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RANKING MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Subcommittee on Economic Growth, Tax and Capital Access, Committee on Small Business
From: Committee Staff
Date: June 6, 2016
Re: Subcommittee Hearing: "*Bearing the Burden: Over-regulation's Impact on Small Banks and Rural Communities*"

On Thursday, June 9, 2016, at 10:00 am, the Subcommittee on Economic Growth, Tax, and Capital Access of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building to examine the effects of banking regulations on small, community banks. Specifically, this hearing will focus on the impact that these regulations have had on rural communities.

I. Introduction

Between December of 2007 and June of 2009, the United States experienced the longest recession since World War II.[1] While the recession officially ended in 2009, the United States economy has continued to feel its effects. Unemployment peaked several months after this official end, with a rate of 10 percent.[2] While this number has since ticked down, the nation's labor participation rate has continued to grow worse. In May 2016, the labor force participation rate dropped to just 62.6 percent, several percentage points lower than even the height of the recession.[3]

Among the causes of the recession were the collapse of 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,

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[1] http://www.nber.org/cycles/sept2010.pdf.
[2] http://data.bls.gov/timeseries/LNS14000000.
[3] http://data.bls.gov/timeseries/LNS11300000. During the recession, the labor force participation rate averaged 65.9 percent, with the lowest recording in March 2009 at 65.6 percent.
[4] *See The Origins of the Financial Crisis: Crash Course*, THE ECONOMIST, Sep. 7, 2013, *available at* http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article; *see also* Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 23, 2008, *available at* 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.

Ben Bernanke, to express 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

In response to this distrust of banks and calls for regulation, the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (hereinafter "Dodd-Frank")[8] was enacted in an attempt to prevent another collapse of the financial system. This law has proved to be highly controversial. Proponents have touted greater consumer protection, while others have raised concerns over the scale of the regulations that have been issued as a result, and the effect those regulations have had on small banks.

Dodd-Frank requires agencies to adopt nearly 400 new rules, and as of the end of 2015, 267 had been finalized with an addition 40 proposed.[9] These new rules have created over $20 billion in compliance costs, and over 60 million paperwork burden hours, with the promise of more still to come.[10] Generally, regulatory burdens and compliance costs are greater for small firms that have less revenue and a small employee base to spread over costs.[11] Given this, small financial institutions such as community banks have been forced to bear a severe regulatory burden.

When Dodd-Frank was drafted, attempts were made to spare small financial institutions, which did not significantly contribute to the financial crisis, from harmful regulations.[12] The law creates different categories of banking organizations and applies different regulatory requirements to these categories.[13] However, as noted by Federal Reserve Board Governor Daniel Tarullo, these

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[6] *See, e.g,.* Damian Paletta, Greg Ip, & Michael M. Phillips, *Paulson Plan Begins Battle Over How to Police Market*, WALL ST. J., March 31, 2008, *available at* http://www.wsj.com/articles/SB120675834275673863; Brian W. Walsh & Ryan O'Donnell, *Congress's Investigation into the Subprime Mortgage meltdown: The So-Called Search for the Truth*, THE HERITAGE FOUNDATION, Oct. 27, 2008, *available at* http://www.heritage.org/research/reports/2008/10/congresss-investigation-into-the-subprime-mortgage-meltdown-the-so-called-search-for-the-truth; Chairman Ben. S. Bernanke, Speech at the Federal Reserve Bank of Boston 54th Economic Conference: Fiancial Regulation and Supervision after the Crisis: The Role of the Federal Reserve (October 23, 2009), *available at* 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] DAVIS POLK, DODD-FRANK PROGRESS REPORT 2, 4 (4th Qtr. 2015), *available at* http://www.davispolk.com/sites/default/files/Q32015_Dodd.Frank_.Progress.Report.pdf.

[10] 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.

[11] 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.

[12] Under Dodd-Frank and the Federal Deposit Insurance Corporation, exemptions for small financial institutions apply to those with under $10 billion in assets. This is significantly larger than most community banks, especially in rural areas, that often have assets under $100 million.

[13] Daniel K. Tarullo, Governor, Bd. of Governors of the Fed. Reserve Sys., 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.

exemptions still have left a "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."[14]

As Dodd-Frank regulations have been implemented, small banks have, in fact, felt an increased regulatory burden.[15] Compliance costs associated with new regulations are making it more difficult for community banks to survive.[16] In fact, over 80 percent of small banks have reported seeing their annual compliance costs increase at least 5 percent.[17] As more money is spent on regulatory costs, the real world consequence is less capital available for customers, entrepreneurs, and small businesses.[18]

III. Effect on Rural Communities

As regulations are imposed on community banks, the effects of these restrictions are felt throughout the community.[19] Small businesses and low-income consumers who have few, if any, alternatives to bank credit have paid the price for increased bank regulations.[20] This effect is felt acutely in rural communities where a small, community bank could be the only local option. The advantage of a community bank in a rural community is its ability to understand the unique markets of an area and provide flexible services.[21] It is not surprising, therefore, that some rural industries, such as agriculture, overwhelmingly favor community banks for their lending needs.[22]

Along with providing over 48 percent of small business loans, community banks provide 44 percent of all farmland lending and all farm lending.[23] The imposition of "one size fits all" regulations forces banks to conform to a system that may not fit their community, and in turn force the banks to alter or abandon valuable services. The impact of these lost services on a local community can be quite large.

Though the recession may have officially ended in 2009, its harsh effects are still being felt in rural America.[24] Specifically, rural communities are not seeing new businesses develop within

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[14] *Id.*

[15] *See Financing Main Street: How Dodd-Frank is Crippling Small Lenders and Access to Capital: Hearing Before the Subcomm. on Econ. Growth, Tax and Capital Access, H. Comm. on Small Business*, 114th Cong. (2015).

[16] *See* Preston Ash, Cristoffer Koch and Thomas F. Siems, *Too Small to Succeed?- Community Banks in a New Regulatory Environment*, FINANCIAL INSIGHTS, (Federal Reserve Bank of Dallas) Dec. 31, 2005, 1, *available at* http://www.dallasfed.org/assets/documents/banking/firm/fi/2015/fi1504.pdf (hereinafter "DallasFed").

[17] Hester Pierce, Ian Robinson, & Thomas Stratmann, *How Are Small Banks Faring Under Dodd-Frank* 34 (Mercatus Center, Working Paper 2014), *available at* http://mercatus.org/sites/default/files/Peirce_SmallBankSurvey_v1.pdf (hereinafter "Mercatus Center").

[18] *See* Frank Keating, *Trickle-down Regulation is a Real-life Problem*, THE HILL (Feb. 2, 2015).

[19] A survey conducted by the Independent Community Bankers of America found that 73 percent of community banks point to regulatory burdens as preventing them from making more residential mortgage loans. *See* http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=190663.

[20] *See* 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.

[21] *See* DallasFed, *supra* n. 16, 3-4.

[22] *Id*. Whereas community banks represent just 19 percent of total commercial-bank assets, they account for 75 percent of agricultural loans.

[23] Mercatus Center, *supra* n. 17, 11.

[24] *See* Jim Tankersley, *A Very Bad Sign for All But America's Biggest Cities*, WASH. POST, May 22, 2016, https://www.washingtonpost.com/news/wonk/wp/2016/05/22/a-very-bad-sign-for-all-but-americas-biggest-cities/.

their local economies. Past recoveries from recessions had been fueled by new business establishment – new firms opening up to provide jobs and create new opportunities. The first five years following the recessions of the early 1990's and early 2000's saw business establishment increase at rates of 6.7 percent and 5.6 percent respectively, yet between 2010-2014, business establishments have increased at a rate of just 2.3 percent.[25] However, that 2.3 percent increase is itself misleading, as even this meager growth is not being felt in rural communities.

Just 20 counties in the country, all located near large metropolitan centers, have been responsible for half of all net new businesses established since the recession.[26] By contrast, 59 percent of counties saw more businesses close between 2010-2014 than open.[27] The 2.3 percent national average is actually 4.8 percent for counties with a population over one million, but for rural counties with a population under 100,000, there has been a decrease in the rate of business establishment of about 1 percent.[28] As credit availability has become more restricted in these communities, rural entrepreneurs have not been able to put together the tools needed to start and grow a business, and improve the local economy.

IV. Conclusion

In the aftermath of the recession from 2008-2009, hundreds of new regulations were imposed on the nation's financial institutions. These regulations were meant to target the institutions that were seen as causing many of the events that led to the recession. Whatever the intentions behind these regulations may have been, the effect has been that many of the smallest financial institutions, our community banks, have borne a harsh regulatory burden. Regulations have hampered the ability of these banks to serve their communities, and nowhere is this more apparent than in rural areas.

Rural communities have had an especially difficult time rebounding from the recession. The job gains and economic recovery that may have been felt in other areas of the country have not been realized in rural counties. This hearing will look at banking regulation with a specific focus on rural communities in order to ascertain what effects these regulations have had on often overlooked areas of our nation.

[25] http://eig.org/wp-content/uploads/2016/05/recoverygrowthreport.pdf. Page 4
[26] *Id*. at 9.
[27] *Id.* at 6. By comparison, during the recovery in the 1990s, only 17 percent of counties continued to see a net decline in business establishments, and in the 2000s recovery, only 37 percent continued to see a net decline.
[28] *Id.* at 23.