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CONSUMER FINANCIAL PROTECTION AND COMMUNITY BANKS

*John T. Adams**

The Dodd-Frank Act (the “Act,” or “Dodd-Frank”) took shape after the 2007-2008 financial crisis led to calls in Washington to protect average Americans from the depredations of Wall Street.¹ Its proponents in Congress diagnosed greed as the root cause of the crisis and business practices at big commercial and investment banks as the immediate cause.² It became clear that the largest financial institutions would face stiffer restrictions on their activities from Dodd-Frank than from any legislation since the Great Depression.³

The public and political perception of community banks lacked the same clear storyline. Situated somewhere between Main Street and Wall Street, community bankers engage in the financial business by establishing deposit accounts for customers, lending to individuals and businesses at interest, and offering payment card services. Yet politicians of both parties

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1. See, e.g., 156 CONG. REC. S2468 (daily ed. Apr. 20, 2010) (statement of Sen. Sherrod Brown) (“If we do this right, Wall Street reform will provide the strongest consumer protections for people in Ohio, in Colorado, and in every State in this country—no more of the tricks and the traps in the mortgage market and elsewhere that led to the near collapse of our economy. We need to bring new accountability to Wall Street that protects the pensions of our retirees, the home values of our families, and the jobs of our workers.”).

2. See, e.g., *Wall Street and The Financial Crisis: The Role of High Risk Home Loans: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. 119 (2010) (statement of Sen. Carl Levin, Chairman, Sen. Permanent Subcomm. on Investigations) (“To rebuild our defenses, it is critical to understand that the recent financial crisis was not a natural disaster. It was a man-made economic assault. People did it. Extreme greed was the driving force. And it will happen again unless we change the rules.”); 156 CONG. REC. H2998 (daily ed. Apr. 28, 2010) (statement of Rep. Yarmuth) (“So while we worry about what Goldman has done, and I think most of us, most Americans, are outraged at, if for nothing else, the ethical shortcomings of the techniques that they have been using, we have to ask ourselves as well what good does Goldman Sachs, what good does Bear Stearns, may it rest in peace, and Lehman Brothers, what good do they do for the American economy? Because I think the evidence is pretty strong that, in fact, they have been extremely detrimental to the American economy and to the average American in their activities over the last few years.”).

3. See Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. ON REG. 91, 92 (2012).

share a strong sense that community banks fuel the engine of American progress rather than clog it.⁴ Community banks directly serve Main Street even as, in many cases, they interact and trade with Wall Street to make that happen.⁵

Aligned on some issues with Main Street and on others with Wall Street, community banks faced a difficult choice during the drafting of Dodd-Frank: side with Wall Street banks and oppose the bill in its entirety or side with Main Street and push for limited exemptions for small financial institutions.⁶ To some extent, community banks stood to gain from provisions in financial reform legislation that imposed new regulatory burdens on big banks.⁷ For example, Dodd-Frank established a new method of calculating deposit insurance premiums that shifted the burden of Federal Deposit

4. 156 CONG. REC. S3147 (daily ed. May 5, 2010) (statement of Sen. Lincoln) (“Community banks are the backbone of economic activity for cities and towns throughout this great land. They don’t deal in risky swaps that put the whole financial institution in jeopardy. Instead, they perform the day-to-day business of banking, making the smart, conservative decisions that banking institutions should be making.”); 156 CONG. REC. S2489 (daily ed. Apr. 21, 2010) (statement of Sen. Hutchison) (“While the large financial institutions were making bad bets on subprime mortgage markets, community banks were making home and business loans to local customers. Local community banks provide the lending and deposit services for our Nation’s small businesses so they can operate, invest, create jobs, and drive our economy. It is this business lending that will help create jobs and grow our economy.”).

5. See, e.g., *Legislative Proposals Amending Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing on H.R. 1840, H.R. 2586, H.R. 2682, and H.R. 2779 Before the H. Comm. on Agric.*, 112th Cong. 117 (2011) [hereinafter *Legislative Proposals*] (statement of Indep. Comm. Bankers of Am.).

6. See Dave Clarke, *Analysis: Small Banks Wooed in Fight over Dodd-Frank*, REUTERS (Mar. 25, 2011, 4:39 PM), <http://www.reuters.com/article/2011/03/25/us-financial-regulation-smallbanks-idUSTRE72O5DT20110325> (“In interviews with several bankers at the Independent Community Bankers of America convention this week, most acknowledged the law directly benefits them in specific ways. They will pay less into the fund that covers the cost of bank failures, as supporters have argued. They are skeptical, however, that new restrictions aimed only at big banks will not also cost them time and money through more staff training and compliance work.”); Lisa Hooker, *Community Banks & Dodd-Frank*, COLUMBUS CEO (Nov. 2011), http://www.columbusceo.com/industry_news/banking_and_finance/article_577a1380-0a53-11e1-ae09-001a4bcf6878.html (“‘This was supposed to be a bill that reined in Wall Street banks for not adhering to sound financial principles, but Congress has a difficult time separating large institutions from community banks,’ says Community Bankers Association of Ohio President and CEO Robert Palmer. ‘We got sucked in like a vacuum on Dodd-Frank, even though community banks had nothing to do with the financial collapse.’ For community banks—defined as institutions with no more than \$10 billion in assets—Dodd-Frank carried both good and bad news.”).

7. See, e.g., Maria Aspan, *Free Checking Thrives at Smaller Banks, Durbin Notwithstanding*, AMERICAN BANKER (Aug. 29, 2011, 2:03 PM), http://www.americanbanker.com/issues/176_168/free-checking-durbin-debit-interchange-1041641-1.html?zkPrintable=true.

Insurance Corporation (FDIC) assessment towards large banks.⁸ However, community banks also knew that some costs imposed on large banks would be transferred directly from Wall Street banks to small financial institutions. For example, increases in costs on big derivatives dealers would increase the spread community banks needed to pay to convert their floating rate obligations to fixed rates.⁹

Community banks exist between Main Street and Wall Street¹⁰ (in the minds of the drafters of the Act, the public, and the community banks themselves) and this led to a regulatory regime in which community banks are included in the scope of some new financial market regulations, explicitly excluded from others, and subject to regulatory discretion in yet others. This lack of consistency is evident not only when comparing parts of the Act, but even when looking within specific provisions.

In this article, the author seeks to describe the impact of Dodd-Frank in one particular area of financial regulation—consumer protection—and how the Act’s creation of a new Consumer Financial Protection Bureau (CFPB) might affect community banks. In Part I, the author describes the difficulty in defining what constitutes a “community bank” and how Dodd-Frank uses asset size to limit several of its provisions. In Part II, the author provides a brief history of Dodd-Frank’s passage. In Part III, the author describes Dodd-Frank’s provisions creating the CFPB and giving the new bureau its mandate. In Part IV, the author describes how proposed CFPB rulemaking has covered community banks and revealed some of the regulatory risks that community banks face as regulators implement the Act.

I. WHAT IS A COMMUNITY BANK?

Dodd-Frank introduced new regulations that touch upon almost every business line in the financial services industry. Though supporters of Dodd-Frank claim that it was designed primarily to regulate Wall Street banks, community banks will not escape the Act’s myriad requirements. This should come as no surprise—community banks participate in many of the same activities as larger Wall Street banks. Many community banks engaged in the types of lending that resulted in the financial crisis. Community banks

8. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 331(b), 124 Stat. 1376, 1538 (2010) (codified as amended at Act, 12 U.S.C. § 1817 (2006)); *see also* Hooker, *supra* note 6 (“In a big win for community banks, Dodd-Frank shifts the FDIC insurance premium calculation from a deposit-based formula to one based on assets.”).

9. *See, e.g., Legislative Proposals, supra* note 5. “By requiring initial margin, by requiring clearing, and by prohibiting rehypothecation, either separately or in combinations, regulators are increasing costs *upon all parties at every stage* of OTC transactions.” *Id.* (emphasis added).

were and continue to be active participants in the secondary market for mortgages, though on a smaller scale than Wall Street banks.¹¹ And, like Wall Street banks, many community banks also purchase and sell derivatives to hedge their exposure to changing interest rates.

Though community banks and their larger cousins engage in many of the same business lines, community banks are not simply smaller versions of Wall Street banks. Community banks rely on a fundamentally different business model. Community banks serve local populations by taking deposits from individuals and making loans to local businesses. Unlike Wall Street banks, community banks depend on “relationship lending” to generate business. Rather than relying largely on credit scores or other financial models, like behemoths J.P. Morgan Chase and Citibank, community banks more often make their decisions based on “soft information”—information that cannot be directly verified by anyone other than the person obtaining it.¹² Community banks use soft information to evaluate the creditworthiness of informationally opaque borrowers who more often either lack long credit histories or have idiosyncratic needs and collateral that must be underwritten by a lender familiar with the local market.¹³ Community banks, therefore, disproportionately serve local customers whose credit profiles can easily be evaluated in person.¹⁴

11. Approximately eighty-five percent of community banks surveyed by the Independent Community Bankers of America—a community bank trade group—indicated that they sell mortgages in the secondary market. “[A]pproximately 25 percent [of respondents] indicated that they sell over 90 percent of their mortgages.” Letter from Ann Grochala, Vice President, Lending and Accounting Policy, Indep. Cmty. Bankers of Am., to Alfred Pollard, Gen. Counsel, Fed. Hous. Fin. Agency and Christopher Curtis, Senior Deputy Gen. Counsel and Managing Counsel, Fed. Hous. Fin. Agency, <http://www.fhfa.gov/webfiles/2142/ICBA.pdf>.

12. Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized vs. Hierarchical Firms* (Nat’l Bureau of Econ. Research, Working Paper No. 7705, 2000), <http://www.nber.org/papers/w7705>.

13. Tim Critchfield, Tyler Davis, Lee Davison, Heather Gratton, George Hanc, & Katherine Samolyk, *Community Banks: Their Recent Past, Current Performance, and Future Prospects*, FDIC, <http://www.fdic.gov/bank/analytical/banking/2005jan/article1.html> (last updated Feb. 11, 2005).

14. Banks play an outsized role in small-business and agricultural lending. While commercial banks with assets of less than \$1 billion hold only eleven percent of all the assets held by FDIC-insured commercial banks, they held, in recent years, by dollar value, twenty-seven percent of the commercial and industrial loans of \$1 million or less; thirty-nine percent of loans secured by nonfarm nonresidential property of \$1 million or less; seventy-five percent of loans of secured by farmland of \$500,000 or less; and seventy-seven percent of other loans to finance agricultural production and loans to farmers of \$500,000 or less. FDIC, <http://www2.fdic.gov/SDI/> (last updated Aug. 16, 2011) (follow the “Predefined Standard Reports” and “advanced feature” hyperlinks). The FDIC acting chairman noted that “[w]hile community banks with assets under \$1 billion represent less than 11 percent of banking assets, they provide nearly 40 percent of the loans the banking industry makes to small busi-

Relying on relationship-oriented loan origination processes, community banks are able to consider loans that otherwise would have been rejected by the more inflexible lending guidelines to which Wall Street banks subscribe.¹⁵ This has enabled community banks to step into the void left by larger banks crippled by the financial crisis, providing loans to businesses starved for credit.¹⁶

II. THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

In 2007, both Main Street and Wall Street banks began to feel the effects of what would ultimately be the worst financial crisis since the Great Depression. Housing prices, which had doubled between 2000 and 2005, began to drop precipitously.¹⁷ Banks both large and small underwrote mortgages for “subprime” borrowers who were eager to take advantage of historically low interest rates. Many of these borrowers found that they were unable to keep up with their mortgage payments. As the housing boom sputtered, homeowners defaulted on their home loans *en masse*, sticking mortgage lenders, mortgage insurers, banks, and purchasers of securitized mortgages with the bill.¹⁸

nesses, extending credit that is crucial to job creation.” Martin J. Gruenberg, FDIC Acting Chairman, Remarks at the American Bankers Regulatory Symposium (Sept. 19, 2011), <http://www.fdic.gov/news/news/speeches/chairman/spsep1911.html>.

15. Ben Bernanke, Fed. Reserve Chairman, Speech on Community Banking at the Independent Community Bankers of America National Convention and Techworld (Mar. 14, 2012), <http://www.federalreserve.gov/newsevents/speech/bernanke20120314a.htm>; Stacy Perman, *Community Banks Increase Small Business Loans*, BLOOMBERG BUSINESSWEEK (Jan. 27, 2009), http://www.businessweek.com/smallbiz/content/jan2009/sb20090127_581741.htm.

16. Bernanke, *supra* note 15; Perman, *supra* note 15.

17. Peter S. Goodman, *Uncomfortable Answers to Questions on the Economy*, N.Y. TIMES, July 19, 2008, at A10, available at <http://www.nytimes.com/2008/07/19/business/economy/19econ.html?pagewanted=all> (“After roughly doubling in value from 2000 to 2005, home prices have fallen about 17 percent—and more like 25 percent in inflation-adjusted terms—according to the widely watched Case-Shiller index.”).

18. See Gretchen Morgenson, *How the Thundering Herd Faltered and Fell*, N.Y. TIMES, Nov. 8, 2008, at B1, available at <http://www.nytimes.com/2008/11/09/business/09magic.html?pagewanted=all> (“As subprime lenders began toppling after record waves of homeowners defaulted on their mortgages, Merrill was left with \$71 billion of eroding mortgage exotica on its books and billions in losses.”); Karen Richardson, *Bond Insurer’s Woes Add to Credit-Market Stress—MBIA Posts Huge Loss on Subprime Bets; Investors See Rebound*, WALL ST. J., Feb. 1, 2008, at A1 (“MBIA reported a \$2.3 billion loss for the fourth quarter, due mainly to declines in values of securities it insures. It said it incurred losses of \$714 million on securities backed by mortgages.”); Casey Serin, *Cracks in the Facade*, THE ECONOMIST (Mar. 22, 2007), <http://www.economist.com/node/8885853>.

Wall Street banks were among the most prolific consumers of residential mortgages.¹⁹ As the value of mortgages declined, investors began to question the financial wherewithal of once invincible investment banks, such as Bear Stearns and Lehman Brothers.²⁰ After the Federal Reserve hastily arranged the purchase of Bear Stearns by J.P. Morgan, and Lehman Brothers declared bankruptcy in 2008, panic ensued.²¹ Credit tightened, and businesses struggled to find willing lenders.²² Consumers lost hundreds of billions of dollars as home values and stock prices plummeted.²³ Neither Wall Street nor Main Street was spared.

In response to the crisis, President Obama proposed what he referred to as “the most ambitious overhaul of the financial system since the Great Depression.”²⁴ The Administration’s first step in the march towards financial reform legislation occurred in the spring of 2009 when the Department of the Treasury released a White Paper entitled “Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation” (“White Paper”).²⁵ In the White Paper, the Treasury set out a broad range of

19. See Morgenson, *supra* note 18, at B1.

20. Greg Ip, *Fed's 'Supercop' Role May Give It Headaches*, WALL ST. J., Mar. 31, 2008, at A1 (“For months, Bear Stearns had faced questions about its reliance on short-term funding and heavy exposure to risky mortgage-backed securities.”); Matthew Karnitschnig, *Bankers Face a Grim Fall—Worsening Outlook Suggests It’s Time for Consolidation*, WALL ST. J., Aug. 25, 2008, at C10 (“The damage caused by mortgage-backed securities remains the focus for investors. The investment banks might have taken most of the balance-sheet hits from their subprime problems, but other areas, in particular commercial real estate and higher-grade residential mortgages, have begun to show cracks. . . . Of the major firms, Lehman Brothers Holdings and Merrill Lynch are most likely to feel the squeeze.”).

21. See FINANCIAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT 417 (2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (“The primary features of that [global] financial crisis were a financial shock in September 2008 and a concomitant financial panic.”).

22. Joe Nocera, *Anxiety On Economy Wins Out*, N.Y. TIMES, Oct. 4, 2008, at C1, available at http://www.nytimes.com/2008/10/04/business/04nocera.html?pagewanted=all&_r=1&; Elizabeth Olson, *Small Firms Find Credit is Tightening*, N.Y. TIMES, Mar. 25, 2008, at C1, available at www.nytimes.com/2008/03/25/business/25sbiz.html?pagewanted=all.

23. Dick K. Nanto, THE GLOBAL FINANCIAL CRISIS: ANALYSIS AND POLICY IMPLICATIONS, 35 (2011), available at <http://www.fas.org/sgp/crs/misc/RL34742.pdf> (“By mid-October 2008, the stock indices for the United States, U.K., Japan, and Russia had fallen by nearly half or more relative to their levels on October 1, 2007.”); Bob Ivry, *U.S. Foreclosures Double as House Prices Decline*, BLOOMBERG (July 28, 2008, 9:58), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aomtw8.Pro2E>.

24. President Barack Obama, Speech on Financial Reform at the Federal Hall in New York City (Sept. 15, 2009), <http://www.nytimes.com/2009/09/15/business/15obamatext.html?pagewanted=all>.

25. See David A. Skeel, Jr., The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences (Oct. 2010) (unpublished research paper, University of Pennsylvania Law School) (manuscript at 3), available at

recommendations aimed at reducing systemic risk in the market place and streamlining regulatory authority.²⁶ The White Paper recommended the creation of a regulatory regime to resolve failing bank holding companies and called for improved oversight of the global financial markets.²⁷ In addition, it proposed new capital requirements for bank and thrift holding companies and systemically important nonbank financial companies. Though many of its proposals were aimed at improving the regulation of Wall Street banks, the release also outlined plans for a new agency that would be responsible for protecting consumers from unfair, deceptive, and abusive practices.²⁸ The White Paper's recommendations also addressed a number of issues that were seemingly unrelated to the recent financial crisis, such as executive compensation reform.²⁹

Many of the White Paper's recommendations were incorporated into a draft of the financial reform bill, which was eventually titled the "Dodd-Frank Wall Street Reform and Consumer Protection Act" after its legislative shepherds—Senator Chris Dodd and Representative Barney Frank. The House of Representatives passed a preliminary version of the bill in December 2009.³⁰ After months of contentious and highly politicized debate, the Senate followed suit, passing its own version on May 20, 2010.³¹ The bill then proceeded to the conference committee. Following a marathon twenty-hour negotiation involving members of the House and Senate,³² Congress passed the final version of the Act on July 15, 2010,³³ which was signed by President Obama on July 21, 2010.³⁴

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690979 ("The Dodd-Frank Act got its start in March 2009, when the Department of the Treasury released a framework it called 'Rules for the Regulatory Road' shortly before a major meeting of the G-20 nations.").

26. U.S. DEPARTMENT OF TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 10–18 (2009), *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

27. *Id.*

28. *Id.* at 3. For the origins of the proposal, see Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY J. (2007), <http://www.democracyjournal.org/pdf/5/Warren.pdf>.

29. U.S. DEPARTMENT OF TREASURY, *supra* note 26, at 73.

30. David Cho & Brady Dennis, *Dodd Bill Aims to Overhaul Financial Regulatory System*, BOSTON.COM (Mar. 16, 2010), http://www.boston.com/news/nation/washington/articles/2010/03/16/dodd_introduces_plan_to_overhaul_financial_regulatory_system/.

31. Kristina Wong, *Financial Reform Bill Passes in Senate*, 59-39, ABC NEWS (May 20, 2010, 9:13 PM), <http://abcnews.go.com/blogs/politics/2010/05/financial-reform-bill-passes-in-senate-5939/>.

32. Jim Puzzanghera, *House, Senate Lawmakers Reach a Deal on Financial Reform*, L.A. TIMES, June 26, 2010, *available at* <http://articles.latimes.com/2010/jun/26/nation/la-na-financial-reform-20100626>.

33. Binyamin Appelbaum & David M. Herszenhorn, *Financial Overhaul Signals Shift on Deregulation*, N.Y. TIMES, July 15, 2010, at A1, *available at* <http://www.nytimes.com/2010/07/16/business/16regulate.html?pagewanted=all>.

34. Skeel, *supra* note 25, at 3.

III. THE CONSUMER FINANCIAL PROTECTION BUREAU

One of the most critical elements of the new law, at least for community banks, is the creation of the CFPB. As an independent agency, the CFPB was designed to be a consumer watchdog with authority over all institutions that sell consumer financial products or services.³⁵ In particular, Dodd-Frank granted the CFPB enforcement and supervisory authority with respect to substantially all federal consumer protection laws and a host of new provisions.³⁶ In addition, Dodd-Frank empowered the CFPB to make rules pursuant to both the Act itself and existing consumer protection laws enumerated within the Act.³⁷

The debate over the creation of a proposed consumer financial protection agency “emerged as the main impediment to bipartisan agreement on financial regulation reform.”³⁸ From the beginning of the debate over financial reform, Democrats and consumer advocacy groups placed a strong and independent consumer regulator at the center of its agenda.³⁹ They did so for several reasons. Prior to implementation of Dodd-Frank, federal consumer regulation was dated and ineffective.⁴⁰ Non-bank financial institutions largely escaped federal consumer protection laws. Meanwhile, authority for federal consumer laws with respect to banking organizations was split among seven different agencies. As a result of this fragmentation, each bank was able to select as its primary regulator the particular agency that would impose the least burdensome regulatory requirements.⁴¹ In addition, federal banking agencies were subject to criticism that they were more concerned with ensuring that banks were adequately capitalized and less concerned about protecting consumers from unfair practices.

Resistance to a consumer financial protection agency from Republicans and their industry allies was fierce. Indeed, Senator Richard Shelby, the

35. See Raj Date, Deputy Director, Consumer Fin. Prot. Bureau, Remarks on Consumer Financial Protection Bureau Initiatives at the American Bankers Association Conference (June 11, 2012), <http://www.consumerfinance.gov/speeches/remarks-by-raj-date-to-the-american-bankers-association-conference/>.

36. See *id.*

37. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1022, 124 Stat. 1376, 1980 (2010) (codified as amended at 12 U.S.C. § 5512 (Supp. 2012)).

38. Kevin Drawbaugh, *Consumer Watchdog Debate Threatens U.S. Financial Reform*, REUTERS (Feb. 12, 2010), <http://blogs.reuters.com/financial-regulatory-forum/2010/02/12/consumer-watchdog-debate-threatens-u-s-financial-reform/>.

39. See Edmund L. Andrews, *Banks Balk at Agency Meant to Aid Consumers*, N.Y. TIMES, July 1, 2009, at B1, available at <http://www.nytimes.com/2009/07/01/business/economy/01regulate.html>; Robert G. Kaiser, *How a Crusade to Protect Consumers Lost Its Steam*, WASH. POST, Jan. 31, 2010, at G01.

40. Barr, *supra* note 3, at 107.

41. *Id.*

ranking Republican on the Senate Banking Committee, called the idea of an independent agency “a folly and dangerous.”⁴² Supporters of the United States Chamber of Commerce pledged millions to kill the agency and sent more than 200,000 opposition letters to lawmakers.⁴³ Despite strong opposition from Republicans, community banks, and Wall Street banks,⁴⁴ the Consumer Financial Protection Act—added as Title X of Dodd-Frank—included a strong CFPB.⁴⁵

Title X of Dodd-Frank was designed to centralize power over the federal consumer financial laws within a single regulator—the CFPB. Section 1022 of the Act transferred rulemaking authority to the CFPB for seventeen consumer protection statutes that predated Dodd-Frank.⁴⁶ Prior to July 21, 2011 (“transfer date”), rulemaking authority for various consumer protection statutes was divided between seven federal regulators, including the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Trade Commission, and others. Dodd-Frank concentrated this authority and power in the CFPB by transferring broad rulemaking authority for substantially all consumer protection laws from various federal regulators to the CFPB.⁴⁷

While section 1022 transferred *preexisting* rulemaking authority to the CFPB, other provisions of Dodd-Frank confer new and independent rulemaking authority on the new agency. Of particular note is section 1031, which authorizes the CFPB to prescribe rules defining and preventing “unfair, deceptive, or abusive acts or practices.”⁴⁸ The scope of this authority is broad. Unlike section 1022, section 1031 does not require the CFPB to consider the impact of rulemaking on community banks.⁴⁹ In addition, rules promulgated under section 1031 are applicable to all “covered persons,”⁵⁰ which includes any person that “engages in offering or providing a consumer financial product or service.”⁵¹ Section 1031 is, therefore, applicable to persons selling almost every product or service imaginable related to con-

42. Kaiser, *supra* note 39, at G01.

43. Phil Mattingly & Carter Dougherty, *Senate Republicans Plan to Block Consumer Bureau While Seeking Changes*, BLOOMBERG (May 6, 2011, 7:51 AM), <http://www.bloomberg.com/news/2011-05-05/republican-senators-to-block-consumer-nominee-absent-changes-1-.html>.

44. Drawbaugh, *supra* note 38.

45. See Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, tit. X, §§ 1002–1100H, 124 Stat. 1376, 1955–2113 (2010) (codified as amended at 12 U.S.C. § 5481–5603 (Supp. 2012)).

46. *Id.* § 1022 (codified as amended at 12 U.S.C. § 5512 (Supp. 2012)).

47. *Id.*

48. *Id.* § 1031 (codified as amended at 12 U.S.C. § 5531 (Supp. 2012)).

49. *Id.*

50. *Id.*

51. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1002, 124 Stat. 1376, 1955 (2010) (codified as amended at 12 U.S.C. § 5481 (Supp. 2012)).

sumer lending, from payday lenders to real estate settlement service providers.

To complement the CFPB's rulemaking authority, Dodd-Frank also granted certain enforcement and supervisory powers to the CFPB.⁵² Specifically, the CFPB may enforce federal consumer protection laws against parties that violate enumerated consumer financial laws and may conduct examinations of subject institutions.⁵³ This authority, however, is limited by an exemption for insured depository institutions or insured credit unions with less than \$10 billion in total assets.⁵⁴ Such institutions are exempt from the enforcement and supervisory authority transferred to the CFPB. Instead, these small banking organizations remain subject to supervision and enforcement by their primary prudential regulators.⁵⁵ Importantly, even though the CFPB may not enforce rules or conduct examinations of small banking organizations, small banking organizations must nevertheless comply with applicable rules issued by the CFPB.⁵⁶ In addition, small banking organizations may be required to submit reports to the CFPB for the purposes of supporting the CFPB's efforts to detect risk to consumers and implement various consumer financial laws.⁵⁷

IV. THE CONSUMER FINANCIAL PROTECTION BUREAU AND COMMUNITY BANKS

To some extent, the Consumer Financial Protection Act attempts to limit the powers of the CFPB over community banks. The CFPB's power to enforce and supervise federal consumer protection laws does not apply to insured community banks and other insured banking organizations with less than \$10 billion in total assets.⁵⁸ In addition, though the CFPB may exercise broad authority to make rules under federal consumer financial laws, in doing so, the CFPB must consider the impact of proposed rules on banking organizations with less than \$10 billion in assets, which, of course, covers all community banks.⁵⁹

52. *Id.* §§ 1021, 1025 (codified as amended at 12 U.S.C. §§ 5511, 5515 (Supp. 2012)).

53. *Id.*

54. *Id.* § 1025 (codified as amended at 12 U.S.C. § 5515 (Supp. 2012)).

55. *See id.* § 1026 (codified as amended at 12 U.S.C. § 5516 (Supp. 2012)). Thus, the Office of the Comptroller of the Currency (OCC) for national banks and federal thrifts, etc. *See id.*; *see also id.* § 1002 (codified as amended at 12 U.S.C. § 5481 (Supp. 2012)).

56. *Id.* § 1026 (codified as amended at 12 U.S.C. § 5516 (Supp. 2012)).

57. Note, however, that the CFPB may conduct examinations of small banks on a sampling basis.

58. *See* Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1026, 124 Stat. 1376, 1993 (2010) (codified as amended at 12 U.S.C. § 5516 (Supp. 2012)).

59. *Id.* § 1022 (codified as amended at 12 U.S.C. § 5512(b)(2) (Supp. 2012)).

Statements by Richard Cordray, the CFPB's first director, offered reasons for optimism among community bankers during the rulemaking process.⁶⁰ Cordray acknowledged that community banks have a different business model from larger banks and were not responsible for the financial crisis.⁶¹ In addition, he announced plans to create a Community Banker Advisory Council that will act as a conduit between the CFPB and community bankers around the country.⁶²

A. Community Bank Exemptions: Mortgage Rules

To some extent, the hopes of community bankers were fulfilled on January 17, 2013 when the CFPB promulgated its final rules on mortgage servicing.⁶³ The rules significantly restrict when a mortgage servicer can foreclose on a borrower's residence, prohibiting "dual tracking," or simultaneous foreclosure, requiring servicers to wait 120 days before filing a foreclosure action, and mandating "loss mitigation" in the form of better communication with borrowers about options to avoid foreclosure.⁶⁴ However, after receiving comments from groups like the Small Business Administration, the CFPB exempted mortgage servicers from these rules that service fewer than 5000 mortgage loans and also exempted only the mortgages that they or an affiliate originated.⁶⁵ The CFPB summarized its reasoning in a way that nicely captures the overall dynamics of community-bank exemptions built into Dodd-Frank and its rulemaking:

The Bureau believes that the 5,000 mortgage loan threshold further identifies the group of servicers that make loans only or largely in their local communities or more generally have incentives to provide high levels of customer contact and information. The Bureau also believes, in light of

60. Richard Cordray, Dir. of the Consumer Fin. Prot. Bureau, Prepared Remarks on Consumer Financial Protection Bureau Initiatives at the Independent Community Bankers of America National Convention (Mar. 14, 2012), <http://www.consumerfinance.gov/speeches/prepared-remarks-by-richard-cordray-at-the-icba-national-convention/>.

61. *Id.*

62. Matt Doffing, *CFPB Creates Community Bank Advisory Committee*, CFPB J. (Oct. 1, 2012), <http://cfpbjournal.com/issue/cfpb-journal/article/cfpb-creates-community-bank-advisory-committee>.

63. Bureau of Consumer Financial Protection, *Mortgage Servicing Rules under the Truth in Lending Act (Regulation Z)*, CONSUMERFINANCE.GOV (Jan. 17, 2013), http://files.consumerfinance.gov/f/201301_cfpb_final-rule_servicing-tila.pdf.

64. Rachel Witkowski & Kate Berry, *Cheat Sheet: A Detailed Look at CFPB's Tough New Servicing Rules*, AMERICAN BANKER (Jan. 17, 2013, 12:01 AM), http://www.americanbanker.com/issues/178_12/cheat-sheet-a-detailed-look-atcfpb-s-tough-new-servicing-rules-1055926-1.html?zkPrintable=1&nopagination=1.

65. *Id.*

the available data, that no other threshold is superior in balancing potential over-inclusion and under-inclusion. With the threshold set at 5,000 loans, the Bureau estimates that over 98% of insured depositories and credit unions with under \$2 billion in assets fall beneath the threshold. In contrast, only 29% of such institutions with over \$2 billion in assets fall beneath the threshold and only 11% of such institutions with over \$10 billion in assets do so. Further, over 99.5% of insured depositories and credit unions that meet the traditional threshold for a community bank—\$1 billion in assets—fall beneath the threshold. The Bureau estimates there are about 60 million closed-end mortgage loans overall, with about 5.7 million serviced by insured depositories and credit unions that qualify for the exemption.

The Bureau believes that the insured depositories and credit unions that fall below the 5,000 loan threshold consist overwhelmingly of entities that make loans in their local communities and have incentives to provide high levels of customer contact and information. Further, while some such entities may service more than 5,000 loans, the Bureau believes that relatively few do, so expanding the loan count above 5,000 is more likely to include entities that use a different servicing model. If the loan count threshold were set at 10,000 mortgage loans, for example, over 99.5% of insured depositories and credit unions with under \$2 billion in assets would fall beneath the threshold. However, 50% of insured depositories with over \$2 billion in assets and 20% of those with over \$10 billion in assets would fall beneath the threshold. The Bureau recognizes that some of these servicers may not qualify as small servicers because some may not own or have originated all of the loans they service. However, the Bureau believes that these figures give a fair representation of the types of servicers that would qualify as small servicers given the respective thresholds.⁶⁶

So, the mortgage servicing rules do not attempt to regulate the foreclosure activities of most community banks. The evidence suggests that abuses at the largest servicers contributed to the financial crisis and consumer abuse.⁶⁷ Community banks have a more customer-focused model that relies on individualized attention and contributes to lower default rates.⁶⁸ Assuming these rules go into effect,⁶⁹ however, they will create standard procedures for mortgage foreclosure activity that prudential regulators are likely to expect to see even in financial institutions that service fewer than 5000 mortgages and service mortgages only they originate. The biggest issue will be the evolving standards within the mortgage foreclosure process and in

66. Bureau of Consumer Financial Protection, *supra* note 63, at 293–95.

67. See Cordray, *supra* note 60; Hooker, *supra* note 6.

68. See Cordray, *supra* note 60.

69. See *infra* Part V for the discussion of *Canning* and CFPB rulemaking authority.

bank activities generally for what qualifies as “unfair, deceptive, or abusive acts or practices.”

B. The Unfair, Deceptive, or Abusive Act or Practice (UDAAP) Trap

Of the many provisions in Dodd-Frank that endow the CFPB with rulemaking authority, section 1031 presents perhaps the greatest challenge to community banks. It grants the CFPB *new* authority independent of pre-existing statutes.⁷⁰ Specifically, section 1031 empowers the CFPB to make rules defining and preventing “unfair, deceptive, or abusive acts or practices.”⁷¹ The principles of “unfair” and “deceptive” practices in the Act are similar to those under section 5 of the Federal Trade Commission Act (FTCA), which prohibits “unfair or deceptive acts or practices in or affecting commerce.”⁷² The critical difference between section 5 of the FTCA and section 1031 of Dodd-Frank is the latter’s inclusion of the word “abusive.”⁷³ While the definitions of “unfair” and “deceptive” evolved over the last decade and are well-understood by market participants today, the term “abusive” introduces substantial uncertainty into the provision.⁷⁴

The uncertainty that shrouds the definition of “abusive” is in large part a result of statutory language in section 1031(d) that purports to circumscribe the authority of regulators who declare an act or practice “abusive.”⁷⁵ Unfortunately for market participants, instead of carving out permissible behavior, the provision outlines an exclusive list of four acts or practices that regulators may deem “abusive.” Specifically, section 1031(d) provides that an “abusive” act or practice is one that

(1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or (2) takes unreasonable advantage of—(A) a lack of understanding on the part of the consumer of material risks, costs, or conditions of the product or service; (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial produce or service;

70. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2008 (2010) (codified as amended at 12 U.S.C. § 5531 (Supp. 2012)).

71. *Id.*

72. 15 U.S.C. § 45(a) (2006).

73. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2008 (2010) (codified as amended at 12 U.S.C. § 5531 (Supp. 2012)).

74. John D. Wright, *Dodd-Frank’s “Abusive” Standard: A Call for Certainty*, 8 BERKELEY BUS. L.J. 164, 165 (2011).

75. *Id.* at 166 (“The language used ostensibly to limit the Bureau’s authority may be interpreted by banks to require compliance with dramatically higher standards for consumer product development and marketing in order to avoid Bureau enforcement against abusive practices.”).

or (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.⁷⁶

Interpreting section 1031(d)(2) broadly, a community banker selling a consumer financial product to a customer may be acting in an “abusive” fashion if he does not recognize that the customer has not understood the “material, risks, costs, or conditions of the product or service[;]” cannot protect his or her own interests; or has reasonably relied on the community bank to act in his best interest.⁷⁷ Banks have never before been required to evaluate the legality of a transaction on the basis of subjective criteria.⁷⁸ However, section 1031(d)(2) appears to impose this very obligation.⁷⁹

The primary risk to community banks involves the direct cost of new UDAAP regulations. Most community banks cannot compete with larger banks on price because larger banks typically have access to cheaper funds. Instead, community banks compete with larger banks by customizing financial products to accommodate the varying needs of local clients.⁸⁰ Community banks are “frequently the only providers who are willing to customize products to meet customer needs.”⁸¹ For example, many small businesses that rely on seasonal revenue may encounter difficulties paying down traditional credit lines that require payment on a fixed schedule. Community banks can offer a broader and more flexible range of services to small businesses, such as customized lines of credit. The ability to tailor products to

76. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2008 (2010) (codified as amended at 12 U.S.C. § 5531 (Supp. 2012)).

77. See Wright, *supra* note 74, at 166–69.

78. *Id.* at 166 (“Absent clarification from the Bureau, banks may interpret Section 1031(d)(2)(A) to require them to have a much greater understanding of the ‘financial literacy’ of each individual customer than is the case today. Previously, banks have not been required to determine whether customers actually understand the terms of banking products, much less their risks. Instead, the focus of banking regulation has primarily been on the technical adequacy of disclosures of product terms and conditions.”).

79. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2008 (2010) (codified as amended at 12 U.S.C. § 5531 (Supp. 2012)).

80. Letter from Craig G. Blunden, Chair, Pres. & CEO, Provident Savs. Bank, et al., to Timothy F. Geithner, Secretary, U.S. Dept. of the Treasury 2 (Aug. 18, 2009), http://www.aba.com/aba/pdf/gr/CFPA_Geithner_081809.pdf (“Our competitive advantage is the ability to tailor products to individual customers.”).

81. IBCA Policy Resolutions for 2013, ICBA.ORG, <http://www.icba.org/advocacy/index.cfm?ItemNumber=31886&sn.ItemNumber=1709> (last updated Mar. 9, 2013); see also *Proposals to Reduce Unnecessary Regulatory Burden on Depository Institutions Insured by the Federal Deposit Insurance Corporation: Hearing for the Consideration of Regulatory Relief Before the S. Comm. on Banking, Hous., & Urban Affairs*, 109th Cong. 113 (2005) (statement of Eric McLure, Commissioner, Missouri Division of Finance) (“[Community banks] can often more readily provide customized products that fit the unique needs of small businesses.”).

small businesses enables community banks to stay competitive with larger banks that benefit from greater economies of scale.

The “abusive” standard in section 1031 as it stands will increase the risks of offering customized products, making it harder for community banks to stay competitive. Section 1031 layers an additional risk onto products offerings that, though legal, depart from a pre-approved “plain vanilla” standard. The risk is not insignificant. According to the CFPB’s 2011 Supervision and Compliance Manual’s section on “abusive” practices, “even a single substantive [consumer] complaint may raise serious concerns that would warrant further review.”⁸²

In addition, the costs of training employees to identify whether various iterations of standard financial products conform to the “abusive” standard may be prohibitive.⁸³ It is one thing to train an employee to comply with certain objective requirements, such as providing standard transaction documentation, but training employees to recognize a customer’s subjective basis for completing a transaction is a much more difficult exercise, especially in the absence of economies of scale.⁸⁴ According to one bank official, “[i]t is unlikely that many banks will want to ensure the additional training and compliance costs that would be required to enable customized, product and customer-specific suitability determinations for what are, for the most part, commodity products.”⁸⁵ If community banks are forced to standardize their financial offerings, larger banks may gain a significant competitive advantage.⁸⁶

82. CONSUMER FINANCIAL PROTECTION BUREAU, CFPB SUPERVISION AND EXAMINATION MANUAL 10 (2012), available at http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

83. The CFPB Supervision and Examination Manual requires examiners to specifically consider whether “[t]he entity ensures that employees and third parties who market or promote products or services are adequately trained so that they do not engage in unfair, deceptive or abusive practices.” *See id.* at 6.

84. *See* Charles Carver, *The Changing Landscape of Community Banking*, 2010 CENT. BANKER 9 (2010), available at <http://www.stlouisfed.org/publications/cb/articles/?id=1997> (“Because community banks lack scale, technology and regulatory costs are spread across a smaller customer base.”); *but cf. Examining the Current Economic and Regulatory Environment Facing Community Banks: Hearing Before the Subcomm. on Fin. Inst. & Cons. Of the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 38 (2011) (statement of Jennifer Kelley, Senior Deputy Comptroller, Office of the Comptroller of the Currency) (“[I]t is important to recognize that the fixed costs associated with changing marketing and other product-related materials will have a proportionately larger impact on community banks due to their smaller revenue base.”).

85. Wright, *supra* note 74, at 167.

86. Letter from Craig G. Blunden to Timothy F. Geithner, *supra* note 80, at 2 (“Commoditization, contrary to the administration’s assertions, will favor large institutions with economies of scale and larger advertising budgets.”).

Moreover, sections 1031 and 1032 vest rulemaking authority in the CFPB that, if exercised, may also impose disproportionate costs on community banks.⁸⁷ Section 1032 authorizes regulators to make rules to improve the quality of disclosures provided to consumers in connection with consumer finance transactions.⁸⁸ Pursuant to section 1032(a), the CFPB may prescribe rules to

ensure that the features of any consumer financial product or service, both initially and over the term of the product or service, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances.⁸⁹

Empirical studies provide support for the proposition that regulatory “start-up costs” exhibit economies of scale.⁹⁰ “Start-up costs” include “learning the requirements of a regulation, reviewing and redesigning credit applications, changing data processing systems, and revising credit evaluation models.”⁹¹ As a result, smaller banks face higher average regulator compliance costs than larger banks, especially in connection with these start-up activities. Rules promulgated under section 1032(a) will likely impose high “start-up” costs on subject institutions. For example, section 1032(a) will likely require community banks to craft new consumer finance documentation to comply with the applicable disclosure regime. Unlike larger institutions, community banks cannot utilize economies of scale as effectively to decrease the costs of overhauling their portfolios of consumer finance documents. Community banks will, therefore, incur a more severe cost burden and be placed at a competitive disadvantage.

As the mortgage servicing rule shows, some of the primary risks of the consumer regulatory burden on community banks may be avoided if the CFPB continues to take seriously its mandate to consider the effects of its rulemaking on community banks. However, the secondary risk in market standardization may be more significant and impossible for the CFPB to avoid. The Government Accountability Office described the community bank industry’s concern that “the standardization of processes through

87. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111-203, § 1031-1032, 124 Stat. 1376, 2008 (2010) (codified as amended at 12 U.S.C. § 5531 (Supp. 2012)).

88. *Id.* § 1032 (codified as amended at 12 U.S.C. § 5532 (Supp. 2012)).

89. *Id.*

90. See GREGORY ELLIEHAUSEN, THE COST OF BANK REGULATION: A REVIEW OF THE EVIDENCE 16–19 (1998), available at <http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss171.pdf>.

91. See *id.* at 26.

CFPB regulations could reduce the ability of community banks and credit unions to offer differentiated products to better serve their communities.”⁹²

Standardization risk is the large and immeasurable risk to community banks as consumer protection laws are strengthened. In the experience of one author, standardization risk takes three forms. First, the third-party vendors of software and compliance services will almost certainly not create a separate track of consumer disclosures and collection management systems with anything less than “best practices” conforming to CFPB rules applicable to large banks. Community banks rely on these products and services more than larger banks able to utilize custom software and in-house compliance specialists. Second, personal and institutional reputational interest will drive many managers of community banks to discontinue, sooner or later, a set of consumer compliance practices deemed less than the most stringent by regulators. And finally, despite the apparent disjunction between prudential and consumer regulation noted above, the primary prudential regulators of community banks will not encourage practices deemed “abusive” at financial supermarkets in their examination of community banks.

V. CONCLUSION: WORSENING UNCERTAINTY

Even if the CFPB rules go into effect as issued, and future rules continue to exempt small banks from their explicit scope, the changing regulatory landscape will likely impose significant costs on community banks. Community banks do not have the scale to spread the cost of added regulation when it does apply to them. They also have a business model based upon, and comparative advantage in, providing customized financial products to small borrowers and to those customers with financial characteristics that do not easily fit into the standardized models and matrix decision-making larger institutions use to leverage their scale to deploy capital at lower cost. While the overall effect of increased consumer protection remains uncertain, the emerging consensus is that the regulatory costs will contribute to an increase in the minimum viable scale for banks in the years ahead. From a policy perspective, fewer community banks may well be a desirable outcome if capital remains available to small businesses and if costs decrease, but the regulatory and, ultimately, standardization risk has not been squarely faced by legislators and regulators.

Political and legal uncertainties only exacerbate the situation faced by community banks as they attempt to plan their business to comply with on-

92. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *Community Banks and Credit Unions: Impact of Dodd-Frank Act Depends Largely on Future Rule Makings*, in REPORT TO CONGRESSIONAL REQUESTERS 35 (2012), available at <http://www.gao.gov/assets/650/648210.pdf>.

going consumer protection rulemaking. Immediately prior to this article going to press, a decision of the United States Court of Appeals for the District of Columbia Circuit called into question the power of the CFPB to promulgate rules. In *Canning v. National Labor Relations Board*,⁹³ that court ruled that President Obama failed to comply with the Appointments Clause of the United States Constitution when announcing three appointments to the National Labor Relations Board (NLRB) on January 4, 2012.⁹⁴ Two of the three judges also ruled that recess appointments may be made to fill vacancies that occur only during intersession recesses, as opposed to vacancies that remain unfilled at the time of a recess, which was the case of the three NLRB positions.⁹⁵ These facts also apply to Richard Cordray, appointed January 4, 2012, to fill a position left unfilled by the Senate due to its inaction on Cordray's nomination to the post.⁹⁶

Many commentators predict that at least forty senators will remain opposed to the CFPB in its current form and block any rulemaking to the extent they are able. If *Canning* is affirmed by the Supreme Court, the concerns of this paper may be rendered moot. So, regulatory risk for community banks ultimately stems not only from the risk that the business of banking may be standardized to their detriment, at least in part by detailed rulemaking, but also from the risk that the political and legal system will make even ascertaining which rules will apply in a given year impossible.

93. 705 F.3d 490, 499 (D.C. Cir. 2013).

94. *Id.*

95. *Id.* at 503.

96. See First Amended Complaint for Declaratory and Injunctive Relief, *State Nat'l Bank of Big Spring v. Geithner*, No. 1:12-cv-1032-ESH (D.D.C. Sept. 20, 2012), available at <http://www.doddfrankupdate.com/Resource.ashx?sn=StateNationalBankofBigSpringvGeithner-Amended92012>.