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Subcommittee on Subcommittee on Economic Growth, Tax, and Capital Access

Topic: Enabling Success: Examining the Competitive
Landscape for Small Businesses

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Chairman Meuser, Ranking Member Landsman, and Members of the Subcommittee:

Thank you for the opportunity to be here today. Small businesses are the backbone of the U.S. economy and I appreciate the opportunity to discuss how—and how not—to ensure that small businesses in this country have access to the capital they need to survive and thrive. I will focus my written remarks on the impact the reform proposals issued by the Federal Reserve, Federal Deposit Insurance Corporation and Comptroller of the Currency commonly referred to as the Basel III endgame reforms[1] and a simultaneous proposal from the Federal Reserve to revise the methodology for calculating the capital surcharge for global systemically important banking organizations (collectively, the "Proposed Reforms").[2]

The overarching message is that the Proposed Reforms will enhance the resilience of the banking system, making it more likely that large banking organizations will remain healthy and capable of supporting businesses and families in good times and bad. The Proposed Reforms are thus fully consistent with the important aim of enhancing the ability of small businesses to access outside financing. It is true that many small businesses face difficulties obtaining as much funding as they could use, and I will close by touching on these challenges and opportunities. Allowing the largest banks in the country to remain inadequately capitalized is not the answer.

I. Why Capital

Capital regulation is the cornerstone of banking regulation in the United States and abroad, and for very good reason. Capital refers to how banks fund themselves—how much equity relative to debt they use to fund their lending and other activities. In general, banks and banking organizations use far less equity, and far more debt, than other types of businesses. There are some good reasons for this. For example, much of the debt that banks issue takes the form of deposits, which are socially useful. But there are also drawbacks to banks being so reliant on debt. The biggest one is that as a bank's reliance on debt goes up, so does the probability that

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[1] Department of Treasury: Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity (Notice of Proposed Rulemaking, July 27, 2023), *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-basel-iii-20230727.pdf ("Basel III Endgame Proposal").

[2] Board of Governors of the Federal Reserve, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (Notice of Proposed Rulemaking, July 27, 2023), *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-gsib-20230727.pdf ("GSIB Surcharge Proposal".

it will fail. This is particularly bad news when it comes to large banks, as the failure of a large bank can undermine faith in the health of other banks and impede the functioning of the broader financial system. The good news is that the more capital a bank uses to fund its activities, the more capacity the bank has to absorb losses. Better capitalized banks are less likely to fail. This is a core reason that capital is so central to bank regulation.

A distinct advantage of regulating capital regulation is that a well-capitalized bank can absorb losses irrespective of the cause. As recent experience makes all too clear, all kinds of shocks can hit the economy in ways that impact bank health. If a pandemic sweeps the globe, causing many businesses shutter and unemployment to spike, capital can help banks absorb the losses that might result. If that pandemic contributes to a permanent shift in where people live and work, leading to significant declines in the value of office buildings and certain other real estate and higher defaults on loans backed by those properties, capital helps. If a deep recession takes hold, and rising unemployment, declining home values and corporate distress reduces the capacity of all sorts of borrowers to repay their loans, capital helps. If interest rates go up rapidly, leading to declines in the value of Treasuries, mortgage-backed securities, mortgages and other fixed-interest credit instruments, capital helps. In all of these instances and more, having additional capital enables banks to absorb more losses and remain solvent. In a world where no one can predict the future, this is very useful.

A related reason capital plays such a central role in bank regulation is that it creates better incentives for bank shareholders and bank leadership.[3] Bank shareholders, like all shareholders, have unlimited upside, but only limited downside. This can cause them to favor excessive risk-taking. For most companies, the potential for skewed shareholder incentives is kept in check by creditors that demand additional compensation when asked to assume a higher risk of default. This mechanism is imperfect even for nonfinancial companies, but it provides much less of a check with banks. All too often, allowing a bank to fail, and allowing depositors and other creditors to bear the losses they have contractually agreed to bear, can have adverse collateral consequences, such as triggering runs on other banks. As a result, as happened in 2008 and again in 2023, the government sometimes intervenes to protect depositors and other creditors. While such interventions are sometimes warranted to limit the damage that ensues, the expectation of such interventions changes the incentives of bank creditors. The combination of explicit and implicit government backstops thus preclude holders of bank debt from imposing the type of discipline typically imposed by creditors of nonbank companies.

Again, capital helps to address these challenges. When a bank is well capitalized, bank shareholders have more skin in the game. The asymmetry between the upside gains and possible downside losses is reduced. This reduces the inclination of bank shareholders and leadership toward excessive risk taking, and makes it more likely that banks will be managed in a way that promotes real value creation.

More broadly, a well-capitalized banking system is a more resilient banking system. A system-wide capital shortfall was a significant factor exacerbating the 2007-2009 financial crises and the recession that followed. Financial crises hurt businesses and families. After that crisis, the rate of small business creation went down and stayed depressed for more than a decade.

[3] For an overview of the relevant research, including a discussion of how capital requirements reduce the risk-seeking propensity of bank shareholders, see Anjan V. Thakor, Bank Capital and Financial Stability: An Economic Trade-Off or a Faustian Bargain? 6 *Annu. Rev. Financ. Econ*. 185 (2014).

Enhancing the capacity of the banking system to weather shocks can go a long way in reducing the long-term costs that crises can inflict.

II. Capital requirements and lending

The relationship between capital requirements and lending is the source much confusion and contestation. To make progress on this question, we can start by looking at what actually happened as Congress and regulators required banks to hold more capital pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and banks responded by increasing their use of capital. Economists Stephen Cecchetti and Kermit Schoenholtz, co-authors of the influential textbook *Money, Banking and Financial Markets*, now in its sixth edition, compiled data on how banks' changing capital affected lending. Looking at the period between 2013 and 2019, they found that during the early years, when bank capital levels were going up, the rate of overall credit availability remained robust—and that the portion of credit provided by banks, as opposed to nonbanks not subject to the new rules, actually went up.

This analysis suggests that banks made more loans even as they increased capital.[4] Based on their analysis of the data, Cecchetti and Schoenholtz conclude: "To be as clear as we can possibly be, higher capital requirements have not hurt banks, they have not hurt borrowers, and, if there was any macroeconomic impact, it was probably offset by monetary and fiscal policy. In other words, it is difficult to find any social costs associated with increasing capital requirements and improving the resilience of the financial system."[5]

Another lesson from the data available is that better capitalized banks extend more credit during downturns—precisely when small businesses need it most. Not all credit is created equal. During boom times, credit is often easy to obtain, and sometimes too easy to obtain. Boom times can inflate asset prices, contributing to excessive extensions of credit on overly favorable terms. The opposite is true when a boom goes bust. It is often during and after financial crises that businesses often most need capital in order to survive, and it is during such periods that the loans extended are most beneficial for the broader economy. Nonetheless, that is often when it is hardest for small businesses and others to access the credit they need.

Research shows that well capitalized banks are more willing and able to extend credit during these challenging times—benefitting businesses and the economy. For example, a work stream organized by the Basel Committee on Banking Supervision reviewed the literature on the costs and benefits of capital requirements, coupled with its own analysis of the impact of such requirements. They found that "a country whose banks enter a crisis with a one percentage point higher capital ratio experiences 0.29 percentage points higher annual loan and 0.18 percentage points higher GDP growth in the following five years, compared to other countries."[6] This finding was consistent with other research suggesting that the greatest benefit of capital

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[4] Stephen G. Cecchetti & Kermit L. Schoenholtz, Setting Bank Capital Requirements, *Money and Banking Blog*, October 12, 2020, *available at* www.moneyandbanking.com/commentary/2020/10/11/setting-bank-capital-requirements

[5] *Id.*

[6] Basel Committee on Banking Supervision, The costs and benefits of bank capital – a review of the literature (BIS Working Paper 37, June 2019), *available at* https://www.bis.org/bcbs/publ/wp37.pdf, at 10.

requirements may be to lessen the adverse impact of financial crises by positioning banks to lend more after a crisis strikes.

More generally, based on their own analysis and the literature, the Basel Committee on Banking Supervision work stream concluded that higher capital requirements can "significantly lower the cost of a crisis by sustaining bank lending during the resulting recession. In addition, in normal times, bank capital does not seem to be negatively correlated with loan growth."[7]

None of this is to deny that at some point, capital requirements can impede bank lending. There is an extensive albeit far from conclusive body of literature trying to assess the tradeoffs at play between the impact of capital and other bank regulatory requirements in good times and bad. Nonetheless, the overall picture that emerges from the research is that capital requirements in the range proposed will help banks do more lending during periods of distress, when businesses and the economy stand to benefit the most. This is consistent with the assessment of the Federal Reserve, Comptroller of the Currency and FDIC with respect to the impact of the proposed Basel III endgame reforms: "Although a slight reduction in bank lending could result from the increase in capital requirements, the economic cost of this reduction would be more than offset by the expected economic benefits associated with the increased resiliency of the financial system."[8]

There are also more specific reasons to expect that the Proposed Reforms will not adversely impact credit access for small businesses. Rather than providing a detailed overview of the Proposed Reforms (which run over 1,000 pages), I will focus on two features: (1) the types of banks most impacted by the Proposed Reforms; and (2) the types of banking activities most impacted by the proposed reforms.

The United States is fortunate to have a diverse banking sector, with a range of different types of banks that specialize in serving different types of businesses and other clients. This includes a robust set of community financial institutions and other community banks and smaller regional banks that continue to prioritize relationship lending. Smaller banks have long played, and continue to play, an outsized role in small business lending. In 2021, for example, community banks held just 13 percent of the banking system's assets and 17 percent of its loans, yet they also held 40 percent of outstanding small business loans.[9] This is a smaller figure than it used to be, but it reflects the persistent and positive relationship between small banks and local, small business lending.

The small business credit survey conducted by the Federal Reserve shows that small businesses also report having a much better experience when they borrow from a small bank than when they seek financing from a large bank or a nonbank, such as a fintech lender.[10] Community and other smaller banks also often have a different business model than the largest banks, focusing more on relationships and relationship lending. Research shows that relationship

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[7] *Id.* at 11.
[8] Basel III Endgame Proposal at 489.
[9] FED. RSRV. BANK OF KAN. CITY, COMMUNITY BANKS CONTINUE TO PLAY A PIVOTAL ROLE FOR SMALL BUSINESSES (2021), https://www.kansascityfed.org/Banking/documents/8441/Oct142021_CommunityBankingBulletinHighlight.pdf.
[10] FED. RSRV. BANKS, 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY 7 (2023) *available at* https://www.fedsmallbusiness.org/survey/2023/report-on-employer-firms.

lending can be helpful to both banks and the businesses they serve, and can play a particularly important role in increasing the amount of credit available to small businesses.[11]

Yet the Proposed Reforms do not target small or even midsized banks. Instead, they are focused on strengthening the health of very large banking organizations, those with at least $100 billion in assets, and much of the impact would fall on the largest, more complex banks. As the accurately summarized in the press release accompanying the Proposed Reforms: "Community banks would not be impacted by this proposal."[12] In short, the types of banks that do the best job providing credit to small businesses are not the banks that will be affected by the Proposed Reforms.

Yet another reason not to worry about the impact of the Proposed Reforms on small business lending is that they do not contemplate an across-the-board increase in capital requirements even for the affected banking organizations. Instead, many of the Proposed Reforms are efforts to strengthen how banks assess the risks that arise from activities than extending credit and to introduce more standardization in how banks assess a range of risks.

For example, the Proposed Reforms tackle the challenge of trying to ensure banking organizations are adequately capturing the risks associated with trading. It requires that, as a default, all banking organizations subject to market risk requirements use the standardized measure for market risk. It does still allow banks to use a models-based measure, but it requires that all uses of internal models be subject to supervisory approval at the trading-desk level and introduces additional controls. These types of reforms should enhance the risk sensitivity and calibration of market risk capital requirements, and make it more likely that banks can only use internal models when they are adequately robust to capture the relevant risks. Similarly, the Proposed Reforms would improve the risk sensitivity of the GSIB surcharge to better capture the systemic footprint and potential threat posed by a banking organization. Such reforms should reduce opportunities for gamesmanship and do a better job of deterring banks from altering their activities or footprint in ways that could threaten systemic stability.

In general, the Proposed Reforms introduce more transparency and consistency into the regulatory framework. They are the byproduct of years of effort, both internationally and in the United States, to assess just how best to promote the health of the banking sector and the broader economy that it supports. Small businesses would be among the many beneficiaries of the more robust, accountable regime embodied in the Proposed Reforms.

III. Small Business Access to Credit

There may be little reason to worry about the impact of the Proposed Reforms on small business lending, but there are good reasons to be concerned about the ability of small businesses to access the credit they need to grow during good times and make it through the tough times.

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[11] *E.g.*, Vitaly M. Bord, Victoria Ivashina & Ryan D. Taliaferro, Large banks and small firm lending, 48 Journal of Financial Intermediation, Volume 48, October 2021,
Mitchell A. Petersen & Raghuram G. Rajan, The Benefits of Lending Relationships: Evidence from Small Business Data, The Journal of Finance, Vol. 49, No. 1 (Mar., 1994), pp. 3-37;
[12] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, Joint Press Release: Agencies request comment on proposed rules to strengthen capital requirements for large banks, July 27, 2023,
https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm.

According to the Federal Reserve's 2023 Small Business Credit Survey, only 17 percent of the businesses surveyed reported their financial condition as either "very good" or "excellent," whereas 57 percent viewed their financial condition as either "poor" or fair."[13] More than a quarter identified credit availability as a challenge in the preceding year, and just over half of the small businesses that sought funding or a credit line in the preceding year received all of the financing they sought.[14]

There are some bright spots. Overall, more small businesses sought outside financing in the past year than in the preceding two years, and more firms had those applications approved. Dealings with small banks also proved to be a bright spot along many dimensions Applicants at small banks were not only most satisfied with their experience, as already noted, they were also most likely to receive at least partial approval—with more than four out of every five applicants obtaining at least some of the financing sought—and applicants at small banks reported fewer challenges than small businesses who sought financing from an alternative source.[15]

Strikingly, however, even though small businesses had more access to outside, nongovernment financing in 2022 than they enjoyed in the preceding year, how small businesses fund themselves has not returned to pre-pandemic trends. Back in 2019, 62 percent of all small businesses had obtained funding from a financial institution or other lender in the preceding five years, making outside loans the more common source of financing for small businesses.[16] In 2022, that figure was just 51 percent—placing financial institutions and other lenders behind (1) an owner's personal savings, family or friends (66%, up from 56% in 2019) and (2) government programs (55%) as a source of funding that the business had used during the preceding five years.[17] This decline in outside financing could reflect ways that the government's response to the pandemic may have inadvertently greased financing for large companies without providing any commensurate boost for small businesses.

At first glance, the government did far more to support small businesses than large in its response to Covid-19.[18] Through the Paycheck Protection Program (PPP), for example, the government provided significant financial support for small businesses, and nothing comparable was instituted for most large businesses. But zooming out to look at how the myriad pandemic-era programs affected incentives to extend credit and invest in the infrastructure needed to provide and monitor such credit extensions reveals a very different picture.

PPP, understandably, largely functioned as a grant program. The banks and other financial intermediaries through which the funds flowed were not asked to play any role screening the creditworthiness of the small businesses to whom funds were extended. And so long as the program's terms were followed, the government guaranteed that the amounts so extended would be repaid in full. As a result, the design of PPP did little to provide banks or other financial intermediaries any incentive to make investments in the type of information production required

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[13] FED. RSRV. BANKS, 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY 2 (2023) *available at* https://www.fedsmallbusiness.org/survey/2023/report-on-employer-firms.
[14] *Id.* at ii, 7.
[15] *Id.* at 19-22
[16] *Id.* at 9.
[17] *Id.*
[18] For more on these dynamics, see Todd Baker, Kathryn Judge & Aaron Klein, *Credit, Crises and Infrastructure: The Differing Fates of Large and Small Businesses*, 102 B.U. L. REV. 1353 (2022) and sources cited therein.

to underwrite loans or credit lines. Nor did it meaningfully change the perceived risks associated with making loans to small businesses.

Shift the focus to large businesses and the picture looks very different. With few exceptions, most large companies did not receive any direct financial aid from the government. Instead, much of the support for large businesses came via innovative lending facilities designed by the Treasury Department and the Federal Reserve pursuant to the Fed's authority to make loans to nonbanks during "unusual and exigent circumstances," bolstered by special provisions in the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act).[19] The legal and logistical constraints associated with this type of lending, combined with other dynamics then at play, resulted in a secondary credit program that significantly reduced the liquidity risk associated with corporate bonds, syndicated loans and other credit instruments of the type that can only be used by the largest companies. This not only made it easier for large companies to borrow during the height of the pandemic, but also changed perceptions of the risks associated with such lending long after the threat receded. Although the Federal Reserve worked hard to launch a Main Street Lending Program, that program largely targeted pretty big companies, not small ones, and its impact was far more muted. This was not the result of any apparent intent to favor large businesses, but instead a reflection of the mismatch between the types of programs that the Fed could readily institute and the mechanisms through which credit typically flows to small businesses.

Putting these pieces together, although Congress provided far more funding to small businesses than large ones, the aggregate mix of the government programs instituted did far more to grease the wheels on the extension of credit to the largest companies, companies that already have a much easier time accessing outside financing than small businesses. Although far from intentional, the net effect of these interventions was a reminder of the inequities that already exist when small and large companies seek financing, and just how much more might appropriately be done to try to support small businesses.

Although it is beyond the scope of this hearing, I would be happy to discuss ways that Congress and regulators may seek to do more to support access to financing for small businesses. Given what we know about the credit environment small businesses face, and the experience of small businesses seeking outside financing, such efforts are most likely to have the greatest impact when implemented in ways that encourage relationships between small businesses and community financial institutions and other smaller banks.

Thank you again for the opportunity to engage on the Proposed Reforms and small business financing. Capital regulation, like bank regulation generally, is a process that requires ongoing diligence to succeed. The Proposed Reforms should enhance the health of the largest banking organizations and the resilience of the financial system. In so doing, the Proposed Reforms should bolster the long-term health of small businesses and the economy of which they are a part.

[19] Pub. L. 116–136 (2020).