Testimony before the U.S. House Committee on Small Business Subcommittee on Economic Growth, Tax and Capital Access

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Hearing Titled: "How Dodd-Frank is Crippling Small Lenders and Access to Capital"

Delivered to the Subcommittee on September 17, 2015

Chairman Rice, Ranking Member Chu, and members of the Subcommittee, thank you for the opportunity to speak before you today. In doing so, I will draw heavily from "The State and Fate of Community Banking," a working paper I co-published in February 2015 as a Senior Fellow at the Mossavar-Rahmani Center for Business & Government at Harvard University's John F. Kennedy School of Government with Robert Greene, a Research Assistant at the Center who is seated behind me today. Before I begin, let me make clear that the views expressed here today do not necessarily reflect those of any organization that either Robert Greene or I are affiliated with, and instead stem from independent scholarly research we have undertaken to understand the critical issues facing America's financial system.

The Critical Role of Community Banks in Small Business Lending

Capital access for small businesses remains a critical pillar of economic vitality. Members of this committee are likely aware that small businesses account for approximately one-third of enterprise employment.[1] But the current size of a business matters much less than its potential to expand, and capital access is critical to achieving such growth.

As of 2012, banks were the primary financial institution for over 85 percent of small businesses.[2] In our February working paper, Mr. Greene and I found that an astonishing 51 percent of small business bank loans were from community banks.[3]

Why is this? Community banks leverage interpersonal relationships in lieu of financial statements and data-driven models in making lending decisions.[4] As Fed Governor Daniel

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[1] Anthony Caruso, U.S. Census Bureau, Economics & Statistics Administration, U.S. Department of Commerce, *Statistics of U.S. Businesses Employment and Payroll Summary: 2012* (Feb. 2015).
[2] Karen Mills & Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game" (General Management Unit Working Paper No. 15-004, Harvard Business School, July 2014), 17.
[3] Marshall Lux & Robert Greene, "The State and Fate of Community Banking" (Mossavar-Rahmani Center for Business & Government, John F. Kennedy School of Government, Harvard University, M-RCBG Associate Working Paper Series, Working Paper No. 37, Feb. 2015), 11.

Tarullo has noted: "[C]redit extension to smaller firms is an area in which the relationship-lending model of community banks retains a comparative advantage. It means that community banks are of special significance to local economies." [5]

Recent Trends in Community Bank Small Business Lending

Yet the state of community bank small business lending today is different than that of several years ago. For starters, the number of community banks (banks with less than $10 billion in assets) has declined rapidly in recent years. In mid-1994 there were 10,329 and in mid-2014 there were only 6,094.[6] Similarly, since 1994, community banks' share of U.S. banking assets has decreased by more than half to 18 percent (SEE FIGURE 1).[7]

Most concerning to this subcommittee is the post-crisis decline in the volume of bank loans to small businesses (SEE FIGURE 2).[8] In the four years before the crisis (from mid-2003 to mid-2007), outstanding bank loans to small businesses grew 25 percent overall, and 15 percent at community banks.[9] Yet outstanding bank loans to small businesses have declined 10 percent between mid-2010 and mid-2014, and much of this decline is attributable to small community banks (defined as banks having $1 billion or less in assets), which realized a 17 percent fall.[10] During this time, small business lending by larger community banks remained relatively flat.[11]

What factors are at play here? Non-bank lenders, while growing rapidly and increasingly playing a valuable role in both credit markets and the overall U.S. economy, have and will only fill only some of the gaps left in the wake of less community bank small business lending. The vast share of small business lending is still performed by banks,[12] so while these non-bank firms and technology-based platforms are a factor, community banks will remain a critical part of small business lending markets even if, or as, the market share of alternative credit sources grows rapidly.

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[4] *See* U.S. Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rulemakings*, GAO-12-881, September 2012, 17-18.
[5] Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System (speech at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, Ill., May 8, 2014).
[6] Lux & Greene, *supra* note 3, at 15. There were 6,937 community banks in mid-2010, meaning that the number of community banks declined 12 percent between mid-2010 and mid-2014. FDIC, *Statistics on Depository Institutions, All SDI Data* (calculation by Marshall Lux & Robert Greene).
[7] Lux & Greene, *supra* note 3, at 15. In mid-1994 community banks held 41 percent of U.S. banking assets. *Ibid*.
[8] Small business loans are defined as the sum of loans "secured by nonfarm nonresidential properties with original amounts less than $1,000,000" and "currently outstanding commercial and industrial loans less than $1,000,000 held in domestic offices." *See* FDIC, Statistics on Depository Institutions, SDI Map & Definitions (accessed Sep. 14, 2015); Small Business Administration, *Small Business Lending in the United States 2013* (Dec. 2014).
[9] FDIC, *Statistics on Depository Institutions, All SDI Data* (calculation by Marshall Lux & Robert Greene).
[10] *Ibid* (calculation by Marshall Lux & Robert Greene).
[11] Community banks with $1 billion or more realized a 0.8 percent decrease in small business loans outstanding between mid-2010 and mid-2014. *Ibid* (calculation by Marshall Lux & Robert Greene).
[12] *See* Mills & McCarthy, *supra* note 2, at 42.

Instead, a major cause of decreased community bank small business lending is our nation's tepid economic recovery: labor force participation is at a 10-year low[13] and quarterly GDP growth has averaged at just 2.5 percent for the last 2 years.[14] An August 2015 survey of small businesses by the National Federation of Independent Businesses (NFIB) reinforces this concern: it finds that 49 percent of respondents were on the "credit sidelines" with "no good reason to borrow."[15]

But the most troubling factor is that firms seeking credit may be unable to access it. As former Small Business Administration head Karen Mills recently noted, while measuring the credit gap is difficult, the evidence "strongly suggests" that there are "acute impediments" to accessing capital for many creditworthy small businesses.[16]

How Is Dodd-Frank Impacting Community Banks and Small Business Credit Access?

Dodd-Frank shrinks credit access because of its sheer scope; it stands to increase financial regulatory restrictions by 32 percent.[17] As a recent paper published by the Federal Reserve Bank of Richmond notes, "banking scholars [] have found that new entries are more likely when there are fewer regulatory restrictions."[18] The current lack of new bank formation[19] inherently hampers credit access. Furthermore, a recent ICBA survey found that 21 percent of banks report new regulatory burdens as a factor in preventing commercial lending.[20] Also, according to another recent survey, for 83 percent of small banks compliance costs have increased at least 5 percent since the passage the Dodd-Frank Act.[21] That is capital not being deployed in our economy.

Some will argue that because consolidation has occurred for quite some time, Dodd-Frank is not a factor in declining community bank lending. But in fact large-scale regulatory accumulation within the banking sector has simultaneously occurred with rapid consolidation; regulatory restrictions within Title 12 of the Code of Federal Regulations – which regulates

[13] Bureau of Labor Statistics, U.S. Department of Labor, Labor Force Statistics from the Current Population Survey, Seasonally Adjusted Labor Force Participation Rate (accessed Sep. 14, 2015).
[14] Bureau of Economic Analysis, U.S. Department of Commerce, National Economic Accounts (accessed Sep. 14, 2015).
[15] William C. Dunkelberg & Holly Wade, *NFIB Small Business Economic Trends* (Aug. 2015), 4
[16] Karen Mills, "Is A Gap In Small-Business Credit Holding Back The American Economy?," *Forbes* (Jul. 2014)
[17] Patrick McLaughlin & Robert Greene, "Dodd-Frank's Regulatory Surge: Quantifying Its Regulatory Restrictions and Improving Its Economic Analyses" (Mercatus on Policy, The Mercatus Center at George Mason University, Feb. 2014) (using RegData to measure regulatory restrictions, which are defined as "words that indicate an obligation to comply, such as 'shall' or 'must'").
[18] Roisin McCord, Edward Simpson Prescott & Tim Sablik "Explaining the Decline in the Number of Banks since the Great Recession" (Economic Brief 15-03, The Federal Reserve Bank of Richmond, Mar. 2015), 4.
[19] *See ibid*, at 1 (there was only one newly formed U.S. bank in 2013, and no new banks formed in 2012).
[20] Independent Community Bankers of America, *2014 ICBA Community Bank Lending Survey* (Jan. 2015), 3
[21] Hester Peirce, Ian Robinson & Thomas Stratmann, "How Are Small Banks Faring under Dodd-Frank?" (Working Paper 14-05, The Mercatus Center at George Mason University, Feb. 2014), 34.

banks and banking – grew every year between 1999 and 2008.[22] This regulatory accumulation is intuitively more costly for smaller institutions. As Fed Governor Tarullo notes: "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets."[23] How costly is it? A 2014 study published by the Minneapolis Fed finds that hiring just two additional personnel at small community banks results in one-third of these banks becoming unprofitable.[24]

What Does This Mean for Policy-Makers?

Reforming federal financial regulatory processes is critical to expanding small business credit access. Mr. Greene and I propose several strategies to do so in our working paper, one of which is requiring that financial regulators undertake robust economic analyses of financial regulatory rulemakings.[25] Cost-benefit analysis brings about transparent deliberation that enables regulators to avoid unintended regulatory costs to small businesses and other stakeholders.[26]

Another solution to expand small business credit access is to exempt community banks from certain rulemakings. Yet I urge the subcommittee to recognize that exemptions often fail to exempt – regulatory standards "trickle down."[27] For example, community banks have recently reported being held to the same stress test and capital standards as large financial institutions.[28] Similarly, almost half of responding community banks in a recent Mercatus Center survey report being impacted by the Durbin Amendment from which they are formally exempted.[29] So while it is appropriate to exempt community banks from the Volcker Rule and Section 956 compensation requirements,[30] a broader examination of our financial regulatory system and its ever-increasing regulatory restrictions is necessary. Future American economic vitality is at stake.

Conclusion

In conclusion, small businesses clearly play a critical role in bringing about heightened U.S. economic growth, and community banks today are, and for many years have been, essential sources of credit for these firms. The reliance upon community banks by small businesses stems

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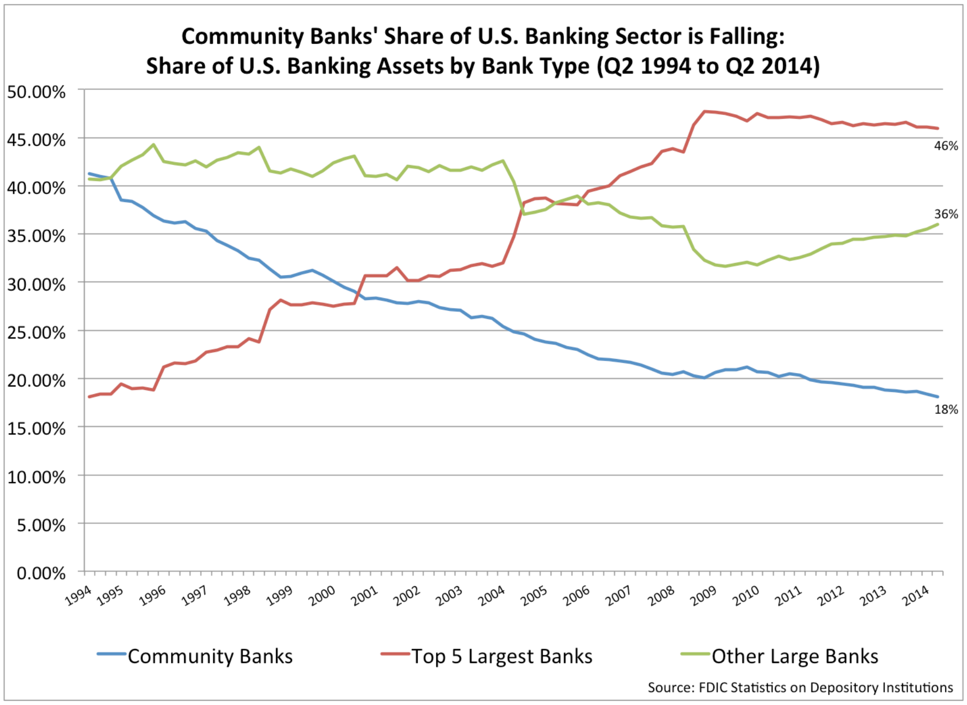
[22] Patrick McLaughlin & Robert Greene, "Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank" (The Mercatus Center at George Mason University, Jul. 2013). The authors use RegData to measure regulatory restrictions. For an explanation of RegData's methodology, *see supra* note 17.
[23] Tarullo, *supra* note 5.
[24] Ron Feldman, Ken Heinecke & Jason Schmidt, "Quantifying the Costs of Additional Regulation on Community Banks" (Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis, May 2013), 4-5.
[25] Lux & Greene, *supra* note 3, at 27-30.
[26] *See* Cass Sunstein, *Cost-Benefit Analysis and the Knowledge Problem*, Regulatory Policy Program Working Paper RPP-2015-03, Mossavar-Rahmani Center for Business & Government, John F. Kennedy School of Government, Harvard University, 2015); Eric A. Posner & E. Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation* (University of Chicago, Coase-Sandor Institute for Law & Economics, Working Paper No. 660, Oct. 2013).
[27] *See* Frank Keating, "Trickle-down regulation is a real-life problem," *The Hill* (Feb. 2, 2015).
[28] *See ibid*.
[29] Peirce et al., *supra* note 21, at 41.
[30] *See* Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System (speech at the Community Bankers Symposium, Chicago, Ill., November 7, 2014).

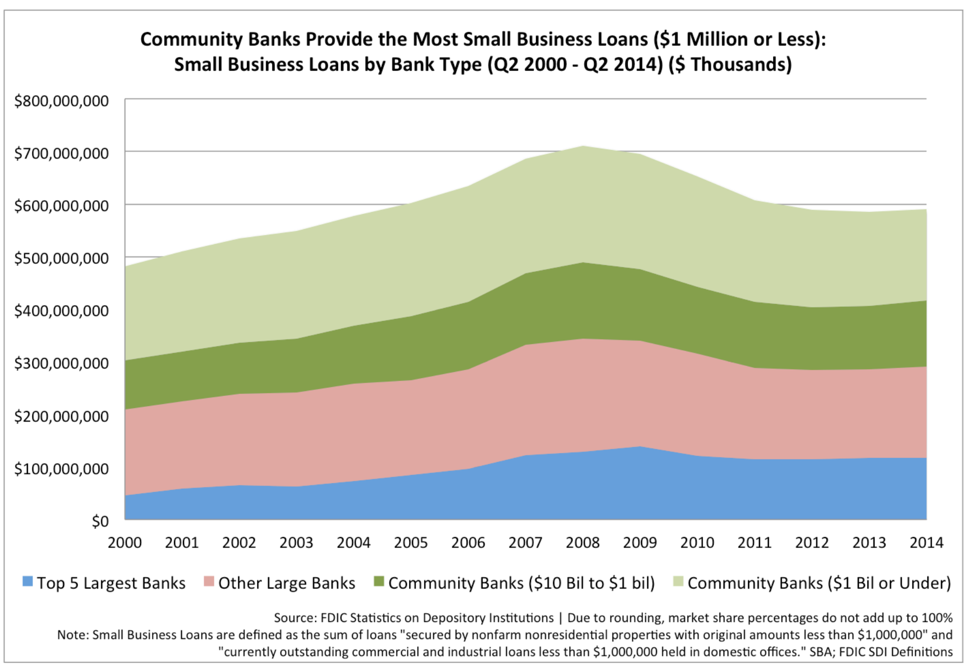
from a variety of factors: an emphasis on relationship-based business, non-standardized lending practices, and geographic necessity, to name a few. Certainly, market factors may diminish the role of the community bank in small business lending, and to the extent that occurs and credit demands continue to be met there is not reason for concern. Unfortunately, regulatory pressures – such as those brought about by Dodd-Frank – are undermining the competitiveness of community banks, preventing new community banks from forming, and curbing their ability to lend. This trend merits action. While cost-benefit analysis and exempting community banks from particularly burdensome rulemakings would be steps in the right direction, a broader effort to simplify and streamline U.S. bank regulation is best suited to curb this troubling trend that threatens the ability of American small businesses to access capital.

Figure 1



Source: Lux & Greene, *The State and Fate of Community Banking* (Feb. 2015)

Figure 2



Source: Lux & Greene, *The State and Fate of Community Banking* (Feb. 2015)