The Impact of the Dodd-Frank Act on Small Banks

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Abstract

The Dodd-Frank Act is single longest bill ever passed by the U.S… The Dodd-Frank Act passed in reply to the latest financial meltdown, which applies to prevent further fraud and abuse in the markets, also geared toward protecting consumers with regulations like keeping borrowers from abusive lending conditions and mortgage practices by lenders. Dodd-Frank regulatory requirements set too many restrictions on local lenders and appraisers and that the Act created for large banks "too-big-to-fail". However, the small banks, which do not fit neatly into standardized financial modeling, will face unintended consequences, as increased operations costs, which lead to reduced income and limited potential growth. The Act created enormous difficulties on small banks, which has little to do with the financial crisis.

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Background

In 2008, the world economy faced its most the worst crisis since the great depression of the 1930s. According to the conclusions of a federal inquiry (2011), the financial crisis was a "preventable" disaster caused by widespread failures in government regulation, corporate mismanagement and reckless risk-taking by Wall Street. The global financial crisis in 2008 resulted of unethical practices of the financial firms' leaders and their financial management (Alqatawni, 2013). The Congress blamed the financial problems on a lack of federal oversight. Dodd-Frank Wall Street Reform and Consumer Protection Act passed in 2010 in an effort to stop the recurrence of events that caused the 2008 financial crisis, and protected consumers from abusive financial services practices (Liberty of Congress, 2010). The act name attributed to each of the Senator Christopher J. Dodd and U.S. Representative Barney Frank because of their significant involvement in the act's creation and adoption.

The government established more than twenty federal agencies to issue nearly 400 new rules, such as Consumer Financial Protection Bureau, the Financial Stability Oversight Council and Orderly Liquidation Authority (Rose, 2013). However, the previous agencies monitor the performance of companies, considered in order to prevent a global economic collapse, and encourage integrity and transparency for credit cards, mortgages, and all other consumers' financial products and services. Anyhow, the financial institutions find themselves subject to oversight by the new agencies' requirements; these requirements had different impacts on the financial sector depending on the size of the firm. The Act regulations are becoming increasingly unfair for smaller financial institutions, leading to decreased outside investment, increased regulatory costs, and faced with difficult choices (Saltzman, 2013).

Areas of Debate

Some opponents in Congress and banking industry claim that the Dodd-Frank Act produced a credit crunch and damaged the economy. Wallison (2010) described the Act as follows “the most troubling—maybe even destructive—single piece of financial legislation ever adopted” (p. 2). Ramirez (2011) argued that the Dodd-Frank Act will win the subprime crisis, but it will not prevent future debt crises. In addition, The Act allows massive government guarantees of the largest financial concerns to persist and even makes such backstops explicitly available under law. However, Ramirez believed the mere risky securities, trading activities that culminated in the 2008 crisis may persist despite the presence of the massive subsidized funds provided by the government, and this bill could deliver a shock to the financial system worse than the last crisis.

Wallison (2010) argued that the Act result in a financial market decline, competitiveness, innovation, and economic growth. In addition, the new regulation affected the small companies, which cause them to raise their prices, certainly, but also to merge with larger companies or leave the business (Wallison, 2010). Marsh and Norman (2013) argued that the Act created for large banks "too-big-to-fail” the small banks which do not fit neatly into standardized financial modeling, will find it more difficult to obtain credit, which force community banks to merge, consolidate, or go out of business.

The small banks hit extremely hard by the new regulations, especially the ones without crews of lawyers, lobbyists, and compliance officers. The Dodd-Frank Act gives the largest financial institutions advantages over smaller competitors in obtaining credit, which create a restriction on proprietary trading would weaken financial firms by depriving them of another source of revenue (wallison, 2011). However, the Act made use of derivatives more costly, and the small banks could be more sensitive to interest rate changes than their larger rivals who normally use derivatives to hedge interest-rate risk (Peirce, 2013).

On the other party, there are many advocates believe that the Dodd-Frank Act will lead to promote financial stability in the United States. Seligman (2011) believes that the act addresses the critical gaps in financial regulation by extending the jurisdiction of Securities and Exchange Commission to investment advisers to hedge funds and other private-equity funds. Seligman argued that the Act would succeed in reducing systemic risk while the Act is not perfect, but it moves in the right direction.

According to McEnroe and Sullivan (2013), the benefits of the increased regulation by Dodd–Frank Act exceed the costs. However, the surveys conducted by research showed that there are a significant number of high-level auditors and CFOs support some aspects of regulations contained in the Act (McEnroe, 2013).

Dodd-Frank Act

Through a review of the literature have been developed advantages and disadvantages of Act as follows:

Dodd-Frank Act disadvantages

1. Affect the cost and availability of credit and securities lending and borrowing activities.
2. The Act adds the uncertainty and complexity to the financial sector, by increasing complexity in financial regulation, as well as increasing regulatory capital requirements.

3. Preoccupation the employees in the financial sector to understand the large amount of regulations reduces ability on serving customers
4. Increased regulatory burden especially on small banks, which weakens its competitiveness with other financial institutions
5. The new rules impose costs on non-financial companies that cost incurred by investors and customers.

Dodd-Frank Act advantages

1. Protect consumers from the kind of abusive practices
2. Increase transparency and refine pricing in the derivatives and marketplace. The traded will be only on regulated exchanges or swap execution facilities, which will increase competition and promote better pricing to the marketplace that leads to lower costs for businesses and client.
3. Increase transparency in hedge funds trades, which must register with the Securities and Exchange Commission (SEC) and issue date about their trades and portfolios. Therefore, the SEC can estimate overall market risk.
4. It created affordable insurance that will be available to low income citizens
5. Reducing over-reliance on credit ratings of the leading companies in the rating industry

Literature Gap

Based on a review of the literature review who covering the Dodd-Frank Act, which related to domains of influence on a financial market especially small bank. There is a significant gap in research about the proposals seek to maximize the benefits and minimize the costs and risks, caused by Dodd-Frank Act regulations. Marsh (2013) proposed that the regulatory agencies to implement a two-tier regulatory system, which requires increased concentration of assets on the books of the large financial institutions, and might focus less on community banks.

Peirce (2013) suggested taking steps to reduce the regulatory burden so that small bankers can get loans, which will serve their customers and earn profits for bank owners, some of these steps as follows:

- Creating new appropriate exemptions for small banks or expanding existing ones
- Designing better regulations and identifying instances by the financial regulators who have expertise in financial analysis

The regulatory reform created by Dodd-Frank should not turn the clock back, must provide further research to find the best ways to reduce the negative impacts, which enhance the stability of small banks. The regulatory reform would come through improve the stability of this interconnected financial system through minimizing regulatory arbitrage and increasing transparency (Kroszner, 2011).

Future Directions

There is many in the financial industry already feel tired by the enormous response the Dodd Frank Act has required to date. Ramirez (2011) believed the mere risky securities, trading activities that culminated in the 2008 crisis may persist despite the presence of the massive subsidized funds provided by the government, and this act could deliver a shock to the financial system worse than the last crisis. Wallison (2010) thought that the new regulation affected the small companies, which cause them to raise their prices, certainly, May force the small banks to merge with larger companies or leave the business (2010).

While these Dodd-Frank Act regulations may be painful now, in many cases the resulting benefits are likely to be significant. Sielgman (2011) argued that the Dodd-Frank Act would succeed in reducing systemic risk while the Act is not perfect, but it moves in the right direction. The survival small banks must have the potential to turn out to be more highly capitalizes, strengthen their balance sheets, improve flexibility, and increase liquidity.

Conclusion

The purpose of the enactment of the Dodd-Frank Act to reduce risk, enhance transparency and consumer protection. However, some opponents in Congress and banking industry claim that the Dodd-Frank Act produced a credit crunch and damaged the economy, especially small banks and their customers. While these Dodd-Frank Act regulations may be painful now, in many cases the resulting benefits are likely to be significant. However, the regulatory reform created by Dodd-Frank should not turn the clock back, must provide further research to find the best ways to reduce the negative impacts, which enhance the stability of small banks. Moreover, the small banks must have the ability to survive through that turn out to be more capitalizes, strengthen their balance sheets, improve flexibility, and increase its liquidity by creating new investment channels.

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