFPB noted that it does not plan to provide an exemption for open network transfers, because the Dodd-Frank Act clearly covers these types of transfers.\textsuperscript{125} However, insured depository institutions, including community banks and credit unions, are provided with a temporary

\textsuperscript{122}For example, if the remittance amount delivered is less than the amount stated on the disclosure and this error is successfully disputed, the provider (such as a bank or credit union), at no additional charge, must either refund the consumer or transfer to the recipient the portion of the funds that were not received.

\textsuperscript{123}\textit{Report to the Congress on the Use of the Automated Clearinghouse System for Remittance Transfers to Foreign Countries}, Federal Reserve (July 2011). The United States is the largest estimated source of international remittances. Historically, consumers have largely chosen to send remittance transfers through nonbank money transmitters, such as Western Union. Although less common, individuals may also send remittances using services provided by depository institutions, such as banks and credit unions. Banks and credit unions typically transmit funds through an open network, such as international wire transfers and automated clearing house transactions.

\textsuperscript{124}Remittance transfer methods generally are described as closed network and open network systems. Closed network providers, such as Western Union, transfer remittances through a network of agents or other partners that help collect funds domestically and disburse funds abroad. Open network providers, such as banks and credit unions, may collect funds domestically and use the network to transfer remittances to an unaffiliated institution to disburse the funds abroad. In addition, national laws, individual contracts, and rules of various messaging, settlement, or payment systems may constrain certain parts of transfers sent through an open network system.

\textsuperscript{125}77 Fed. Reg. 6,208 (Feb. 7, 2012).
statutory exemption that allows them to provide estimated disclosures for certain information, including exchange rates and foreign fees and taxes, in certain circumstances rather than exact pricing. This exemption expires on July 21, 2015, but CFPB may extend the exemption for an additional 5 years. In addition, to reduce the compliance burden for institutions that provide remittance services outside of their normal course of business, CFPB has excluded from disclosure requirements those institutions that provide 100 or fewer remittance transfers per year.126

Officials from 5 of the 12 community banks and credit unions we spoke with said their institutions offer remittance services, and officials from two of the four state associations we spoke to said that they have members that offer remittance services. Of this group, officials from five of the entities expect that the new remittance transfer rule to decrease their (or their member institutions’) remittance transfer business. In particular, one credit union official told us that his institution may exit this line of business due to the increased disclosure requirements.

Subtitle E of Title IX of the Dodd-Frank Act will provide investors with more input on executive compensation practices, but may impose additional compliance requirements on certain publicly traded community banks and publicly traded companies that hold community banks. According to the Dodd-Frank Act’s legislative history, Subtitle E of Title IX is intended to address executive compensation practices that promoted excessive risk taking.127 The title contains a number of provisions intended to provide shareholders with greater influence over, and insight into, the activities of publicly traded companies. For example, section 951 requires shareholder advisory votes on executive compensation and “golden parachutes.” Section 953 requires disclosure of pay versus performance and the ratio between the chief executive officer’s total compensation and median total compensation for other employees. Section 954 requires listed companies to develop and implement

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clawback policies for incentive-based compensation.\textsuperscript{128} Based on our analysis of SNL Financial data, we identified approximately 200 publicly traded community banks and approximately 1,200 community banks held by public companies, some of which may be affected by these provisions.\textsuperscript{129}

Section 951 amends the Securities Exchange Act of 1934 to require public companies subject to the proxy rules to conduct a separate shareholder advisory vote on compensation for executives ("say-on-pay") at least every 3 years and a vote on the frequency of these votes at least every 6 years ("say-on-frequency").\textsuperscript{130} The amendment also requires a shareholder advisory vote on whether to approve certain golden parachute compensation arrangements in connection with a business combination.\textsuperscript{131} Section 951 provides that SEC may exempt an issuer from the advisory voting requirements. In determining whether to make an exemption, SEC is to take into account, among other considerations, whether the requirements disproportionately burden small issuers.

SEC issued a final rule implementing section 951, which became effective in April 2011.\textsuperscript{132} In commenting on the proposed rule, two industry

\textsuperscript{128}Clawbacks are recovery by the company of amounts paid to an employee based on materially inaccurate financial statements or performance criteria. This is money that the executive would not have received if the accounting was done properly and to which the executive was not entitled.

\textsuperscript{129}OCC staff commented that these numbers will likely be lower because of the Jumpstart Our Business Startups Act of 2012 (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306. With the exception of section 956, all of sections in Title IX, subtitle E of the Dodd-Frank Act, are amendments to the Securities Exchange Act of 1934. Banks and bank holding companies must be registered under the Securities Exchange Act for these provisions to apply. The JOBS Act provides relief from the Securities Exchange Act’s registration requirements for banks and bank holding companies.

\textsuperscript{130}The JOBS Act further amended the Securities Exchange Act of 1934 to provide that emerging growth companies—issuers with less than $1 billion in total annual gross revenues—are not required to seek advisory votes related to executive compensation.

\textsuperscript{131}Section 951 requires disclosure of any agreements or understandings that the person making a proxy or consent solicitation has with named executive officers of the acquiring issuer concerning any type of compensation that is based on or relates to the acquisition, merger, consolidation, sale, or other disposition of all or substantially all of the assets of the issuer and the aggregate total of all such compensation that may be paid or become payable to or on behalf of such executive officer.

\textsuperscript{132}76 Fed. Reg. 6,010 (Feb. 2, 2011).
associations recommended that community banks be exempted from the rule because they believe it will add significant burdens. While SEC did not exempt community banks from the rule, it extended the compliance date for the say-on-pay and say-on-frequency advisory votes for smaller reporting companies and newly public companies that qualify as smaller reporting companies, so that they will not be required to comply until the first annual or other shareholder meeting occurring on or after January 21, 2013. According to SEC, this deferral served, in part, to allow those companies to better prepare for implementation of the rules.

Section 953(a) requires public companies subject to the proxy rules to provide disclosure about pay versus performance, and section 953(b) requires reporting companies to disclose the ratio between the chief executive officer’s total compensation and the median total compensation for all other company employees. An industry association commented that the provision would require complex financial calculations and potentially expand the universe of persons subject to executive compensation disclosure requirements. In addition, the association suggested that SEC should exempt community banks from this provision, in light of SEC’s recognition that the compensation arrangements at smaller reporting companies generally are less complex than at other public companies. SEC has not yet proposed a rule to implement this provision.

Section 954 prohibits securities exchanges from listing securities of issuers that have not developed and implemented incentive-based compensation clawback policies. In addition, it prohibits exchanges from listing securities of issuers that have not disclosed incentive-based compensation policies. According to the Dodd-Frank Act’s legislative history, the purpose of this provision is to prevent executives from retaining compensation that they were awarded erroneously. An industry association has commented that this provision could make it more difficult for community banks to attract and retain qualified officers.

133SEC generally defines smaller reporting companies as those with a public float of less than $75 million.

134Section 953(a) amends section 14 of the Securities Exchange Act of 1934. In addition, the JOBS Act further amended the Securities Exchange Act of 1934 to provide that emerging growth companies are not required to make these disclosures.

and could make privately held community banks reluctant to become publicly traded companies. The industry association suggested that SEC should exempt community banks from this provision. SEC has not yet proposed a rule to implement this provision.

Incentive-Based Compensation Provision

The Dodd-Frank Act’s incentive-based compensation provision, section 956, will require a small percentage of community banks and credit unions to report incentive-based compensation. Specifically, section 956 requires that financial institutions with $1 billion or more in total assets disclose the structures of all incentive-based compensation arrangements to their federal regulators. The required disclosures will be used to determine whether the compensation structure provides excessive compensation, fees, or benefits, or could lead to a material financial loss to the institution, which section 956 also requires the regulators to prohibit. According to our analysis of SNL Financial data, most community banks and credit unions would not be subject to this provision. Our analysis indicates that, as of year-end 2011, around 7 percent of community banks and around 3 percent of credit unions have between $1 billion and $10 billion in assets and, therefore, could be subject to the provision.

The responsible rule-making agencies jointly issued a proposed rule to implement section 956 in April 2011, but a final rule has yet to be issued as of August 2012. Under the proposed rule, financial institutions with $1 billion or more in assets would be required to report incentive compensation arrangements annually to their appropriate regulators. However, pursuant to section 956, specific compensation to individuals will not be disclosed. Incentive compensation arrangements that encourage inappropriate risks through excessive compensation or pose a risk of material financial loss to an institution would be prohibited. Incentive compensation would be considered excessive when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed. In addition,

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136 Depending on the final rule and its implementation, subsidiaries of certain financial institutions with less than $1 billion in consolidated assets could also be affected.

137 Under the proposed rule, total consolidated assets are calculated using the average of the total assets reported in a bank’s or credit union’s four most recent Call Reports.

larger financial institutions—such as banks with $50 billion or more in assets and credit unions with $10 billion or more in assets—would be subject to additional incentive compensation rules. Incentive compensation would be deemed to lead to material financial loss unless the arrangement fulfills certain requirements, including balancing risk and financial rewards and involving effective risk management and strong corporate governance.

In their comment letters, industry associations suggested changes to the proposed rule to benefit community banks and credit unions. One industry association suggested that the final rule be phased in over a longer time period for institutions with assets between $1 billion and $10 billion. Another industry association suggested that institutions with $15 billion or less in assets with few incentive compensation arrangements should be required to disclose incentive-based compensation plans once every 2 years, rather than annually, to relieve excessive disclosure requirements for smaller institutions. Also, several industry associations commented that the definition of excessive incentive compensation was overly broad and should be narrowed. Of the 12 banks and credit unions we interviewed, three of these institutions had more than $1 billion in assets and may be subject to this rule, and officials from all three of these institutions told us that they offer incentive compensation. Two officials expect the proposed rule, if adopted, to have no impact on their institutions, and the other official said that it was too soon to judge what the impact would be.

Section 975 of the Dodd-Frank Act requiring the registration of municipal advisors may or may not affect the majority of community banks, depending on how SEC interprets “municipal advisor” in its final rule. Section 975 amended section 15B of the Securities Exchange Act to require municipal advisors, who previously were largely unregulated, to register with SEC like investment advisers. Before the Dodd-Frank Act, some municipal advisors were involved in, among other abuses, “pay-to-play” scandals—that is, influencing the award of business through political contributions—and recommended unsuitable investments to small municipalities. Section 975 also authorizes the Municipal Securities Rulemaking Board to develop professional standards, continuing education requirements, and business conduct requirements for municipal advisors. SEC proposed a rule to implement section 975 but
has not yet finalized the rule. The proposed rule requires institutions that meet the definition of a “municipal advisor” to submit registration documents to SEC detailing their organizational structure, business activities, and other information. Further, the proposed rule would require employees at institutions that meet the definition of a municipal advisor to register with SEC.

The definition of “municipal advisor” in the proposed rule could cover many community banks. SEC noted in the proposed rule that the statutory definition of a “municipal advisor” in the Dodd-Frank Act is “broad and includes persons that traditionally have not been considered to be financial advisors.” The rule identifies three general types of municipal advisors: (1) financial advisors that provide advice to municipal entities with respect to their issuance of municipal securities and municipal financial products, (2) investment advisers that advise municipal pension funds and other municipal entities on the investment of funds held by or on behalf of municipal entities, and (3) third-party marketers and solicitors.

The proposed rule noted that while some types of financial advisors were exempted in the statutory language, banks were not included in the exemptions. The proposed rule also notes that every bank account of a municipal entity is comprised of funds held by or on behalf of a municipal entity. Thus, if the rule is finalized as proposed, community banks that provide advice to municipal entities with respect to traditional depository services could be considered municipal advisors. If community banks providing such advice to municipal entities are included in the definition of municipal advisors, community banks and the individual employees that provide these services would need to register with SEC, who may be a new regulator for many community banks.

We used SNL Financial data to estimate the number of community banks with deposits from municipal entities and found that around 82 percent of banks with less than $10 billion in assets had deposits from municipal

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entities at the end of 2011. In the proposed rule, SEC analyzed the 
anticipated initial compliance burden for the registration requirement, and 
estimated that the institutions would spend 6.5 hours completing the 
registration, on average, and individuals would spend 3 hours, on 
average.

In the proposed rule, SEC sought comment on whether the definition of a 
municipal advisor should exclude banks to the extent that the bank 
provides advice to a municipal entity about traditional banking products, 
such as deposit accounts. Industry associations commented that banks 
should be explicitly exempted in the proposed rule because their activities 
are already supervised by federal and state banking regulators. However, 
SEC noted that federal and state banking regulators supervise banks for 
safety and soundness purposes and not the quality of the investment 
advice they provide to their municipal entity clients. SEC also received 
several comment letters from members of Congress who noted that it was 
not the intent of Congress to include traditional banking in the definition of 
municipal advice. SEC is reviewing the comments it has received as it 
develops a final rule, and SEC staff commented that the agency expects 
to implement its new oversight responsibilities for municipal advisors after 
careful consideration of the comments received.

Too Early to Determine the 
Impact of the Dodd-Frank Act on Community Banks’ 
and Credit Unions’ Small 
Business Lending

Regulators and industry officials have noted that the full impact of the 
Dodd-Frank Act on community banks and credit unions remains 
uncertain. Industry officials also have noted that it generally is too soon to 
determine the act’s overall impact on community banks’ and credit unions’ 
ability to lend to small businesses. According to our analysis of SNL 
Financial data, almost 90 percent of community banks and about one-
third of credit unions held loans to small businesses in 2011. Although 
any provision in the Dodd-Frank Act that affects these institutions could 
impact their customers (including small businesses), officials from federal 
agencies, state regulatory associations, and industry associations we 
interviewed identified only one provision in the Dodd-Frank Act 
discussed below) that may directly impact community banks’ and credit 
unions’ ability to lend to small businesses. As discussed above, 
community banks are important lenders to small businesses. Over the 
past decade, community banks have done more small business lending 
as a percentage of their total lending than large banks, although large 
banks have done more small business lending overall. Small business 
lending by credit unions with less than $10 billion in assets has increased 
over the past decade from 2 percent to about 7 percent of their total 
lending.
Although a number of provisions may ultimately impact lending by smaller institutions, section 1071 was the only Dodd-Frank Act provision identified by regulators and industry representatives as potentially having a direct impact on small business lending by community banks and credit unions. Section 1071 amends the Equal Credit Opportunity Act to require financial institutions to collect and report information concerning credit applications made by women-owned, minority-owned, and small businesses. The provision serves, among other purposes, to facilitate the enforcement of fair lending laws. CFPB expects to undertake action to implement section 1071 in June 2013.

Industry officials and others have expressed concerns about section 1071. According to industry and regulatory officials, the reporting requirements will increase the costs associated with small business lending. Industry officials also have noted that the reporting requirements could lead community banks and credit unions to develop standardized criteria for their small business lending to avoid being criticized or penalized by regulators for being discriminatory. They added that such standardization could then result in less lending to small businesses. Officials from 12 of the 16 state associations, community banks, and credit unions we spoke with expect this provision to negatively affect their institutions or member institutions, and four officials said it was too soon to tell how this provision would affect their institutions.

We also asked officials from the 16 state associations, community banks, and credit unions if they expected the Dodd-Frank Act generally to impact the amount of small business lending conducted by their institutions. Officials from 11 of these entities told us it was too soon to tell, although two officials said the Dodd-Frank Act would have no impact. Officials from three of the entities said that they expected the act to decrease their small business lending. In our interviews, industry officials also said that the Dodd-Frank Act provisions cumulatively could increase their compliance and other costs and adversely affect their competitiveness in the small business lending market.

Agency Comments and Our Evaluation

We provided a draft of this report to CFPB, FDIC, the Federal Reserve, OCC, NCUA, SBA, and SEC for review and comment. CFPB and NCUA provided written comments that we have reprinted in appendices III and IV. CFPB and NCUA generally agreed with our report. In addition, CFPB, FDIC, OCC, and SEC staff provided technical comments, which we have incorporated, as appropriate. The Federal Reserve and SBA did not provide any comments.
In its comment letter, CFPB generally agreed with the report’s analysis of the role played by community banks and credit unions in the economy and discussion of CFPB’s responsibilities in implementing Dodd-Frank Act reforms. CFPB further elaborated on the status of its rule makings related to mortgage reforms and efforts to seek input from small businesses, community banks, and credit unions about the impacts and potential alternatives for its rule-making initiatives.

Although generally agreeing with our report, NCUA commented on a finding that we cited from a GAO report issued in January 2012. NCUA noted that it does not believe there is sufficient evidence to suggest that member business loans pose a higher risk to credit unions or that a key driver in credit union failures is commercial loans. In our prior report, our analysis of NCUA’s and its Office of Inspector General’s data indicated that member business loans contributed to 13 of the 85 credit union failures from January 2008 to June 2011.

We are sending copies of this report to CFPB, CFTC, FDIC, the Federal Reserve, NCUA, OCC, SBA, SEC, interested congressional committees, members, and others. This report will also be available at no charge on our website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or evansl@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.

Lawrance L. Evans, Jr.
Acting Director, Financial Markets and Community Investment

141See GAO-12-247.
Appendix I: Scope and Methodology

Our objectives in this report were to examine (1) significant changes that community banks and credit unions have undergone in the past decade, including the factors that have contributed to such changes, and (2) the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provisions that regulators, industry associations, and others expect to impact community banks and credit unions, including their small business lending.¹

To address our first objective, we reviewed and analyzed studies by regulators, industry associations, and academics. We conducted searches of social science, economic, and federal research databases, including EconLit, Fed-in-Print, Google Scholar, and JSTOR, to identify relevant studies on community banks and credit unions, including their lending to small businesses. To help us identify relevant studies, we also relied on federal agencies, including the Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency, National Credit Union Administration (NCUA), and Small Business Administration; state regulatory associations (the Conference of State Bank Supervisors and National Association of State Credit Union Supervisors); industry associations (the American Bankers Association, Credit Union National Association, Independent Community Bankers of America, National Association of Federal Credit Unions, National Federation of Independent Business, and Main Street Alliance); and academic or other experts.²

Although we found these studies to be sufficiently reliable for the purposes of our report, the results should not necessarily be considered as definitive, given the potential methodological or data limitations contained in the studies individually and collectively. Moreover, the studies investigating economies of scale and consolidation generally address the relationship in a manner that limits the ability to make definitive causal claims. In addition, we analyzed data from SNL.

¹Although no commonly accepted definition of a community bank exists, the term often is associated with smaller banks (e.g., under $1 billion in assets) that provide relationship banking services to the local community, and have management and board members who reside in the local community. In this report, we generally define banks (insured depository institutions that are not credit unions) with under $10 billion in total assets as community banks. We also include in our analysis federally insured credit unions with under $10 billion in total assets. We use under $10 billion in total assets as our criterion because the Dodd-Frank Act exempts small institutions from a number of its provisions based on that threshold.

²The Main Street Alliance is a national network of state-based small business coalitions.
Financial, a private financial database that contains publicly filed and financial reports, including Consolidated Reports on Condition and Income (Call Reports) submitted to FDIC, Thrift Financial Reports submitted to the Office of Thrift Supervision, and 5300 Call Reports (Call Reports) submitted to NCUA. We used SNL Financial data to identify changes in the total number, profitability, lending activities (including small business lending), expenses, and other metrics of community banks and credit unions from 2002 through 2011. As regulators do not collect data specifically on small business lending, we created a proxy for small business lending using Call Report data on commercial real estate and commercial and industrial loans for under $1 million for community banks and member business lending by credit unions. As a result, what we characterize as small business lending also may include, to some degree, small loans to larger businesses. We analyzed the data for different asset classes of community banks (assets of $10 billion or more, $1 billion to $10 billion, $250 million to $1 billion, $100 million to $250 million, and less than $100 million) and credit unions (assets of $10 billion or more, $1 billion to $10 billion, $100 million to $1 billion, $20 million to $100 million, $5 million to $20 million, and less than $5 million). We reviewed the SNL Financial data and found the data to be sufficiently reliable for our purposes, and we have relied on the data in our previous reports. We also interviewed the federal agencies and associations identified above and four academic and industry experts about trends in the community bank and credit union sectors and their causes.

To address our second objective, we reviewed the Dodd-Frank Act and related materials, including relevant congressional hearings; comment letters on proposed rules; and studies or analysis prepared by federal and state regulators, industry associations, law firms, and academics. To help us identify the Dodd-Frank Act provisions applicable to community banks and credit unions and assess their impact on such institutions, we interviewed and obtained documentation, when available, from the federal agencies, state regulatory associations, and industry associations identified above, and the Bureau of Consumer Financial Protection. Appendix II contains a table of the provisions identified collectively by these groups. We also analyzed a number of the Dodd-Frank Act provisions that regulators, industry officials, and others expect to impact community banks and credit unions. We used Call Report and other data compiled by SNL Financial to assess the extent to which community banks and credit unions may be subject to or otherwise affected by various Dodd-Frank Act provisions. We took steps to ensure consistency in data analyses for the various provisions within this reporting section and determined that any differences in data due to the date on which we
downloaded them from SNL Financial did not have a material impact on our analysis. Our review of the SNL Financial data also found the data to be sufficiently reliable for making judgments about the institutions likely impacted. To obtain further insights into the expected impact of the Dodd-Frank Act, we conducted semistructured interviews with a sample of four state associations and a sample of 12 community banks and credit unions. We interviewed two state banking associations and two credit union associations from Georgia, Illinois, Minnesota, and Pennsylvania, based on the number and uniformity of community banks and credit unions within the states. We randomly selected and interviewed eight community banks and four credit unions from California, Florida, Massachusetts, Michigan, Ohio, Oklahoma, South Dakota, Texas, Virginia, and Wisconsin. For selected associations and institutions that were unavailable to participate, we substituted other similar institutions. In conducting our interviews, we first sent structured questions by e-mail and then followed up with in-depth telephone interviews. These interviews were conducted, in part, to confirm whether the state-level bank and credit union associations and individual community banks and credit unions generally considered the same Dodd-Frank Act provisions identified by regulators, industry associations, and others as potentially impacting their institutions (or member institutions). These interviews also provided further insights on the expected impact of the Dodd-Frank Act, but their responses are not generalizable to the population of community banks and credit unions.

We conducted this performance audit between February and September 2012, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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3As SNL Financial data are updated continually, data downloaded on different dates may differ.
Appendix II: Provisions of the Dodd-Frank Act
Expected by Federal Regulators, State Regulatory Associations, and Industry Associations to Impact Community Banks and Credit Unions

The following table lists the Dodd-Frank Act provisions that are expected to impact some or all community banks and credit unions. These provisions were identified primarily based on information we collected from federal regulators, state regulatory associations, and industry associations. Industry officials also told us that it is difficult to identify all of the provisions that may impact small institutions because such outcomes may depend on how agencies implement certain provisions through their rules, and many rules have not been finalized. For the same reason, regulators and industry officials also have noted that enough time has not passed to assess the full impact of the Dodd-Frank Act on community banks and credit unions. In particular, the table identifies provisions that are expected to impact community banks and credit unions or a subset of these institutions. The table also includes provisions with explicit exemptions for community banks and credit unions or that provide regulators with the authority to exempt certain entities or financial products from a provision.

As discussed in the report, some provisions or exemptions in the act are expected to have an indirect impact on community banks and credit unions. For example, section 1024 is expected to have an indirect impact on community banks and credit unions because it authorizes the Bureau of Consumer Financial Protection (CFPB) to supervise nonbank financial institutions. Before the Dodd-Frank Act, nonbank financial institutions generally were not subject to supervision at the federal level with respect to the federal consumer financial laws, and CFPB’s supervision is expected to help level the playing field between these institutions and regulated institutions, such as community banks and credit unions.

1For some titles, we identified subtitles that included a number of sections that were expected to impact community banks and credit unions, but did not necessarily include every section within that subtitle in the table.
## Table 6: Dodd-Frank Act Provisions Expected by Federal Regulators, State Regulatory Associations, and Industry Associations to Impact Community Banks and Credit Unions

<table>
<thead>
<tr>
<th>Title and subtitle</th>
<th>Provisions expected to impact community banks and credit unions</th>
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<tbody>
<tr>
<td><strong>Title I—Financial Stability</strong></td>
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<tr>
<td>Subtitle C—Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies</td>
<td>Section 165, Enhanced supervision and prudential standards for nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (Federal Reserve) and certain bank holding companies. Section 165(h)(2)(B) permits the Federal Reserve to require publicly traded bank holding companies with less than $10 billion in assets to establish a risk committee.</td>
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<td>Section 171, Leverage and risk-based capital requirements. This section requires federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and systemically important nonbanks. Section 171(b)(4)(C) exempts from capital deductions otherwise required by this section debt or equity instruments issued before May 19, 2010, by bank holding companies with less than $15 billion in assets and mutual holding companies. Moreover, section 171(b)(5)(C) exempts from section 171 bank holding companies subject to the Federal Reserve’s Small Bank Holding Company Policy Statement in effect on May 19, 2010.</td>
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<tr>
<td><strong>Title II—Orderly Liquidation Authority</strong></td>
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<tr>
<td><strong>Title III—Transfer of Powers to the Comptroller of the Currency, the Corporation, and Board of Governors</strong></td>
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<tr>
<td>Subtitle A—Transfer of Powers and Duties</td>
<td>Subtitle A of Title III abolishes the Office of Thrift Supervision and provides for the transfer of its functions and authorities to the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Federal Reserve.</td>
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<tr>
<td>Subtitle C—Federal Deposit Insurance Corporation</td>
<td>Subtitle C of Title III contains provisions that make changes to the federal deposit insurance regime, including (1) redefining the assessment base against which deposit insurance premiums are calculated (section 331) and increasing the standard maximum deposit and share insurance amount from $100,000 to $250,000 (section 335).</td>
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<td>Section 334, Transition reserve ratio requirements to reflect new assessment base. This provision exempts banks with less than $10 billion in assets from the increase in the minimum reserve ratio.</td>
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<tr>
<td>Subtitle D—Other Matters</td>
<td>Section 341, Branching. Section 341 permits any thrift that converts to a bank charter to continue to operate branches and agency offices in existence prior to the charter conversion.</td>
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<td>Section 343, Insurance of transaction accounts. Section 343 provided temporary unlimited deposit and share insurance coverage for non-interest-bearing transaction accounts from December 31, 2010, through December 31, 2012.</td>
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<tr>
<td><strong>Title IV—Regulation of Advisers to Hedge Funds and Others</strong></td>
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<tr>
<td><strong>Title V—Insurance</strong></td>
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<tr>
<td><strong>Title VI—Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions</strong></td>
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<td>Section 613, De novo branching into states. Section 613 expands the de novo interstate branching authority of national and state banks by eliminating the requirement that a state expressly opt-in to de novo branching.</td>
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<td>Section 619, Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds. This section prohibits banking entities from engaging in proprietary trading and private fund management activities, subject to certain exemptions.</td>
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<td>Section 627 Interest-bearing transaction accounts authorized. This section eliminates the prohibition against the payment of interest on demand deposits (e.g., commercial checking accounts).</td>
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</table>
Appendix II: Provisions of the Dodd-Frank Act
Expected by Federal Regulators, State Regulatory Associations, and Industry Associations to Impact Community Banks and Credit Unions

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<th>Title and subtitle</th>
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<tr>
<td><strong>Title VII—Wall Street Transparency and Accountability</strong></td>
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<tr>
<td>Subtitle A—Regulation of Over-the-Counter Swaps Markets</td>
<td>Title VII contains provisions that authorize Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) to regulate the OTC derivative markets and subject various market participants to capital, margin, business conduct, and other requirements.</td>
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<tr>
<td>Section 721, Definitions. Section 721 amends the Commodity Exchange Act to require CFTC to exempt an entity that engages in de minimis derivatives from the swap dealer definition.</td>
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<tr>
<td>Section 723, Clearing. This section provides CFTC with the authority to exempt from the mandatory clearing requirement community banks and credit unions with less than $10 billion in assets.</td>
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<tr>
<td>Section 737, Position limits. This section provides CFTC with the discretionary authority to exempt community banks or credit unions, among other entities and transactions, from the position limits.</td>
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<tr>
<td>Subtitle B—Regulation of Security-Based Swap Markets</td>
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<tr>
<td>Section 761, Definitions under the Securities Exchange Act of 1934. Section 761 amends the 1934 act to require SEC to exempt an entity that engages in de minimis quantity of security-based swap dealing from the swap dealer definition.</td>
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<tr>
<td>Section 763, Amendments to the Securities Exchange Act of 1934. This section amends the 1934 act to authorize SEC to exempt from the mandatory clearing requirement community banks and credit unions with less than $10 billion in assets. The amendment also provides SEC with the discretionary authority to exempt entities from position limits.</td>
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<td><strong>Title VIII—Payment, Clearing, and Settlement Supervisor</strong></td>
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<td><strong>Title IX—Investor Protections and Improvements to the Regulation of Securities</strong></td>
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<tr>
<td>Subtitle C—Improvements to the Regulation of Credit Rating Agencies</td>
<td>Section 939A, Review of reliance on ratings. Section 939A requires federal banking and other agencies to review their regulations requiring the use of credit ratings with a goal of modifying those regulations by substituting for such use the standard of creditworthiness they deem appropriate.</td>
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<tr>
<td>Subtitle D—Improvements to the Asset-Backed Securitization Process</td>
<td>Subtitle D of Title IX contains provisions that require federal agencies to jointly issue rules requiring a securitizer of an asset-backed security (other than a residential mortgage-backed security) to retain at least 5 percent of the credit risk in any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.</td>
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<tr>
<td>Section 941, Regulation of credit risk retention. This section includes language providing regulators with the discretionary authority to exempt entities from the risk retention requirements.</td>
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<td>Subtitle E—Accountability and Executive Compensation</td>
<td>Subtitle E of Title XI contains provisions that require additional executive compensation-related disclosures by public companies, including requiring such companies to hold a non-binding vote to approve the compensation of certain executives (Section 951).</td>
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<tr>
<td>Section 956, Enhanced compensation structure reporting. This section requires financial institutions to report incentive compensation to their regulator and prohibits incentive compensation that is “excessive” or “could lead to material financial loss” at an institution. Financial institutions with less than $1 billion in assets are exempted from this provision.</td>
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<tr>
<td>Subtitle G—Strengthening Corporate Governance</td>
<td>Section 971, Proxy access. Subsection 971(c) provides SEC with the authority to exempt certain issuers from the proxy access requirement.</td>
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<td>Subtitle H—Municipal Securities</td>
<td>Section 975, Regulation of municipal securities and changes to the board of the Municipal Securities Rulemaking Board. Section 975 amends section 15B of the Securities Exchange Act, 15 U.S.C. § 78o-4, to require municipal advisors, who were largely unregulated, to register with SEC like other financial advisors.</td>
</tr>
<tr>
<td>Subtitle I—Public Company Accounting Oversight Board, Portfolio Margining, and Other Matters</td>
<td>Section 989G, Exemption for nonaccelerated filers. Section 989G exempts smaller issuers from section 404(b) of the Sarbanes-Oxley Act, 15 U.S.C. § 7262(b).</td>
</tr>
</tbody>
</table>
## Title and subtitle
Provisions expected to impact community banks and credit unions

### Title X—Bureau of Consumer Financial Protection

| Subtitle A—Bureau of Consumer Financial Protection | Subtitle A of Title X contains provisions that create CFPB to regulate financial products or services provided by insured depository institutions, finance companies, mortgage lenders, and a broad range of nontraditional financial services entities, and provides CFPB with the authority to prevent covered institutions from engaging in unfair, deceptive, or abusive acts or practices in the provision of consumer financial products and services. |
| Subtitle B—General Powers of the Bureau | Subtitle B of Title X contains provisions that provide CFPB the authority to prescribe rules and issue orders and guidance, as may be necessary or appropriate to enable the Bureau to administer federal consumer financial laws. |
|  | Section 1022, Rule-making authority. Section 1022(b)(3) grants CFPB broad authority to exempt entities from the provisions of Title X or any rule under Title X. This could include community banks and credit unions. |
|  | Section 1024, Supervision of nondepository covered persons. Provides CFPB with supervisory and enforcement authority for federal consumer financial protection laws for certain nonbank institutions such as nonbank institutions that provide origination, brokerage, or servicing of residential real estate loans. |
|  | Section 1025. Supervision of very large banks, savings associations, and credit unions. This provision generally excludes banks and credit unions with $10 billion or less in assets (other than affiliates of large banks) from CFPB supervision. |
|  | Section 1026, Other banks, savings associations, and credit unions. This section provides CFPB with certain authority over small banks and credit unions with less than $10 billion in assets. This authority allows CFPB to require reports, as necessary, from small banks and credit unions and CFPB, at its discretion, may include its examiners on a sampling basis in small banks and credit union examinations conducted by their prudential regulator. |
| Subtitle C—Specific Bureau Authorities | Subtitle C of Title X contains sections that provide CFPB with the authority to prescribe rules identifying as unlawful, unfair, deceptive, or abusive acts or practices for a consumer financial product or service and to ensure that the features of any consumer financial product or service are fully, accurately, and effectively disclosed to consumers. In addition, it requires the CFPB to establish reasonable procedures to provide a timely response to consumers to complaints against or inquiries concerning a financial institution. |
|  | Section 1032, Disclosures. This section includes a provision (section 1032(f)) that requires CFPB to combine disclosures required under the Truth in Lending Act (TILA) and sections 4 and 5 of the Real Estate Settlement Procedures Act of 1974 into a single disclosure. |
| Subtitle G—Regulatory Improvements | Section 1071 Small business loan data collection. This section requires that lenders collect and report to CFPB certain women-owned, minority-owned, and small business loan data. In addition, this provision provides CFPB with the discretionary authority to exempt any financial institution from the data collection and reporting requirements. |
|  | Section 1073 Remittance transfers. This section requires disclosures to consumers that send money remittance transfers in accordance with rules to be prescribed by CFPB. |
|  | Section 1075 Reasonable fees and rules for payment card transactions. This section requires the Federal Reserve to prescribe regulations regarding any interchange transaction fee that an issuer may receive or charge for an electronic debit transaction. This provision includes an exemption for institutions with less than $10 billion in assets from the cap on debit card interchange fees. |
| Subtitle H—Conforming Amendments | Section 1094 Amendments to the Home Mortgage Disclosure Act of 1975 (HMDA). This section amends HMDA to expand the scope of information relating to mortgage loans to add a number of new data elements. |
## Appendix II: Provisions of the Dodd-Frank Act

**Expected by Federal Regulators, State Regulatory Associations, and Industry Associations to Impact Community Banks and Credit Unions**

### Title XIV—Mortgage Reform and Anti-Predatory Lending Act

<table>
<thead>
<tr>
<th>Subtitle A—Residential Mortgage Loan Origination Standards</th>
<th>Provisions expected to impact community banks and credit unions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 1098 Amendments to the Real Estate Settlement Procedures Act of 1974. This section requires CFPB to issue rules that combine two different mortgage loan disclosures, one required by the TILA and the other by the Real Estate Settlement Act.</td>
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<tr>
<th>Subtitle B—Minimum Standards For Mortgages</th>
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<tbody>
<tr>
<td><strong>Title XI—Federal Reserve System Provisions</strong></td>
</tr>
<tr>
<td><strong>Title XII—Improving Access to Mainstream Financial Institutions</strong></td>
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<tr>
<td><strong>Title XIII—Pay it Back Act</strong></td>
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<tr>
<th>Subtitle A—Residential Mortgage Loan Origination Standards</th>
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<tbody>
<tr>
<td>Section 1405. Regulations. CFPB may, by rule, exempt from or modify disclosure requirements, in whole or in part, for any class of residential mortgage loans for which it determines that such exemption or modification is in the interest of consumers and in the public interest.</td>
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<tr>
<th>Subtitle C—High-Cost Mortgages</th>
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<tbody>
<tr>
<td><strong>Title XIV—Mortgage Reform and Anti-Predatory Lending Act</strong></td>
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<table>
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<tr>
<th>Subtitle D—Minimum Standards For Mortgages</th>
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<td>Section 1405. Regulations. CFPB may, by rule, exempt from or modify disclosure requirements, in whole or in part, for any class of residential mortgage loans for which it determines that such exemption or modification is in the interest of consumers and in the public interest.</td>
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<tr>
<th>Subtitle E—Mortgage Servicing</th>
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<tr>
<td><strong>Title XIII—Pay it Back Act</strong></td>
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<tr>
<th>Subtitle F—Appraisal Activities</th>
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<tbody>
<tr>
<td>Subtitle F of Title XIV contains provisions regarding appraisals in connection with residential mortgage loans.</td>
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### Title and subtitle
**Provisions expected to impact community banks and credit unions**

<table>
<thead>
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<tbody>
<tr>
<td><strong>Section 1471</strong>, Property appraisal requirements. This section provides regulators with discretionary authority to exempt, by rule, a class of loans from the appraisal requirements in this section if they determine that the exemption is in the public interest and promotes the safety and soundness of creditors.</td>
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<tr>
<td><strong>Section 1472</strong>, Appraisal Independence Requirements. This section amends TILA by adding appraisal independence requirements. These requirements include, among other things, a description of acts or practices that violate appraisal independence, a list of actions that an appraiser can take at the request of an interested party but do not violate independence, and mandatory reporting of appraisers that do not comply with Uniform Standards of Professional Appraisal Practice to state appraiser certifying and licensing agencies.</td>
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**Title XV—Miscellaneous Provisions**

**Title XVI—Section 1256 Contracts**

Source: GAO analysis of information collected from federal regulators (the Federal Deposit Insurance Corporation, the Federal Reserve, National Credit Union Administration, Office of the Comptroller of the Currency, and the Bureau of Consumer Financial Protection); state regulatory associations (Conference of State Bank Supervisors and National Association of State Credit Union Supervisors); and industry associations, including the American Bankers Association, Independent Community Bankers of America, Credit Union National Association, and National Association of Federal Credit Unions.
September 5, 2012

Mr. Lawrance J. Evans, Jr.
Acting Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20546

Dear Mr. Evans:

Thank you for the opportunity to comment on the draft report, Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rulemakings.

The report sets forth the Government Accountability Office's (GAO) valuable analysis of the state of community banks and credit unions and the importance of these institutions to our economy. Community banks and credit unions play critical roles in ensuring a fair, transparent, and competitive marketplace for consumer financial products and services. The Consumer Financial Protection Bureau (CFPB or Bureau) is committed to working with community banks and credit unions to improve these markets where needed and avoid unnecessary regulatory burdens.

The GAO report reviews the CFPB's and other agencies' statutory obligations under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and considers the possible impact of those obligations on community banks and credit unions. The report discusses CFPB's mandate to supervise certain nonbank financial institutions that often compete in the same markets as community banks and credit unions. This new authority is largely viewed as having a positive impact on these small depositories by helping ensure that the
consumer financial market is subject to more consistent standards that apply equally to all businesses.

The report correctly notes that the Dodd-Frank Act's reforms are directed primarily at large U.S. financial institutions. Similarly, the CFPB's supervision and enforcement authority is generally limited to banks with over $10 billion in assets and their affiliates. The CFPB does have the authority to adopt regulations that can affect community banks and credit unions, as well as larger financial institutions. Since our inception, the CFPB has actively and consciously designed a number of mechanisms to seek the input of small businesses to support its decision-making process. For example, the CFPB has created an Office of Small Business, Community Banks, and Credit Unions to engage with small depositories and businesses in carrying out the Bureau's functions. In addition, the CFPB is currently working to convene various advisory councils that focus specifically on community banks and credit unions.

The CFPB also considers it a priority to integrate direct input and advice from small businesses into its rulemaking process. Section 1100G of the Dodd-Frank Act, which requires the Bureau to convene panels with small businesses prior to proposing certain rules, is a critical piece of that larger effort. The panels provide a mechanism for the CFPB to seek intensive input from small businesses about the impacts and potential alternatives for rulemaking initiatives.

As discussed in the report, the Bureau currently is engaged in several rulemakings to implement Dodd-Frank Act requirements related to mortgage reform and plans to finalize most of these rules on or before January 21, 2013. These include a new statutory requirement that lenders make a good faith and reasonable determination that borrowers have the ability to repay a residential mortgage loan, a requirement that the Bureau combine existing mortgage origination disclosures to help consumers better understand their loans, and other rules that are intended to better protect and inform consumers throughout the mortgage process. The Bureau is fully committed to coordinating constructively with community banks and credit unions to ensure that we exercise our statutory obligations in an effective manner.
Appendix III: Comments from the Bureau of Consumer Financial Protection

Thank you again for the opportunity to comment on the draft report.

Sincerely,

[Signature]

Dan Sokolov
Deputy Associate Director
Research, Markets and Regulations
Appendix IV: Comments from the National Credit Union Administration

August 31, 2012

Via Email

Lawrence J. Evans, Jr.
Acting Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548
evansj@gao.gov

Dear Mr. Evans:

We have reviewed your report entitled Community Banks and Credit Unions – impact of the Dodd Frank Act Depends Largely on Future Rulemakings.

We agree with your conclusion that credit unions play a significant role in rural small business and agricultural lending. The report goes on, however, to cite comments made in report GAO 12-247 regarding the risk posed to credit unions by commercial loans. NCUA closely monitors commercial lending in our insured institutions, and we do not believe there is sufficient evidence to suggest member business loans pose a higher risk to credit unions or that a key driver in credit union failures is commercial loans.

We agree with the overarching themes of the report with respect to credit unions, namely that (1) despite industry consolidation, credit unions still play an important role in relationship lending to consumers and small businesses and (2) a full assessment of the impact of Dodd-Frank on the industry must await the conclusion of the rulemaking process.

NCUA appreciates the professionalism of the review team. Thank you for the opportunity to comment.

Sincerely,

David M. Marquis
Executive Director

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300 - 703-518-6319 FAX
# Appendix V: GAO Contacts and Staff Acknowledgments

<table>
<thead>
<tr>
<th>GAO Contact</th>
<th>Lawrance L. Evans, Jr. (202) 512-8678 or <a href="mailto:evansl@gao.gov">evansl@gao.gov</a></th>
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<tbody>
<tr>
<td><strong>Staff Acknowledgments</strong></td>
<td>In addition to the contact named above, Richard Tsuhara (Assistant Director), Allison Abrams, Jeremy Conley, Stuart Kaufman, Colleen Moffatt, Patricia Moye, Jennifer Schwartz, Seyda Wentworth, and Henry Wray made key contributions to this report.</td>
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