SAM GRAVES, MISSOURI
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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

Memorandum

To:	Members, Committee on Small Business, Subcommittee on Economic Growth, Tax and Capital Access
From:	Joe Walsh, Chairman
Date:	June 13, 2011
Subject:	Subcommittee Hearing: "The Dodd-Frank Act: Impact on Small Business Lending"

Introduction

On Thursday, June 16, 2011, at 10:00 am, in Room 2360 of the Rayburn House Office Building, the Small Business Committee, Subcommittee on Economic Growth, Tax and Capital Access will meet for the purpose of conducting a hearing titled, *"The Dodd-Frank Act: Impact on Small Business Lending."* The hearing will examine the regulatory structure of financial institutions, including the new requirements placed on them by the Dodd-Frank Act. The hearing will also examine the new regulations being proposed to implement the Act that have the greatest impact on small financial institutions and on small business lending. The witnesses will discuss the impact of the new law and offer solutions to minimize the burdens.

Bank Regulatory Structure

Over the past 90 years, a regulatory structure for the financial services industry has developed consisting of a series of overlapping state and federal regulations for banks and other financial institutions based on their organizational structure and business model. Once a bank has been chartered by the government, they are assigned a regulator. In general, financial institutions can either be chartered as a bank or thrift.[1] When it comes to small business lending, thrifts face a

[1] A thrift institution is a financial institution that obtains the majority of its funds from the savings of the public; savings and loan association (S&Ls) and savings banks are types of thrift institutions.

lending limit for commercial loans of less than 20 percent of assets, of which half may only be used for small business loans.[2]

Financial regulators are responsible for the safety and soundness of the institutions and ensuring that depositors' and other customers' money is being treated responsibly. Regulators typically accomplish their oversight duties through both on-site and off-site investigations to ensure that the institution is in compliance with the regulators' rules and procedures for conducting business. Further, a percentage of the institutions loan files are reviewed to determine that credit decisions comply with appropriate standards. If the regulators find weakness, they have the authority to enter into binding consent decrees that specify action to be taken to improve policies and procedures, increase capital reserves, or foreclose on nonperforming loans.

Anecdotally, many small business lenders claim that federal regulators have increased the capital requirement imposed on banks.[3] When increased capital requirements are imposed, this can have a detrimental impact on the number a loans that an institution can issue. Financial institutions have two main ways to increase their capital ratio, they can (a) raise additional capital in the market; or (b) shrink their assets down so that capital reserves become a greater percentage of total assets.[4] To shrink assets, banks stop issuing new loans, or foreclose on under-performing loans, resulting in not only less capital being made available to small businesses, but also businesses losing lines of credit which can be vital for purchasing inventory or managing day-to-day expenses.

Because of the power of regulators to impact lending operations, it is important that any change to the regulatory structure take into consideration both the risk of failure of financial institutions and the credit needs of customers. On the federal level, there are four distinct regulators that monitor financial institutions. Below is a summary of the four federal banking regulators:

<u>Federal Reserve (Fed)</u>- The Fed is the central bank of the United States with responsibility for monetary policy and supervision of member banks.[5] Through its network of 12 regional banks, the Fed supervises bank holding companies, state-chartered member banks and foreign-chartered banks operating in the United States.[6] The Fed uses both on-and off-site examination and

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[2] Federal Reserve Bank of San Francisco, *Bank Charters vs. Thrift Charters*, (April 24, 1998).

[3] *Access to Capital: Can Small Business Access the Credit Necessary to Grow and Create Jobs, Hearing: H. Comm. on Small Business*, (June 1, 2011) (Testimony of Lynn Ozer, Executive Vice President, Susquehanna Bank, Pottstown, PA on behalf of the National Association of Government Guaranteed Lenders).

[4] Id.

[5] Pub. L. No. 63-43.

[6] CRS Report RS20826, *Structure and Functions of the Federal Reserve System* by Marc Labonte, (Nov. 10, 2010).

monitoring in its supervision process. Each institution is examined on-site every 12 to 18 months.

Federal Deposit Insurance Corporation (FDIC)- FDIC is responsible for regulating federally insured depository institutions, including state banks that are not members of the Federal Reserve system. The FDIC manages the deposit insurance fund, which is funded by risk-based assessments levied on depository institutions.[7] The fund is used for various purposes, including paying deposit holders in the event of a bank failure and resolving failed or failing institutions. The FDIC conducts examinations of supervised institutions approximately once every 18 months depending on the bank's financial health.[8]

Office of the Comptroller of the Currency (OCC)- OCC is an independent entity within the Department of the Treasury, responsible for regulating national banks, U.S. federal branches of foreign banks and federally chartered thrift institutions.[9] OCC conducts on-site examinations of each national bank at least three times within every two-year period.[10]

National Credit Union Administration (NCUA)- NCUA is an independent agency responsible for chartering and managing deposit insurance and providing lender-of-last-resort liquidity for federal credit unions.[11] [12]

Deposit Insurance

One way that federal regulators protect the public from bank failures is through federally guaranteed deposit insurance. Deposit insurance is designed to instill confidence in banking customers so that in the event of a bank failure, the federal government will fully pay the banking customer 100 percent of their insured deposit.[13] Deposit insurance was first created in

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[7] CRS Report R40249, *Who Regulates Whom? An Overview of U.S. Financial Supervision* by Mark Jickling and Edward V. Murphy, (Dec. 8, 2010).

[8] CRS Report RS20826, *Structure and Functions of the Federal Reserve System,* by Marc Labonte, (Nov. 10, 2010).

[9] Id.

[10] CRS Report R41176, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis* by Walter W. Eubanks, (April 12, 2010).

[11] CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter, (May 25, 2011).

[12] Pub. L. No. 91-468 made CUNA an independent agency.

[13] The maximum amount of federal deposit insurance will be discussed in greater detail later in the memorandum. However, for discussion purposes, the maximum limit currently stands at $250,000.

1933 after many financial institutions experienced runs of depositors withdrawing money from their accounts, for fear that the bank would fail and their money would be lost.[14] To prevent future runs on banks, federal deposit insurance was created.[15] Because of this insurance, bank customers no longer had the need withdraw their money for fear of losing their life saving. Deposit insurance also helped stabilize banks by ensuring that the bank would not face a liquidity problem that would put the financial institution in greater jeopardy for failure.

Both FDIC and NCUA manage deposit insurance through a series of premiums charged to participating financial institutions. Therefore, in the event of a bank failure, the money funded through the premiums are paid to depositors of the failed financial institution. The premiums are assessed on banks based on several factors including size of the institutions and risk for failure.[16] While the depository insurance fund typically has sufficient capital to fund bank failures, the managing agencies also have statutory authority to borrow from the Treasury in the event of a shortfall. Shortfalls are required to be paid back to the Treasury through additional assessments made on financial institutions.

Bank and Credit Union Failures

Since 2008, both banks and credit unions have seen a dramatic increase in failure resulting from the downturn in the real estate market. These failures have put tremendous stress on the deposit insurance fund resulting in higher assessments on participating institutions.[17][18]

Year	Bank Failures	Credit Union Failures
2010	157	19
2009	140	28
2008	25	18
2007	3	12
2006	0	16
2005	0	15

[14] William L. Silber, *Why Did FDR's Bank Holiday Succeed?* Federal Reserve Bank of New York Economic Policy Review, (July 2009).

[15] Pub. L. No. 73-66.

[16] Risk-based assessments are authorized by The Federal Deposit Insurance Corporation Improvement Act of 1991 Pub. L. No. 102-242.

[17] CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter (May 25, 2011).

[18] National Credit Union Administration, Home Page http://www.ncua.gov/Resources/ClosedCU/2010.aspx (June 8, 2011).

The Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) was signed into law on July 21, 2010. This law, which was borne of the financial crisis of 2008, provides for a comprehensive reorganization of the regulatory structure surrounding the financial services industry.[19] The new law has the potential have a disproportionate impact on both small business lending and small financial institutions through increased reporting requirements, risk retention, limitation of certain fees and restructured resolution authority. According to an analysis performed by SBA's Office of Advocacy, in 2008 small businesses faced an annual regulatory cost of $10,585 per employee, which is 36 percent higher than the per employee regulatory cost for larger businesses.[20] Since many smaller financial institutions are community lenders, this disproportionate impact of regulations will have the greatest impact on small businesses that rely on community banks to meet their capital requirements. Below is a summary of several provisions of Dodd-Frank that have been identified as potentially having the greatest impact on small business lending.

<u>Abolition of the Office of Thrift Supervision (OTS)</u>- Prior to the passage of Dodd-Frank, federal and state chartered thrift institutions were regulated by OTS. Dodd-Frank shifted the responsibility for regulating federal thrifts and national banks to the OCC and state-chartered thrifts and banks to the Fed. Further, the Consumer Financial Protection Bureau (CFPB) will be responsible for overseeing compliance with consumer protection laws. Banks previously regulated by OTS must now comply with a new regulator.

<u>Making Permanent the Increase in Federal Deposit Insurance to $250,000 from $100,000</u>- The increase in the deposit insurance was originally a temporary measure.[21] In addition to increasing the maximum coverage limit, the limit on Individual Retirement Account (IRA) coverage was also increased.[22] Section 335 of Dodd-Frank makes these changes permanent. Because of the increased coverage levels, assessment on insured lenders might need to be increased. Any increase could limit the amount of money an institution has available to lend.

<u>Establishment of the Consumer Financial Protection Bureau (CFPB)</u>- CFPB is an independent bureau established within the Fed responsible for enforcement of consumer protection laws. It is

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[19] *The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic: Hearing Before the H. Fin. Svcs. S. Comm. on Oversight and Investigations*, 112th Cong. (March 30, 2011) (Statement of Douglas W. Elmendorf, Director Congressional Budget).

[20] SBA Office of Advocacy, *Impact of Regulatory Costs on Small Firms*, Nicole V. Crane and Mark W. Crain (September 2010).

[21] Pub. L. No. 110-343 increased the federal deposit insurance to $250,000 until December 31, 2009. The Helping Families Save their Homes Act extended the increase until December 31, 2013.

[22] Pub. L. No. 109-171.

headed by a director to be named by the President, subject to the advice and consent of the Senate. The CFPB has the authority to review regulatory reports, as well as enforce and promulgate regulations under existing consumer protection laws.[23] [24] According to the Congressional Research Service, "[u]nder the [Dodd-Frank] Act, the Bureau has authority over an array of consumer financial products and services, including deposit taking, mortgages, credit cards and other extensions of credit, loan servicing, check guaranteeing, collection of consumer report data, debt collection, real estate settlement, money transmitting, financial data processing, and others."[25] Given the potential scope of the CFPB's authority, many banks are concerned about the scope of regulations emanating from this new agency.

<u>Establishment of the Financial Stability Oversight Council (FSOC)</u>- FSOC is a council comprised of the heads of various regulatory agencies responsible for monitoring systemic risk in the financial system. The FSOC also has the authority to overturn a regulatory action by the CFPB by a two-thirds vote of the council. The FSOC is composed of ten voting and five nonvoting members.[26] To overturn a rule, the FSOC must determine that it places the entire banking system at risk, or undermine the stability of the financial system.

<u>Small Business Data Collection</u>- Section 1071 of Dodd-Frank requires financial institutions to provide the CFPB with data on its lending to women-owned, minority-owned and small businesses. Lending institutions are required to inquire whether the business is owned by one of the groups specified above, how the application for credit was received and maintain the responses to these questions.[27] This data collection requirement requires lenders to retool their computer systems to accurately capture the information. This could have a greater impact on smaller financial institutions who have less ability to absorb the cost and whose small business lending makes up a greater percentage of their portfolio.

<u>$10 Billion Exemption</u>

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[23] CRS Report R41338, *Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau*, by David H. Carpenter, (July 21, 2010).

[24] For a full listing of the consumer protection laws see Subtitle H of Title X of Pub. L. No. 111-203.

[25] CRS Report R41338, *Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau*, by David H. Carpenter, (July 21, 2010).

[26] The 10 voting members include the Treasury Secretary (who will chair the FSOC), the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Bureau, the Chair of the Securities and Exchange Commission, the Chair of the FDIC, the Chair of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chair of the National Credit Union Association Board, and an independent member appointed by the President and confirmed by the Senate with insurance expertise.

[27] Section 704B of Subtitle G of Title X of Pub. L. No. 111-203.

Section 1026 of Dodd-Frank exempts depository institutions and credit unions with under $10 billion in assets from primary examination and enforcement by the CFPB. The institution's primary regulator retains authority to oversee the institution without interference from the CFPB. Despite this exemption, institutions under $10 billion must still comply with all generally applicable CFPB regulations including consumer protection and reporting requirements. In testimony before the House Financial Service Subcommittee on Financial Institutions and Consumer Credit, representatives from both exempted entities expressed concerns that the exemption did not go far enough to minimize the regulatory burdens on smaller institutions.

Mainly, those entities are concerned about the following

- the $10 billion exemption is not indexed for inflation;[28]
- the ability of CFPB to join primary regulators as passive observers during examinations; [29] and
- primary rule writing authority of the CFPB.[30]

To fully implement the provisions of the Dodd-Frank Act, federal agencies are required to conduct 243 new rulemaking actions.[31] Below is the breakdown of the agencies and the number of new rulemakings they are required to conduct:

Agency	Number of Regulations
Bureau of Consumer Financial Protection	24
Commodities Futures Trading Commission	61
Financial Stability Oversight Council	56
Federal Deposit Insurance Corporation	31
Federal Reserve	54
Federal Trade Commission	2
Office of the Comptroller of the Currency	17
Office of Financial Research	4
Securities and Exchange Commission	95
Treasury	9

[28] *Legislative Proposals to Improve the Consumer Financial Protection Bureau: Hearing before the H. Fin. Svcs. Comm S. Comm. on Financial Institutions and Consumer Credit* (April 6, 2011) (Testimony of Rod Staatz, President and Chief Executive Officer SECU of Maryland, on behalf of the Credit Union National Association).

[29] *Legislative Proposals to Improve the Consumer Financial Protection Bureau: Hearing before the H. Fin. Svcs. Comm S. Comm. on Financial Institutions and Consumer Credit,* (April 6, 2011) (Testimony of Noah Wilcox President and CEO of Grand Rapids State Bank Grand Rapids, MN, on behalf of the Independent Community Bankers of America).

[30] Id.

[31] Wall Street Journal, *The Uncertainty Principle*, (July 14, 2010).

Hearing Objective

From 2003 to 2010, many small banks increased their small business lending despite massive declines in small business lending from their larger counterparts.[32] [33] Because of their importance as a lender to small business, we need to insure that a proper balance exists between an effective regulatory structure that protects depositors and a financial institution's ability to lend.

This hearing will examine the impact of the new regulatory structure on both small business lending and small banks. Witnesses will also identify solutions that both protect the public and allow banks to lend to businesses driving our economic recovery.

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[32] Small Banks are defined as those with assets ranging from $100 million to $10 billion.

[33] SBA Office of Advocacy, Gregory W. Haynes and Victoria Williams, *Lending by Depository Lenders to Small Businesses, 2003 to 2010*, (March 2011).