One Mission. Community Banks.

Finding Balance

How Well-Intended Policies Hamper Small Business Lending and Undermine Relationship Banking

June 2024

Table of Contents

Executive Summary

- Community banks play a unique and important role in the U.S. financial system. They are typically smaller, have simpler organizational structures, are more focused on traditional banking activities, and are deeply involved in their communities. Relationships are at the heart of community banking, and community banks leverage these relationships to offer more flexible products and services and tailor lending criteria to the needs of their customers.
- Community banks are particularly important to small business lending. They make a disproportionately large share of small business loans compared to larger banks, and their asset portfolios are more dependent on small business loans. The relationship with small businesses is symbiotic, as Main Street business owners rely on community banks for a variety of financial services because of their flexibility and deep local knowledge.
- Small businesses are highly satisfied with community banks. About 95% of respondents to ICBA's Small Business Survey were satisfied with both their overall community bank experience and the loan and credit offerings they received. The survey also found that small businesses choose community banks because of their flexible offerings and unique knowledge of the local community, and prefer partnering with community banks over other lenders.
- Despite their success in small business lending, community banks face several obstacles. They must compete with other lenders on an unlevel playing field and navigate a variety of challenges, including shifting economic conditions, operational barriers, and regulation.
- Regulation is a major challenge for community banks, with nearly three quarters of community banks responding to ICBA's Member Survey identifying one or more regulatory factor as a top challenge for their bank. The regulatory burden costs community banks not only money and staff time but also opportunities to better serve their customers.
- The regulatory environment has become more difficult in recent years, as more than 90% of community bank survey respondents observed that the current environment is more challenging than it was five years ago. The key factor behind this change is the need to devote more staff time to compliance activities or to contract with an external entity for compliance assistance. A challenging regulatory environment also inhibits small business lending.
- Multiple recent rules — including Section 1071, revisions to the Community Reinvestment Act, and bank fee rules — are adding to the regulatory burden for community banks. While well intentioned, these rules threaten to undermine community banks' unique approach to partnering with small businesses and are likely to reduce small business lending.
- ICBA supports several policies to address challenges associated with recent regulatory changes and ease the cumulative regulatory burden. These proposals include nullifying and rewriting Section 1071, right-sizing data collection requirements, and improving policymaking to more fully consider how regulations acutely impact community banks and the customers they serve.

I. Introduction

In a complex and global financial system, community banks stand out for their relative simplicity and local focus. As an integral part of Main Street, community banks catalyze economic growth in the communities they serve by investing in small business, supporting local jobs, and providing a wide variety of financial services in urban, suburban, and rural areas across the country — including areas that have been traditionally underserved by larger institutions and other lenders.

Similar to other financial institutions, community banks must cope with shifting economic and market conditions, cybersecurity threats, and regulatory changes, among other challenges. Unlike other financial institutions, however, community banks face unique regulatory burdens due to their limited resources, small size, and distinct business model. While some regulations exempt or are tailored to smaller banks in an effort to reduce the compliance burden, the deluge of banking regulations in recent years has led to a steady increase in the cumulative regulatory burden, making it more difficult for community banks to serve their small business customers.

To be sure, regulations often provide important public benefits, and the U.S. financial system could not function without appropriate regulation. ICBA supports efforts to protect consumers from unfair, deceptive, or discriminatory lending practices; ensure financial system stability; and create a level playing field for small banks to compete against one another and other lenders, including non-banks. However, regulations can also create significant costs for businesses and consumers that must be carefully weighed against the benefits, both individually and cumulatively, across the full spectrum of rules already on the books.

In this report, ICBA explores how regulations impact community banks and the small businesses that depend on them. Using a pair of recent surveys of small business owners and community bank leaders, the report finds that the regulatory burden facing small banks is a significant challenge, and that new rules are making matters worse. The continued growth of the regulatory burden could undermine the community banking model to a point where it is no longer viable and small business customers will suffer. Fortunately, such an outcome is avoidable. Policymakers can help alleviate the regulatory burden by rethinking recent regulations and improving rulemaking processes to better account for the acute impact of regulation on community banks while still achieving many of the benefits each regulation is intended to generate.

This report builds on the existing body of evidence around regulations, community banks and small business lending by introducing new survey data and community banker perspectives. ICBA conducted two surveys to inform this report:

- *Member Survey*: ICBA surveyed leaders from all its member banks between November 2023 and January 2024 and received responses from more than 200 community banks. The pool of respondents generally reflects the diverse size and geographic distribution of ICBA's broader membership, and nearly all respondents have less than $10 billion in assets, the typical size-based definition for community banks. ICBA supplemented the survey with several member interviews and a focus group of eight member banks, covering how they engage local small businesses and the extent to which recent regulatory developments are expected to affect this engagement.
- *Small Business Survey*: ICBA also partnered with Concentrix, a survey research firm, to survey 573 small business owners about their experiences with community banks. Respondents owned businesses with annual sales between $100,000 and $5,000,000 and had applied for credit at a community bank within the past 2 years. The survey was conducted between November and December 2023 and featured a diverse pool of respondents from 47 states and the District of Columbia that serve customers in urban, suburban, and rural areas and lend to a wide range of industries. Because recent regulatory activity has focused on how financial institutions interact with historically marginalized groups, the survey oversampled small business owners that identified as minorities, women, veterans, or people with a disability.

This report begins by discussing the value of community banks and their role in sustaining local communities and small businesses in section II. Section III discusses the various challenges that community banks face, while section IV focuses in on the burden of the current regulatory environment and section V explores how recent regulatory activity is expected to impact community banks and small business lending. Section VI offers recommendations for how policymakers could ease the regulatory burden on community banks and promote small business lending while still accomplishing regulatory goals, and section VII concludes the report.

II. The Value of Community Banks

Community banks play a unique and important role in the U.S. financial system. Though they are definitionally smaller than major banks and thus generally have a reduced geographical reach, size alone does not fully capture how community banks operate. In a recent speech, Federal Reserve Governor Michelle Bowman emphasized that community banks tend to have simpler organizational structures, focus more on traditional banking activities, and typically emphasize business segments where they have a competitive advantage, particularly in small business lending and meeting the banking needs of the local communities they serve.[1]

2.1 Community Banks Sustain Communities

Though community banks compete with a wide variety of lenders (e.g., national and regional banks; credit unions; farm credit system lenders; and financial technology firms, or fintechs), community banks tend to have a local focus. Whereas regional and national banks often collect deposits in one part of the country and lend to another, community banks typically lend to areas where their depositors live. As such, they are particularly important in rural areas, where other financial institutions may not exist. Indeed, rural small business owners most often identified community banks as their primary financial institution in ICBA's Small Business Survey.

> "We're involved in local economic development groups. They rely on us to help recruit industry into our community. We want to attract jobs for our customers."
>
> ***Community Banker from Alabama***

Relationships are also a fundamental component of community banking, as bank officers tend to know their customers personally and may consider individual circumstances when making loans in a manner that large banks typically do not. Community bankers are often deeply involved in their communities, leading community organizations, volunteering, and donating to local charities. When disasters strike, community banks are typically on the front lines of recovery efforts, facilitating access to federal relief funds and leading food drives and other voluntary initiatives.[2] Ultimately, community banks give back because their success is inextricably linked to that of the local communities they serve.

Relationship banking is a cornerstone of the community bank model. Researchers at the Federal Reserve Bank of Kansas City note that "by establishing longer-term relationships with customers, community banks can obtain information not readily available through more standardized means, providing them advantages in lending to

> "Community banks tend to focus on loans as relationships, originating loans that require local knowledge, a greater personal touch, individual analysis, and continued administration rather than loans that can be made according to a formula."
>
> ***Federal Deposit Insurance Corporation***

1 Governor Michelle W. Bowman, Board of Governors of the Federal Reserve System, "Defining a Bank", Speech at American Bankers Association Conference for Community Bankers, Feb. 12, 2024

2 ICBA, "National Community Bank Service Awards," 2017-2024.

small or newly formed businesses that may lack extensive credit history."[3] Relationship banking is also growing in importance: according to the 2023 Annual Survey of Community Banks from the Conference of State Bank Supervisors (CSBS), roughly 40% of respondents expect relational loans to increase in the future, compared to just 18% that expect transactional loans to grow.[4]

By leveraging the knowledge that relationships bring, community banks can offer more flexible products, services, and lending criteria that are tailored to the needs of their communities. Whereas other lenders may reject applications that fail to meet rigid criteria, community bankers are typically more willing to work with prospective borrowers to offer terms that may fall "outside the credit box" but still benefit both parties. This more collaborative and flexible approach allows community banks to approve a larger share of loan applications.[5] Recent Small Business Credit Surveys from the Federal Reserve Banks have found that small businesses had higher financing approval rates at community banks.For example, in 2023, three-fourths of small businesses reported that their applications for loans, lines of credit, or cash advances were at least partially approved at small banks, compared to two-thirds at large banks.[6] Community banks can also tailor their services to the unique demands of their local economies, especially those with large agricultural sectors, and have a reputation for responding more quickly to changing economic conditions.[7] Flexibility is central to the community bank business model.

"Our unique understanding of the local economy [and] business challenges helps us develop custom financing solutions that help the business survive and maintain local employment, including unique terms not offered by regional or larger banks."

Community Banker from Wisconsin

2.2 Community Banks Sustain Small Businesses

Small businesses rely on community banks for a variety of financial services. ICBA's Small Business Survey found that small businesses that primarily use community banks most value core business services (e.g., business accounts, loans, and credit cards), but nearly half reported that relationship banking and personalized services were important to them. Community banks are a top choice for small businesses because they offer valuable and flexible financial services while maintaining personal relationships with owners.

"We provide our small business customers with people that will listen to their struggles and work on solutions to grow their businesses."

Community Banker from Minnesota

3 Matt Hanauer, Brent Lytle, Chris Summers and Stephanie Ziadeh, Federal Reserve Bank of Kansas City, "Economic Review: Community Banks' Ongoing Role in the U.S. Economy," Jun. 24, 2021.

4 Conference of State Bank Supervisors (CSBS), 2023 Annual Survey of Community Banks, Oct. 2023.

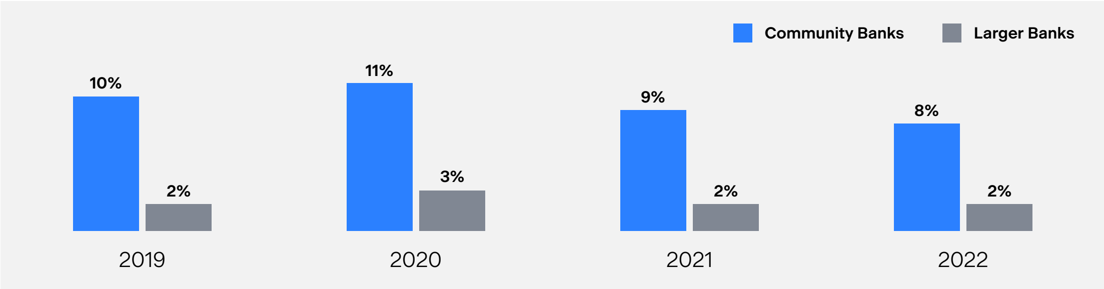
5 Eldar Beiseitov, Federal Reserve Bank of St. Louis, "Small Banks, Big Impact: Community Banks and Their Role in Small Business Lending," Oct. 20, 2023.

6 Federal Reserve Banks, 2024 Report on Employer Firms: Findings from 2023 Small Business Credit Survey (SBCS), Mar. 8, 2023.

7 Hanauer, et. al, Federal Reserve Bank of Kansas City.

Though they hold fewer assets than larger banks, community banks have an outsized role in small business lending. Small business loans comprise a far higher share of assets at community banks than at larger banks (Figure 1). One reason that community banks comprise an outsized share of small business lending is that they tend to make loans that reflect a deeper relationship with the borrower, as opposed to larger banks that rely more on scoring models.[8] The relationship-banking model is a key reason that community banks play such a crucial role in small business lending.

Figure 1: Small Business Loans as a Share of Assets



Source: CSBS 2023 Annual Survey of Community Banks.

Differences in loan size notwithstanding, small businesses borrow from community banks for the same reasons they approach other institutions. ICBA's Small Business Survey found 61% of small business owners applied for credit at a community bank to pay for operational costs, 37% for marketing, and 34% for payroll costs.[9] Investing in their business was another key reason that small business owners applied at a community bank, with 41% reporting borrowing for the purpose of capital expenditures. These results are similar to the 2023 Small Business Credit Survey, which found that 59% of small employers applied for financing to meet operating expenses and 46% applied to invest in expanding their business, pursuing new opportunities, or acquiring business assets.[10] Small businesses borrow to pay for day-to-day operations and grow.

Small businesses notably turned to community banks for operational funds during the COVID-19 pandemic. Community banks were instrumental in helping small businesses access federal loans quickly due to their ability to adapt and their knowledge of community needs.[11] Roughly 60% of all Paycheck Protection Program (PPP) funds came from community banks, including 72% of PPP loans to minority businesses.[12]

> "We worked around the clock processing PPP applications because we thought it might be the only chance we have to save our local economy."
>
> ***Community Banker from Alabama***

8 FDIC Community Banking Study.

9 ICBA Small Business Survey. Percentages do not sum to 100% as the question allowed respondents to "select all that apply."

10 Federal Reserve Banks, 2024 Report on Employer Firms.

11 Hanauer, et. al, Federal Reserve Bank of Kansas City.

12 Noah Yosif, ICBA, "Paycheck Protection Program Data Show Community Banks Served Those Most in Need," Nov. 10, 2021.

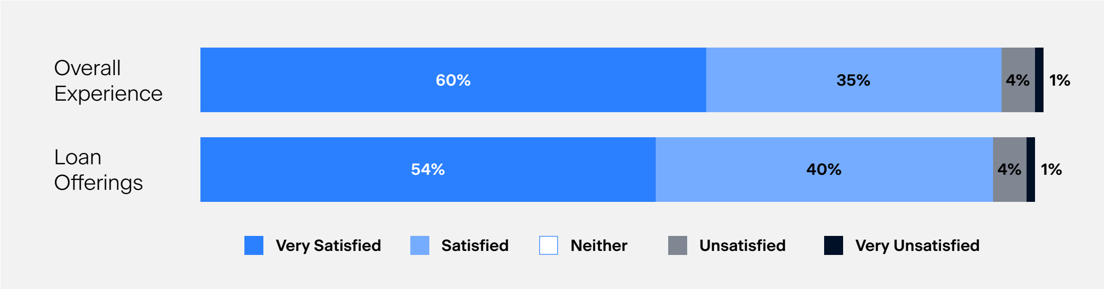
Community banks also delivered funds 5 – 10 days faster than other PPP lenders.[13] Their response to the pandemic exemplifies how community banks leverage the relationship banking model to sustain small businesses.

2.3 Small Businesses Value Community Banks

The outsized role community banks play in small business lending stems from their customers' high degree of satisfaction with their community bank experience. ICBA's survey demonstrates that an overwhelming share of small business owners (95%) are either satisfied or very satisfied with both their overall experience partnering with community banks and the loan and credit offerings they receive (Figure 2). Small business respondents frequently noted that community banks take time to understand their concerns, offer more loan terms and repayment structures, understand their business operations and their clientele, and approach lending as a partnership rather than a transaction.[14] Community banks have earned their outsized market share through local relationships and a devotion to client service.

> "I'm more than just a number. [Our] community bank recognizes personal needs and has a closer relationship than a large commercial bank."
>
> ***Small Business Owner from Illinois***

Figure 2: Small Business Satisfaction with Community Banks



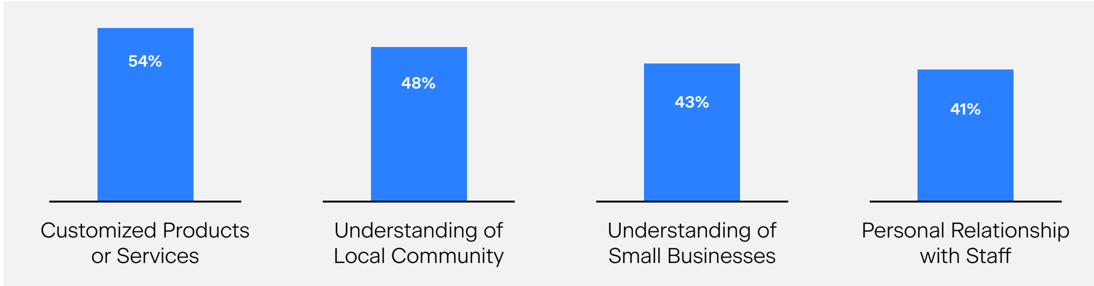
Source: ICBA Small Business Survey. Percentages may not total 100% due to rounding.

Small business owners choose community banks because of their flexibility, local knowledge, and personal relationships. According to ICBA's Small Business Survey, small businesses most often use a community bank because they offer or customize products and services that are unique to small business needs, understand the local community, understand small businesses, or have a personal relationship with their business (Figure 3). Indeed, nearly 9 in 10 small business owners cited at least one of these reasons to explain why they chose to partner with a community bank.

13 ICBA, "Press Release: Data Show Community Banks Lead Economic Recovery," Aug. 19, 2020

14 ICBA Small Business Survey.

Figure 3: Top Reasons Small Businesses Use a Community Bank



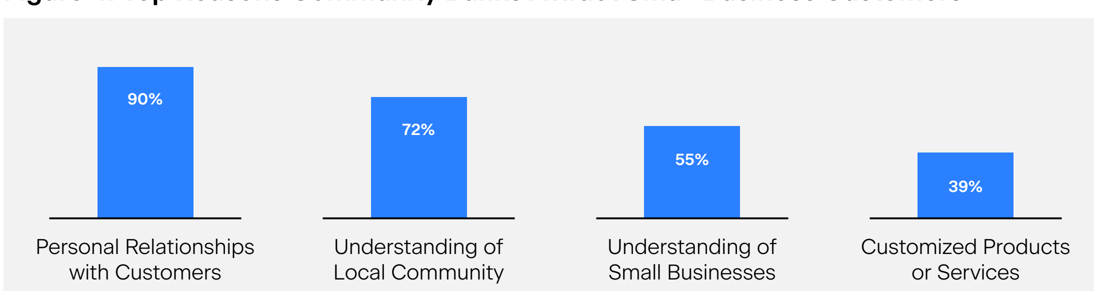
Source: ICBA Small Business Survey.

The ability of community banks to focus on unique business needs may explain why small business owners with a disability are particularly satisfied with community banks. In ICBA's Small Business Survey, respondents with disabilities reported that they were "very satisfied" with their overall community bank experience and loan offerings at an even higher rate than the broader respondent pool (69% compared to 60% and 62% compared to 54%, respectively). Small business owners with disabilities were more likely to use a community bank because of their understanding of the local community (67% compared to 48%) and customized products and services (62% compared to 54%). By working with small businesses to accommodate their distinct needs, community banks play a special role in small business lending.

> "The VP of the bank handled my account requests to ensure they were expedited. She gave honest and useful advice on when to apply. She follows up regularly."
>
> ***Small Business Owner from New York***

Community bankers also recognize that these factors help attract small business clients. When asked for the top reasons small businesses choose their bank, respondents to ICBA's Member Survey cited their personal relationships and customer service, their understanding of the local community, their understanding of small business needs, and their customized products and services that target small business needs (Figure 4). Clearly, community banks' relationship model and flexibility when partnering with small business lenders gives them a competitive advantage.

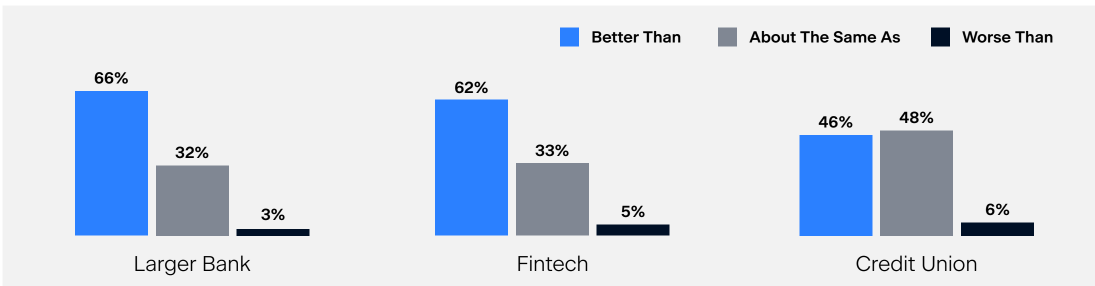
Figure 4: Top Reasons Community Banks Attract Small Business Customers



Source: ICBA Member Survey.

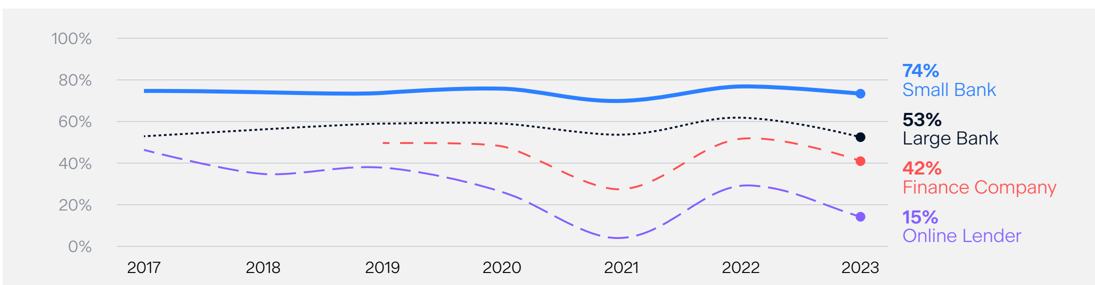
In a marketplace where a variety of financial service providers compete for borrowers, small businesses consistently prefer partnering with community banks. When asked to compare their experience at a community bank to that at other lenders, roughly two-thirds preferred community banks to larger banks and to fintechs, and just under half preferred community banks to credit unions (Figure 5). By contrast, the share of respondents who prefer these alternative lenders to community banks is just 3–6%. Community banks perform particularly well in rural communities, where nearly three-quarters of small business owners prefer community banks to larger banks.[15] The 2023 Small Business Credit Survey also finds that small businesses have been more satisfied with small banks than with large banks, finance companies, or online lenders for the past six years (Figure 6). Small businesses also report they were less likely to experience challenges with small banks than with other lenders.[16] Community banks apply their local knowledge to offer more flexible terms and a better experience.

Figure 5: Small Business Experience at a Community Bank Compared to Other Lenders



Source: ICBA Small Business Survey.

Figure 6: Small Business' Net Satisfaction with Lenders



Source: Federal Reserve Banks, 2024 Report on Employer Firms. Net satisfaction is the share of satisfied respondents less the share of dissatisfied respondents.

15 ICBA Small Business Survey.

16 Federal Reserve Banks, 2024 Report on Employer Firms.

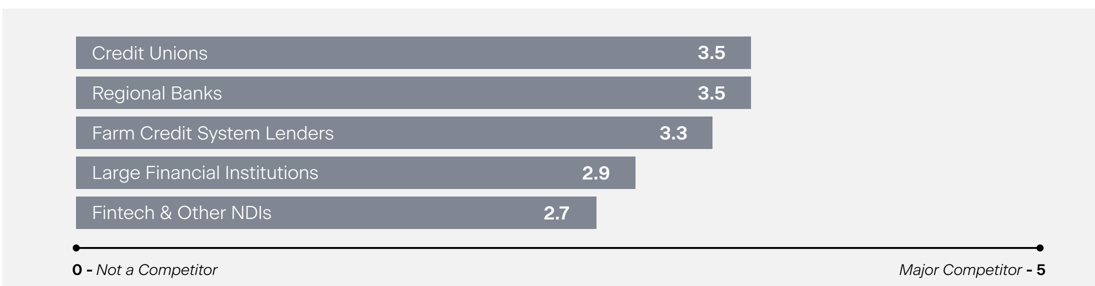
III. Community Banks Compete in a Challenging Environment

Despite their success in sustaining communities and small businesses, community banks face several obstacles. They compete with other lenders and navigate a variety of challenges, including shifting economic conditions, operational barriers, and regulation. Regulatory challenges are particularly important, because community banks compete in a market in which the rules are more stringent for banks than other non-bank lenders.

3.1 Community Banks Face Stiff Competition

To maintain their leading role in small business lending, community banks must compete with a range of financial service providers. Large regional and national banks are a major competitor, with roughly 3 in 4 banks noting them as a primary or secondary competitor for small business loans in the 2023 CSBS survey.[17] ICBA's Member Survey also found that regional banks, credit unions and farm credit system lenders are leading competitors. (Figure 7).

Figure 7: Average Response for Level of Competition for Small Business Customers

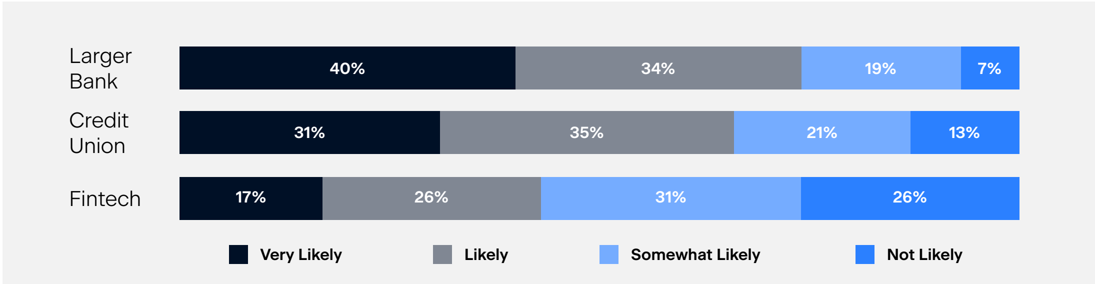


Source: ICBA Member Survey. NDI = Non-Depository Institution.

When small businesses cannot borrow from a community bank, they typically turn to a larger bank or credit union, but a sizeable share would also seek financing from a fintech (Figure 8). Community banks may be a preferred lender, but small businesses have multiple alternatives.

17 CSBS, 2023 Annual Survey of Community Banks.

Figure 8: Likelihood Small Business Will Apply at a Competitor if Credit or Loan Not Available from a Community Bank



Source: ICBA Small Business Survey. Percentages may not total 100% due to rounding.

As community banks compete with an expanding variety of financial service providers, the number of community banks has declined. From 2000 to 2020, the total number of such banks has fallen by half, and their share of total bank assets fell from 28.3% to 13.5%.[18] The FDIC observes that market consolidation has contributed to this trend, but a significant drop in bank formation is also driving the decline. An average of just four new institutions were chartered per year between 2012 and 2019, compared to 183 chartered per year between 1985 and 2011.[19] Stiff competition with a variety of financial service providers may limit new bank formation, but community banks face other more prominent challenges, including a challenging regulatory environment, with which some competitors do not have to contend.

3.2 Community Banks Face Several Challenges

Current macroeconomic conditions, marked by a strong labor market, stubbornly elevated inflation, and high interest rates, are a notable challenge. Nearly 4 in 10 respondents to ICBA's Member Survey indicated that the macroeconomic climate was one of the three biggest challenges facing their bank, while about one-third of respondents pointed to rising operational costs and competing for workers. CSBS's 2023 survey also found that macroeconomic factors are a significant risk for community banks, with bankers identifying interest rate-sensitive factors (e.g., net interest margins and cost of funds) and general economic conditions as among the most important external risks to their bank. Moreover, staff retention was one of the top three internal risks for community bankers.[20] If there is any relief for community banks struggling with macroeconomic conditions, it is that some of these challenges may fade over the next year if inflation returns to target and interest rates normalize.

The same cannot be said for more persistent challenges like cybersecurity and regulation. Cybersecurity was the most important internal risk in CSBS's 2023 survey, retaining the top spot for the past few years,[21] and more than one-fourth of respondents to ICBA's Member Survey identified cybersecurity threats as one of their three biggest challenges. However,

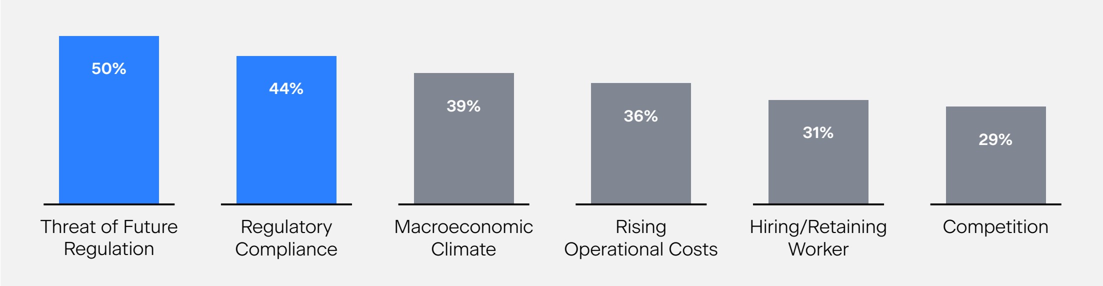
18 Hanauer, et. al, Federal Reserve Bank of Kansas City.
19 FDIC Community Banking Study.
20 CSBS, 2023 Annual Survey of Community Banks.
21 CSBS, 2023 Annual Survey of Community Banks.

the two most prominent challenges in ICBA's survey were related to regulation (Figure 9), with 71% of respondents identifying at least one regulatory factor as a top three challenge for their bank. Regulation is also a top external risk in CSBS's 2023 survey, with 81% of community banks reporting it as a very or extremely important risk. The existing demands of compliance and the threat of future regulations create a regulatory burden that is perhaps the biggest challenge facing community banks.

"The regulatory environment forces our bank to offer more "cookie cutter" products than be able to adapt what we do to the specific and different needs of our customers."

Community Banker from Georgia

Figure 9: Top Challenges Facing Community Banks



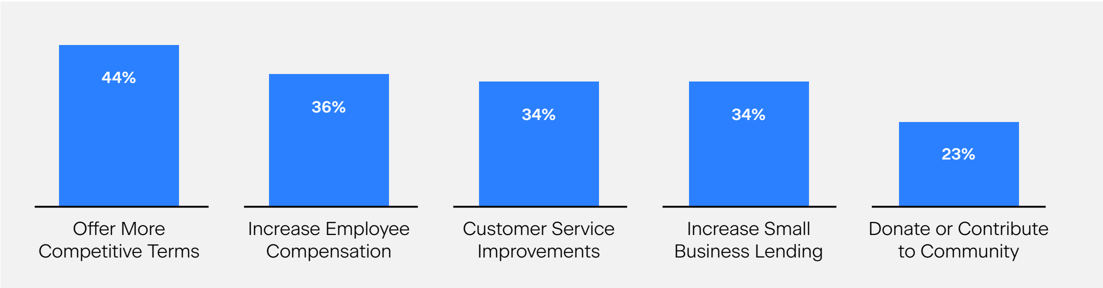
Source: ICBA Member Survey.

IV. The Regulatory Burden is a Major and Growing Challenge

The regulatory burden costs community banks not only precious money and staff time, but also opportunities to better serve their customers. In ICBA's Member Survey, the median community bank respondent devoted three full-time employees to compliance activities. These compliance costs are significant, both in monetary terms (they are equivalent to 4-7% of the net income for the median respondent)[22] and, as shown in Figure 10, in how they prevent banks from engaging in other activities that would have provided greater benefit to the small businesses and broader communities they serve. Indeed, several ICBA member banks commented on the "opportunity cost" of regulations, noting the time needed to decipher regulations and prepare for audits could be better spent serving their customers or focusing on their core business. The rising cost of the regulatory burden community banks face makes it more challenging to operate a bank and serve communities effectively.

> "Our key leaders have to spend too much time and effort on maintaining compliance, dealing with audits, when they could be spending that time working with customers, improving products for our customer base, and training a new generation of bankers."
>
> ***Community Banker from North Carolina***

Figure 10: Spending Plans if Regulatory Compliance Costs Decreased by 20%



Source: ICBA Member Survey. "Donate or contribute to community" entails donating to the local community or investing in relationships with community organizations.

Other research has documented how regulatory costs impact community banks. A study from the Federal Reserve Bank of Kansas City concludes that regulatory burdens have probably contributed to the decline in new bank formation and have impacted bank decisions to exit or consolidate.[23] The FDIC's Community Banking Study from 2020 also acknowledged that compliance costs may have contributed to increased community bank exits and that regulatory burdens explain some of

> "The focus on regulations and audit preparation is an incredible time burden on our staff. We spend more and more of our time preparing for audits and training our staff than we do trying to help customers with their needs."
>
> ***Community Banker from New Mexico***

22 ICBA Member Survey. The median net income for survey respondents was $2.7 million.

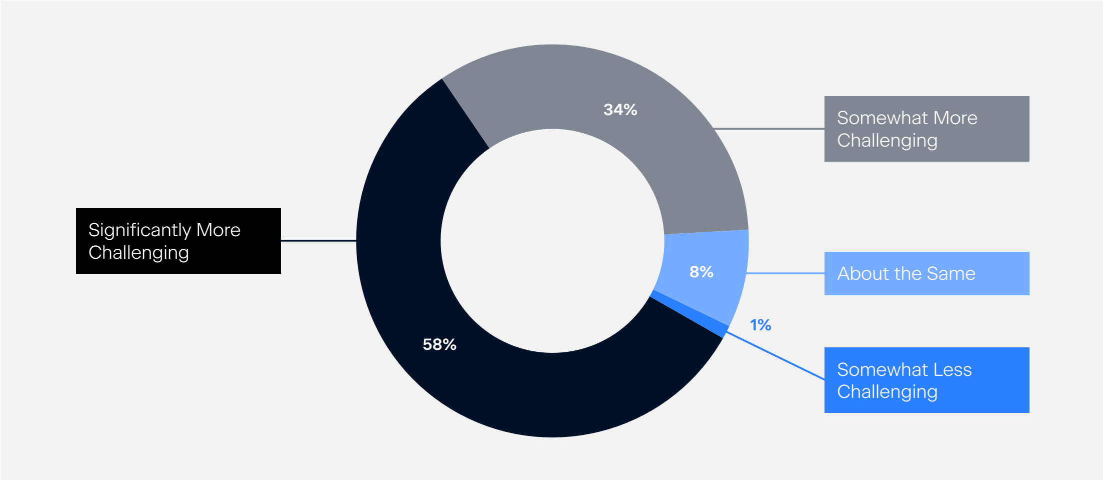
23 Hanauer, et. al, Federal Reserve Bank of Kansas City.

the decline in community bank profitability in the 2010s. Notably, the FDIC sympathized with community banks trying to implement new regulations, observing that "merely keeping current on banks' regulatory requirements as they evolve cumulatively through time is a daunting task for anyone, and certainly for a small bank with modest staff and resources."[24] Modelling the impact of regulations on community banks, researchers at the Federal Reserve Bank of Minneapolis estimated that new regulatory costs can reduce the profitability of community banks by creating new staffing needs — and in some cases even cause community banks to become unprofitable.[25]

The regulatory environment has become more challenging in recent years. More than 9 in 10 respondents to ICBA's Member Survey observed that the current regulatory environment is more challenging than it was five years ago (see Figure 11). The key driver of the growing regulatory burden is the need for additional staff or outside resources to support compliance activities. Specifically, ICBA survey respondents reported that the top factors causing the regulatory environment to become more challenging were (1) the need to retain more compliance staff (both through internal hires and by contracting with external service providers), (2) devoting additional staff time to train on compliance requirements, and (3) investing in compliance software or systems (Figure 12).

> "The greater the regulatory burden, the harder it is to comply. Community banks are going to make business decisions to consolidate, causing branches in small communities to close. Small businesses lose a point of access when they can't walk into a bank and tell their story."
>
> ***Community Banker from Colorado***

Figure 11: The Regulatory Environment Today Compared to Five Years Ago

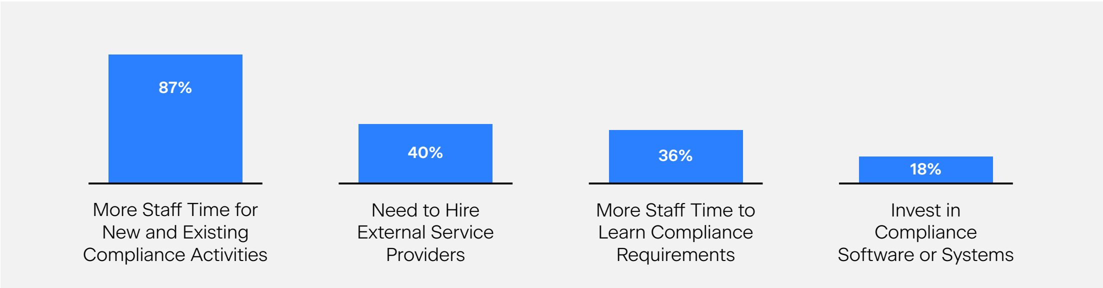


Source: ICBA Member Survey.

24 FDIC Community Banking Study.

25 Ron J. Feldman, Ken Heinecke, Jason Schmidt, Federal Reserve Bank of Minneapolis, "[Quantifying the Costs of Additional Regulation on Community Banks](#)," May 30, 2013.

Figure 12: Top Factors Contributing to a More Challenging Regulatory Environment



Source: ICBA Member Survey.

A challenging regulatory environment not only harms community banks but it also inhibits small business lending. Regulations are pushing community banks to become less flexible in their lending, as several ICBA members commented that the regulatory environment dissuades community banks from working with small businesses to tailor deals. Researchers at Harvard Business School also noted that increased regulatory scrutiny in the wake of the 2007-2009 recession made bankers less likely to apply "softer" criteria (e.g., knowledge of the customer built through relationship banking) to make a loan.[26] Small businesses and community banks alike are feeling the costs of the growing regulatory burden, which will only worsen with recent regulatory activity.

> "Regulations hinder the bank's ability to adapt to customer/borrower's unique needs. In small business lending, a community bank's strength is tailoring products for each specific borrower."
>
> ***Community Banker from New York***

> "One of the greatest threats to smaller banks' business models comes not from any one regulatory reform initiative or changed expectations in supervision but rather from the cumulative impact. The tendency of policymakers can be to add new regulations, guidance, and supervisory expectations, becoming more and more prescriptive and creating an ever-larger body of material that a banker must digest and apply over time. At some point, however, this overwhelming body of material (more than 5,000 pages just last year) is simply undigestible by the individual or small staff at a community bank..."
>
> **Michelle W. Bowman*, Federal Reserve Board of Governors***

26 Karen Gordon Mills, Brayden McCarthy, Harvard Business School, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game," Jul. 22, 2014.

V. New Rules Are Increasing the Burden and Limiting Small Business Lending

Recently finalized and proposed regulations exemplify how well-intended but poorly executed policies are adding to the cumulative regulatory burden and undermining the relationship banking model on which community banks depend to serve local small businesses.

5.1 Section 1071

In March 2023, the Consumer Financial Protection Bureau (CFPB) finalized a rule implementing Section 1071 of the Dodd-Frank Act. The rule — which is intended to promote lending to historically underserved businesses, improve transparency and accountability, and prevent discrimination — requires financial institutions that originated at least 100 small business loans in each of the two preceding calendar years to request and report data on small business lending. The data includes (but is not limited to) information on the race, ethnicity, and gender of business owners, the size of the loan, the interest rate, and the business's revenue. Data must be requested for all applications for credit, regardless of approval status, and the lender must furnish the data to CFPB. CFPB intends to aggregate, anonymize, and analyze the data to identify lending trends and, at the agency's discretion, scrutinize individual lenders based on their submissions. CFPB also intends to make the anonymized data available to the public.

Though Section 1071's policy objectives are laudable, the rule will exacerbate the regulatory burden for community banks, forcing them to spend time and money establishing data collection and other compliance processes. CFPB estimated one-time implementation and ongoing compliance costs for Section 1071, noting that costs will vary by a financial institution's size and complexity. According to CFPB's estimates, typical "low-complexity" and "mid-complexity" institutions (which are most likely to be community banks) will incur approximately $45,000–60,000 in one-time implementation costs and $8,000–40,000 per year in ongoing compliance costs.[27]

However, ICBA's member survey illustrates that a substantial share of community banks will face costs that exceed CFPB's estimates. Specifically, more than 30% of respondents expect implementation costs to exceed the top end of CFPB's cost range, while 37% expect recurring compliance costs to exceed the agency's range — in fact, roughly 1 in 5 community banks expect recurring costs to be at least double CFPB's highest estimate. Over a five-year period, these banks will face costs that exceed CFPB's cost estimates by $240,000 – 360,000 — a sizeable resource commitment for a small bank, particularly

27 Federal Register, Consumer Financial Protection Bureau (CFPB), Final Rule, "Small Business Lending under the Equal Credit Opportunity Act (Regulation B)," May 31, 2023. Range includes estimates for Type A and Type B financial institutions which receive fewer than 300 or between 300 and 2,000 loan applications per year. In ICBA's Member Survey, 77% of respondents originated fewer than 300 small business loans and 99% originated fewer than 2000.

for the purposes of complying with a single regulation.[28] While compliance costs are not expected to be this high for all community banks, ICBA's survey nonetheless concluded that recurring costs for Section 1071 are expected to increase overall compliance costs by 10–30% each year.[29] In short, Section 1071 will lead to a meaningful increase in the regulatory burden for community banks.

Section 1071 could also limit small business lending by deterring small businesses from seeking credit. In ICBA's Small Business Survey, roughly 1 in 10 business owners indicated that they would be uncomfortable providing Section 1071-related information to their community bank and 1 in 6 would be unlikely or very unlikely to provide such information. Veteran-owned small businesses may be the least likely to provide Section 1071-related information, with 1 in 4 veteran respondents reporting they would be unlikely or very unlikely to provide it. Moreover, merely requesting this sensitive data could harm community banks' relationships with their customers. In ICBA's Small Business Survey, nearly half of the respondents indicated that they would probably or definitely look for another lender that did not ask for this information. Rural and minority-owned small businesses would be most likely to look for an alternative lender, with about 6 in 10 respondents from these groups answering "definitely" or "probably" to the question. The potential chilling effect is a key concern for bankers as well: in ICBA's Member Survey, 84% of respondents expect that the rule will inhibit their ability to lend to small businesses to some degree.

"When I'm with a small business, I'm their partner. We're a team. I don't want to do things that will impede their success. I fear 1071 will prevent us from waiting on small business and inhibit what we can offer them to ensure they're successful."

Community Banker from Tennessee

Section 1071 could also undermine the flexible approach that attracts small business borrowers to community banks. With greater scrutiny of lending practices, community banks may shift to less personalized lending approaches. One community banker from Indiana commented that Section 1071 "will ultimately prevent us from customizing loans for small business" and push them to embrace more rigid criteria so that "if the loan doesn't fit in the matrix, we don't make the loan." Another community banker from Georgia predicted that the rule would "effectively mandate a small business loan 'rate sheet' that will make it difficult to tailor small business loan terms to the unique needs of each business." A community banker from Colorado cautioned that the potential standardization of small business lending "isn't good for small businesses or community banks" because their "value proposition is working with customers to craft solutions." By reducing flexibility, Section 1071 could dampen community banks' competitive advantage and deprive small businesses of better borrowing opportunities.

28 This figure was calculated by comparing the implementation and recurring costs for the most impacted ICBA Member Survey respondents to the CFPB's cost estimates over the first five years (implementation costs for one year plus four years of recurring costs). The most impacted survey respondents are those expecting implementation costs to exceed $90,000 (30% of respondents) and recurring costs to exceed $90,000 (17%). So, the most impacted respondents expect to spend over $450,000 in compliance costs in the first five years, compared to the CFPB's estimate of $92,000 for "low complexity" institutions and of $205,000 for "middle complexity" institutions over the same period.

29 ICBA Member Survey.

5.2 Revisions to the Community Reinvestment Act

Enacted in 1977, the Community Reinvestment Act (CRA) aimed to address systemic discrimination in people's access to credit and other financial services (including "redlining") by ensuring that insured depository institutions served entire communities, including low- and moderate-income areas. In October 2023, the Federal Reserve Board, Office of the Comptroller of the Currency (OCC), and FDIC issued a new CRA rule to better evaluate online lenders and make exams more quantitative and transparent. The modernized rule increases asset thresholds for determining bank size and changed the responsibilities for banks in some size categories, but it also establishes more complicated tests to determine whether banks are complying with the CRA's requirement to serve entire communities. These more complex tests will increase compliance costs for intermediate and large community banks.[30]

ICBA's Member Survey (which took place immediately after regulators released the final CRA rule) demonstrates how the revisions will increase compliance costs.[31] Evaluating the compliance impact of the revisions, nearly two-thirds of respondents expect the new CRA revisions to increase their annual compliance costs moving forward, which were already estimated to be at least $50,000 per year for the previous CRA rule, further adding to the cumulative regulatory burden.[32]

> "The final [CRA rule] is unnecessarily complex, overly prescriptive, and contains disproportionately greater costs than benefits, adding significantly greater regulatory burden for all banks, but especially for community banks… The new rule will require [community] banks to make significant changes to policies and systems to comply with the new requirements, all of which will come at significant ongoing cost… I am concerned that the aggregate effect of the increased burden could lead to a reduction in lending to offset the increased costs…"
>
> **Michelle W. Bowman*, Federal Reserve Board of Governors***

With the CRA revisions, large community banks will be required to delineate additional Retail Lending Assessment Areas (RLAAs) in areas where they do not have a physical branch but originate more than 20% of certain loans.[33] This provision will increase compliance requirements for impacted banks and could encourage banks that are approaching a threshold to pull back on lending to avoid triggering extra compliance obligations — or, in some cases, close physical branches to avoid having to comply with the new requirement. Federal Reserve Governor Bowman has expressed concern over this unintended consequence,[34] and ICBA's Member Survey indicates there is merit to her concern. Of respondents that indicated the provision would apply to their bank, nearly

30 ICBA, "ICBA Regulatory Update: Community Reinvestment Act Modernization," Feb. 2024.
31 ICBA Member Survey.
32 ICBA Member Survey.
33 ICBA, "2023 CRA Final Rule: High-Level Summary," Nov. 2023.
34 Governor Bowman, Oct. 24, 2023.

one-third said they would reduce lending in an area to avoid triggering an RLAA.[35] In addition to exacerbating the regulatory burden for community banks, the CRA revisions could also introduce perverse incentives that deter small business lending.

5.3 Small Business Administration's 7(a) Loan Program

The Small Business Administration's (SBA) 7(a) Loan Program provides loan guaranties to lenders that provide financial assistance to small businesses. The loans can be made for up to $5 million and can be used for several purposes, including purchasing and improving buildings, working capital, refinancing debt, purchasing machinery, equipment and other supplies, and changing ownership.[36] In April 2023, the SBA implemented a rule that lifts the moratorium on the number of non-federally regulated institutions (including fintechs) that can make loans under the 7(a) program and loosens underwriting standards for these firms[37]. These changes will expand the network of lenders eligible for SBA 7(a) loans and are designed to increase access to capital, particularly in underserved communities.[38]

While well-intended, the changes to the 7(a) program create risks for community banks. First, expanding the program to fintechs and other nonbanks could lead to higher defaults and incidences of fraud. Fintechs have a poor recent track record with preventing fraud in government programs, with a House of Representatives Select Subcommittee finding that many fintechs "failed to stop obvious and preventable fraud, leading to the needless loss of taxpayer dollars" when administering PPP funds.[39] Additionally, one of the fintech lenders that received a new program license reported losses in 2023.[40] By increasing the risk of defaults and fraud, the expansion could drive up fees and make the program less accessible to borrowers.[41]

In addition, expanding the 7(a) program will make it more difficult for community banks to compete for small business loans. Historically, community banking partnerships with the SBA have helped prudently deploy government resources to increase small business lending where it might not otherwise exist.[42] With the program now expanded to non-federally regulated institutions, community banks must now compete with 7(a) lenders that do not need to follow the same stringent rules. Indeed, 79% of respondents to ICBA's Member Survey believe the expansion of the 7(a) program will inhibit their ability to compete with fintechs and other financial institutions (Figure 13). Not only will the expansion undermine small business lending, but it will also create a regulatory disadvantage for community banks.

35 ICBA, Member Survey, 2024.

36 Small Business Administration (SBA), "7(a) Loans," Mar. 7, 2024 (last updated).

37 ICBA, "Press Release: ICBA Statement on New SBA 7(a) Lending Companies," Nov. 3, 2023.

38 SBA, "Press Release: U.S. Small Business Administration Implements Rules to Address Persistent Capital Access Gaps," Apr. 12, 2023.

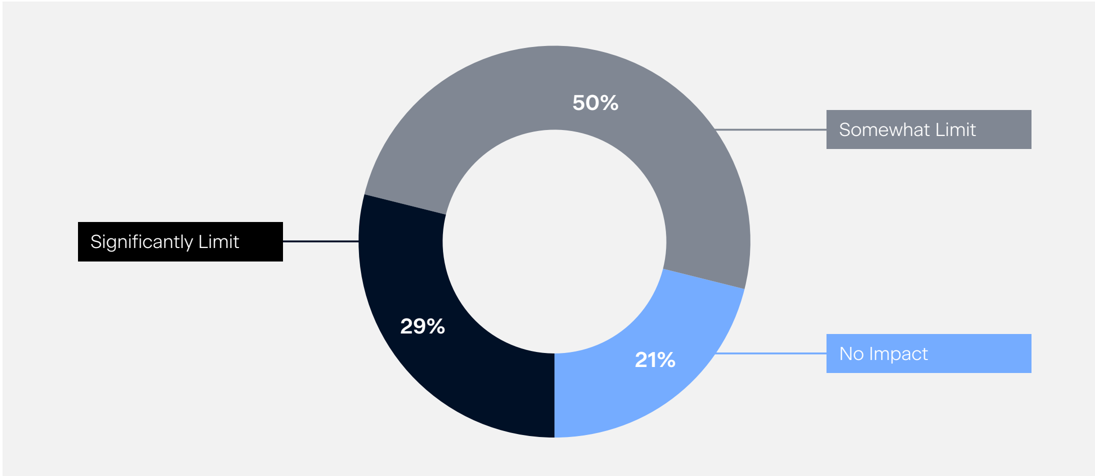
39 Select Subcommittee on the Coronavirus Crisis, Staff Report, "'We Are Not the Fraud Police': How Fintechs Facilitated Faud in the Paycheck Protection Program," Dec. 2022.

40 John Reosti, American Banker, "SBA critics pounce on setback for fintech participation in 7(a)," Mar. 21, 2024.

41 ICBA, "Press Release: ICBA Statement on New SBA 7(a) Lending Companies," Nov. 3, 2023.

42 ICBA, Comment Letter, "Small Business Lending Company Moratorium Rescission and Removal of the Requirement for a Loan Authorization," Jan. 5, 2023.

Figure 13: Impact of Expanding the SBA 7(a) Program on Community Banks' Ability to Compete with Other Financial Institutions



Source: ICBA Member Survey.

5.4 Other Recent Regulatory Developments

Several other recent regulatory changes and proposals could exacerbate the regulatory burden for community banks and inhibit small business lending.

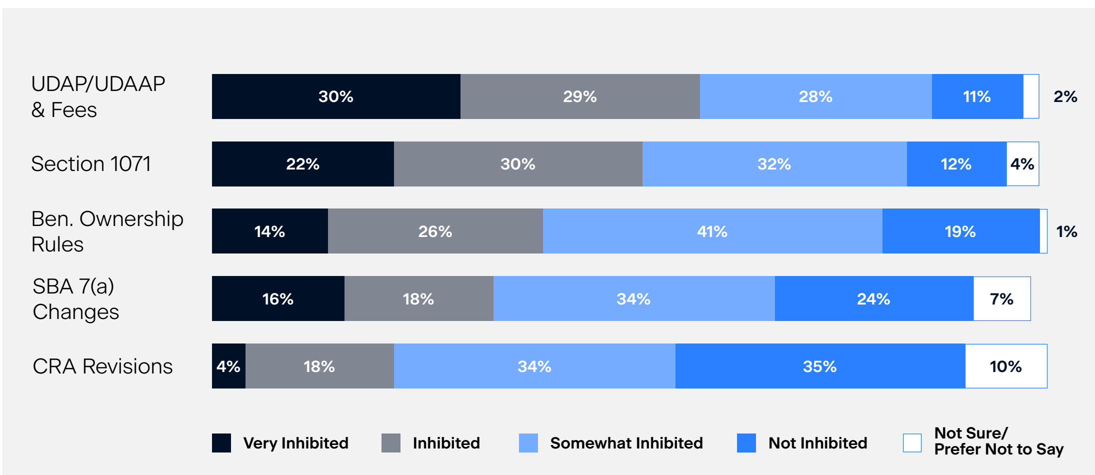
- **UDAP/UDAAP and bank fees:** CFPB and other regulatory agencies have scrutinized Unfair or Deceptive Acts or Practices (UDAP), Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) and bank fees in recent regulatory and policy activity. Specifically, they have targeted banks for the practice of charging customers, including small businesses, fees related to overdrafts, re-presented ACH or checks, non-sufficient funds, or late credit card payments. Community banks consider protecting their customers to be fundamental to relationship banking and a core of their business. To build positive and trusted relationships, community banks must ensure that their customers are fully informed. While the goal of ensuring well-informed customers is desirable, regulatory and policy activity in this area can create confusion due to inconsistent enforcement during examinations and community banks may not have advance notice to address a UDAP/UDAAP concern.
- **Beneficial Ownership Rules:** The Financial Crimes Enforcement Network (FinCEN) requires financial institutions to collect and verify identification information for the beneficial owner of legal entities and small business customers. Though combatting financial crimes is a worthy objective, the beneficial ownership rules as written are duplicative, ineffective, and can unduly burden community banks by increasing their data collection obligations. Moreover, the rules also increase the application burden for customers — it would be more effective and efficient for the government to collect and verify the required beneficial ownership information at the time a legal entity is formed rather than leverage the customer's relationship with their bank.[43]Requiring the collection and verification of this information once again distracts community banks from their core role of serving local communities.

43 ICBA, Comment Letter, "Docket Number FINCEN-2023-0002 - Beneficial Ownership Information Reports," Mar. 20, 2023.

- **Regulation II:** The Federal Reserve Board recently finalized a proposal updating Regulation II to modify the interchange fees covered card issuers receive on debit transactions. Though the rule applies to larger banks with $10 billion in assets, the proposal would also harm community banks by putting downward pressure on debit interchange fees across the market. When the regulation was first introduced, it drove down the average interchange income for community banks even though they were technically exempt from the rate cap.[44] Further, community banks are not exempt from the rule's dual network routing requirement, including the recent expansion of this requirement to card-not-present transactions. The expanded routing requirement is likely to increase fraud incidence and loss by allowing merchants to choose cheaper payment networks that do not invest as much in fraud prevention as larger networks. Facing downward pressure on interchange revenue and increased costs for compliance and fraud, community banks may need to raise rates or fees and may not have as much flexibility to offer certain services and products to their small business customers.

These recent regulatory changes and proposals will collectively increase the already daunting regulatory burden facing community banks and will likely reduce small business lending as a result. In ICBA's Member Survey, 87% of respondents expected UDAP/UDAAP and fee rules to inhibit their ability to lend to small businesses to some degree, while 84% and 80% expressed the same concern regarding Section 1071 and beneficial ownership rules, respectively (Figure 14).

Figure 14: Impact of Recent and Proposed Regulations on Community Bank Ability to Lend to Small Businesses



Source: ICBA Member Survey.

44 Electronic Payments Coalition, "Out of Balance: How the Durbin Amendment has Failed to Meet Its Promise," July 2023.

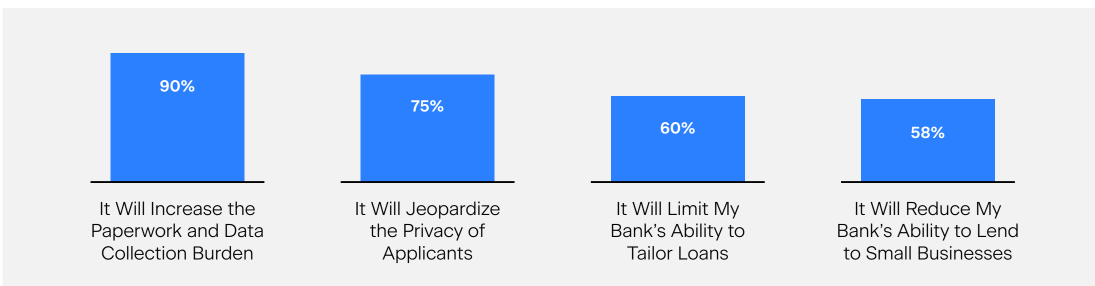
VI. Reducing Regulatory Burdens and Promoting Small Business Lending

To mitigate the challenges caused by recent rules and ease the cumulative regulatory burden facing community banks, ICBA recommends a series of policy changes, as described below.

6.1 Addressing Challenges with Recent Regulatory Changes

- **Nullify and Rewrite Section 1071.** Section 1071 will create new costs for banks, undermine the flexibility that helps community banks compete, and may deter some small businesses from borrowing. In light of this detrimental impact on community banks, ICBA supports nullifying Section 1071 and developing a new one. Respondents to ICBA's Member Survey overwhelmingly endorse this position, with 94% answering "nullify and rewrite entirely" when asked what should happen to the rule. ICBA members want an entirely new rule because the current formulation harms both community banks and small business borrowers (Figure 15). ICBA supports the underlying goal of expanding access to credit for underserved groups, but the current formulation is fundamentally flawed and cannot be salvaged without a full nullification and rewrite that incorporates greater input from community banks and the businesses they serve.

Figure 15: Community Bank Rationale for Wanting to Nullify and Rewrite Section 1071



Source: ICBA Member Survey. Respondents that selected nullify and rewrite Section 1071.

- **Rethink CRA Revisions.** Modernizing the CRA is a laudable goal that ICBA wholeheartedly supports, but recent revisions present serious challenges for community banks. The new rule will add to an already daunting regulatory burden and introduce perverse incentives that are likely to distort small business lending practices, including a reduced physical presence and less lending in some communities to avoid triggering new requirements. To address these challenges, ICBA supports new, more tailored rules that better differentiate community banks from larger banks and reduce new data collection and reporting burdens while still achieving the desired regulatory objectives.

- **Limit Risky New Licenses to SBA 7(a) Program.** The SBA's decision to expand the 7(a) small business lending program introduces new risks for small business lending and perpetuates an unequal regulatory environment for community banks and nonbank lenders. ICBA urges SBA not to issue additional licenses for the program, so that it can adequately oversee and regulate the current participants. ICBA also encourages SBA to focus on maximizing community bank partnerships, which have a long record of expanding lending to underserved communities.

6.1 Addressing the Regulatory Burden

- **Exempt Community Banks from Regulations Intended for Large Financial Institutions.** Too many regulations fail to recognize that community banks and large financial institutions have distinct business models and risk profiles. ICBA urges policymakers to enhance the tiered regulatory system to expand exemptions based on asset size, risk profile, and transaction volume. This could include increasing the threshold for 'systemic risk' under the Dodd Frank Act or an exemption for community banks from climate-related financial risk guidance. In ICBA's Member Survey, 88% of respondents indicated that such exemptions were one of the three most promising policies for reducing the regulatory burden and expanding small business lending (Figure 16). ICBA is not against regulation, but rules need to be properly tailored. Too often, community banks are ensnared, either directly or indirectly, in new regulatory requirements that impair their ability to serve Main Street and, ultimately, do more harm than good.

Figure 16: Policy Proposals with the Most Promise for Reducing the Regulatory Burden for Community Banks and Expanding Small Business Lending

Source: ICBA Member Survey. Respondents could select up to three policy choices.

- **Hold Fintechs & Other Non-Depository Institutions to the Same Regulatory Standards.** Fintechs and other non-depository institutions often compete with community banks while benefiting from reduced regulatory oversight, including their exemption from the CRA. Numerous lenders and policy officials have expressed concern over the threat such institutions pose to the financial system, including Acting OCC Comptroller Michael Hsu in recent remarks on risks to financial stability.[45] ICBA supports a regulatory framework that includes fintechs but ensures they follow similarly stringent standards as those applied to community banks.

45 Acting Comptroller of the Currency Michael J. Hsu, Remarks at Vanderbilt University, "Preventing the Next Great Blurring," Feb. 21, 2024.

> "The prospect of banking being rebundled by nonbank entities outside of the bank regulatory perimeter bears careful monitoring because of the financial stability implications…Arguably, some fintechs are already doing this, blurring the line between banks and nonbanks (and raising concerns about level playing fields). Companies that started off simply facilitating payments now offer customers the ability to deposit paychecks directly into their accounts, earn yield on the cash held there, and access credit, all with a few clicks of a mouse or taps on a phone. From a financial stability perspective, the deposit-taking-like activity warrants the most scrutiny because of the vulnerability it creates to [bank] runs…"
>
> **Michael J. Hsu*, Acting Comptroller of the Currency***

- **Reform the Governance of the CFPB to Make it More Inclusive and Accountable.** ICBA is concerned that CFPB's recent rulemaking actions have overstepped its statutory authority. ICBA supports legislation replacing single-director governance of the CFPB with a five-member commission and recommends including prudential banking regulators in the consumer protection rule-writing process and the CFPB's governance. In ICBA's Member Survey, half of respondents stated that reforming the CFPB's governance structure to make it more inclusive and accountable was one of the three most promising policies for reducing the regulatory burden (Figure 16).
- **Reduce Data Collection Requirements.** Current and proposed data collection requirements for community banks, such as those for beneficial ownership rules and Section 1071, have had or will likely have a detrimental effect on small business lending. ICBA members report that some small business owners are not comfortable with giving the federal government sensitive data about their business and are likely to balk at requests for such information from community banks. Collecting this information is also costly and time-consuming for banks and will redirect resources away from more productive activities. ICBA supports policies that reduce data collection requirements for community banks, and 43% of ICBA member survey respondents agree that such policies show great promise for reducing the regulatory burden and expanding small business lending (Figure 16).
- **Improve Policymaking to More Fully Consider How Regulations Acutely Impact Community Banks.** Community banks find the cumulative regulatory burden taxing, and each new or revised regulation can make it worse. One way to address this burden is to rigorously evaluate regulations during the policymaking process. ICBA supports several policies to this end:

    - Federal banking regulators should use their latest regulatory review under the Economic Growth and Regulatory Paperwork Reduction Act to provide substantive regulatory relief for community banks. ICBA recommends that regulators hire an independent consultant to quantify the current regulatory burden on community banks, meet with community bankers to address concerns with CFPB regulations, and thoroughly review past regulation assessments that have understated the burden for community banks.

- Policymaking should also follow the notice and comment requirements of the Administrative Procedure Act. Too often, agencies rely on informal communications, including press statements and social media, to convey expectations and effectively make rules. This practice can create confusion and lead to inconsistent enforcement. A 2021 rule from the CFPB that clarifies the role of supervisory guidance should serve as a model for all regulators to follow.[46]
- Regulators should also rigorously and quantitatively justify new rules. This entails applying more thorough cost-benefit analysis to account for the impact on community banks that lack the scale and resources to absorb new compliance costs. Applying and documenting regulatory flexibility analyses is also critical, as alternative regulatory approaches could deliver similar benefits to the public at far lower costs for community banks. Policymaking should adhere to the spirit of the Regulatory Flexibility Act which requires agencies to assess how rules may impact small entities and consider alternatives that could reduce the burden.

46 Federal Register, CFPB, "Role of Supervisory Guidance," Feb. 12, 2021.

Conclusion

Community banks play a unique and vital role supporting small businesses and local communities, but they are hampered by a regulatory burden that has grown rapidly in recent years. Due to their smaller size and limited resources, community banks are particularly exposed to the costs imposed by these regulatory changes, both in terms of direct compliance costs and the related opportunity costs. When regulators issue new rules, bank leaders must either redirect staff away from serving customers to address compliance requirements or devote additional resources to compliance. In either case, the result is more time and money spent on compliance and less on serving customers and communities. Making matters worse, some regulations discourage community banks from offering flexible lending terms that small businesses value, and others may deter small businesses from borrowing at all. Weakened by the cumulative regulatory burden, the relationship banking model may become unviable for some community banks, harming the local communities and small businesses they serve.

Tailored regulation, however, can reinvigorate community banking by acknowledging and encouraging the critical role small banks play on Main Street. Policymakers should carefully consider how proposed regulations will impact community banks and embrace policies that strike a proper balance between an agency's regulatory objectives and the value community banks generate using the relationship banking model. With a more manageable regulatory burden, a thriving community banking sector can continue to sustain small businesses and local communities.