Statement before the House Financial Services Committee

# The Dodd Frank Act Five Years Later: Are We More Prosperous?

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*The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.*

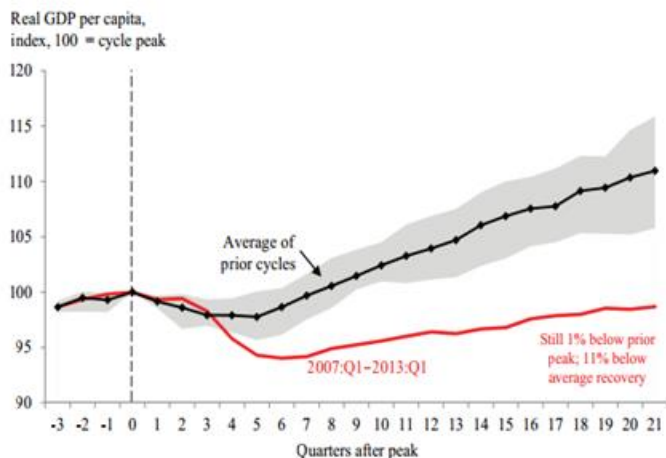
Chairman Jeb Hensarling, Ranking Member Waters and members of the Committee:

I am grateful for the opportunity to testify before this committee on the question: "The Dodd-Frank Act Five Years Later: Are We More Prosperous?" My name is Peter Wallison. I am the Arthur F. Burns Fellow in Financial Market Studies at the American Enterprise Institute. My testimony is my own and does not necessarily represent the views of AEI.

I am particularly delighted to be seated here with Phil Gramm, not only the teacher of the chairman of this committee but to my mind the greatest political economist ever to sit in the US Senate. He is sorely missed by everyone who recognizes the need today for pro-growth economic and financial policies. To be sure, there are great advocates for these policies in Congress today, but the knowledge and clarity of expression of Senator Gramm was and is unique. Although I like to have the opportunity to speak once in a while when I testify before congressional committees, I would happily cede all of my time to Phil Gramm. In that way, not only will the members of this committee be educated, but so will I.

Dodd-Frank became a law on July 21, 2010, and this testimony will use that date as the reference point for determining the economic effects of the act. On whether we are more prosperous since July 21, 2010, it is important to understand that the question of prosperity or economic growth is relative. There has certainly been economic growth since July 21, 2010. In that sense, we are more prosperous, but as Senator Gramm said in his written testimony: "Had this recovery simply matched the strength of the average of the other ten recoveries since World War II, 14.4 million more Americans would be working today and the average income of every man, woman and child in the country would be $6,042 higher."

Below is a chart, prepared by the Federal Reserve Bank of Dallas that encapsulates the point that Senator Gramm is making.



As the chart shows, through the first quarter of 2013, there had been some economic growth, but far less than in a normal recovery. Since then, as we know, things have not improved substantially. 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 this 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."[1]

What's the problem?

I believe that all the new regulation added by the Dodd-Frank Act in 2010 is the primary reason for the slow growth this country has experienced since 2010. Later in this testimony, I will show that the new regulations imposed on banks—particularly small banks—has created a bifurcated economy. Large firms in the real economy, which can access the capital markets for financing, have been growing roughly in line with previous recoveries, but smaller firms that rely on banks for financing are growing far more slowly. Since most of the growth in the US economy, and especially in employment, comes from small firms, the economy is underperforming and will continue to underperform until the treatment of banks under Dodd-Frank Act is substantially modified or repealed.

**A Cost-Benefit Analysis of Dodd-Frank's Additional Regulations on Banks**

The relevant question about the efficacy of any new regulation such as the Dodd-Frank Act is always one of balancing costs and benefits. Regulation inevitably imposes costs, and placing additional costs on any business will virtually always reduce the system's productivity and growth by diverting expenditures to regulatory compliance instead of greater production. In banking and finance, which rely heavily on human capital, it may be easier to measure at least one element of cost—the effect on hiring practices. If, in order to comply with a regulation, a bank has to hire a compliance officer rather than a loan officer, the bank will inevitably be less productive—it will make fewer loans for the same amount of revenue.

Looking simply at employment practices instead of other effects of regulation is a very simple idea, and it doesn't fully reflect all the costs of additional regulation. As Greg Ip recently wrote in the *Wall Street Journal*, "[N]o one knows the true costs or benefits of the blizzard of laws, rules and penalties imposed since the financial crisis…Unlike the rules governing pollution and automobile safety, the costs and benefits of big new financial rules are seldom rigorously quantified… The costs of financial regulation go beyond what banks and their shareholders must pay for more compliance personnel. By making credit more expensive and restricting supply, new regulation can ding growth, especially at times like the recent past when the Fed can't compensate by lowering interest rates, which are already near zero."[2]

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[1] Glenn Hubbard and Kevin Warsh, "How the U.S, Can Return to 4% Growth," *Wall Street Journal*, June 23, 2015.

[2] Greg Ip, "Missing in Financial Rules Debate: Hard Numbers," *The Wall Street Journal*, May 13, 2015.

Nevertheless, although we can't put a number on all the costs of more regulation, at least for the banking industry we can say that hiring practices shaped by additional regulation may be one way to measure some of the costs of the new regulation that came with the Dodd-Frank Act. I will assume in the discussion that follows that all the new regulations that have been imposed on banks have required them to add compliance officers instead of loan officers, and that this was one major cost of the Dodd-Frank Act. It added costs, but reduced the amount of lending. The next question is measuring the benefit.

Giving Congress its due, in enacting Dodd-Frank Congress was trying to achieve financial stability in the future through stricter regulation of the financial system. In doing so, I believe Congress misdiagnosed the financial crisis as the result of lax regulation of the private financial sector. In effect, it treated the symptoms rather than the disease. The symptoms were the weakness of private financial institutions as unprecedented numbers of mortgages defaulted in 2007 and 2008, but the disease was the government's housing policies, which—between 1992 and 2008—caused a drastic deterioration in residential mortgage underwriting standards. A single fact demonstrates the government's role in weakening the financial system: in 2008 more than half of all mortgages in the US—31 million loans—were subprime or otherwise weak and risky. And of these 31 million mortgages, 76 percent were on the books of government agencies. This shows, without question, that the government created the demand for these low quality mortgages.[3]

For purposes of this testimony, however, whether Congress was right or wrong in its diagnosis of the financial crisis is immaterial. Even if Congress was correct in its assessment of the causes of the crisis, we can evaluate whether the balance it struck between costs and benefits in the regulation of banks was correct. Here we can be reasonably sure that we know what benefit Congress was seeking. Because of its diagnosis of the crisis, Congress was seeking to create future stability in the financial system by imposing greater regulation on private sector financial firms, particularly banks. So the question is whether the stability Congress was hoping to achieve through additional regulation in Dodd-Frank outweighs the costs.

Before beginning this analysis, it is important to note that we cannot weigh all the costs of Dodd-Frank. We don't have the capacity to do that at this point. When Jamie Dimon, the chair of JPMorgan Chase, asked Ben Bernanke in 2011 whether "anyone bothered to study the cumulative effect of all these things," Bernanke replied, "I can't pretend that anybody really has. You know, it's just too complicated. We don't really have the quantitative tools to do that."[4]

Nevertheless, the fact that we can't quantify all the costs of Dodd-Frank does not mean that we can't assess at least one of them, and that is the cost of hiring compliance officers instead of loan officers. Compliance officers are necessary to meet the regulatory demands of the government; loan officers are necessary to increase lending or to sustain it at previous levels. To the extent that banks have to hire compliance officers instead of loan officers, they are inevitably reducing the amount of lending they will do.

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[3] For additional details, see Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again*, Encounter Books, 2015.

[4] Deal Book, "What Dimon Told Bernanke," *New York Times*, June 8, 2011.

A good place to assess the cost-benefit question underlying Dodd-Frank is the act's requirement that all bank holding companies with $50 billion in assets or more be considered systemically important financial institutions (SIFIs) and subjected to "stringent" regulation by the Fed. Among many other requirements, these banking organizations must also prepare 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" regulation entails. These substantial additional costs, even if only in the form of more compliance officers than loan officers, will mean that these banks will supply less credit to the real economy. If banks did not have to hire any compliance officers, all their new hires—if any—would be loan officers, which would generate more loans and hence more revenue and more economic growth for the real economy.

Do the benefits that Congress sought in imposing substantial new regulation on banking organizations with assets of $50 billion or more outweigh the costs? The benefit is added stability. With "stringent" regulation, stress tests and living wills, it is fair to assume that these banks will be less likely to fail in the future, and if they fail their failure will not be as disorderly as failures in the 2008 financial crisis. The cost is that these banking organizations will, through their subsidiary banks, be making less credit available to the real economy because they have been required to hire more compliance officers instead of loan officers.

The Federal Reserve's Flow of Funds accounts tells us that as of the end of the first quarter of 2015 the total financial assets in the US were $86 trillion, and total assets of private depository institutions were $17 trillion. $50 billion is .3% of 17 trillion. So the drafters of the Dodd-Frank Act believed that a banking organization with .3% of the assets of the entire banking business would cause the financial system to become unstable if it failed. A bank with $200 billion in assets would have 1.2% of total bank assets. Even a bank with $500 billion in assets has only a little over 3% of all bank assets. It seems completely implausible that in an economy with $85 trillion in financial assets and a banking system with $17 trillion in assets the failure of a $50 billion banking organization—or even a $200 billion or $500 billion bank—would cause any significant instability. Losses, yes. Instability in the whole financial system, no.

So it seems that Congress struck the wrong cost-benefit balance between economic growth and stability when it decided that any banking organization with assets of $50 billion or more ought to be subjected to costly new regulations in the interest of assuring the future stability of the financial system. This new regulatory burden imposes a high cost in the form of much slower growth—especially, as we will see, for businesses dependent on banks—with very little benefit in the form of additional stability. Senator Gramm described the high cost relative to benefits in the statement from his testimony that I quoted above. In that case, which assumed that Dodd-Frank had not been adopted at all, the cost came in the form of a slower economic recovery since the end of the 2009 recession than the average recoveries of the past.

We don't know how much additional growth we would have had if Dodd-Frank had drawn the SIFI line for banking organizations at the different place—say, at $500 billion or $1 trillion. Although we know that regulation has some cost, there is insufficient data available to draw any connection between a certain amount of new regulatory cost and a certain amount of reduced economic growth. But what we do know in the case of the special regulations imposed

on banks with more than $50 billion in assets up to as much as $500 billion is that we have bought more stability than we need at the cost of reduced economic growth.

The same is true for small banks, which have also been required to address many new regulations coming out of Dodd-Frank, especially in mortgage lending, debit and credit card activity and consumer lending. There has actually been some solid academic work on how regulation affects the employment practices and profitability of community banks—those with assets of less than *$50 million*. In 2013, three economists at the Federal Reserve Bank of Minneapolis actually looked at the effect of new regulations on these 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."[5]

Although community banks with less than $50 million in assets are of course much smaller and simpler than banks with $50 billion in assets, the point is the same if we are talking about the effect of regulations on hiring practices. 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 will also be reduced, a certain number of those banking organizations will then become vulnerable to failure, and all of them will reduce the amount of credit they provide because relatively more of their human capital is engaged in compliance rather than sales.

In March, 2014, for example, JPMorgan Chase, the largest US banking organization, cut back its projections for the coming year, saying that its trading profits and return on equity would be down. It noted that it would also add 3000 new compliance employees, on top of the 7000 it added the year before. But the total number of employees of the banking organization were expected to fall by 5000 in the coming year.[6] Absent the regulatory imperative, the bank might have cut 8000 employees instead of 5000, thus cutting its costs somewhat further, or it might have added 3000 new loan officers instead of compliance officers to increase its revenues. But with the regulatory imperative it faced, even a large banking organization that is experiencing a decline in profitability had to increase its hiring of compliance officials and cut employees from its profit-making activities. What we are seeing, then, is a clear case—even at the level of the largest banking organizations—of compliance costs substituted for the personnel that are normally the sources of revenue and profit.

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

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[5] 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.

[6] Dan Fitzpatrick, "J.P. Morgan Dims Its Light on 2014," *Wall Street Journal*, February 26, 2014.

Defenders of Dodd-Frank sometimes argue that a slow recovery is typical after financial crises, 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."[7] [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. What do 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 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 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 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-Stegall 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

[7] 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.

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. As one observer put it, 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, the regulatory attitudes had apparently changed: "Bank examiners became too restrictive, helping to create a near credit crunch."[8] 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." [9]

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 21st century economist would judge disastrous. Confronted with plunging prices, incomes and

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[8]Alan Gart, *Regulation, Deregulation, Reregulation: the Future of the Banking, Insurance, and Securities Industries.* New York: John Wiley & Sons. 1994. p 163.

[9] James Grant, *The Forgotten Depression:1921: The Crash That Cured Itself*. Simon & Schuster, 2014, p4

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."[10] Needless to say, there was no new regulation, and the economy recovered quickly.

This is not to say that a laissez-faire policy is always best,[11] but simply that 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, 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. Nor should either of them significantly suppress capital investment—again, it's more likely that they've both had stimulative effects. So that leaves Dodd-Frank as the most likely cause of the slow-growth economy we have been experiencing.

Finally, quite apart from the fact that Dodd-Frank has probably slowed the recovery from the financial crisis and the ensuing recession through adding excessive regulatory costs, it is important to note that it has also added regulations that impose major costs but which have little or no relationship with the financial crisis. In a 2014 study, the American Action Forum showed that three requirements in the Dodd-Frank Act, the pay ratio rule, the Conflict Minerals provisions and the Volcker Rule totaled more than $10 billion in costs for financial firms, but none has been shown to be a cause of the crisis.[12] For the reasons outlined earlier, these costs are reducing the availability of credit and slowing economic growth for reasons of social justice or the placation of a special interests, not because they were deemed necessary to address the financial crisis. In the case of the Volcker Rule, as discussed later, it may be the eventual cause of another financial crisis by reducing liquidity in the financial markets. In this case, the eagerness of Congress to impose more restrictions on the financial system than were warranted by its own misdiagnosis of what happened in 2008 may have planted the seeds for a future crisis.

## How Dodd-Frank has Slowed Economic Growth

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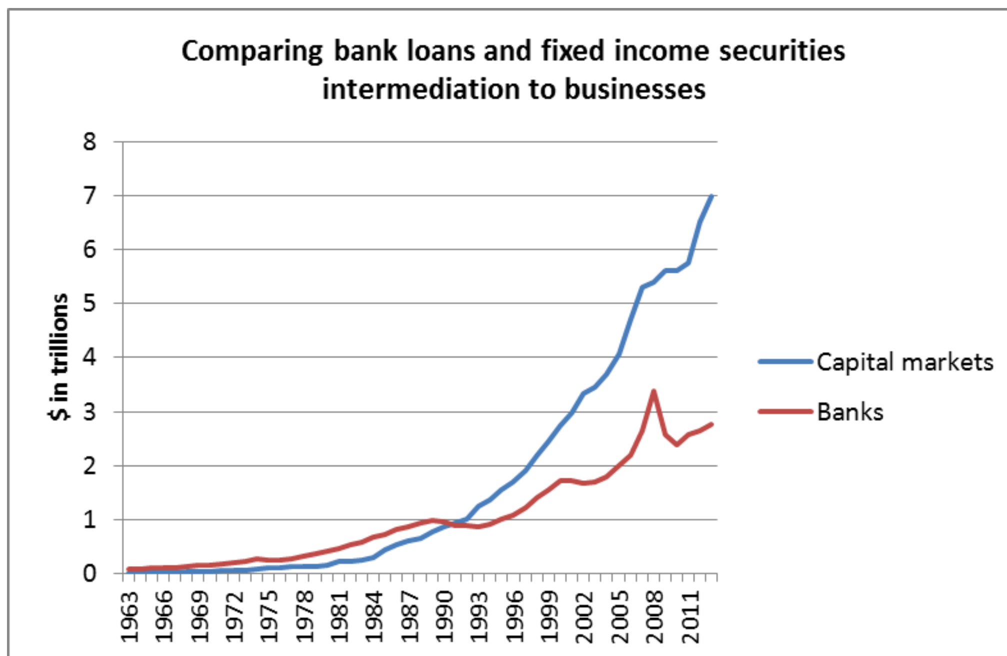
[10] Id., p 1

[11] See, however, Murray Rothbard, *America's Great Depression*, Nash Publishing, 1963, p 167: "If government wishes to alleviate, rather than aggravate, a depression, its only valid course is laissez-faire—to leave the economy alone. Only if there is not interference, direct or threatened, with prices, wage rates, and business liquidation will the necessary adjustment proceed with smooth dispatch. Any propping up of shaky positions postpones liquidation and aggravates unsound conditions."

[12] Andy Winkler, Ben Gitis, Sam Batkins, "Dodd-Frank at 54: More Regulation, More Regulators, and a Sluggish Housing Market," American Action Forum, July 15, 2014. http://americanactionforum.org/research/dodd-frank-at-4-more-regulation-more-regulators-and-a-sluggish-housing-mark.

If excessive regulatory costs have slowed the recovery from the financial crisis, they will continue to slow economic growth until they are reduced or eliminated. In the balance of this testimony, I will focus on the additional regulatory costs imposed on banking organizations, especially small banks, because I think there is a strong case that reducing credit availability from banks is having a particularly adverse effect on small business, which in turn is the principal source of growth and employment in the US economy.

The most important factor in this analysis is the dependence of small and medium sized businesses on bank lending. Larger businesses have access to other sources of credit, primarily through the capital markets. Firms that have registered their securities with the SEC are able to sell bonds, notes and short-term paper in the capital markets—normally a less expensive and easier process than borrowing from a bank. The chart below shows that since the mid-1980s the capital markets have outcompeted the banking industry as a source of credit for business corporations.[13] This popular 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. Accordingly, they are more dependent on bank financing than larger firms. Greater and more costly regulation of banks, then, would inevitably cause either an increase in the cost of bank credit, a reduction in its availability, or both, to these smaller firms.




[13] 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 are 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 capitali 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

A second factor causing difficulties for small banks in particular is the narrative underlying the Dodd-Frank Act—that the financial crisis was caused by insufficient regulation of banks and other financial firms. Solid academic work by my AEI colleague Paul Kupiec and two others has shown that when the regulators were said to have been lax, that is followed by more intrusive activity by bank examiners, and this reduces the amount of lending. "[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."[14] This analysis received confirmation from Fed Governor 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."[15]

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."[16]

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 in the act—which have been cited again and again by small banks since 2010—are responsible. In any event, the decline in new banks caused an overall decline of 800 in the total number of small independent banks between 2007 and 2013. This would have had a disproportionate effect on small business and account in part for the failure of the economy to gain any momentum since the enactment of Dodd-Frank.

Another 2015 study ties the decline of community banks even more closely to the Dodd-Frank Act: "[C]ommunity banks' share of U.S. banking assets and lending markets has fallen from over 40 percent in 1994 to around 20 percent today. Interestingly, we find that community banks emerged from the financial crisis with a market share 6 percent lower, but since the second quarter of 2010—around the time of the passage of the Dodd-Frank Act—their share of

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[14] Paul Kupiec, Yan Lee and Claire Rosenfeld, in "Does Bank Supervision Impact Bank Loan Growth?", draft of May 7, 2015, p1.

[15] Quoted in Kupiec, note 16, p3

[16] 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.

commercial banking assets has declined at a rate almost double that between the second quarter of 2006 and 2010. Particularly troubling is community banks' declining market share in several key lending markets, their decline in small business lending volume and the disproportionate losses being realized by particularly small community banks."[17]

If these factors are indeed adversely affecting banks and thus small business, we should see a difference in growth rates between small business and larger businesses since 2010, when the Dodd-Frank Act was adopted. A recent paper shows exactly that kind of disproportionate effect on small and medium size businesses.

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."[18] But banking regulation was not the only regulation that had an effect on small business: "While banking regulation has played a key role, regulation outside of banking has also raised the fixed costs of doing business." These costs fall most heavily on small firms because larger firms can more easily cope with the fixed costs imposed by regulation.

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. Using Census data, Goldman 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, whereas this figure had grown by roughly 54,000 per month on average over the prior four recoveries."[19]

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 and 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 is the principal source of new employment growth in the US economy.

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,

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[17] Marshall Lux and Robert Greene, "The State and Fate of Community Banking," *M-R Associate Working Paper Series*, No. 37, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, February 2015, p1

[18] Goldman Sachs, "The two-speed economy," April 2015.p3 http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf.

[19] Id., p8

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."[20]

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."[21]

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

**Dodd-Frank, the Volcker Rule and the Danger of another Financial Crisis**

Any policy that reduces market liquidity should be worrisome for this country, given the experience of the financial crisis. More than anything else, the crisis was a liquidity crisis, not a solvency crisis. When Lehman Brothers was allowed to fail, liquidity in the market dried up, meaning that firms that wanted to sell securities to raise cash were not able to do so. We don't know what lies before us, and what event or events could cause many investors to seek to liquidate their holdings of fixed income securities, but what is clear is that if the market does not have the liquid resources to buy these securities their prices will drop precipitously. The securities "fire sales" that regulators say they are worried about will become a reality. The irony is that it is the laws and regulations that Congress has put in place through the Dodd-Frank Act that will cause the crisis.

Chief among these is The Volcker Rule, which forbids banks or their affiliates to engage in proprietary trading of debt securities. Although it was justified by the claim that banks were taking risks with insured deposits, this was truly an absurd idea. The riskiest thing that banks do with their insured deposits is make loans. Trading securities in a liquid market is far less risky than giving a borrower a substantial amount of money in the hope of eventual repayment. Before the Volcker rule, banks were active in making markets in debt securities by standing ready to buy or sell these securities . It is very difficult to tell the difference between making a market—that is, buying and selling for your own account—and proprietary trading. As a result, banks have begun to reduce their market-making activities, leaving the market for all securities with far less liquidity than it had before the Volcker rule was adopted. Some large banks have simply disbanded their bond-trading groups.

This has substantially reduced the amount of capital and liquidity available to the debt markets. The lack of liquidity has almost certainly increased the buy-sell spreads in the debt markets and the costs of buyers, sellers and investors who trade in fixed income securities. It is now much more difficult to sell a fixed income security and thus much more risky to buy one. As reported on May 20, 2015 in the *Wall Street Journal*,

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[20] Id., p3
[21] Ibid.

> Talk to almost any banker, investor or hedge-fund manager today and one topic is likely to dominate the conversation. It isn't Greece, or the U.S. economy, or China…It is the lack of liquidity in the markets and what this might mean for the world economy—and their businesses. Market veterans say they have never experienced anything like it. Banks have become so reluctant to make markets that it has become hard to execute large trades even in the vast foreign-exchange and government bond markets without moving prices, raising fears investors will take unexpectedly large losses when they try to sell. The U.S. corporate-bond market has almost doubled to $4.5 trillion since the start of the crisis, yet banks today hold just $50 billion of bonds compared with $300 billion precrisis.[22]

As Douglas Elliott of the Brookings Institution has pointed out, there have been several periods of extreme volatility in recent years, for which market liquidity was necessary. Nevertheless, Basel III's capital requirements and Stable Funding Ratio, and the Fed's new Liquidity Coverage Ratio have all increased the cost of funding a portfolio of bonds, all of which—together with the Volcker Rule—reduce the amount of liquidity in the market. This could lead to a serious liquidity crisis if one or more major financial institutions is required to sell assets to meet its cash needs: "Illiquidity in financial markets," says Elliott, "can help trigger or exacerbate a financial crisis by creating actual or paper losses at banks or other financial institutions. If a bank needs to raise cash quickly, perhaps to meet deposit outflows in the event of a loss of confidence in that institution, they will likely need to sell securities, especially if they have an excessive mismatch between the maturities of their assets and liabilities. In illiquid markets, this would require 'fire sales' in which the seller accepts a significantly lower price in order to get cash quickly."[23]

On October 15, 2014, the Treasury market moved 40 basis points, an almost unheard of drop for the world's most liquid market. Investigations are underway, but it is difficult to believe that this move was not related to the fact that banking organizations—the largest players in the fixed income markets—now hold only one-sixth of the amount of bonds they held before the crisis. There are fewer market makers and the fewer market makers have fewer cash resources. This is a prescription for a liquidity disaster similar to the 2008 financial crisis.

The Obama administration has denied that the Volcker Rule could be a major factor—or indeed any factor—in the decline of market liquidity, but in July 2015, Lael Brainard, Fed governor, admitted that regulation could be playing a role.[24] Other experienced market observers have been more definitive. In a Wall Street Journal op-ed piece on June 9, 2015, Stephen Schwartzman, the CEO of Blackstone, noted that "A warning flashed last October in the U.S. Treasury market with huge intraday moves, unrelated to external events. Deutsche Bank has reported that dealer inventories of corporate bonds are down 90% since 2001, despite

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[22] Simon Nixon, "Why Liquidity-Starved Markets Fear the Worst," *The Wall Street Journal*. May 20, 2015

[23] Douglas J. Elliott, "Market Liquidity: A Primer," Brookings, June 25, 2015.

[24] Ian Katz, "Brainerd Says Rules Probably Have a Role in Liquidity Volatility," BloombergBusiness, July 9, 2015, http://www.bloomberg.com/news/articles/2015-07-09/brainard-says-rules-probably-have-a-role-in-liquidity-volatility.

outstanding corporate bonds almost doubling. A liquidity drought can exacerbate, or even trigger, the next financial crisis."[25]

Another article in the Wall Street Journal in May 2015, reported that a board member of the European Central Bank, Benoit Coeure, saw "extreme volatility in global capital markets [as] showing signs of reduced liquidity." The article noted that "The world's largest banks dumped around $1 trillion in assets from government bond-trading businesses between 2010 and the end of last year."[26]

Still a third article, in the *American Banker* in June 2015, quoted Richard Berner, the director of the Office of Financial Research, a Treasury unit, to the effect that "the financial reform law could 'be contributing to more permanent adjustments that could impair market functioning,' including by reducing market liquidity."[27]

The administration's refusal thus far to admit that the Dodd-Frank Act may be responsible for what could be a future financial catastrophe, must be seen as a wholly political effort to defend what they see as one of President Obama's key legacies. With financial markets "flashing danger" it is time to look objectively at this problem before it causes another financial crisis. Thus, the Dodd-Frank Act is not only holding back the growth of the economy by reducing the credit available for small businesses; it is also creating the foundation for another financial crisis in the future.

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[25] Stephen A. Schwartzman, "How the Next Financial Crisis Will Happen," *The Wall Street Journal*, June 9, 2015.

[26] Christopher Whittal, "ECB's Coeure: Volatility Signals Reduce Market Liquidity," *The Wall Street Journal*, May 19, 2015.

[27] John Heltman, "Regulators Worry New Rules May Freeze Markets," *American Banker*, June 12, 2015.