Three Years Later: Dodd-Frank and Those too Small to Succeed

By Brian DeFoe & Reuben J. Ortega, Lane Powell

Much can happen in three years. For example, the earth travels around the sun three times — roughly 17.7 billion miles — in that span. That is an impressive feat. Somewhat less impressive: your average hamster reaches old age in that same interval. Even less impressive: three years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), we are still waiting for the full implementation of rules required under the Act.

Yes, it has been three years since enactment. So, what have we learned? For community banks the answer is, unfortunately, not much. We do know that new regulations are coming. We also know that with this new regulation there is likely to be additional expense. But how much? That's still a bit of an open question.

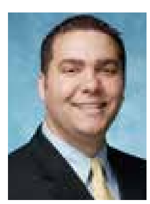
Recently, staff at the Federal Reserve Bank of Minneapolis tried to quantify the costs of Dodd-Frank compliance on community banks. Not surprisingly, their efforts required them to make a number of assumptions — such as the common sense assumption that with increased regulatory requirements, community banks will be required to hire additional personnel. And, of course, they made certain assumptions about the potential compensation expense of those personnel. In the end what they found will not shock you: community banks will see a reduction in return on assets as a result of Dodd-Frank. Specifically, the authors of the study concluded that hiring one full-time employee reduces return on assets by approximately 23 basis points in a typical bank with assets below $50 million. At the other end of the community bank spectrum, hiring one new full-time employee should only reduce ROA by approximately 4 bps for a bank with assets between $500 million and $1 billion.

That smaller banks will be disproportionately affected by the new rules isn't exactly new information. In fact, one of the nation's largest financial institutions suggested as much in its annual report to stockholders last year, when it suggested that the additional regulatory burdens imposed by Dodd-Frank should allow it to gain market share. The issue is simple. Costs that may simply be a drag on the margins at banking behemoths may be the difference between profit and loss at a smaller institution. In other words, in trying to eliminate "too big to fail," Dodd Frank may have rendered some "too small to succeed." And while only 14 percent of community banks hold less than $50 million in assets, the Minneapolis study suggests that over 50 percent of those smallest banks – roughly 100 banks nationwide – will become unprofitable simply as a result of the need to hire additional personnel to address Dodd Frank and its new regulatory requirements.

So what does this all mean? In all likelihood, it means we will see further consolidation among community banks, with the smallest banks banding together through mergers or being acquired by their larger peers. At the same time, however, Wall Street pressures on the biggest banks seem likely to make those institutions close additional branches and flee their smallest markets. This may leave whole communities underserved, but may also make room for entry into those markets by community banks who pride themselves on relationship banking.

Of course, until we see the final panoply of regulations under Dodd-Frank, all of this is, to a certain extent, speculation. After all is said and done, it is possible that the regulations will actually result in better protections for consumers, more effective safeguards of our Nation's economic health and a decreased level of regulatory complexity for community banks. It is also possible that the earth will travel around the sun four times in the next three years or that your hamster will reach the ripe old age of twenty-five. Possible perhaps, but unlikely.

Brian B. DeFoe is a shareholder at Lane Powell, where he focuses his practice on matters involving corporate governance, the federal and state regulation of securities, corporation finance and product regulatory issues. He can be reached at defoeb@lanepowell.com or 206.223.7948.



Reuben J. Ortega is an attorney at Lane Powell, where he focuses his practice on a variety of corporate and transactional matters, including mergers and acquisitions, corporate financing, corporate governance, public and private securities offerings and early-stage corporate matters including formation. He can be reached at ortegar@lanepowell.com or 206.223.7095.