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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
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Memorandum

To: Members, Subcommittee on Economic Growth, Tax, and Capital Access, Committee on Small Business
From: Committee Staff
Date: September 14, 2015
Re: Subcommittee Hearing: "*Financing Main Street: How Dodd-Frank is Crippling Small Lenders and Access to Capital*"

On Thursday, September 17, 2015, at 1:00 pm in Room 2360 of the Rayburn House Office Building, the Subcommittee on Economic Growth, Tax, and Capital Access of the Committee on Small Business will meet to examine the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) on small financial institutions and small business lending. Specifically, the hearing will discuss the regulatory changes promulgated by Dodd-Frank and the impact those have had on small business.

I. Introduction

According to economists, the United States experienced an economic recession from December 2007 through June 2009.[1] This recession, often referred to as the "Great Recession," lasted 18 months and was the longest recession experienced in the United States since World War II.[2] Although the Great Recession officially ended in June of 2009, the United States experienced its peak of unemployment at 10 percent in October 2009.[3]

While the exact cause of this recession may be debated, a substantial contributor was the collapse of various financial institutions due to subprime lending and risky derivative trading.[4] As Lehman Brothers slipped into bankruptcy, lawmakers passed the Emergency Economic Stabilization Act of 2008 which allowed the federal government to purchase troubled assets rather than allow certain financial institutions to succumb to the same fate as Lehman Brothers.[5] The need for this action led several commentators, including most importantly, the then – Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, to express

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[1] http://www.nber.org/cycles/sept2010.pdf. It is important to note that the National Bureau of Economic Research is not affiliated with the federal government. The federal government does not declare the existence of recessions.
[2] *Id.*
[3] http://data.bls.gov/timeseries/LNS14000000.
[4] *See* http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article; *see also* http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=0.
[5] Pub. L. No. 110-343, Div. A., § 2, 112 Stat. 3765, 3766 (2008), codified at 12 U.S.C. § 5201.

concerns regarding banking practices and whether the industry was properly regulated.[6] It also fostered a general level of distrust and dissatisfaction with the banks.[7]

II. Dodd-Frank Reform

In response to the problems of highly leveraged banks, speculative derivatives trading, and overly lenient lending in the real estate market, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010[8] (hereinafter "Dodd-Frank") to prevent another collapse of the financial system. The law provides for a comprehensive reorganization of the regulatory structure surrounding the financial services industry. Since its passage, this law has been highly controversial, particularly given the potential it has to impose a disproportionate impact on both small business lending and small financial institutions through increased regulations such as reporting requirements, risk retention, limitation of certain fees, and restructured resolution authority. Five years later, while proponents of Dodd-Frank are quick to tout enhanced financial stability, transparency in financial markets, and greater consumer protection,[9] Main Street small businesses, which include small financial institutions, question whether this has led to a more stable financial economy or if it instead has harmed small businesses through rising regulatory costs and decreased access to debt capital.

III. Effects on Small Financial Institutions

Dodd-Frank was enacted on July 21, 2010, with a majority of the provisions not going into effect until after rules were promulgated. Dodd-Frank required nearly 400 new rules, and as of July 15, 2015, 247 rules have been implemented and 60 proposed.[10] Statistically, this means that approximately 21 percent of the rules from Dodd-Frank are still outstanding.[11] Thus far, for all parties affected by the law, Dodd-Frank is estimated to have created $24 billion in compliance costs and 61 million paperwork burden hours.[12] As is true across all industries, in general regulatory burdens and compliance costs are greater for small firms.[13] Given this small financial

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[6] *See, e.g,.* http://www.wsj.com/articles/SB120675834275673863; http://www.heritage.org/research/reports/2008/10/congresss-investigation-into-the-subprime-mortgage-meltdown-the-so-called-search-for-the-truth; http://www.federalreserve.gov/newsevents/speech/bernanke20091023a.htm.

[7] TRACI L. MACH, COURTNEY M. CARTER, & CAILIN R. SLATTERY, DIVISIONS OF RESEARCH & STATISTICS AND MONETARY AFFAIRS, FEDERAL RESERVE BOARD, PEER-TO-PEER LENDING TO SMALL BUSINESSES 1 (2014), *available at* http://www.federalreserve.gov/pubs/feds/2014/201410/201410pap.pdf.

[8] Pub. L. No. 111-203, 124 Stat. 1376.

[9] DEPT. OF TREASURY, DODD-FRANK AT FIVE YEARS: REFORMING WALL STREET AND PROTECTING MAIN STREET 3 (July 2015), *available at* http://www.treasury.gov/press-center/Documents/DFA%205%20Year%20Deck.pdf.

[10] http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

[11] *Id.*

[12] BEN GITIS, ANDY WINKLER, AND SAM BATKINS, AMERICAN ACTION FORUM, DODD-FRANK AT 5: HIGHER COSTS, UNCERTAIN BENEFITS (July 2015), *available at* http://americanactionforum.org/research/dodd-frank-at-5-higher-costs-uncertain-benefits#_edn5.

[13] W. MARK CRAIN AND NICOLE V. CRAIN, NATIONAL ASSOCIATION OF MANUFACTURERS, THE COST OF FEDERAL REGULATION TO THE U.S. ECONOMY, MANUFACTURING AND SMALL BUSINESS 1(Sept. 2014), *available at* http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Full-Study.pdf. Small businesses with less than 50 employees annually spend 17 percent more than an average firm to company with federal regulations.

institutions, such as community banks and credit unions, are feeling the weight of increased regulatory burdens promulgated under Dodd-Frank.[14]

In crafting Dodd-Frank, proponents of the law argue that, for example, "the authors of the Dodd-Frank Act understood the important role of community banks and that they were not the cause of the crisis. That is why Dodd-Frank is focused on constraining risk at the largest institutions and on closing gaps in regulation for activities, like derivatives trading, that are not central to the business of community banks."[15] Given this, Dodd-Frank created "different categories of banking organizations – largely, but not exclusively, on the basis of total assets – to which different regulatory requirements are to apply."[16] By creating these varying categories, the law was meant to ensure small financial institutions did not become entwined in regulatory red tape when lawmakers understood they did not significantly contribute to the financial crisis.

Despite the positive intent of these exceptions, it has been repeatedly noted that the law "also contains provisions that will impose additional restrictions and costs on these institutions."[17] Federal Reserve Board Governor Daniel Tarullo noted that these exemptions still have left "risk of 'supervisory trickle down,' whereby supervisors informally, and perhaps not wholly intentionally, create compliance expectations for smaller banks that resemble expectations created for larger institutions."[18] For example, Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) and exempted credit unions with under $10 billion from examination and enforcement action by this newly created Bureau.[19] Further, the CFPB was given broad "authority to exempt certain institutions, such as credit unions, from agency rules, they have been reluctant to use this authority."[20] In light of that, credit unions, with less than $10 billion still appear to feel the burden of regulations under Dodd-Frank despite the fact that credit unions were not involved in creating the financial crisis of 2008.[21]

Additionally, as the number of Dodd-Frank regulations increased, there has been a parallel reduction in the number of financial institutions. At the end of 2010, the Federal Deposit

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[14] Notably a 2012 report meant to examine the regulatory burden of Dodd-Frank on community banks and credit unions was unable to ascertain the full impact until regulations were implemented. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE (GAO), COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF THE DODD-FRANK ACT DEPENDS LARGELY ON FUTURE RULE MAKINGS 1 (Sept. 2012) (GAO-12-881), *available at* http://www.gao.gov/assets/650/648210.pdf.

[15] NEAL WOLIN, DEPT. OF TREASURY, FINANCIAL REFORMS PROTECTS AND STRENGTHENS COMMUNITY BANKS (April 2011), *available at* http://www.treasury.gov/connect/blog/Pages/Financial-Reform-Protects-and-Strengthens-Community-Banks.aspx.

[16] Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, Speech at the Federal Reserve Bank of Chicago Bank Structure Conference: Rethinking the Aims of Prudential Regulation (May 8, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm.

[17] GAO, *supra* note 14, at 1.

[18] Daniel K. Tarullo, *supra* note 16.

[19] Dodd-Frank, § 1025, 124 Stat. at 1990 (codified at 12 U.S.C. § 5515).

[20] Letter from the National Association of Federal Credit Unions to the United States House of Representatives Committee on Financial Services, Re: Tomorrow's Hearing: "Dodd-Frank Act Five Years Later: Are We More Stable?" 1-2 (July 8, 2015), *available at* http://www.nafcu.org/policyletters/.

[21] *Id. See also* http://www.americanbanker.com/bankthink/count-credit-unions-among-dodd-franks-collateral-damage-1075566-1.html.

Insurance Corporation (FDIC) insured 7,657 commercial banks and saving institutions.[22] However, five years later the number of FDIC-insured banks has dropped to 6,419.[23] For credit unions, which are overseen by the National Credit Union Administration (NCUA) and insured by the National Credit Union Insurance Fund, the trend has been disturbingly similar, as at the end of 2010 there were 7,339 reported[24] and as of March 2015 this has dropped to 6,206.[25] Further, the rate of new bank growth has slowed dramatically, resulting in only 4 new banks from 2011 through 2013, a stark contrast from 2002-2008 where they were more than 100 new banks started.[26] The factors that lead to new entrants in the market are varied, but research suggests that after the financial crisis the additional regulatory hurdles imposed by Dodd-Frank "may be particularly burdensome for small banks that are just getting started."[27]

It is important to note that prior to Dodd-Frank, there were legislative changes which may have also led to a reduction in these institutions. For example, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 made it easier for interstate banking mergers to occur beginning in June 1997.[28] Similarly, in 1998 the Credit Union Membership Access Act made it easier for charters to expand membership which could result in consolidation.[29] Given this, proponents may argue these other factors led to the reduction rather than increased regulatory burdens under Dodd-Frank. However, a recent 2014 study indicated due to Dodd-Frank "many small banks are considering mergers or acquisitions in order to spread regulatory costs across a larger bank."[30]

IV. Effects on Small Business Lending

Since many smaller financial institutions are community lenders, this disproportionate impact of regulations will have the greatest impact on small businesses that rely on local community financial institutions to meet their capital requirements. In general, access to capital is challenging for small businesses and despite minor recovery since the Great Recession, small

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[22] FDIC, 2010 ANNUAL REPORT 124 (March 2011), *available at* https://www.fdic.gov/about/strategic/report/2010annualreport/AR10final.pdf.
[23] FDIC, STATISTICS AT A GLANCE (March 2015), *available at* https://www.fdic.gov/bank/statistical/stats/2015mar/industry.pdf.
[24] NCUA, 2010 YEARNED STATISTICS FOR FEDERAL INSURED CREDIT UNIONS 1, *available at* http://www.ncua.gov/Legal/Documents/Reports/CUStat2010.pdf.
[25] NCUA, OVERALL TRENDS 1 (June 2015), *available at* http://www.ncua.gov/Legal/Documents/Reports/FT20150331.pdf.
[26] ROISIN MCCORD, EDWARD SIMPSON PRESCOTT, AND TIM SABLIK, FEDERAL RESERVE BANK OF RICHMOND, EXPLAINING THE DECLINE IN THE NUMBER OF BANKS SINCE THE GREAT RECESSION 2 (March 2015), *available at* https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf. Please note the term new as used in this memo refers to a de novo entrant which is a newly formed bank rather than a bank converting its charter, opening a new branch, or a bank that was part of holding company spinning off into independent status.
[27] *Id.* at 4.
[28] Pub. L. No. 103-328, 108 Stat. 2333. *See also* GAO, *supra* note 14, at 8.
[29] Pub. L. No. 105-219, 112 Stat. 913. *See also* GAO, *supra* note 14, at 8-9.
[30] HESTER PIERCE, IAN ROBINSON, AND THOMAS STRATMANN, MERCATUS CENTER, GEORGE MASON UNIVERSITY, HOW ARE SMALL BANKS FARING UNDER DODD-FRANK? 58 (Feb. 2014), *available at* http://mercatus.org/sites/default/files/Peirce_SmallBankSurvey_v1.pdf.

businesses have noted the lending environment continues to be challenging.[31] Unlike large enterprises that can obtain funds from commercial debt and equity markets, small businesses must rely on their own personal assets, retained earnings, and commercial banks for needed capital.

Following Dodd-Frank it appears that "low-income consumers and small businesses – which generally have fewer or less effective alternatives to bank credit – have paid the largest price for increased bank regulation."[32] Credit cards, for example, tend to be a significant source of funding and small businesses "are hurt by higher credit card rates and lower availability of credit, as well as by higher borrowing rates for bank loans and lines of credit."[33] Further, as big banks tend to be more risk-averse lenders in general, they approved less than 20% of all small business loan requests submitted to them in January 2014.[34]

As previously noted, as the number of available financial institutions dwindles there is a direct negative correlation on access to capital for small firms. The basic concept of supply and demand reasons that when a small business has fewer places to go there will inevitably be less capital. However, this vast simplification is further complicated by the fact that small financial institutions "have a comparative advantage in lending to small businesses; [therefore] their declining number could affect the allocation of credit to different sectors in the economy."[35]

Generally, small financial institutions such as community banks "leverage interpersonal relationships in lieu of financial statements and data-driven models in making decisions, rending them better able to serve small businesses."[36] For example, "community banks provide 77 percent of agricultural loans and over 50 percent of small business loans."[37] Unfortunately, though, since the second quarter of 2010 the overall volume of small business lending by community banks is down by 11 percent.[38] As small business already face significant obstacles in accessing credit the reduction in small business lending from small financial institutions who traditionally provide that critical capital as the predominate lenders to small businesses following the implementation of Dodd-Frank raises concerns.

V. Conclusion

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[31] *See* http://www.entrepreneur.com/article/247506; http://www.nfib.com/surveys/small-business-economic-trends/; and http://www.wsj.com/articles/small-business-lending-is-slow-to-recover-1408329562.

[32] GLOBAL MARKETS INSTITUTE, GOLDMAN SACHS, WHO PAYS FOR BANK REGULATION? 2-3 (June 2014), *available at* http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/who-pays-for-bank-regulation-pdf.pdf.

[33] *Id.* at 12.

[34] http://www.nytimes.com/2014/03/06/business/smallbusiness/cant-get-a-bank-loan-the-alternatives-are-expanding.html?_r=1.

[35] ROISIN MCCORD, EDWARD SIMPSON PRESCOTT, AND TIM SABLIK, *supra* note 26, at 1. Please note while traditional financial institutions are declining, there has been a rise in alternative lenders. For more information, please view the Committee's memo on *Bridging the Small Business Capital Gap: Peer-to-Peer Lending* (May 2015), *available at* http://smbiz.house.gov/uploadedfiles/5-13-2015_hearing_memo.pdf.

[36] MARSHALL LUX AND ROBERT GREENE, HARVARD KENNEDY SCHOOL MOSSAVAR-RAHMANI CENTER FOR BUSINESS AND GOVERNMENT, THE STATE AND FATE OF COMMUNITY BANKING 5 (Feb. 2015), *available at* http://www.hks.harvard.edu/content/download/74695/1687293/version/1/file/Final_State_and_Fate_Lux_Greene.pdf.

[37] *Id.* at 2.

[38] *Id.* at 11.

Five years after enactment, proponents of Dodd-Frank are quick to tout enhanced financial stability, greater transparency in financial markets, and increased consumer protection.[39] Nevertheless, Main Street small businesses, which include small financial institutions, express concerns that it has had the opposite effect. Rather than provide greater stability, protections, and opportunities for small businesses it has led to further challenges in small businesses obtaining access to capital due to increased regulatory burdens.

[39] DEPT. OF TREASURY, DODD-FRANK AT FIVE YEARS: REFORMING WALL STREET AND PROTECTING MAIN STREET 3 (July 2015), *available at* http://www.treasury.gov/press-center/Documents/DFA%205%20Year%20Deck.pdf.