Hearing Before House Small Business Committee
Marcus Stanley
Policy Director
Americans for Financial Reform
Thursday, June 9, 2016

Chairman Heulskamp, Ranking Member Chu, and members of the committee, thank you for the opportunity to testify before you here today. My name is Marcus Stanley and I am the Policy Director of Americans for Financial Reform.[1]

Today's hearing asks us to consider the impact of the Dodd-Frank Act on small banks and rural communities. I believe that an unbiased consideration of the record leads to the conclusion that the overall impact of the Dodd-Frank Act on community bank lending has been very limited. At the same time, community banks clearly face long-term economic issues that have led to a significant decline in their number.

Regarding the relationship between Dodd-Frank and the economic well-being of community banks, I would like to make two broad points.

First, both long-term economic trends and the experience of the 2008 financial crisis and resulting Great Recession have put major pressures on the community banking sector. Neither of these factors should be ascribed to the Dodd-Frank Act, which is designed to prevent another harmful financial crisis and to protect consumers from abusive lending and financial practices.

Second, the period since the Dodd-Frank Act was passed in 2010 has been a period of economic recovery for community banks. Since 2010, the vast majority of community banks, over 95 percent, have returned to profitability. It is crucial to understand that the Dodd-Frank Act, both in its statutory language and its regulatory implementation, contains numerous exemptions that act to reduce regulatory impact on community banks and focus regulatory efforts on the larger banks and non-banks that were more central to the 2008 financial crisis. This focus on larger banks and on non-banks should in the long run help the competitiveness of community banks.

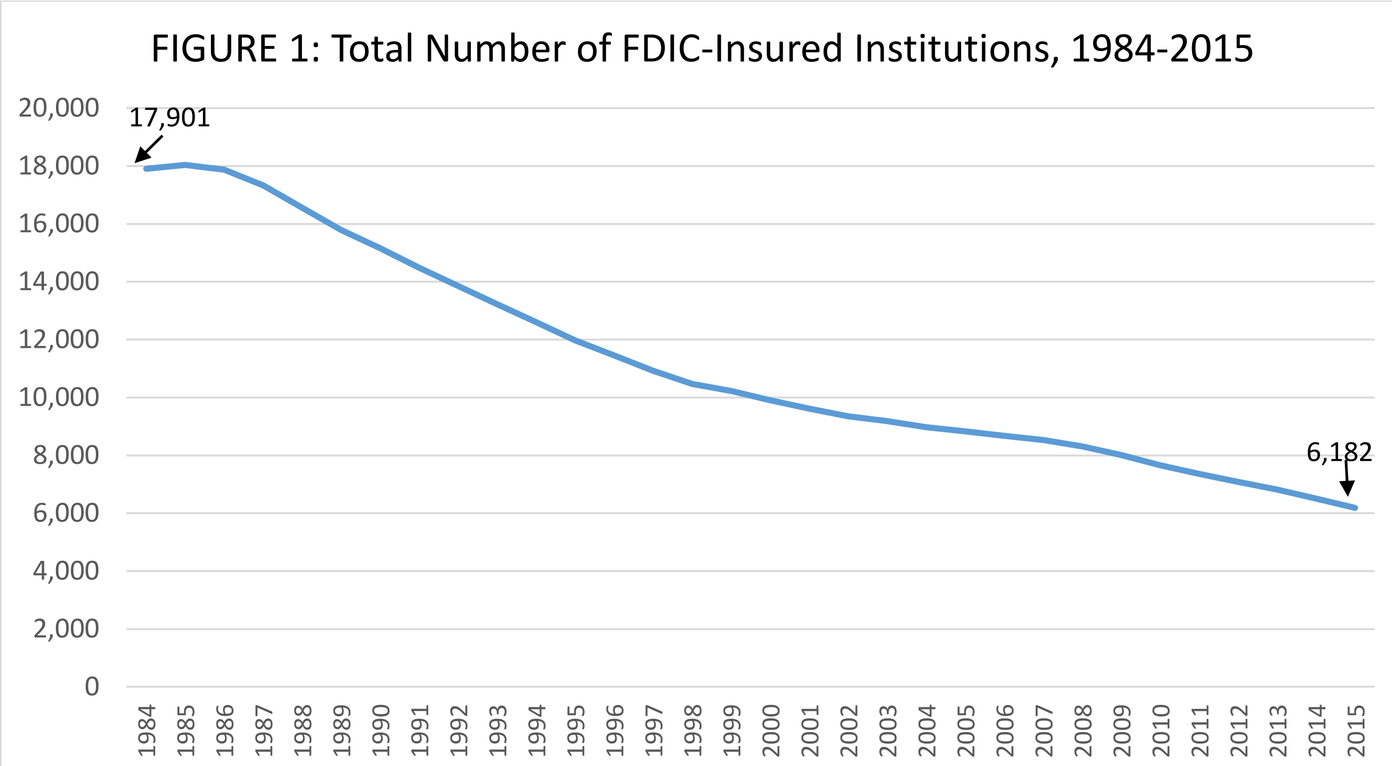
After discussing these two points, I will conclude with some thoughts on the broader issues related to small business lending and the recovery, including our concern that non-bank small business lenders are not competing on a level playing field with community banks.

<u>Economic Pressures on The Community Banking Sector Unrelated To Dodd-Frank</u>

Figure 1 shows the total number of FDIC-insured banks over the past 30 years. As the figure shows, the number of banking entities has been steadily declining, and this pattern long predates Dodd-Frank. The decline is centered among community banks. Indeed, the number of U.S. community banks has declined every single year since 1984. The declining number of community banks is entirely due to the decline in the number of small banks with under $1 billion in assets, with the majority of the issue

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

related to a declining number of extremely small banks with under $100 million in assets.[2] Banking scholars believe that long-term economic and regulatory changes, including changes in economies of scale for banking activities, as well as bank consolidation following deregulation during the 1990s (such as the Riegle-Neal Act of 1994), are important contributors to these declines.[3]



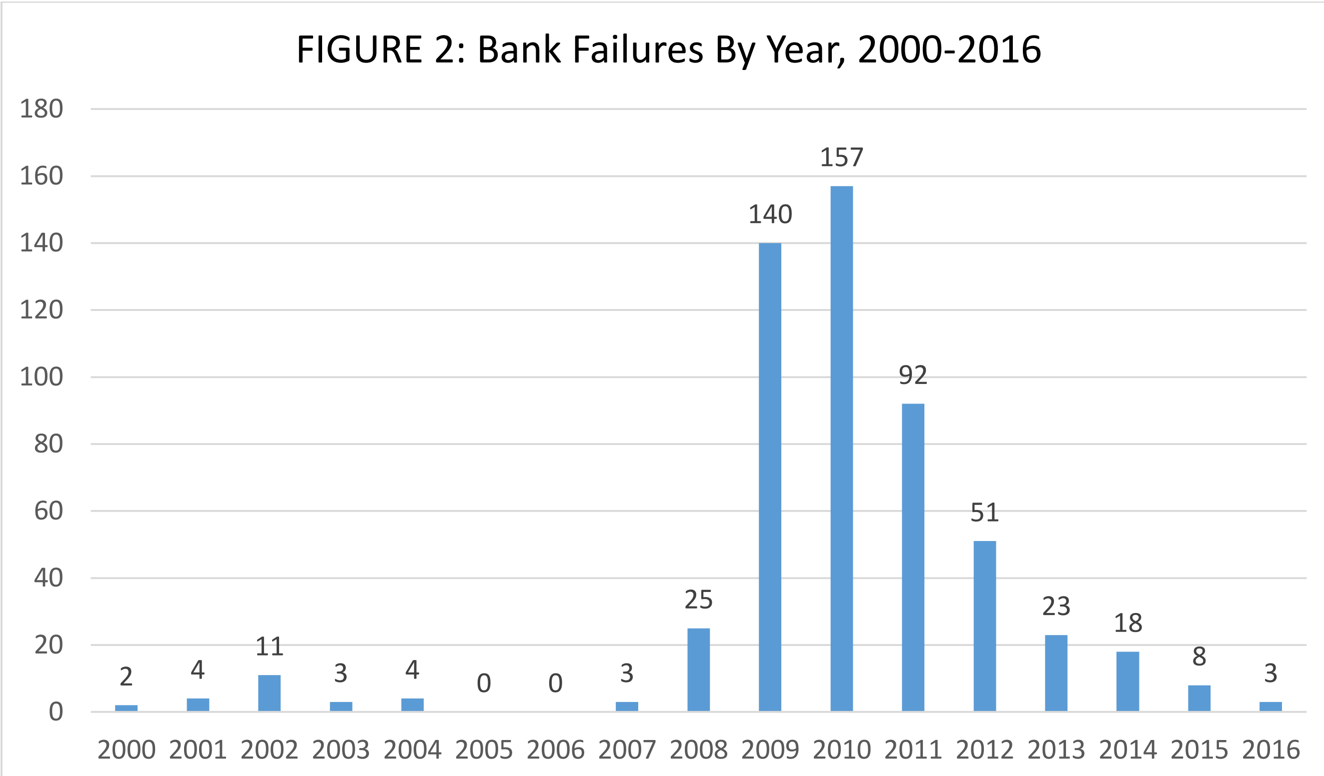
The impact of the 2008 financial crisis only accelerated these trends. The financial crisis had several interrelated effects. First, the failure rate of community banks significantly increased due to the fallout from the financial crisis. Figure 2 shows bank failures each year since 2000. As the financial crisis took hold in 2008, bank failures skyrocketed, reaching a high of 156 bank failures in 2010. Almost all of these failed banks were community banks, both because larger banks were often not permitted to fail and because community banks make up most of the banks in the U.S.

Over 400 banks failed between 2008 and 2011, or almost 5 percent of all the banks in the country. In contrast, only 26 banks total failed between 2000 and 2007. During the peak periods of the financial crisis, almost as many banks were failing in a month as failed in the entire eight years between 2000 and 2007. Only recently has the rate of bank failures returned to something like normal levels.

---

[2] FDIC Community Banking Study, Federal Deposit Insurance Corporation, December, 2012, available at https://www.fdic.gov/regulations/resources/cbi/study.html. See also more recent data from FDIC QBP.

[3] Jones, Kenneth D. and Tim Critchfeld, "Consolidation in the U.S. Banking Industry: Is the Long Strange Trip About to End?", FDIC Banking Review, Volume 17, No. 4, December, 2005. Available at https://www.fdic.gov/bank/analytical/banking/2006jan/article2/article2.pdf



These bank failures occurred for multiple reasons, including overexposure to commercial real estate acquired during the real estate bubble period and the general economic weakness resulting from the crisis. The failures put severe pressure on the Federal Deposit Insurance Commission (FDIC). The deposit insurance fund was completely drained, and at its low point reached a negative balance of almost $21 billion at the close of 2009.

As the custodian of the deposit insurance fund and the primary regulator of community banks, the FDIC was naturally motivated to seek out and address excessive risks among community banks in order to prevent unnecessary bank failures and losses to the deposit insurance fund. Thus, a second effect of the financial crisis was a substantial increase in FDIC supervisory oversight of banks. While there is some evidence that supervisory stringency did not increase by any more than would be justified by the generally weak economy, there is no question that it did increase.[4]

Another important change in FDIC supervisory practice appears to have occurred in relation to the granting of new (de novo) bank charters. Since the financial crisis, there has been a collapse in the number of new entrants into the banking system, with de novo charters dropping to almost zero. This decline in new entrants – not an increase in bank closings – has led the number of community banks to decline more rapidly in recent years than would otherwise have been expected.[5] While the decline in de

[4] Bassett, William F., "Estimating Changes in Supervisory Standards and Their Economic Effects", Federal Reserve Board Finance and Economics Discussion Paper No. 2012-55, August 24, 2012. Available at http://www.federalreserve.gov/pubs/feds/2012/201255/201255pap.pdf

[5] McCord, Roisin, Edward Prescott and Tim Sablik, "Explaining the Decline In The Number of Banks Since The Great Recession", Federal Reserve Bank of Richmond Economic Brief, March, 2015. Available at https: //www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf

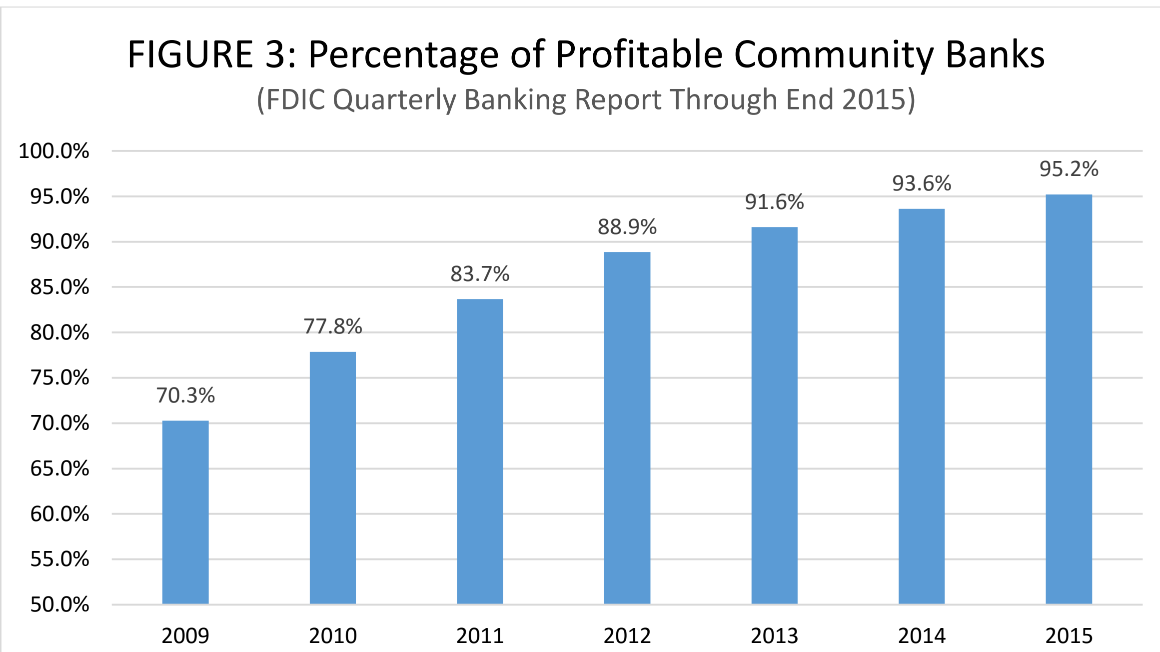
novo entrants is related to weak economic conditions and low interest rates, there have also been a number of changes in FDIC practices related to de novo entrance that likely contributed as well. These include a 2009 change in FDIC policy that significantly increased in the length of enhanced supervisory oversight following the granting of a new charter, and possibly also an increase in the length and intensity of the charter approval process.[6]

It is important to note that the changes referred to above are essentially *unrelated to the Dodd-Frank Act* and are the result of changes in economic conditions and regulatory practices that would have occurred *even if the Dodd-Frank Act had never passed.*

It should also be noted that there has been another supervisory change that is unrelated to either economic trends or to the Dodd-Frank Act, namely an increase in supervisory and legal enforcement of the Bank Secrecy Act and related anti money laundering (AML) provisions.[7] These changes may also increase compliance work at small banks. The Bank Secrecy Act was passed in 1970 and reflects concerns about money laundering, tax evasion, and criminal activities that long predate Dodd-Frank.

The Dodd-Frank Act and Community Banks

Since the passage of the Dodd-Frank Act in 2010, the profitability of community banks has significantly increased, as shown in Figure 3 below.



[6] "Enhanced Supervisory Procedures for Newly Insured Depository Institutions", FDIC Financial Institution Letters FIL 50-2009, August 28, 2009. Available at https://www.fdic.gov/news/news/financial/2009/fil09050.html. Peters, Andy, "Amish Bank Charter to Set Standard for Future Applications," American Banker, December 4, 2013.

[7] Paul Hastings Global Banking and Payment Systems Practice, "Key Trends in BSA/AML Compliance", Insights, April 14, 2015. Available at http://www.paulhastings.com/publications-items/details/?id=58f9e369-2334-6428-811c-ff00004cbded

As Figure 3 below shows, more than 95 percent of community banks were profitable over the full year of 2015, up from less than 78 percent in 2010, the year Dodd-Frank was passed. Average community bank return on equity has also increased every year since 2009, reaching 8.9 percent in 2015. In recent years loan growth at community banks has also outpaced loan growth at other types of banking institutions. Community bank loan growth reached 8.6 percent over each of the last two years, while loan growth at larger banks lagged at less than 6 percent.

Of course, these trends are more related to the economic recovery than to Dodd-Frank itself. But it certainly does not appear that Dodd-Frank has prevented community banks from taking advantage of the general economic recovery. A closer examination of Dodd-Frank and its relationship to community banks gives further reason to believe that this is the case. The Dodd-Frank statute is explicitly designed to exempt community banks from many of its major provisions. Even when the statute does not specifically exempt small banks, regulators have granted numerous small bank exemptions to key Dodd-Frank regulations.

There are too many explicit statutory exemptions for small banks in Dodd-Frank to easily list. Major exemptions include the following:

- Banks under $10 billion are exempted from all of the enhanced bank prudential standards laid out in Title I of Dodd-Frank, and banks under $50 billion are exempted from the great majority of them.

- The Commodity Futures Trading Commission was instructed to, and did, exempt small banks from most of the new derivatives oversight provisions, such as mandatory derivatives clearing and exchange trading, enacted in Title VII of Dodd-Frank.

- Banks under $10 billion are exempted from the examination authority of the Consumer Financial Protection Bureau. Their pre-Dodd Frank regulator continues to examine them for compliance with consumer laws.

- Banks under $10 billion are exempted from the direct effects of Dodd-Frank provisions regarding interchange fees (the ‘Durbin Amendment’).

In addition, numerous elements of Dodd-Frank simply do not affect small banks at all, such as provisions addressing investment advisors, insurance companies, investor protection, financial market utilities, Federal Reserve governance, and resolution of systemically important institutions.

Beyond the statutory focus on large banks and non-banks, regulators have also taken numerous steps to exempt smaller banks when implementing Dodd-Frank rules. Again, examples are too many to easily list, but some major instances include:

- The banking agencies have scaled new liquidity and capital requirements to bank size, with community banks entirely exempted from new liquidity requirements and subject to less stringent capital requirements.

- New derivatives margin rules include de minimis levels that effectively exempt community banks from most margin requirements.

- The Consumer Financial Protection Bureau (CFPB) has created significant exemptions from consumer and mortgage rules for small and rural lenders, including Qualified Mortgage (QM) rules, mortgage servicing requirements, and various escrow requirements.

- The banking regulators have set up a streamlined small bank compliance program for the Volcker Rule that effectively exempts almost all banks under $10 billion from Volcker Rule compliance burdens.

Beyond the numerous exemptions created for small banks, the focus in the Dodd-Frank Act on higher regulatory standards for large banks and increased regulatory coverage of non-banks, should in the long run help the competitiveness of community banks. Many provisions of Dodd-Frank are explicitly designed to ensure that large banks and non-banks are held to equal or higher regulatory standards as community banks. For example, Title I of Dodd-Frank requires that large banks be held to higher overall capital and prudential standards than small banks, and the Collins Amendment floors ensure that large banks will not be able to manipulate capital rules to hold lower levels of capital than smaller banks, as occurred prior to the financial crisis. The CFPB is explicitly charged with extending the coverage of consumer protections to non-bank financial entities.

With all this said, it is true that Dodd-Frank is a major regulatory reform that creates some direct and indirect effects for smaller banks. The 2008 financial crisis was the greatest financial system collapse since the Great Depression. The failure of regulatory oversight prior to the financial crisis created many trillions of dollars in avoidable economic costs, to community banks and rural areas as well as to many people in all parts of the country. The regulatory response to this crisis has been, and should be, a far-reaching one. While regulators have consistently sought to create appropriate small bank exemptions from the new regulatory requirements put in place in response to the financial crisis, the far-reaching reconsideration of financial risk management and consumer protection associated with Dodd-Frank and the new Basel rules will unavoidably have some impact on community banks. But a careful consideration of the implementation of Dodd-Frank and the economic record of the last several years shows that this impact is limited.

<u>The Economic Recovery and Small Business and Rural Lending</u>

I would like to conclude with some general thoughts on small business lending and the recovery, outside of Dodd-Frank. The evidence seems to show that the recovery of small business lending from the Great Recession has been slower and less complete than it should be. Surveys such as the Wells Fargo Small Business Index show that the proportion of companies reporting difficulties in obtaining credit is still elevated over pre-financial crisis levels.[8] Proxies for bank lending to small and rural businesses show that the absolute level of such lending has dropped somewhat compared to pre-crisis levels, and the proportion of lending going to small vs large businesses has declined even more.[9] In

[8] Wells Fargo Small Business Survey Top Line, Second Quarter 2016, available at https://wellsfargoworks.com/File/Index/gJdhq3IlPUG_VxjDIcqBLg

[9] FDIC data on loans to small businesses and farms, available at https://www.fdic.gov/bank/analytical/qbp/

general, the benefits of the economic recovery have been more concentrated in urban and highly populated geographic areas than has been seen in previous recoveries.[10]

These trends are almost certainly related to continuing economic weaknesses among non-financial small businesses. Business issues with customer demand and revenue will also affect credit availability, outside of any changes in credit supply. But it is also reasonable to look at what could be done to increase credit supply. This is especially true given the long-term pressures on community banking and the crucial role of community banks in providing high quality, relationship based small business lending.

As I have discussed above, I believe that looking to Dodd-Frank for the cause or solution of issues related to credit supply is misguided. However, there are other areas that this committee could and should consider. These include the possibility of expanding assistance to small business credit provided by the Small Business Administration and the Farm Credit System. In addition, given the crucial role of community banks in supporting small business lending, the Committee could examine additional ways to protect small banks from unfair competition by large 'too big to fail' banks.

I believe this Committee should also take a serious look at issues created by the rapid expansion of on-line lending to small businesses, a new area of non-bank competition with community banks. While on-line lending could be a valuable new source of credit, there is disturbing evidence that too much of such lending is marked by exploitative terms and excessive interest rates. For example, a recent joint study by seven regional Federal Reserve Banks found extremely high levels of dissatisfaction with on-line loans among small business borrowers.[11] Just 15 percent of small business borrowers expressed satisfaction with their treatment by on-line marketplace lenders, as opposed to 75 percent of those who borrowed from community banks. Sources of dissatisfaction included high interest rates, poor repayment terms, and non-transparent terms of the loan.

On-line marketplace lenders are not currently competing on a level playing field with community banks. Non-bank small business lenders are generally exempt from CFPB supervision and thus not subject to regulatory oversight concerning consumer protection while community banks are subject to oversight from banking regulators. Congress should consider empowering the CFPB with additional authority to do rulemaking and supervision in the small business lending space, particularly as it applies to non-bank small business lenders. This would go far to creating a level playing field for community banks and on-line marketplace lenders.

Thank you for the opportunity to testify before you today. I look forward to taking questions.

---

[10] Economic Innovation Group, "The New Map of Economic Growth and Recovery", May 2016. Available at http://eig.org/wp-content/uploads/2016/05/recoverygrowthreport.pdf

[11] Federal Reserve Bank of Cleveland, "2015 Small Business Credit Survey: Report on Employer Firms", March 2016, Available at https://www.clevelandfed.org/community-development/small-business/about-the-joint-small-business-credit-survey/2015-joint-small-business-credit-survey.aspx