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Written Testimony of

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Before the United States House of Representatives
Committee on Small Business
Subcommittee on Oversight, Investigations, and Regulation

"Regulatory Landscape: Burdens on Small Financial Institutions"

October 24, 2013
10:00 am

Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, contracts, bankruptcy, and commercial law.

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin currently chairs the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

Mr. Chairman Schweikert, Ranking Member Clarke, Members of the Committee:

Good morning. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in consumer finance, contracts, bankruptcy, and commercial law. I also serve on the Consumer Financial Protection Bureau's statutory Consumer Advisory Board. I am here today solely as an academic who has written extensively on consumer finance and financial regulation and am not testifying on behalf of the CFPB or its the Consumer Advisory Board.

In my testimony today, I focus on five areas where new regulatory changes affect small businesses or small financial institutions:

1. The effect of the CARD Act on small business credit;
2. The effect of the CFPB on small business credit
3. The effect of the CFPB on small financial institutions
4. The effect of the Durbin Interchange Amendment on small depositories; and
5. The effect of the US implementation of the Basel III Capital Accords on small financial institutions.

Neither the CARD Act nor CFPB nor Basel III is likely to have a major effect on smaller financial institutions; the Durbin Interchange Amendment actually makes small financial institutions more competitive vis-à-vis large banks. These changes in regulation will undoubtedly impose some compliance costs. Some of these will be one-time costs, and some will be recurring. And these costs may affect the competitive landscape in financial services. It is hard, however, to see any currently proposed regulations as having a material effect on the ability of smaller financial institutions to compete or on the availability of credit to small businesses. When weighed against the clear benefits of better consumer protection regulation, more competitive markets, and safer banks, the overall effect of the regulatory changes appears positive.

I. The Effect of the CARD Act on Small Financial Institutions and Small Business Credit

The Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the "CARD Act") is the first major statutory overhaul of the credit card market since the 1968 Truth in Lending Act. During the intervening four decades, the credit card market expanded and evolved dramatically, and the CARD Act was much needed legislation to rein in some of the more egregious billing "tricks and traps" that had emerged in the credit card market. The credit card market is one dominated by large banks—roughly 85% of credit card lines outstanding is on cards issued by just ten large banks.[1] Many smaller banks do not even offer credit cards. Accordingly, the brunt of the CARD Act's regulatory burden has been born by a handful of megabanks.

The CARD Act applies only to consumer credit cards; small business credit cards remain virtually unregulated. Accordingly, the CARD Act cannot be held responsible for the reduction in small business credit lines. Thus, a recent statutorily mandated study by the CFPB on the impact of the CARD Act notes that:

[1] NILSON REPORT, #1012, Feb. 2013, at 9.

> [N]othing in the evidence reviewed suggests that the CARD Act was responsible for the reduction in credit access – which largely preceded the Act's enactment – or that the CARD Act has retarded the pace of the recovery. The parallels between the consumer credit card market and the small business credit card market, and between the credit card market and other consumer credit markets, do not suggest that, in general, recovery in the card marketplace has been negatively impacted by the CARD Act.[2]

The CARD Act may have even helped small businesses by lowering their costs of credit and by enabling greater consumer purchasing power for goods and services. A recent study estimates that the CARD Act has saved US consumer $20.8 billion per year.[3] Similarly, the CFPB concluded that "the CARD Act likely did not raise credit card costs for consumers."[4] To the extent that the CARD Act has helped consumers by making credit markets more transparent and thus allowing markets to operate more efficiently, it also has helped small businesses in two ways. First, small businessmen are consumers themselves. And second, to the extent that better consumer protection laws result in a more competitive consumer protection market place and reduce the rents that can be extracted from consumers by financial institutions, it means that consumers will have more money left over that can be spent on goods and services in the real economy. This suggests that the CARD Act has actually had a positive impact on small businesses generally.

II. CFPB and Small Business Credit

Small businesses account for roughly half of private-sector employment and 46 percent of GDP.[5] These small businesses—like any type of commercial enterprise—require credit to operate. As an initial matter, I want to underscore that the CFPB has no almost direct regulatory authority relating to small business credit.

The CFPB's organic authority is limited to products and services "offered or provided for use by consumers primarily for personal, family, or household purposes".[6] Most statutes administered by the CFPB, such as the Truth in Lending Act are similarly restricted. The sole areas in which the CFPB has jurisdiction are a pair of seldom-invoked provisions of the Truth in Lending Act prohibiting the issuance of unsolicited credit cards[7] and limiting liability of employees to card issuers for unauthorized business card usage[8] and the Equal Credit Opportunity Act (ECOA), which prohibits various

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[2] CFPB, CARD Act Report: A review of the impact of the CARD Act on the consumer credit card market, Oct. 1, 2013, at 61, *at* http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.

[3] Sumit Agrawal et al., *Regulating Consumer Financial Products: Evidence from Credit Cards*, Sept. 25, 2013, *at* http://ssrn.com/abstract=2330942.

[4] CFPB, CARD Act Report: A review of the impact of the CARD Act on the consumer credit card market, Oct. 1, 2013, at 36, *at* http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.

[5] Kathryn Kobe, Small Business GDP: Update 2002-2010, Jan. 2012, *at* http://www.sba.gov/sites/default/files/rs390tot_0.pdf (the 46% figure is for 2010).

[6] 12 U.S.C. § 5481(5)(A).

[7] 15 U.S.C. § 1642.

[8] 15 U.S.C. § 1645.

discriminatory lending practices,[9] and which was amended by the Dodd-Frank Act to include a data collection provision on small business lending.[10] This means that the CFPB can engage in only very limited regulation of small business financial products, and then primarily to ensure against discriminatory lending, rather than to regulate the terms and conditions of financial products.

Thus, the CFPB's direct authority over small business credit is primarily to the extent that the small business credit is obtained as consumer credit. While this is commonly done, it is typically in contravention to representations made by the borrowers to their lenders. Still, many small businesses rely on consumer credit cards and home equity lines of credit for liquidity, use consumer deposit accounts, and make use of vehicles financed through consumer loans or leases.

To date, however, CFPB rulemaking and enforcement has had little impact on any of these particular financial products in a way that would affect small businesses. The CFPB has done only minor rulemakings relating to credit cards (and these loosened pre-existing regulations);[11] the CFPB's major mortgage rulemaking regarding the "qualified mortgage" or QM exemption to the statutory ability-to-repay requirement does not apply to home equity lines of credit;[12] and the CFPB has done no rulemakings in the deposit account or auto finance areas. Similarly, the CFPB has yet to engage in a rulemaking regarding data collection on small business lending, and has indicated that until such a rulemaking occurs, the reporting requirements do not go into effect.[13]

Instead, to the extent that the CFPB is affecting small business credit, it is only indirectly, to the extent that financial institutions are responding to CFPB regulation by changing their small business lending practices. To date, there is no evidence that this is occurring, much less that any such indirect effects are negative and outweigh any concomitant benefits. I make no attempt here to quantify the benefits of any particular consumer protection regulation, but note again, that small businesses benefit from such regulations both as because small businessmen are consumers themselves and because better consumer protection laws leave more money in consumers' pockets to spend on goods and services instead of on bank fees and interest.

[9] 15 U.S.C. § 1691 *et seq*.

[10] 15 U.S.C. § 1691o-2.

[11] 78 Fed. Reg. 25818 (May 3, 2013) (amending Regulation Z to remove the requirement that card issuers consider consumers' *independent* ability to pay for applicants who are at least 21 years old and permitting issuers to consider in ability to repay income and assets which a consumer can reasonably expect to access, such as spousal income and assets); 78 Fed. Reg. 18795 (Mar. 28, 2013) (amending Regulation Z to apply the limitation on the total amount of fees that a credit card issuer may require a consumer to pay solely to the first year after account opening and not also prior to account opening).

[12] 12 C.F.R. § 1026.43(a)(1). Some rules, such as regulations relating to mortgage counseling, mortgage servicing, and compensation rules for arbitration and credit insurance do apply to home equity lines of credit, but the impacts are minor. Similarly, the application of the Home Owners Equity Protection Act rules (requiring additional disclosures for high-cost mortgages) also apply to high-cost home equity lines of credit.

[13] Letter from Leonard J. Kennedy, General Counsel, Consumer Financial Protection Bureau to Chief Executive Officers of Financial Institutions under Section 1071 of the Dodd-Frank Act, April 11, 2011, *at* http://files.consumerfinance.gov/f/2011/04/GC-letter-re-1071.pdf.

III. CFPB and Small Financial Institutions

The creation of the CFPB has changed the regulatory landscape for consumer protection regulation, but the CFPB's impact on small banks is limited, and the CFPB has shown a particular solicitude toward the concerns of smaller financial institutions, such as community banks and credit unions, which are the source of a disproportionate share of small business lending.[14]

The CFPB's attention to small financial institutions is partially a matter of statute. The CFPB is required to identify and address "unduly burdensome regulations," which are a particular concern of smaller financial institutions.[15] As part of these safeguards against unduly burdensome regulation, the CFPB is required to:

- Consult with prudential regulators and State bank regulators in order to minimize the regulatory burden upon lending institutions.[16]
- Consult with the prudential regulators of small banks and credit when proposing regulations.[17] The prudential regulators are permitted to formally object to the rules and their written objections must be included in the rule-making record, along with the Bureau's response to their concerns.[18]
- Evaluate the potential impact of rules on small businesses under the Regulatory Flexibility Act.[19]
- Give small businesses a preview of new proposals and receive extensive feedback from small businesses before even giving notice to the broader public (under the Small Business Regulatory Enforcement Fairness Act).[20]
- Assess possible increases in the cost of credit for small entities and consider any significant alternatives that could minimize those costs.[21]
- Assess the effectiveness of each rule within five years of implementation, including soliciting public comments on whether to change or eliminate the regulations.[22]
- Finally, the CFPB also has the authority to exempt any consumer financial services provider from its rules.[23]

The CFPB's real attention to the concerns of smaller financial institutions is also a matter of agency culture. My observation from serving on the CFPB's Consumer Advisory Board is that the CFPB is an agency that is deeply committed, from the top down, to working with small financial institutions. Institutionally, the CFPB understands that small financial institutions play an important role in consumer protection through

[14] 57% of small business loans by dollar amount outstanding are on the books of depositories with less than $10 billion in assets. FDIC Statistics on Depository Institutions ($335 billion of $586 billion in small business credit outstanding is from institutions with less than $10 billion in assets)
[15] 12 U.S.C. § 5511(b)(3).
[16] 12 U.S.C. § 5513(b)(2)-(3).
[17] 12 U.S.C. § 5512(b)(2)(B).
[18] 12 U.S.C. § 5512(b)(2)(C).
[19] 5 U.S.C §§ 603, 604.
[20] 5 U.S.C §§ 603, 609; Executive Order 12866 of September 30, 1993.
[21] 5 U.S.C. § 603.
[22] 12 U.S.C. § 5512(d).
[23] 12 U.S.C. § 5512(b)(3)(A).

fostering greater competition, particularly along the lines of providing better service and simpler products for consumers. Moreover, small financial institutions play a particularly important role in consumer finance in smaller and rural communities. Thus, the CFPB has created an important exemption from the ability-to-repay requirement for mortgages for smaller financial institutions.[24]

Because of the importance of small financial institutions to consumer finance, the CFPB has set up special community bank and credit union advisory boards—not required by statute—so that it gets regular feedback directly from small banks themselves, not simply from trade associations. When CFPB leadership travels outside of Washington, a routine and important part of the agenda are meetings with the officers of small financial institutions.

The CFPB's outreach to smaller financial institutions is particularly important because the CFPB does not have much formal direct contact with small depositories and credit unions. Of the roughly 14,000 depositories and credit unions in the United States, only around 111 of them (those with over $10 billion in net assets in the holding company) are subject to examination by the CFPB. The rest—all small depositories—are examined for consumer protection compliance by their prudential regulators: the FDIC, the Federal Reserve Board, the NCUA, and the OCC.

While this spares smaller institutions the burden of having to deal with two separate examinations, it also means that there is no direct communication between the CFPB and these smaller institutions. Instead, what the CFPB expects in terms of regulatory compliance is communicated indirectly through the examiners from the prudential regulators. In theory, all of the examinations should be coordinated through the Federal Financial Institutions Examination Council, but it is possible, particularly as new regulations go into effect, that the lack of a direct communication channel through the examination process has made it harder for small financial institutions to understand what is—and is not—required of them.

In short, the CFPB is an agency that is very attuned to the concerns of small institutions. This is not to say that the CFPB would or should always agree with these concerns, but it is clearly an agency that is listening with an open mind and trying to balance its statutory charges of consumer protection and access to financial services with the particular needs of smaller financial institutions.

IV. Durbin Interchange Amendment

The Durbin Interchange Amendment to the Dodd-Frank Act regulates the interchange or "swipe" fees that banks can charge on debit card transactions.[25] While parts of the Durbin Amendment apply to all financial institutions, depositories with less than $10 billion in net assets are exempt from the Durbin Amendment's cap on

[24] 12 C.F.R. § 1026.43(e)(5); 1026.35(b)(2)(iii)(B)-(C) (exempting from the QM debt-to-income ratio requirement loans held in portfolio and made by creditors that originate less than 500 mortgages annually and have less than $2 billion in net assets).

[25] 15 U.S.C. § 1693o-2.

interchange fees.[26] The result is to give smaller financial institutions a significant leg up against their larger competitors.

The Durbin Amendment has also helped consumers and small businesses significantly. A recent study estimates that last year the Durbin Amendment saved consumers $5.8 billion in lower costs for goods and services and saved merchants $2.6 billion, which translates into roughly 38,000 new jobs.[27] Taken as a whole, then the Durbin Amendment seems to have benefitted consumers, small businesses, and also small financial institutions.

V. Basel III

In the wake of the financial crisis, bank regulators globally recognized the need to craft more stringent capital requirements for depositories and their holding companies. One of the most fundamental lessons of the financial crisis is that capital is key. Sufficient capital is the only real guarantee that a bank can absorb losses.

The third round of the Basel Capital Accords (Basel III) is an attempt to take this lesson to heart. Basel III creates a more detailed and demanding system of bank capital requirements for US banks and their holding companies. The Basel III rules are not perfect. They are too complex and too gameable because of a continued reliance on risk-weighting. They also still require too little capital and liquidity for banks. In particular, the leverage ratio—the bottom line and simplest measure of capital—is still far too low at 3%.

The proposed US implementation of Basel III,[28] which goes into effect as of January 1, 2015 for most banks and bank holding companies, generally requires more capital for banks. It also defines capital more stringently. These are both good things, and neither should affect financial institutions' willingness to lend. Heightened capital requirements do not limit the amount of lending a bank can do—they are not reserve requirements. Instead, capital requirements merely require that banks be less leveraged. To the extent that a bank is less leveraged, it is less risky, which means that there is less chance that the public will be asked to pick up the tab. Greater capital requirements help move us away from the faux capitalism world of privatized gains and socialized losses.

While Basel III was in reaction to the financial crisis, which was first and foremost a large bank crisis, it applies to all banks. This is the correct approach. While no individual small bank is likely to pose a systemic risk, small bank failures are still costly for the FDIC. Requiring greater capital makes these failures less likely.

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[26] 15 U.S.C. § 1693o-2(a)(6)(A). Smaller financial institutions are still subject to the Durbin Amendment's routing exclusivity provision, but the Federal Reserve rulemaking currently in place does not meaningfully change pre-existing routing arrangements for most debit cards.

[27] Robert J. Shapiro, *The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees*, Oct. 1, 2013, *at* http://21353cb4da875d727a1d-ccea4d4b51151ba804c4b0295d8d06a4.r8.cf1.rackcdn.com/SHAPIROreport.pdf.

[28] Basel III is a non-binding set of coordinated principles agreed to by bank regulators from leading developed economies, in order to head off international arbitrage of regulatory capital standards, but there is room for variation in the actual national-level implementations, which are done via notice-and-comment rulemaking.

There will certainly be one-time costs of understanding the complicated new requirements and implementing proper compliance systems. Beyond that, however, it is hard to identify any provisions that are especially onerous on small banks,[29] although it is notable that Basel III applies to small banks, but not to credit unions.

The limited impact of Basel III on small banks is partially because Basel III left intact some key features of Basel I/II: the total risk-weighted capital ratio remains at 8%, and the leverage ratio remains at 4%. And key asset categories for smaller financial institutions, such as all residential mortgage loans and most commercial real estate loans retain the same risk-weighting.

Basel III's impact on small banks is also limited because the US Basel III rules contain numerous exceptions or exemptions for smaller financial institutions. Significantly, trust preferred securities (TruPS) and cumulative preferred stock issued before May 19, 2010 may still count for Tier 1 capital for institutions with less than $15 billion in assets. Similarly, all institutions with less than $250 billion in assets may keep opt to continue their current regulatory capital treatment of accumulated other comprehensive income (AOCI), which would mean keeping available-for-sale securities on balance sheet without having to adjust regulatory capital levels based on the securities' current market value. And bank holding companies with less than $500 million in assets are entirely exempt from Basel III (their depository subsidiaries must still comply). As a result, the FDIC estimates that 95% of insured depositories already have sufficient capital to comply with the final Basel III rules.[30]

Conclusion: The Multi-Tiered Financial Regulatory System

The past five years have seen remarkable change in the regulation of the financial services industry, starting with the CARD Act of 2009 and continuing through the Dodd-Frank Act and subsequent and still on-going regulatory implementation. On the whole, this regulation addressed serious problems in our financial regulatory system, particularly in regard to consumer protection and bank safety-and-soundness.

The new financial regulations, taken as a whole, are not perfect. In some areas regulation may have gone too far, in other areas not far enough, and in yet other areas, simply taken the wrong approach. I make no claim in this testimony that all the changes in the financial regulatory system have been optimal. Instead, looking at the regulatory changes as a whole, what one sees is the emergence of four-tiered financial regulatory system: big banks and big non-banks; small banks; big non-banks; and small non-banks.

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[29] Basel III did restrict the definition of what can qualify as capital and increased requirements for more finely tuned sub-ratios. In addition, Basel III creates the concept of a "capital conservation buffer" that will, after a phase in, be an additional 2.5% of risk-weighted assets. The capital conservation buffer is not a formal capital requirement—banks are not required to have a capital conservation buffer. The capital conservation buffer will function as a type of de facto capital requirement, however, because any bank that fails to have a capital conservation buffer will be subject to restrictions on dividends, share repurchases, and interest payments on preferred securities, and executive bonus payments. Basel III also caps the inclusion of mortgage servicing and deferred tax assets in capital. Both provisions are potentially burdensome, but not unduly so.

[30] 78 Fed. Reg. 55340, 55347 (Sept. 10, 2013).

In this four-tiered regulatory system, big banks are subject to stricter capital requirements; to examination and enforcement of consumer financial protection statutes by the CFPB; and to debit interchange fee caps. Small banks have looser capital requirements; have consumer protection examination and enforcement done by their prudential regulators instead of by CFPB; and are exempt from debit interchange fee caps. Small banks may also benefit from various exemptions to consumer financial protection statutes. Big non-banks may be subject to capital requirements (if systemically important) and may subject to CFPB examination (if defined by regulation as "larger participants" in their product market). Small non-banks are not subject to capital requirements or CFPB examination, although all non-banks are subject to CFPB enforcement. (Non-banks do not receive debit interchange fees.)

The multi-tiered system has the effect of tilting the competitive playing field toward smaller financial institutions, whether they are banks or non-banks. Even with a tilted regulatory playing field, however, smaller financial institutions are still often at a competitive disadvantage to larger institutions because of the economies of scale that can exist in technology-heavy areas of financial services. There will be compliance costs from any changes in regulation, and some regulations will result in lower revenue for financial institutions. Ultimately, marginal changes in regulatory compliance costs are not what will determine the viability of smaller financial institutions, and no institution's profitability should depend on being able to take advantage of consumers or the ability to gamble with federally insured deposits. Financial regulation has costs for financial institutions, but these costs should not obscure the real and valuable social benefits of consumer protection, competitive markets, and safe-and-sound banks.