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The Cost of Dodd-Frank Act for Commercial Banks

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ABSTRACT

The intent of this article is to explain how the Dodd-Frank Act impacts banks and puts a spotlight on the cost of this Act to financial institutions, especially small banks. As part of the discussion, federal agencies are described as the regulators in charge of supervising strict compliance and adherence to the applicable law. Through our research it is apparent that part of the reporting costs is transferred to the consumers in different fees and charges, which impacts the bank's competitiveness. We depart from the premise that large banks could transfer these costs to consumers easier, because they have a critical mass of clients and products, enough to cover the additional expenses incurred when conforming with the regulation. Additionally, we analyze the cost of implementation from perspective of size which shows a substantial difference to institutions of various sizes. We conclude the paper recommending additional research and primary data collection that could contribute to a better understanding of the cost of the Dodd-Frank Act.

Keywords: Government, Financial Crisis, Finance Banking, Regulation
JEL Classifications: H0, H5, H6, K20, K22

1. INTRODUCTION

Financial institutions can be denominated as depository institutions[1] and non-depository institutions (CFR Definitions, 2005). Independent of the previous denomination, financial institutions are an essential part in developing a strong and sustainable economy. Commercial banks (hereinafter "banks") are the most dominant type of depository institution. They serve as surplus units by offering a wide variety of deposit accounts, and by transferring deposited funds to deficit units by providing direct loans or purchasing debt securities (Madura, 2021). As regulated institutions, banks have numerous financial, social, and legal obligations and duties to federal and state regulators. Banks are also part of a dual pecuniary free market system, and as a result, they need to comply with manifold rules.

Commercial banks serve the private and public sectors; their deposit and lending services are utilized by households, businesses, and government agencies (Madura, 2021). When several banks are in financial distress at once, the economy suffers. Some consequences of financial troubles include a drop in the quality of loans available across the economy, and in a true financial crisis, banks may become reluctant to lend even for short periods, which makes it difficult for money to fulfill its role in greasing the wheels of the economy (by storing value, serving as a unit of account and as a medium of exchange) (Taylor, 2012).

Financial regulators, such as the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC), are mandated by law to perform a cost-benefit analysis (CBA) on regulations (Alvero et al., 2022). A cost-benefit analysis (CBA) is a systematic process that businesses use to analyze which decisions to make and which to forgo (Hayes, 2022). The supervision and

1 Depository institution means a commercial bank (including a private bank), a savings bank, a trust company, a savings and loan association, a building and loan association, a homestead association, a cooperative bank, an industrial bank, or a credit union, chartered under the laws of the United States and having a principal office located in the United States. Additionally, a United States office, including a branch or agency, of a foreign commercial bank is a depository institution.

compliance requirements of these regulations represent a cost to financial institutions while the benefits are reflected qualitatively in the financial system. Banks are intermediaries,' entities in a relationship with their clients, and any additional cost or fee results in a direct transfer of the fee to clients and potential consumers. These costs could include monthly maintenance/service fee, overdraft fee, wire transfer fee, out of network ATM fee and so on.

In a CBA, the external and qualitative social benefits of regulations, such as those arising from a reduced probability of financial crisis, are compared with the internal quantitative regulatory costs, which are mainly borne by financial institutions that must comply with them. Since banks need to comply with the law (federal and state regulations), CBAs are crucial for regulators' rulemaking when forming the basis for judicial review and Congressional oversight of regulatory actions (Alvero et al., 2022). These factors together represent an increase in the operational costs, not necessary reflected as a direct benefit to the bank.

Consider the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which imposes stringent regulations on banks when their assets cross the $10 billion and $50 billion thresholds (Alvero et al., 2022). Many banks shrink their assets to avoid these regulations, creating excess densities around these thresholds (Alvero et al., 2022). Such distortions are not present in the pre-Dodd-Frank period, or around numbers that are not regulatory thresholds, such as $20 billion or $40 billion. The goal of this article is to explain the Dodd-Frank Act's impact on banks based on the mentioned disincentives. Also, we demonstrate how the Dodd-Frank Act represents a cost to financial institutions. As part of the discussion, the federal agencies are described as the regulators in charge of supervising strict compliance and adherence with the applicable law, but it must be understood that part of these costs are transferred to the consumers in different fees and costs. For example, large banks with multiple income streams and diverse customer bases, could transfer theses costs to the consumers more easily through their products. Furthermore, the cost of implementation represents a larger burden to medium and small banks, when compared to larger banks. This article has six sections; after the introduction, the second section defines the Federal Reserve Bank, the third section defines the Dodd-Frank Wall Street Reform and Consumer Protection Act, and The Consumer Financial Protection Bureau (CFPB), the fourth section expands on the Cost Benefit Analysis, followed by the Discussion and Conclusion sections.

2. FEDERAL RESERVE BANK

The Federal Reserve Bank (the Fed) is the central bank of the United States. In 1913, the Fed was established by the United States Congress to provide and assure that the United States obtains and preserves a flexible and reliable financial system. The Federal Reserve Act of 1913 sets out the purposes, structure, and functions of the system as well outlines aspects of its operation and accountability (Federal Reserve Act, 1913). The McFadden Act of 1927 established the Fed as a permanent central bank (Federal Deposit Insurance Corporation, 2014).

The U.S. Federal Reserve System has had an extraordinary century. In the words of one scholar, "the Fed's evolution into an economic power of first-rate importance is the most remarkable bureaucratic metamorphosis in American history" (Federal Deposit Insurance Corporation, 2014). The Fed is an independent central bank, free to pursue its goal without direct interference from other government officials and legislators. Most economists believe that an independent central bank can more freely focus on keeping inflation low (Hubbard and O'Brien, 2014). The Fed also has a role as a lender of last resort. That is, during a financial crash the central bank provides short-term loans, so the financial system won't explode or implode (Taylor, 2012). In the case of a financial crisis the Fed has an important role in working with the US Department of Treasury and the Federal Deposit Insurance Corporation (FDIC) to stabilize the economy.

One of the most recent and important pieces of legislation is the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter "Dodd-Frank Act"). The legislation was created to regulate financial risks in banks and create several federal agencies to protect consumers from systemic risks in the economy. The law included capital requirements, scenario analysis (stress tests), limits speculative trading and restricts investments, among others. The Dodd-Frank Act also strengthened the Sarbanes-Oxley Act of 2002 (SOX), another piece of legislation created to address reporting challenges in the financial markets. One of the federal agencies created by the Dodd-Frank Act was the Consumer Financial Protection Bureau (CFPB).

3. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT AND THE CONSUMER FINANCIAL PROTECTION BUREAU (CFPB)

The Dodd-Frank Wall Street Reform and Consumer Protection Act is an 849-page bill with 16 titles and more than 250 new rules that span more than 11 agencies. The Act addresses many issues that policymakers believe contributed to the financial crisis in 2008. The Dodd-Frank Act is perhaps the most comprehensive financial regulatory reform of the twenty-first century (Le, 2017). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), was signed into law by President Obama on July 21, 2010, and established the Consumer Financial Protection Bureau (CFPB or Bureau) (Lee and Viebrock, 2021). The Act created the Bureau as an independent regulatory agency housed within the Federal Reserve System (Community Financial Services v. Consumer Financial Protection Bureau, 2022). Prior to the creation of the CFPB, consumer financial protection at the federal level was shared by the Federal Reserve Board and other bank regulatory agencies, such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration, as well as the FTC for non-bank creditors (Pridgen, 2020).

The CFPB's primary mission is "to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and the markets for consumer financial products and services are fair, transparent, and competitive" (CFR Purpose, objectives, and functions, 2010). The CFPB is an independent agency established in the Federal Reserve System that regulates the offering and provision of consumer financial products or services under federal consumer financial laws, specifically (1) the CFPB's authority under the Consumer Financial Protection Act (Title of the Dodd-Frank Act), and (2) preexisting laws that have been transferred to the CFPB's authority such as Truth in Lending Act (TILA), the Fair Housing Act (FHA), and Equal Credit Opportunity Act (ECOA), among others (Barr et al., 2018). The CFPB have duties related to the compliance of consumer rights, but also to supervise the services and products offered by banks. The agency also has educational programs providing guidelines for consumers on financial topics such as homeownership and retirement.

The Dodd-Frank Act of 2010 was designed to increase financial stability and prevent future devastation from financial market crises (Baily et al., 2017). Many of the components of the law have been amended since the approval of Dodd-Frank Act. The legislation has had many challenges in implementing changes or modifications to the financial system. One of the arguments against its implementation is that the legislation brought an increased cost for the operation, compliance, and training of employees for every bank (regardless of their size).

3.1. Costs of the Dodd-Frank Act

Jamie Dimon, CEO of Chase Bank, has estimated that the cost to JP Morgan Chase to comply with the Dodd-Frank Act will be "close to $3 billion" over the next few years (Marsh and Norman, 2013) JP Morgan Chase, a "systemically important" financial institution, has acknowledged that the costs of complying with the Dodd-Frank Act will increase the competitive advantage of large banks to the detriment of community banks. To explain the impact of the Dodd-Frank Act we expand on two surveys addressing the costs of the regulations and its implementation. The first survey is the S&P Global Market Intelligence and the second is Mercatus Center. The S&P Global Market Intelligence survey found that the banking industry continues to grapple with compliance costs that have soared since the financial reform legislation became law with 49% saying compliance costs were up 20% or more since the Dodd-Frank Act was implemented, and another 22% saying these costs were up between 10% and 20% (S&P Global Market Intelligence, 2017). While these figures have held steady over the past few years, they represent a substantial increase over pre-Dodd-Frank Act compliance spending. A recent related analysis shows an annual $64.5 billion increase in total non-interest expenses after 2010 (Barr et al., 2018). In addition to the high cost of operations of commercial banks, the compliance budget represents a large part of the operational budget. Additionally, the qualitative costs of compliance represent a huge responsibility affecting consumers, investors, and the market.

The Mercatus Center at George Mason University surveyed nearly 200 small banks-those with total assets <$10 billion-to study the effects of the Dodd-Frank Act on small banks. The survey concluded that "small banks are spending more on compliance in the wake of Dodd-Frank Act." Over 25% of small banks expected to hire additional compliance or legal personnel in the next 12 months. A total of 37.3% of respondents already hired new staff to meet the CFPB's regulations, especially mortgage rules. Most respondents (94%) in the survey reported that they would not add any products because of the Dodd-Frank Act (Le, 2017). By not adding products to benefit the customers, small banks undermine their ability to generate relevant cash flows and services. On the contrary, large banks exploit economies of scale because of the decline in unit costs associated with increased bank size. A large bank can spread fixed costs over more borrowers, which results in a lower cost per customer. Theory also suggests banks should enjoy economies of scale because the credit risk of their loans, their portfolio of their financial services, and the liquidity risk of their deposits will grow more diverse as banks grow larger (Le, 2017).

From a classical economics perspective, there are also those who believe regulation does more harm than good. The role of government in the modern economic system is highly debated in the first place, with the creation of additional bureaucratic burden to the financial system. Huge social and capital costs can be associated with regulations. There is a direct cost to the government of administering the regulatory system, and there are compliance costs to businesses and citizens, such as administrative and paperwork costs, capital costs, and production costs. There are also implementation hurdles such as ensuring that public administrators develop the organizational skills for financial regulation to promote transparency and manage risk. Additionally, some researchers have found that regulation prevents stability as opposed to increasing it (Liou, 2013). The Dodd-Frank Act regulation creates an obligation and requirement for banks to comply with law, but it also represents an economic burden for the compliance department of each bank.

3.2. Compliance

Regulatory-compliance costs are not matters of public record because banks do not separately report the non-interest expenses associated with their compliance efforts. Nonetheless, if these efforts impose significant cost burdens (notably on smaller banks), these burdens should be reflected in various financial-statement measures of bank performance (Le, 2017). Regulatory burden is a concern of both bankers and policymakers whenever new legislation is passed, however researchers and policymakers use different methods to measure the impacts of regulations on the banking industry and on the US economy (Le, 2017).

Historically, compliance takes up a significant portion (10.3%) of a financial institution's personnel expenses, including salary and benefits (Berman, 2021). Compliance, when explained as a percent of spending, is also responsible for 42.3% of accounting and audit spending, 38.2% consulting and advisory spending, 22.7% of legal spending, and 17.1% of data processing spending (Berman, 2021). Taking in consideration that groups of lenders and savers as well as regulators have a fiduciary interest in the bank's financial performance, the Cost Benefit Analysis (CBA) becomes essential in evaluating the system's financial health.

4. THE COST-BENEFIT ANALYSIS

The origins of cost-benefit analysis (CBA) in the United States government can be traced back to the later days of the great depression. It is commonly asserted that Congress "initiated the use of CBA in 1936, when [it] ordered agencies to weigh the costs and benefits of projects designed for flood control," permitting authorization of such projects only if "the benefits to whomsoever they accrue are in excess of the estimated costs" (Coates IV, 2015). The CBA can also be addressed with a marginal analysis. This technique is widely used in business decision making and ties together much of the economic thought (Wessels, 2017). When marginal benefits exceed marginal costs, net benefits increase. Therefore, the marginal unit of the control variable should be added (Wessels, 2017). When analyzing the presumed burden to small banks versus large financial institutions, we must consider the implications of the cost-benefit analysis from an investment perspective, not a marginal one.

The basic principles of capital budgeting and financial approaches used to evaluate risk, benefit, cash flows, and compliance, are also part of the banking cost-benefit analysis. Several factors weigh into an institution's decision to expand services and as a consequence, to provide benefits to society. These factors include opportunity costs, externalities, installation/implementation costs, inflation, initial investments, operating cash flows, as well as others. A community bank compared to a larger institution is at a disadvantage when considering the above-mentioned factors in a cost-benefit analysis. If investing additional resources would imply crossing the "threshold," for example 50 billion in assets, it would considerably increase the bank's expenses while revenue would be uncertain to cover these costs. In other words, the marginal costs would be higher than the marginal benefits in the short run and maybe in the long run as well. Capacity decisions are often driven by the possibility of achieving economies of scale. When small banks expand their capacity (services, products, etc.) more than the forecasted demand growth, the costs exceed the benefits, and the longer it takes for the demand to grow, the higher the costs to the institution. These specific measures from the bank's perspective would have to be part of the regulators' cost-benefit analysis if there is to be a fair assessment of the Dodd-Frank Act by regulators.

4.1. Regulations

In the case of the governmental cost-benefit analysis (CBA) reports, regulators are mandated by law to conduct a CBA on regulations (Alvero et al., 2022). The goal is to enhance the regulators' ability to increase welfare and allow the public to detect and push back against regulations that fail to increase public benefit. CBA reports often formulate the basis for judicial review and Congressional oversight of regulatory actions (Alvero et al., 2022). CBA mandates encompass binding executive orders and other interagency guidelines that stipulate how specific components of CBA policy (such as discount rates, or methods to quantify benefits or costs) will achieve uniformity across governmental agencies. Finally, CBA mandates can be a component of regulation itself, that is, an agency could require a private actor to demonstrate that a new activity or product would have greater benefits than costs before it could be permissibly sold (Coates IV, 2015).

The main question is whether the marginal cost of the Dodd-Frank Act to commercial banks represents a benefit to those banks affected by the legislation. Another important component of the cost-benefit analysis is the "effectiveness lag" of the Dodd-Frank Act to commercial banks or the time it takes for government action to affect economy (Wessels, 2017). "The effectiveness lag is the period between implementing an action to counteract another in the economy and the attainment of a substantial effect or impact. It takes place when a policy has already been implemented upon the identification of economic concern and the effect is awaited" (Nash and Kennedy, 2022), The CBA of financial regulations has emerged as an important point of policy debate since the passage of the Dodd-Frank Act (Alvero et al., 2022). Moreover, as we discussed, CBA assessments are complicated when considering the specifics of diverse financial institutions.

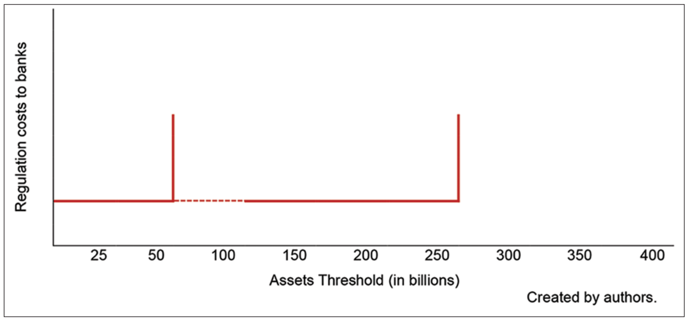
Finally, while most federal regulatory agencies follow a CBA prescribed by law, financial regulators are not subject to these directives. Specifically, individual financial regulators are allowed to perform CBAs under less specific guidelines than other federal regulatory agencies. These financial regulators have discretion to include specific characteristics of the financial industry into the CBA, making the effects of their analysis dependent on factors other than objective market factors (Perkins and Carey, 2017). This discretion provides another insight in the process of evaluating marginal costs and benefits of the Dodd-Frank Act.

4.2. Calculations

Calculating the benefits and costs of consumer financial regulations or any regulations, for that matter, is not easy. Financial institutions do not routinely report expense data that tie directly into the implementation of individual regulations, although survey data makes it clear that the cost of regulatory compliance hits the smallest financial institutions the hardest (Stackhouse, 2012). These regulation implementation costs can be considered sunk costs, for simplicity. However, we can infer that the cost of operation in smaller financial institutions results in larger fees to customers than in bigger financial institutions. The transference of costs in the shape of fees and charges to services and products available in smaller institutions reduces their competitiveness in the marketplace. In the eventuality that the institution decides not to expand their products or services, the overall welfare of the customers and society is reduced.

Furthermore, institutions do not report whether they have stopped offering a product or service to some or all consumers or businesses because of an increase in compliance costs. Therefore, there is no definitive way to quantify the cost or inconvenience to consumers or businesses when a financial product is discontinued by a local institution or pricing is adjusted to reflect intrinsic compliance costs (Stackhouse, 2012). The limitation of products and services could affect the financial institution's ability of doing business and could send them in a downward economic spiral. As an unintended consequence of the limitations in products and services and the

Figure 1: Representation of assets thresholds for banks to comply with the dodd-frank act`



regulatory environment, consumers and the financial markets are impacted negatively.

In principle the CBA can provide public-regarding benefits by disciplining agencies, increasing transparency, and enhancing the public's engagement with the regulatory process. In theory, CBA can reduce the agency costs associated with delegation by politically accountable lawmakers to expert but less accountable agencies. Nonetheless, CBA can have further effects beyond direct costs of the CBA itself. These effects include use of technically opaque analytics to (1) obscure the issues at play, (2) raise the risks for lawmakers to question regulators, (3) shift power from Congress to regulators, (4) hide rent seeking, and (5) favor factions in distributional struggles among lawmakers. One form of camouflage that seems likely to recur is the presentation of conjectures and estimated CBAs' as final and quantified CBAs', which potentially misleads the public by omitting significant information about the uncertainty, judgment, and sensitivity of numerical results in a CBA (Coates IV, 2015).

5. DISCUSSION

Federal agencies are responsible for establishing adequate supervision to comply with the laws and regulations. In addition, the federal agencies should create a trustworthy environment for consumers, financial institutions, and financial markets, but it is important to remember that the investors trust in the financial system takes precedence, since they represent the surplus of funding unit in this equation.

While the cost-benefit analysis reduces the risk of unintended consequences by forcing agencies to consider all costs and benefits as well as the range of regulatory alternatives. Regulators systematically overestimate the likelihood of events that come easily to mind, especially recent high-profile events where regulation failed; indeed, the Dodd-Frank Act is what Larry Ribstein would characterize as a "bubble law" that is particularly susceptible to overestimation of risk (Rose and Walker, 2013). As we understand the purpose and the execution of the law, we remain apprehensive of the economic burden and its disproportional distribution to small and medium banks when compared to large banks.

The concept of asset-based exemptions has been in effect for banks since 1975 under the Home Mortgage Disclosure Act, Community Reinvestment Act, and others. In 2010, banks with <$50 billion in assets were exempted from the Dodd-Frank Act's reporting requirements while banks with $50 billion in assets or more were required to comply with more strenuous capital and liquidity requirements. In 2018, the new law under the Economic Growth, Regulatory Relief, and Consumer Protection Act, the requirements were relaxed for small and medium sized banks and the required threshold increased to $250 billion (Figure 1). Figure 1 illustrate the assets size relative to when the regulation costs are required (Labonte and Perkins, 2021). Until the failure of the Silicon Valley Bank in March 2023, the number of bank failures since 2018 (when the new law took effect) were at pre great recession lows (Federal Deposit Insurance Company, 2023).

6. CONCLUSION

According to the Federal Deposit Insurance Company data, over 200 banks with assets <$250 million have failed in the past 12 years (2011-2023), with most of them occurring before the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018. Jamie Dimon predicted that the pressure of Dodd-Frank act of 2010 would cause additional failures and will cause small banks to merge, reducing competitiveness in the banking industry and limiting accessibility to financial products (Marsh and Norman, 2013). Not taking in consideration recent events with the Silicon Valley Bank (2023), it can be surmised that the outcome of the Dodd-Frank Act may have had the opposite result than desired. While in theory it should have made banking more secure, it seems to have reduced its effectiveness, competitiveness, and reach.

When taking into consideration assets size and bank sizes, the cost of regulation of commercial banks could be higher in comparison with the benefit provided at margin. Consumers and investors prefer to do business with institutions that are safe, but also competitive. The CBA could be a valuable tool if it correctly evaluates the impact of government regulations on all banks. If the imposition of regulations diminishes the competitiveness of the industry, the mentioned groups would be worse off than before the regulations are implemented. Therefore, the importance of factoring in all variables when performing a CBA. However, the lack of competitiveness in the system, as an unintended consequence, might make these services and products more expensive.

The Dodd-Frank Act has been important in the evolution and reliance of the US economy since the great recession of 2007-2008 and possibly boosted the public's confidence in the financial system. However, it could also be the cause of an increase in costs for financial products. After studying the existing literature, surveys, and data within this subject, we can conclude that there is a need for further study and collection of primary data. Additional data needed would provide a better understanding of the cost of the Dodd-Frank Act and include the non-interest expenses associated with their compliance efforts. This data could provide further information regarding the unintended consequences of financial regulations, the specific effects of the various thresholds, the changes of the law, and the variants of the cost benefit analysis, including, regulatory cost effectiveness analysis. Moreover, real data of the non-interest expenses associated with the bank's compliance efforts would provide additional information to assess the real effects of the Dodd-Frank Act.

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