

# Is the Dodd-Frank Act Responsible for the Economy's Slow Recovery from the Financial Crisis and the Ensuing Recession?\*

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## Abstract

*Since the financial crisis of 2008 and the ensuing recession, the U.S. economy has experienced a historically slow recovery. This paper argues that the reason for the slow recovery is the Dodd-Frank Act, enacted in 2010, which placed heavy regulatory costs and new restrictive lending standards on small banks. This in turn reduced the ability of these banks to finance small businesses, particularly the start-up businesses which are the engine of employment and economic growth. Large businesses have not been subject to the same restrictions because they have access to the capital markets, and their growth has been in line with prior recoveries. Research by others has shown that recoveries after financial crises tend to be sharper than other recoveries, not slower as some have suggested. It is likely that, without the repeal or substantial reform of Dodd-Frank, the U.S. economy will continue to grow only slowly into the future.*

## Introduction

How can we assess the effect on the economy of the Dodd-Frank Consumer Protection and Wall Street Reform Act (Dodd-Frank)? This gigantic law—clearly the most significant and costly regulation of the financial system since the New Deal—must be imposing some substantial costs, but how much and where? And are these costs balanced by commensurate benefits? Proponents claim, for example, that without Dodd-Frank we could be plunged back into a financial crisis. This is the argument advanced by Senator Elizabeth Warren, and judging by the coverage she gets in the media for these alarming statements a large number of otherwise intelligent people find these assertions credible.

Others have argued that the financial crisis was not caused by a lack of regulation but rather by the government's housing policy, which forced a deterioration in residential mortgage underwriting standards. Lower standards built a massive housing price bubble, and when the bubble eventually collapsed the rapid decline in housing and mortgage values endangered the stability and solvency of many financial firms that held these loans. The outcome was a financial crisis in 2008 and a deep recession that ended in June 2009.<sup>1</sup>

The winners write history, and the incoming administration of Barack Obama and the Democratic supermajority in Congress blamed the crisis on insufficient regulation of the private financial sector. This narrative, although factually unsupported, gave rise to the Dodd-Frank Act, which imposed significant new regulation on the US financial system but did virtually nothing to reform the government policies that gave rise to the financial crisis.

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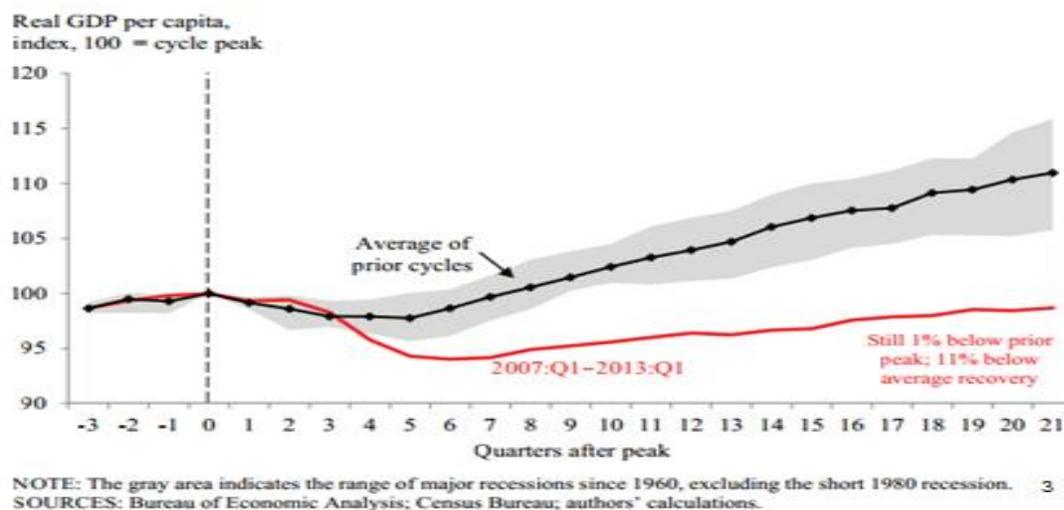
<sup>1</sup> The causes of the 2008 financial crisis, from beginning to end, are detailed in my book, *Hidden in Plain Sight: What Caused the World's Worst Financial Crisis and Why it Could Happen Again*, Encounter Books, 2015

Still, at bottom, the Warren position would be that no one has been able to show that the Dodd-Frank Act has done any particular harm, and therefore it would be risky to repeal the law when its provisions *might be* helpful in preventing another crisis.

It is true that there isn't sufficient data available to balance the costs and benefits of Dodd-Frank, but it may be possible to show that the law has been responsible for the slow recovery from the financial crisis and the recession that followed. In that case, the claimed but unproven benefits of Dodd-Frank would have to be weighed against this slow recovery, and the likelihood that if Dodd-Frank remains in place the weakness in the US economy since 2010 will continue.

Dodd-Frank became a law on July 21, 2010. It is important to keep this date in mind, because it is the after-effects of the law that are of interest. The chart below was prepared by the Federal Reserve Bank of Dallas<sup>2</sup> and shows the quarter-by-quarter growth of the US economy from before the crisis to the second quarter of 2013. The gray area is the range, and the black line is the average, of prior cycles. The chart shows that the current recovery—the line below the shaded area—is far weaker than the range and average of prior periods.

### The recovery from the 2008 crisis and recession compared to previous recoveries.



Correlation is not causation, of course, so the question is whether there is a plausible causal connection between the Dodd-Frank Act and the slow recovery from the financial crisis.

Demonstrating such a connection is difficult; there is no data that does this effectively. What we can do, however, is to make clear how Dodd-Frank regulation could have caused or contributed to the slow growth in the economy. This paper, accordingly, points to Dodd-Frank's extensive regulatory burdens on small banks—the 98.5 percent of all banks that have assets of \$10 billion or less—as the source of the slow recovery. We posit that these costs and the strict

<sup>2</sup> Adapted from Tyler Atkinson, David Luttrell, and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis," *Staff Papers* no. 20, July 2013.

one-size-fits-all lending standards that have been imposed by regulators under Dodd-Frank have reduced the productivity, raised the operating costs, and limited the amount of credit that small banks could provide to small business borrowers—especially the small business startups that are largely responsible for increased jobs and economic growth.<sup>3</sup>

If this analysis is correct, we should see that firms which can access the capital markets—and are not dependent on bank lending—have been growing at a pace that is consistent with most other recoveries. The data shows that this is true. We should also see that small businesses—those that rely on banks for their credit needs—are growing far more slowly than larger businesses that do not have to rely on bank credit. This is also supported by the data. Finally, there is the question whether the crisis of 2008—because it was a financial crisis—was destined to recover more slowly than any previous crisis or recession. Solid academic work has demonstrated that this is not true; past financial crises have resulted in sharp recoveries, except where government has stepped in with new regulations. Together, these supporting elements add weight to the argument that the Dodd-Frank Act was a major cause of US economy’s slow recovery from the 2008 crisis.

### **The Economic Growth Costs of Additional Regulations on Small Banks**

As chart shows, through the first quarter of 2013, there had been some modest economic growth, but far less than in a normal recovery. Since then, as we know, the pattern has continued. A recent op-ed in the *Wall Street Journal* by Glenn Hubbard (former chair of the Council of Economic Advisers under George W. Bush) and Kevin Warsh (a former Governor of the Federal Reserve) in effect updates the chart: “Economic growth in real terms is averaging a meager 2.2% annual rate in the 23 quarters since the recession’s trough in June 2009. The consensus forecast of about 1% growth for the first half of this year offers little solace.”<sup>4</sup>

Is there a plausible connection between this slow growth and the Dodd-Frank Act?

In March, 2014, JPMorgan Chase, the largest US banking organization, cut back its projections for the coming year. It noted that it would add 3000 new compliance employees, on top of the 7000 it had added the year before, but during the coming year the total number of employees of the banking organization was expected to fall by 5000.<sup>5</sup> It seems clear that, no matter what the firm’s actual revenues and profits in 2013 or 2014, they would have been larger—other things being equal—if it had not been required by new regulations to add 10,000 new compliance officers while reducing the overall size of its payroll by 5000. Given the total workforce reduction, it is highly likely that the compliance officers hired in 2013 and 2014 would replace officers that otherwise would be calling on clients, evaluating loan applications and making loans, or providing other revenue-producing services for the firm. Other costs of regulatory compliance will have the same effect, to a greater or lesser extent.

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<sup>3</sup> John Haltiwanger, Ron S. Jarmin, and Javier Miranda, “Who Creates Jobs? Small Versus Large Versus Young,” *The Review of Economics and Statistics*, May 2013, 95(2):347-361

<sup>4</sup> Glenn Hubbard and Kevin Warsh, “How the U.S. Can Return to 4% Growth,” *Wall Street Journal*, June 23, 2015.

<sup>5</sup> Dan Fitzpatrick, “J.P. Morgan Dims Its Light on 2014,” *Wall Street Journal*, February 26, 2014.

In developing and adopting the Dodd-Frank Act, Congress and the administration did not appear to be concerned about placing additional regulatory costs on the financial system. For example, all bank holding companies with \$50 billion in assets or more were treated in the act as systemically important financial institutions (SIFIs) and subjected to “stringent” regulation by the Fed. Among many other requirements, these banking organizations must prepare so-called “living wills”—detailing how they would be broken up if they fail—and participate in annual Fed-designed stress tests. These and other requirements add substantial additional costs to whatever “stringent” new regulation might entail. Even if only in the form of more compliance officers than loan officers, this will mean that these banks will supply less credit to the real economy. If these firms did not have to hire any additional compliance officers, all their new hires—if any—would likely be employees who produce revenue, and hence more revenue for the bank and more economic growth for the real economy.

In a study of the effect of the “systemic” regulations imposed on regional banks with assets of more than \$50 billion—not the largest banks that operate nationally and internationally— Federal Financial Analytics concluded that “the direct costs of systemic standards for a sample of U.S. bank holding companies (BHCs) may be at least \$2 billion, resulting in a possible reduction of credit in the markets served by the largest of these BHCs of 5.7 to 8 percent. Over a five-year period, this reduction in lending by regional banks could total approximately \$14 to \$20 billion.”<sup>6</sup>

A similar analysis applies to small banks, which have also been required to conform to many new regulations coming out of Dodd-Frank, especially in mortgage and consumer lending. A study by the Government Accountability Office (GAO) identified seven Dodd-Frank titles that have the potential to increase the costs or the competitive burdens for “community banks,”<sup>7</sup> which the GAO and many others define as banks with assets of \$10 billion or less (unless otherwise stated, this paper will use that definition). Similarly, studies by the Mercatus Center<sup>8</sup> and the American Enterprise Institute<sup>9</sup> have also shown that Dodd-Frank regulations have imposed substantial additional costs on community banks. As noted earlier, banks of this size or less are 98.5 percent of all US banks; there are only 98 banks in the US with more than \$10 billion in assets,<sup>10</sup> and only 39 with assets of \$50 billion or more.

The additional costs are substantial. Mercatus, in particular, based its study on a survey of approximately 200 small banks, noting that “our survey reveals increased hiring of compliance personnel, more noncompliance employee time spent on compliance, and increased spending on compliance, trends noticed in other surveys.”<sup>11</sup> The study further reported, “[A]pproximately ninety percent of respondents reported an increase in compliance costs, and most (82.9%) of

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<sup>6</sup> Federal Financial Analytics, Inc., “The Consequences of Systemic Regulation for U.S. Regional Banks,” August 6, 2015, p *i*

<sup>7</sup> U.S. Gov’t Accountability Office, GAO-12-881, Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings (2012) Appendix II.

<sup>8</sup> Hester Peirce, Ian Robinson, and Thomas Stratman, “How are small banks faring under Dodd-Frank?” Working Paper, Mercatus Center, George Mason University, February 2014, p15

<sup>9</sup> Tanya D. Marsh & Joseph W. Norman, The Impact of Dodd-Frank on Community Banks (American Enterprise Institute May 7, 2013), available at <http://www.aei.org/papers/economics/financial-services/banking/the-impact-of-dodd-frank-on-community-banks/>.

<sup>10</sup> Mercatus study, *supra* note 7., p 11

<sup>11</sup> *Id.*, p16

participating banks reported that their compliance costs had increased by more than five percent.”<sup>12</sup> In effect, for these banks the median number of compliance personnel doubled—from one to two—after July 2010, and a quarter of respondents planned to hire additional compliance officers.<sup>13</sup> More compliance officers, or more noncompliance employees engaged in compliance activities, translates directly into higher employee costs and lower employee productivity—meaning in the end less credit or more costly credit for the small businesses that borrow from banks.

In 2013, three economists at the Federal Reserve Bank of Minneapolis actually looked at the effect of new regulations on the profitability of very small institutions. They chose to model only the effects on bank hiring, although many other factors—risk-taking, legal liability, product costs—are affected by additional regulation. “[W]e find,” they write, “that the median reduction in profitability for banks with less than \$50 million is 14 basis points if they have to increase staff by one half of a person; the reduction is 45 basis points if they increase staffing by two employees. The former increase in staff leads an additional 6 percent of banks this size to become unprofitable, while the latter increase leads an additional 33 percent to become unprofitable.”<sup>14</sup>

Although banks with less than \$50 million in assets are of course much smaller and simpler than banks with \$10 billion or \$50 billion in assets, the principle is the same if we are describing the effect of regulations on productivity and credit availability. If a banking organization larger than \$50 billion has to hire additional compliance officers in order to meet its new stringent regulation, living will and stress test requirements, its profitability and productivity will also be reduced, and all of them will reduce the amount of credit they provide—or the credit they provide will be more expensive—because relatively more of their human capital is engaged in compliance rather than lending or other revenue producing services.

As a rule of thumb, whatever regulatory costs are imposed on banking organizations—whether they be \$2 trillion banks like JPMorgan Chase, \$50 billion banks or \$50 million banks—the larger the bank the more easily it will be able to adjust to these costs. As Federal Reserve Governor Daniel Tarullo has observed, “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.”<sup>15</sup> William Grant, then chair of Community Bankers Council of the American Bankers Association, noted in congressional testimony in 2012, “The cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks.”<sup>16</sup> That’s most likely why, since the enactment of Dodd-Frank, the smallest banks, as we will see, have suffered the greatest losses of market share and the largest banks have continued to grow.

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<sup>12</sup> Id., p 34

<sup>13</sup> Id., p 35 and 36

<sup>14</sup> Ron J. Feldman, Jason Schmidt, Ken Heinecke, “Quantifying the Costs of Additional Regulation on Community Banks,” Federal Reserve Bank of Minnesota, May 30, 2013, p2.

<sup>15</sup> Daniel Tarullo, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014.

<sup>16</sup> William Grant, Statement before the House Subcommittee on Financial Institutions and Consumer Credit, May 9, 2012.

Ironically, then, although there has been great concern in Congress about the financial advantages of too-big-to-fail banks (TBTF), the heavy regulations in Dodd-Frank has given the largest TBTF banks even more significant competitive advantages over their smaller competitors. Indeed, Jamie Dimon, the chair of JPMorgan Chase, has referred to regulation as a “moat” that reduced competition from its smaller rivals.<sup>17</sup>

Indeed, small banks have been losing market share to larger banks since the enactment of Dodd-Frank. In a 2015 paper, Marshall Lux and Robert Greene noted that “Community banks withstood the financial crisis of 2008-09 with sizeable but not major losses in market share—shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010...But since the second quarter of 2010, around the time of the Dodd-Frank Wall Street Reform and Consumer Protection Act’s passage, we found community banks’ share of assets has shrunk drastically—over 12 percent...Since Q2 2010, the smallest community banks’ (\$1 billion or less in assets) share of U.S. banking assets has fallen 19 percent.”<sup>18</sup>

An important factor in this decline, according to Lux and Greene, is a 44 percent increase in commercial and industrial (C&I) loans outstanding since mid-2010: “Community banks share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks’ market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall growth in the sector, these banks realized a net decrease in volume of 7.5 percent.”<sup>19</sup>

Part of the reason that small banks have been losing market share is the decline in their numbers, because of acquisitions by larger banks and a complete collapse since the financial crisis in the chartering of new banks. Both can be attributed to Dodd-Frank. Many community banks are selling out to larger institutions, which can operate more cheaply in the costly regulatory environment since the enactment of Dodd-Frank. Kelly King, the chairman of BB&T, a larger bank that is aggressively seeking to acquire community banks, recently observed:

I think a lot of banks with \$5 billion to \$10 billion in assets are going to recognize that it is an unsolvable problem when they look at the massive investment they have to make to comply...The cost for them to expand is enormous, and they would go through a trough of several years where their stock price would be diluted. From an economic point of view selling is almost a no-brainer.<sup>20</sup>

Indeed, the chartering of new banks, which at one time averaged 100 per year, has declined to less than one per year since 2010. This is almost certainly attributable to the squeeze on profits as a result increased regulation, although low interest rates could also be a contributing

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<sup>17</sup> John Carney, “Surprise! Dodd-Frank Helps JPMorgan Chase,” CNBC NetNet, February 4, 2013. <http://www.cnbc.com/id/100431660>.

<sup>18</sup> Marshall Lux and Robert Greene, “The State and Fate of Community Banking,” *M-RCBG Associate Working Paper Series*, No. 37, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, February, 2015, p3

<sup>19</sup> *Id.*, pp 17-18.

<sup>20</sup> Kristin Broughton, “Too Costly to Grow: Why National Penn Decided to Sell,” *American Banker*, August 18, 2015.

factor. If existing community banks can't make a go of it in the current environment, why would anyone invest in a new one?

Another factor causing difficulties for small banks and particularly the all-important start-ups is the narrative underlying the Dodd-Frank Act; in this narrative, the financial crisis was caused by insufficient regulation of banks and other financial firms allowing them to take risks that resulted in the financial crisis. As discussed elsewhere, this narrative is false,<sup>21</sup> but blaming the failure of a large number of financial institutions on lax regulation has produced an examiner crackdown in the past, often accompanied by a downgrading of smaller banks. Larger banks are seldom downgraded. As one observer put it, referring to the 1989-91 period when many banks had failed, the Comptroller of the Currency "had softened regulatory policies on banks early in his tenure, helping fuel excessive real estate lending by banks." By mid-1990 and early 1991, however, regulatory attitudes had apparently changed: "Bank examiners became too restrictive, helping to create a near credit crunch."<sup>22</sup> A recent paper by Paul Kupiec, Yan Lee, and Clair Rosenfeld has shown that when regulatory downgrades occur loan growth is impaired. "[S]upervisory restrictions," they report, "have a negative impact on bank loan growth after controlling for the impact of monetary policy, bank capital and liquidity conditions and any voluntary reduction in lending triggered by weak legacy loan portfolio performance or other bank losses."<sup>23</sup>

The idea that aggressive interventions of examiners with small banks can reduce lending activity received some confirmation from former Fed Governor Elizabeth Duke in testimony to Congress in February 2010, "Some banks may be overly conservative in their small business lending because of concerns that they will be subject to criticism from their examiners...some potentially profitable loans to creditworthy small businesses may have been lost because of these concerns, particularly on the part of small banks."<sup>24</sup> Bank regulators, who have heard the politicians blame them for the lax regulation, have responded with tougher treatment of the smaller banks, even though they had no significant role in the financial crisis. Ironically, then, even though it's untrue, the claim that lax regulation caused the financial crisis has generated a bank examiner crackdown and tougher lending standards that in turn has reduce economic growth.

Because of their unique role in local economies, increases in the costs of community banks and tightening credit standards after Dodd-Frank are particularly bad news for small business start-ups. As Drew Breakspear, the commissioner of Florida's Office of Financial Regulation, pointed out in a recent article, "Community banks have traditionally supported local agricultural and small business needs by incorporating information about borrower' characters

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<sup>21</sup> Wallison, *Hidden in Plain Sight*, supra note 1

<sup>22</sup> Alan Gart, *Regulation, Deregulation, Reregulation: the Future of the Banking, Insurance, and Securities Industries*. New York: John Wiley & Sons. 1994. p 163.

<sup>23</sup> Paul Kupiec, Yan Lee and Claire Rosenfeld, in "Does Bank Supervision Impact Bank Loan Growth?", draft of May 7, 2015, p1.

<sup>24</sup> Quoted in Kupiec, note 22, p3

into lending decisions. But Dodd-Frank has standardized lending practices, which works to the advantage of large banks and punishes community banks.”<sup>25</sup>

Indeed, anecdotal information from small business managers and small banks indicates that since the enactment of Dodd-Frank examiners have been insisting that all borrowers with similar financial standing be treated the same way, so that credit is not necessarily available anymore to borrowers that do not meet certain revenue standards or do not have suitable collateral, guarantors, or vouching materials such as audited financial statements. Character loans, as Mr. Breakspear described them, one of the strengths of community banks that know their customers, appear to be a thing of the past.

One-size-fits-all lending standards certainly reduces one of the key advantages of the small bank lending system, but it may be more important for our purposes to understand that it also reduces the availability of credit for small business borrowers, especially start-ups, which generally have none of the supporting elements for credit that regulators want to see. As one study noted, small banks can fill a niche “stemming from their ability either to successfully lend to what have been variously described as ‘informationally opaque’ borrowers—borrowers without long credit histories suitable for credit scoring or other model-based lending practiced by large banks—or to engage in relation- or reputation-based lending or lending in low-volume markets.”<sup>26</sup> In other words, small banks can be unique sources of credit both for start-ups or more mature small businesses that do not have, but because of tougher lending standards after Dodd-Frank their role in lending—especially to new businesses—is quickly declining.

### **The Effect of Additional Regulatory Costs and Tighter Lending Standards on Small Business**

At this point, it is necessary to make a key distinction about the contribution of small firms to economic growth and jobs. It is generally true that small firms are the principal drivers of new growth and jobs in the economy, but most of the discussion about small firms has focused on these firms as a single category. Within the small firm category, however, it turns out the major drivers of growth and jobs are start-ups—firms that are 1-5 years old. In an important paper on this subject, three researchers observed: “The share of jobs created and destroyed by different groups is roughly their share of total employment. An important exception in this context is the contribution of firm start-ups: they account for only 3% of employment but almost 20% of gross job creation.”<sup>27</sup>

In other words, older and more established small firms are not major net contributors to economic growth. As the authors explain, using 2005 as an example: “About 2.5 million net new jobs were created in the U.S. private sector in 2005. Strikingly, firm start-ups (firms with age 0)

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<sup>25</sup> Drew Breakspear, “Too Small to Comply: Florida Regulator on Dodd-Frank’s Defects,” Bank Think, August 9, 2015

<sup>26</sup> Tim Critchfield et al., *The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects*, FDIC BANKING REV. (2004), at 4

<sup>27</sup> Haltiwanger, et al, “Who Creates Jobs? Small Versus Large Versus Young,” *supra*, note 3, p 360.

created about 3.5 million net new jobs. In contrast, every other firm age class except for the oldest firms exhibited net declines in employment in 2005.”<sup>28</sup>

For this reason, data showing that small firms in general are not having difficulty finding credit, or don’t need new credit,<sup>29</sup> should be understood as the result of sampling older established small firms and not the start-up category, which is where the economic and job growth in the U.S. economy is apparently concentrated. It is the start-up category that would be having the most difficulty getting bank credit as a result of the tightening lending standards and greater small bank regulatory costs induced by Dodd-Frank. Banks, especially small banks, are not venture capitalists; to the extent that they are willing to take venture-type risks, it’s with the “informationally opaque” firms that now draw criticism from examiners.

Lux and Greene report that “[C]ommunity banks provide 51 percent of small business loans. In the decade before the crisis (Q2 1998 to Q2 2008), community banks’ lending to small business doubled in volume [citing FDIC data]. Small businesses create the majority of new jobs and account for the vast majority of employers. . . . Alarming, however, community banks’ overall volume of small business lending has declined significantly since Q2 2010—down 11 percent.”<sup>30</sup> While this could also be the result of lower small business loan demand, the authors also point out that the volume of small business lending by the largest banks has declined only 3 percent.

Most significantly, in the same study, the results for community banks since the enactment of Dodd-Frank are even worse in the commercial and industrial (C&I) loan market—loans made to businesses that are not agricultural loans or commercial and residential real estate loans. There, “community banks’ share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks’ market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall lending growth in the sector, these banks realized a net decrease in volume of 7.5 percent.”<sup>31</sup>

These observations are supported by other data. In 2014, two researchers at the Federal Reserve used data in bank call reports to assess whether there is a difference between large banks and community banks in business lending. “Following the financial crisis,” they wrote, “total outstanding loans to businesses by commercial banks dropped off substantially. Large loans outstanding began to rebound by the third quarter of 2010 and essentially returned to their previous growth trajectory while small loans outstanding continued to decline (Chart 1). Furthermore, much of the drop in small business loans outstanding was evident at community banks (Chart 2).”

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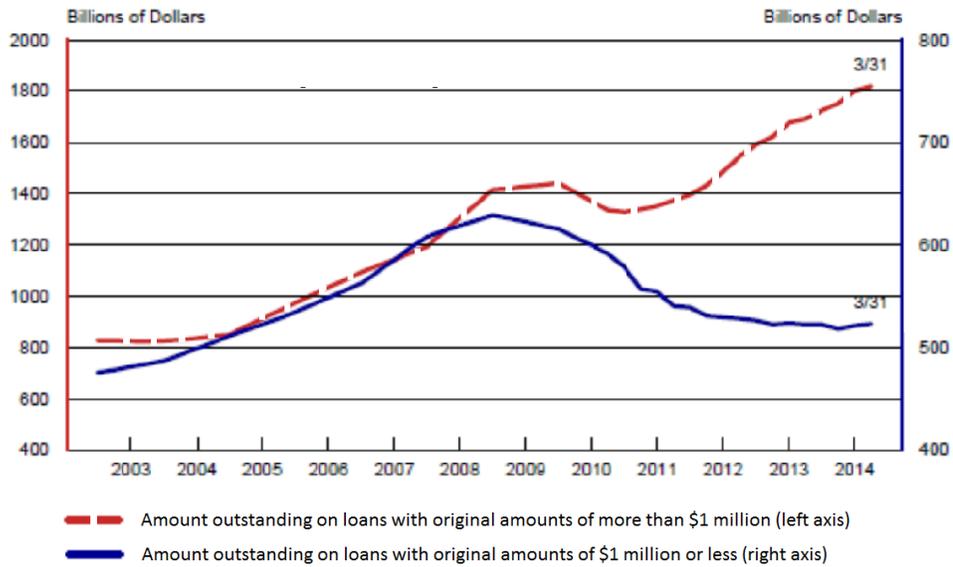
<sup>28</sup> Id., p350

<sup>29</sup> See, e.g., data of the National Federation of Independent Business (NFIB) for 2015, showing that members are having no difficulty obtaining credit. NFIB Research Foundation, “Opinions of Small Employers,” p.8. <http://www.nfib.comsmallbizsurvey2015>.

<sup>30</sup> Lux and Greene, op. cit., p11.

<sup>31</sup> Id., p18

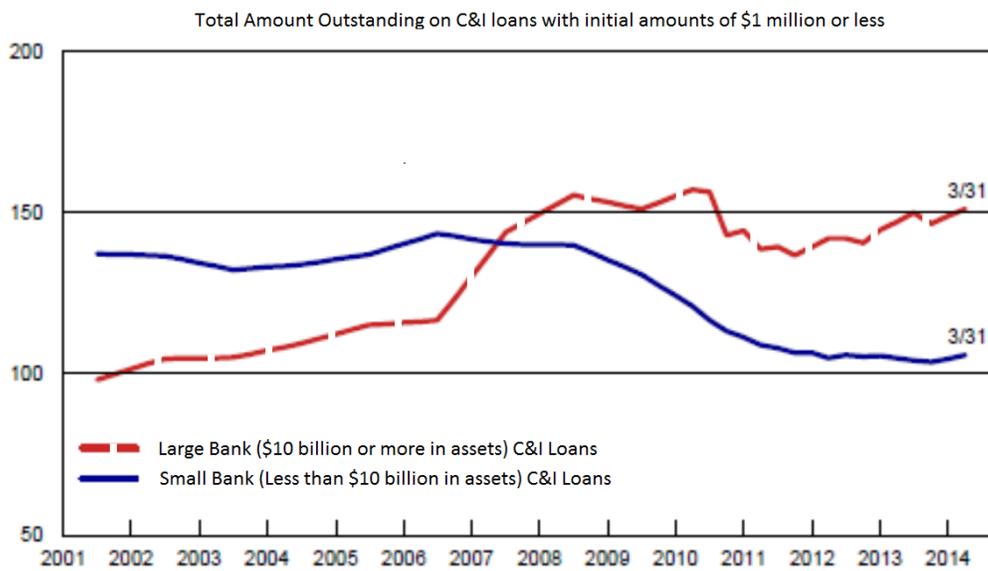
**Chart 1. Amount Outstanding on Loans to Businesses<sup>32</sup>**



Source: According to the authors, these data are constructed from special tabulations of the June 30, 2002 to March 31, 2014 Call Reports.

**Chart 2. Small C&I Loans Outstanding by Banking Organization Size**

<sup>32</sup> These charts appear in Dean Amel and Traci Mach, “The Impact of the Small Business Lending Fund on Community Bank Lending to Small Business,” Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, No. 2014-111, December 2014, p17



Source: According to the authors, these data are constructed from special tabulations of the June 30, 2002 to March 31, 2014 Call Reports.

Bank Call Reports do not provide information on the size of the business that received the loan, but as the authors of the paper note, loans up to \$1 million are frequently seen as a proxy for a small business loan. So what these charts show is that small business lending by small banks, and small business borrowing by small firms, has not recovered from the post-crisis recession and has declined even more sharply after the enactment of the Dodd-Frank Act in 2010. Even banks over \$10 billion have not been expanding their lending to small business. The likely reasons, as outlined above, are that higher regulatory costs and one-size-fits-all lending standards imposed after Dodd-Frank have stymied lending, particularly to start-ups which account for most of the economy’s new jobs and growth.

Finally, the new and more costly regulation imposed by Dodd-Frank appears to have stalled the formation of new banks, which in turn has also affected the availability of credit for the small and medium-sized businesses that are dependent on bank lending. A Federal Reserve Bank of Richmond report in March 2015 notes that “The rate of new-bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010.” Trying to assess the reasons for this sharp decline, the report continued, “Banking scholars . . . have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started.”<sup>33</sup>

The authors suggest other possible causes, but the fact that the decline became so severe in 2010, the year of the enactment of Dodd-Frank, is strong evidence that the new requirements

<sup>33</sup> Roisin McCord, Edward Simpson Prescott, and Tim Sablik, “Explaining the Decline in the Number of Banks since the Great Recession,” Economic Brief, Federal Reserve Bank of Richmond, March 2015.

in the act—which have been cited again and again by small banks since 2010—are responsible. In any event, the decline in the formation of new banks caused an overall decline of 800 in the total number of small independent banks between 2007 and 2013. All these factors—increased regulatory costs, tougher lending standards, and a decline in the absolute numbers of small banks because of regulatory costs—have had an adverse effect on the small businesses, and particularly the small business start-ups, that depend on small banks for credit.

### **Small Business and the Bifurcated Credit Market**

It is not generally understood that the US has a sharply bifurcated credit market. According to the Small Business Administration, in 2010, there were 28 million small businesses in the US, defined as firms with fewer than 500 employees. Of these, about 5.5 million were employers; the rest were small proprietorships (mom and pops) with no formal employees. At the same time, there were 18,500 larger businesses (less than 1 percent of all employers) with 500 employees or more.<sup>34</sup>

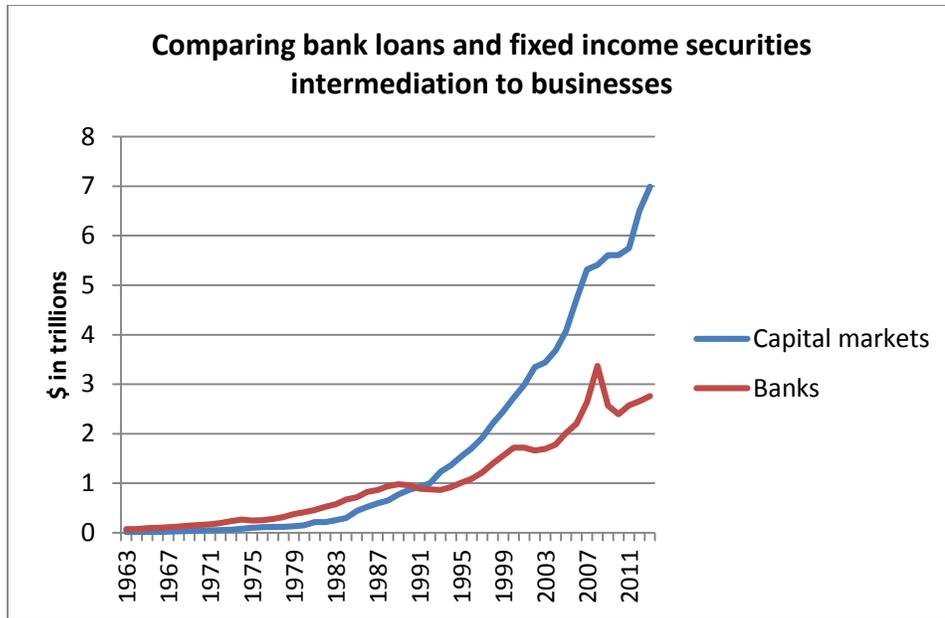
These two classes of businesses have very different sources of credit. Most of the 18,500 larger businesses are in a position to borrow from banks or to finance in the credit markets. In 2014, there were approximately 10,000 firms registered with the SEC and thus in a position to issue securities in the capital markets. However, the 28 million small businesses, including the 5.5 million that were employers, are likely to be completely dependent on banks for their credit needs. For these firms, increases in the cost, or reductions in the availability of bank lending—particularly by small banks—would have a substantial impact on their prospects for growth.

The chart below shows that since the mid-1980s the capital markets have outcompeted the banking industry as a source of credit for business firms.<sup>35</sup> This alternative means of financing, however, is not available to small or medium sized businesses, because they are not generally owned by public shareholders and do not report their financial results to the SEC. In addition, the considerable costs of maintaining a securities registration make registration unaffordable for smaller businesses. For these smaller firms, then, greater and more costly regulation of banks would inevitably cause either an increase in the cost of bank credit, a reduction in its availability, or both.

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<sup>34</sup> Small Business Administration, “Frequently Asked Questions About Small Business,” September 2012, p1.

<sup>35</sup> There are several reasons for this. Agency intermediation is more efficient than the principal intermediation of banks; banks are more heavily regulated than broker-dealers, mutual funds and other participants in the capital markets and thus have higher costs; and technological advances in information distribution have made it easy for firms to communicate their financial position directly to analysts and investors, so banks have lost their special position as the repositories of the best financial information about companies. The trend toward capital markets financing has caused a backlash from bank regulators, who now want to use the Dodd-Frank Act to regulate the capital markets—what they call the “shadow banking system.”



Source: Fed Flow of Funds

There is another explanation for the difficulty of small business, particularly start-ups, in getting credit for growth. In a Goldman Sachs report published in April 2015, and titled “The Two-Speed Economy,” the authors posit that new banking regulations have made bank credit both more expensive and less available. “This affects small firms disproportionately because they largely lack alternative sources of finance, whereas large firms have been able to shift to less-expensive public market financing.”<sup>36</sup>

Using IRS data, the Goldman study finds that large firms—those with \$50 million or more in revenue annually, have been growing revenue at a compounded annual rate of 8 percent, while firms with less than \$50 million in revenue have been growing revenue at an average of only 2 percent compounded annually. Even more significant, using Census data, the Goldman authors found that “firms with more than 500 employees grew by roughly 42,000 per month between 2010 and 2012, exceeding the best historical performance over the prior four recoveries. In contrast, jobs at firms with fewer than 500 employees declined by nearly 700 per month over the same timeframe, although these small firms had grown by roughly 54,000 per month on average over the prior four recoveries.”<sup>37</sup>

This accounts for the dearth of new business formations. Small firms are simply unable to get the credit that used to be available to small business start-ups, and the credit that they can get is more expensive. This would also have a disproportionate effect on employment in the recovery, because small business start-ups are the principal source of new employment growth in the US economy.

<sup>36</sup> Goldman Sachs, “The two-speed economy,” April 2015.p3 <http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf>.

<sup>37</sup> Id., p8

The Goldman paper then turns to the lack of capital investment, and also finds the source of that in financial regulation. “Even as large firms experience a relatively robust recovery, they appear to be investing less than we would expect given their historically high profit margins, and investing with a bias toward shorter term projects; this dynamic may be playing out because large firms are facing less competition from smaller firms. Investments in intellectual property, for example, are tracking nearly five percentage points below even the low end of the historical experience and more than 20 percentage points below the historical average.”<sup>38</sup> Since many start-ups are based on new ideas or new technology, their inability to get adequate credit has made them less competitive with existing larger firms or more willing to sell out to larger firms, reducing the need for greater investments by larger firms in proprietary intellectual property.

Finally, the Goldman paper expresses concern that this is not necessarily a temporary phenomenon: “Taken together, the reduced competitiveness of small firms and the changing investment decisions of larger ones are reshaping the competitive structure of the US economy in ways that are likely to reverberate well into the future, and in ways that any future evaluation of the aggregate effects of post-crisis regulations should consider.”<sup>39</sup>

It would be hard to find a better way to express the dangers of leaving the Dodd-Frank Act in place without serious reforms.

### **Are There Other Explanations for the Slow Recovery?**

Still, defenders of Dodd-Frank sometimes argue that a slow recovery is typical after financial crises, and accounts for the slower economic growth since 2010, but recent scholarship casts doubt on this explanation. Michael Bordo and Joseph Haubrich studied 27 recession-recovery cycles since 1882 and concluded: “Our analysis of the data shows that steep expansions tend to follow deep contractions, though this depends heavily on when the recovery is measured. In contrast to much conventional wisdom, the stylized fact that deep contractions breed strong recoveries is *particularly true* when there is a financial crisis.”<sup>40</sup> [emphasis added]

Bordo and Haubrich find only three exceptions to this pattern; in these cycles, the recoveries did not match the speed of the downturns. The three were the Depression of the 1930s, the 1990 recession that ended in March 1991, and the most recent recession, which ended in June 2009. It is useful to consider what these three exceptions have in common.

In each case, the government’s intervention in the financial system was unusual and extensive. During the Depression Era the Hoover and Roosevelt administrations tried many ways to arrest the slide in the economy, all without success. Hoover was an inveterate activist in all things, and Franklin Roosevelt believed in constant experimentation until something worked. Neither of them seemed to have a consistent theory about what brought on the economic downturn or how to address it. Under President Hoover, Congress passed the Smoot-Hawley

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<sup>38</sup> Id., p3

<sup>39</sup> Ibid.

<sup>40</sup> Michael D. Bordo and Joseph G. Haubrich, “Deep Recession, Fast Recoveries, and Financial Crises: Evidence From the QAmerican Record,” Working Paper 18194, National Bureau of Economic Research, June 2012, p2.

Tariff Act, and the Emergency Relief and Reconstruction Act, and established the Reconstruction Finance Corporation.

Under Roosevelt, the US went off the gold standard, established a deposit insurance system and a federal regulatory system for state-chartered banks; Congress adopted the National Recovery Act, the Emergency Banking Act, Emergency Farm Mortgage Act, the Securities Act, the Securities & Exchange Act, the Glass-Steagall Act, and the Farm Credit Act. Other major laws with financial implications were the National Industrial Recovery Act and the Agriculture Adjustment Act (both of which were eventually declared unconstitutional by the Supreme Court). This enormous flurry of activity, however, while popular with the American people, did not produce a meaningful or prolonged recovery until the nation geared up for war at the end of the 1930s.

In addition, the Pecora hearings of the early Roosevelt administration, propagated the idea that banks' securities activities had caused the crisis; this is uncannily similar to the narrative that produced the Dodd-Frank Act, which blamed the financial crisis on insufficient regulation of the financial system and greed and recklessness on Wall Street. The Pecora hearings resulted in the Glass-Steagall Act, which separated securities and banking activities. Whether or not that was harmful can be debated, but the wholesale revision of financial structures it entailed probably constricted credit and market confidence in the years that followed.

The recession in 1990 and early 1991 came after the collapse of the S&L industry in the late 1980s and the failure of almost 1600 banks during the same period. Both were blamed on insufficient regulatory authority or lax enforcement—again like the narrative that supported the Dodd-Frank Act—and produced the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA) in 1989 and the FDIC Improvement Act (FDICIA) in 1991.

These laws increased the regulatory authority of federal bank regulators, and under pressure from Congress and the public they cracked down on depository institutions, causing a credit crunch and what was called a “jobless recovery” in 1991. In addition, the first set of Basel risk-based capital rules were adopted in 1988 and were gradually phased in at this time, requiring banks to re-compute their capital positions and in many cases required them to increase their capital.

Thus, there is historical evidence that the slow recovery from the 2008 financial crisis is due in part—maybe primarily—to the fact that the Dodd-Frank Act was adopted shortly after the crisis. Instead of allowing the economy and the financial system to heal naturally, it introduced constraints, costs and uncertainties that have interfered with the natural course of the recovery. Moreover, like the Pecora hearings, Dodd-Frank was based on the idea that the private sector was to blame for the crisis and thus sought to punish the very entities that were necessary to finance a recovery.

The idea that a post-recession series of actions can in fact slow an economic recovery receives added weight from a recent book by James Grant called *The Forgotten Depression*. Grant traces the sharp downturn and the following sharp recovery in 1920 and 1921. The downturn in 1920 was severe. “Just how severe,” writes Grant, “is a question yet to be

settled... Official data as well as contemporary comment paint a grim picture. Thus, the nation's output in 1920-21 suffered a decline of 23.9 percent in nominal terms, 8.7 percent in inflation-(or deflation)-adjusted terms. From cyclical peak to trough, producer prices fell by 40.8 percent. Maximum unemployment ranged between two million and six million persons... out of a nonagricultural labor force of 31.5 million. At the high end of six million, this would imply a rate of joblessness of 19 percent.”<sup>41</sup>

But the government did nothing. President Wilson had suffered a second severe stroke in October 1919, and was partially paralyzed, although this fact was withheld by the White House. What little energy Wilson had through the election year of 1920 was reserved for the fight over the League of Nations. The Republican Harding administration, which followed, did nothing either, says Grant. “The successive administrations of Woodrow Wilson and Warren G. Harding met the downturn by seeming to ignore it—or by implementing policies that an average 21<sup>st</sup> century economist would judge disastrous. Confronted with plunging prices, incomes and employment, the government balanced the budget and, through the newly instituted Federal Reserve, raised interest rates... Yet by late 1921, a powerful, job-filled recovery was under way. This is the story of America's last governmentally unmedicated depression.”<sup>42</sup> Needless to say, there was no new regulation, and the economy recovered quickly.

Adding new regulatory activity after a severe recession seems to slow a rapid return of economic growth, and that certainly seems to be borne out by the examples cited above.

It is of course possible that the 2008 financial crisis and the ensuing recession were such shocks to the economic system that they have caused a secular change in the performance of the US economy—a “new normal” of slow growth and declining living standards for the middle class.

However, it is far more likely that government policies are responsible for these conditions, and if we look for the policies that could have had the greatest effect on the economy since the financial crisis, there have been only three—the Affordable Care Act (ACA), the Fed's historically low interest rates, and the Dodd-Frank Act. Neither the ACA nor low interest rates should have had a repressive effect on new business formation; quite the contrary; it's more likely that they've both had temporarily stimulative effects by pumping more government money into the economy.

That leaves Dodd-Frank as the most likely cause of the slow-growth economy we have been experiencing. The implication is strong that the heavy regulation imposed on the financial system—and particularly on community banks—has caused a slowdown in the growth of small businesses—especially small business startups—and hence the unusual and persistent slowdown in the growth of the US economy after a severe recession.

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<sup>41</sup> James Grant, *The Forgotten Depression: 1921: The Crash That Cured Itself*. Simon & Schuster, 2014, p4

<sup>42</sup> *Id.*, p 1