Selling Out to America's Megabanks: Regulation Is Killing Community Banks, Public Banks Can Revive Them

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Crushing regulations are driving small banks to sell out to the megabanks, a consolidation process that appears to be intentional. Publicly-owned banks can help avoid that trend and keep credit flowing in local economies.

At his confirmation hearing in January 2017, Treasury Secretary Stephen Mnuchin said,

> "regulation is killing community banks."

If the process is not reversed, he warned, we could "end up in a world where we have four big banks in this country." That would be bad for both jobs and the economy.

> "I think that we all appreciate the engine of growth is with small and medium-sized businesses," said Mnuchin. "We're losing the ability for small and medium-sized banks to make good loans to small and medium-sized businesses in the community, where they understand those credit risks better than anybody else."

The number of US banks with assets under $100 million dropped from 13,000 in 1995 to under 1,900 in 2014. The regulatory burden imposed by the 2010 Dodd-Frank Act exacerbated this trend, with community banks losing market share at double the rate during the four years after 2010 as in the four years before. But the number had already dropped to only 2,625 in 2010. What happened between 1995 and 2010?

Six weeks after September 11, 2001, the 1,100 page Patriot Act was dropped on congressional legislators, who were required to vote on it the next day. The Patriot Act added provisions to the 1970 Bank Secrecy Act that not only expanded the federal government's wiretapping and surveillance powers but outlawed the funding of terrorism, imposing greater scrutiny on banks and stiff criminal penalties for non-compliance. Banks must now collect and verify customer-provided information, check names of customers against lists of known or suspected terrorists, determine risk levels posed by customers, and report suspicious persons, organizations and transactions. One small banker complained that banks have been turned into spies secretly reporting to the federal government. If they fail to comply, they can face stiff enforcement actions, whether or not actual money-laundering crimes are alleged.

In 2010, one small New Jersey bank pleaded guilty to conspiracy to violate the Bank Secrecy

Act and was fined *$5 million* for failure to file suspicious-activity and cash-transaction reports. The bank was acquired a few months later by another bank. Another small New Jersey bank was ordered to shut down a large international wire transfer business because of deficiencies in monitoring for suspicious transactions. It closed its doors after it was hit with *$8 million* in fines over its inadequate monitoring policies.

Complying with the new rules demands a level of technical expertise not available to ordinary mortals, requiring the hiring of yet more specialized staff and buying more anti-laundering software. Small banks cannot afford the risk of massive fines or the added staff needed to avoid them, and that burden is getting worse. In February 2017, the Financial Crimes Enforcement Network [proposed a new rule](#) that would [add a new category](#) requiring the flagging of suspicious "cyberevents." According to [an April 2017 article in American Banker](#):

> [T]he "cyberevent" category requires institutions to detect and report all varieties of digital mischief, whether directed at a customer's account or at the bank itself. . . .Under a worst-case scenario, a bank's failure to detect a suspicious attachment or a phishing attack could theoretically result in criminal prosecution, massive fines and additional oversight.

One large bank estimated that the proposed change with the new cyberevent reporting requirement would cost it an additional $9.6 million every year.

Besides the cost of hiring an army of compliance officers to deal with a thousand pages of regulations, banks have been hit with [increased capital requirements](#) imposed by the Financial Stability Board under Basel III, eliminating the smaller banks' profit margins. They have little recourse but to sell to the larger banks, which have large compliance departments and can [skirt the capital requirements](#) by parking assets in off-balance-sheet vehicles.

In a September 2014 article titled "[The FDIC's New Capital Rules and Their Expected Impact on Community Banks](#)," Richard Morris and Monica Reyes Grajales noted that "a full discussion of the rules would resemble an advanced course in calculus," and that the regulators have ignored protests that the rules would have a devastating impact on community banks. Why? The authors suggested that the rules reflect "the new vision of bank regulation – that there should be bigger and fewer banks in the industry." That means bank consolidation is an intended result of the punishing rules.

House Financial Services Committee Chairman Jeb Hensarling, sponsor of the Financial CHOICE Act downsizing Dodd-Frank, concurs. [In a speech](#) in July 2015, he said:

> Since the passage of Dodd-Frank, the big banks are bigger and the small banks are fewer. But because Washington can control a handful of big established firms much easier than many small and zealous competitors, this is likely an intended consequence of the Act. Dodd-Frank concentrates greater assets in fewer institutions. It codifies into law 'Too Big to Fail' . . . . [Emphasis added.]

Dodd-Frank institutionalizes "too big to fail" by authorizing the biggest banks to "bail in" or confiscate their creditors' money in the event of insolvency. The legislation ostensibly reining in the too-big-to-fail banks has just made them bigger. Wall Street lobbyists were well known to have their fingerprints all over Dodd-Frank.

Restoring Community Banking: The Model of North Dakota

Killing off the community banks with regulation means killing off the small and medium-size businesses that rely on them for funding, along with the local economies that rely on those businesses. Community banks service local markets in a way that the megabanks with their standardized lending models are not interested in or capable of.

How can the community banks be preserved and nurtured? For some ideas, we can look to a state where they are still thriving – North Dakota. In an article titled "How One State Escaped Wall Street's Rule and Created a Banking System That's 83% Locally Owned," Stacy Mitchell writes that North Dakota's banking sector bears little resemblance to that of the rest of the country:

> With 89 small and mid-sized community banks and 38 credit unions, North Dakota has six times as many locally owned financial institutions per person as the rest of the nation. And these local banks and credit unions control a resounding 83 percent of deposits in the state — more than twice the 30 percent market share that small and mid-sized financial institutions have nationally.

Their secret is the century-old Bank of North Dakota (BND), the nation's only state-owned depository bank, which partners with and supports the state's local banks. In an April 2015 article titled "Is Dodd-Frank Killing Community Banks? The More Important Question is How to Save Them", Matt Stannard writes:

> Public banks offer unique benefits to community banks, including collateralization of deposits, protection from poaching of customers by big banks, the creation of more successful deals, and . . . regulatory compliance. The Bank of North Dakota, the nation's only public bank, directly supports community banks and enables them to meet regulatory requirements such as asset to loan ratios and deposit to loan ratios. . . . [I]t keeps community banks solvent in other ways, lessening the impact of regulatory compliance on banks' bottom lines.We know from FDIC data in 2009 that North Dakota had almost 16 banks per 100,000 people, the most in the country. A more important figure, however, is community banks' loan averages per capita, which was $12,000 in North Dakota, compared to only $3,000 nationally. . . . During the last decade, banks in North Dakota with less than $1 billion in assets have averaged a stunning 434 percent more small business lending than the national average.

The BND has been very profitable for the state and its citizens – more profitable, according to the Wall Street Journal, than JPMorgan Chase and Goldman Sachs. The BND does not compete with local banks but partners with them, helping with capitalization and liquidity and allowing them to take on larger loans that would otherwise go to larger out-of-state banks.

In order to help rural lenders with regulatory compliance, in 2011 the BND was directed by the state legislature to get into the rural home mortgage origination business. Rural banks that saw only three to five mortgages a year could not shoulder the regulatory burden, leading to business lost to out-of-state banks. After a successful pilot program, SB 2064, establishing the Mortgage Origination Program, was signed by North Dakota's governor on April 3, 2013. It states that the BND may establish a residential mortgage loan program under which the Bank may originate residential mortgages if private sector mortgage loan services are not reasonably available. Under this program a local financial institution or credit union may assist the Bank in taking a loan application, gathering required documents, ordering required legal documents, and maintaining contact with the borrower. At a hearing on the bill, Rick Clayburgh, President of the North Dakota Bankers Association, testified in its support:

> Over the past years because of the regulatory burdens our banks face by the passage of Dodd Frank, and now the creation of the Consumer Financial Protection Bureau, it has become very prohibitive for a number of our banks to provide residential mortgage services anymore. We two years ago worked both with the Independent Community Bankers Association, and our Association and the Bank of North Dakota to come up with the idea in this program to help the bank provide services into the parts of the state that really residential mortgaging has seized up. We have a number of our banks that have terminated doing mortgage loans in their communities. They have stopped the process because they cannot afford to be written up by their regulator.

Under the Mortgage Origination Program, local banks get paid what is essentially a finder's fee for sending rural mortgage loans to the BND. If the BND touches the money first, the onus is on it to deal with the regulators, something it can afford to do by capitalizing on economies of scale. The local bank thus avoids having to deal with regulatory compliance while keeping its customer.

The BND is the only model of a publicly-owned depository bank in the US; but in Germany, the publicly-owned Sparkassen banks operate a network of over 15,600 branches and are the financial backbone supporting Germany's strong local business sector. In the matter of regulatory compliance, they too capitalize on economies of scale, by providing a compliance department that pools resources to deal with the onerous regulations imposed on banks by the EU.

The BND and the Sparkassen are proven models for maintaining the viability of local credit and banking services. It is time other states followed North Dakota's lead, not only to protect their local communities and local banks, but to bolster their revenues, escape the noose of Washington and Wall Street, and provide a bail-in-proof depository for their public funds.

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