

Chairwoman Warren, Ranking Member Kennedy, and Senators on the subcommittee,

Thank you for the opportunity to speak with you today on the importance of a safe, sound, resilient, and growth-facilitating financial system for our nation. I have been a finance professor since 2002, having published extensively on the capital raising activities of firms and previously was an Associate Editor at the Journal of Finance and the Journal of Financial Services Research. In addition, I had the privilege of serving as the Assistant Secretary for Economic Policy at the US Department of the Treasury during the previous administration. In that role, I worked closely with the Small Business Administration to quickly implement the Paycheck Protection Program and ensure that the economic devastation that might have resulted from the pandemic was not realized.

Part of my team's work at Treasury was to engage with a vast array of lenders across our nation to ensure that eligible small businesses were able to obtain their PPP funds. I worked closely with community, regional, and large banks, CDFIs, MDIs, credit unions and FinTechs to better understand the issues they were confronting and to resolve the challenges they and their borrowers were facing. In December 2020, Treasury worked closely with Congress on legislative updates to PPP, extension of a second round of loans for the hardest hit small businesses, and enactment of additional capital funding for CDFIs and MDIs.

Historically, our nation's economic strength has arisen from the ingenuity and dynamism of our private sector. Advancements in industries such as technology, pharmaceuticals, financial services, and entertainment disproportionately occur in the United States. This outcome is consistent with the [academic literature](#) that compares economic outcomes in different countries around the world and documents that "a business environment that promotes competition, private property rights, and sound contract enforcement boosts economic growth." A critical part of that business environment is access to capital. Unlike Europe where the history of the banking sector was largely to facilitate the borrowings of governments, in the United States, we have historically had a decentralized banking system to meet the needs of businesses and consumers.

Significant economic growth originates from America's small businesses. According to [data from the US Chamber of Commerce and the US Small Business Administration](#), small businesses account for 64% of new jobs in the United States and the comprise 46% of US employment. In a nation as ethnically diverse and geographically dispersed as ours, a robust private sector comprised of millions of small businesses is essential to meet the heterogeneous needs and desires of our Nation.

Indispensable to meeting the needs of US small businesses has been the availability of credit from local and regional lenders. [According to a recent Federal Reserve report](#), "large banks tend to be proportionately less committed than smaller banks to small business lending." Smaller banks with less than a billion dollars in assets on average had loan portfolios in June 2021 that were more than 13% comprised of small business loans. That figure was just 6% for the largest banks.

To understand why this disparity exists, it is helpful to employ a dichotomy used in the academic banking literature – the difference between hard and soft information. [As my coauthor](#)

[Mitchell Petersen defines it](#), hard information is knowledge that can be “easily reduced to numbers.” On the other hand, soft information “requires a knowledge of its context to fully understand, and that becomes less useful when separated from the environment in which it was collected.” Things like FICO scores, debt-to-income ratios, and collateral values are hard information that can just as easily be evaluated from across a desk as from across the country. The unique needs of a local demography and why a particular business model is viable in a particular geography is much more difficult to translate numerically and communicate in a large, hierarchical organization. That is why access to financing at the local level depends on a robust network of financial institutions with local roots, not just a handful of national megabanks.

The other factor at play has been the innovation of technology and telecommunications. The last 50 years have seen extraordinary advancements in computing power and the speed with which information moves at ever lower cost. Within financial services, we have witnessed the deployment of ATMs around the nation. Online and mobile banking means that depositing checks and paying bills is faster and more convenient than ever. Customers can now make deposits from anywhere in the country, access their money 24 hours a day, 7 days a week, easily transfer money between accounts, and pay bills from their computer or their phone. Lending underwriting models can now be programmed with borrower information verified entirely electronically and credit decisions issued nearly instantaneously. What we must understand about the economics of creating these ATM networks, online platforms, and lending systems is that they have large fixed-development costs and low variable costs, resulting in enormous returns to scale that make a partial shift toward larger banks something to be expected. The cost of creating the online platform is substantial for the first customer with almost zero incremental cost for the second.

Individual states and the US Congress recognized the benefits of these technological and communication advances, green lighting the realization of such scale economies when it facilitated intrastate branching and later interstate banking. However, an important implication is that we now have greater concentration of banking activity than ever, with [four megabanks serving nearly 48 percent of the nation’s deposits](#) in 2022. [According to the FDIC](#), in 1934, there were 14,146 commercial banks in the United States. That number stayed above 13,000 between 1934 and 1984 when the number of commercial banks in our nation peaked at 14,496. Since 1984, that number has declined every single year down to 4,136 in 2022, a decline of more than 71%.

This enormous consolidation creates new challenges. Returning to the intersection of the information environment with advancements in technology, an equilibrium has emerged where hard information banking activities are being done primarily by large scale, multi-trillion dollar banks who can easily incorporate numerical inputs into lending decisions. However, this model does not work for soft information loans. Some of the [necessary information is lost as scale increases due to the difficulty of passing that information through a large organization](#).

Critical banking activities that rely on soft information are where community and regional banks are pivotal. Local knowledge requires local decision-making. Bankers in New York do not necessarily understand the local needs of Baton Rouge, LA just as bankers in San

Francisco may not know the lending opportunities in western Massachusetts. Local and regional bank executives and their boards constantly strive to find the balance between deploying the technological advances their customers require at an affordable cost while maintaining credit allocation decisions among those with the best information. We must ensure a vibrant ecosystem for providers of soft-information loans and not allow our concerns about systemic risks from large institutions to create extraordinary burdens for the primary capital providers to America's thriving small businesses.

This raises the third major factor banks must contend with – the evolving regulatory environment. Following the financial crisis, Congress enacted Dodd Frank to impose greater requirements on the banking sector. In my view, this approach was misguided in numerous ways:

First, it presumes that financial regulators will be able to stay ahead of the banks they supervise. As the recent collapses of Silicon Valley Bank and First Republic Bank demonstrate though, if bank supervisors cannot identify and address simple interest rate risk and duration imbalances at the banks it oversees, how can we rely upon them to stave off more complicated risks from exotic derivatives or lending activities to new industries? This problem is compounded when banks have an incentive to complicate or obfuscate their operations.

Second, it causes the banking sector to be more uniform, as Tyler Goodspeed and I discussed in a recent [Wall Street Journal opinion piece](#). One of the historical strengths of our financial system has been its vast number of participants and heterogeneity of business models. This means that when one bank fails, others are not identically weak. The overall system benefits from different banks pursuing different technologies, customer segments, and underwriting models. When regulators replace the judgement of the banks with their own, regulatory failures that over-emphasize credit risk and under-emphasize interest rate risk, for example, cause common shocks that put the entire system in greater jeopardy. For our largest institutions, I believe that the solution is greater capital, not greater bureaucracy. When investors have more of their own money at risk, they will force bank management to manage the risk they create better than any bank regulator.

Third, the systemic risk exception on deposit insurance has proven extraordinarily problematic. The Treasury Secretary's recent decision to declare uninsured deposits to be covered even though the banks clearly were not systemic means that depositors no longer have reason to discipline the banks at which they place their money. Imposing five percent haircuts on the deposits of large technology companies, private equity funds, foreign depositors, and wealthy individuals would have sent a message that chasing yield with uninsured deposits is risky and sometimes results in losses. Instead, the outcome is that [regional banks have seen significant deposit losses with some of those funds flowing to large banks](#), making them even larger. Statutory language implicitly saying that large banks have a more robust deposit guarantee than community and regional banks causes exactly the concentration of risk that policymakers should avoid. I agree that we need to take another look at deposit insurance and perhaps guarantee non-interest-bearing transaction accounts so that American workers can be sure that paychecks written on bank accounts with balances above the deposit limit are protected. Nowhere should law or policy provide differential deposit insurance based on the size of the bank.

Fourth, uniformly applying regulation and supervisory tactics to all banks when only the largest pose particular types of risk make small and regional banks less competitive. Large banks have the scale to implement large fixed-cost regulatory compliance obligations economically. This is why during the Trump Administration, we raised the threshold for heightened supervision to \$250 billion in assets while allowing supervisors discretion to extend such requirements to banks as small as \$100 billion in assets. Such a bank without a chief risk officer for eight months certainly should have received that heightened supervision. However, even if SVB had undergone the Fed's stress test, it would have passed because stress tests in 2022 focused on credit risk and ignored the 40-year high inflation caused by Congress' excessive spending. However, it is not just what statutes and regulations say that create problems. When bank supervisors request that small banks comply with more onerous requirements because they are "best practices", even though they are not mandated, compliance costs rise, and small banks are less economical.

Finally, bank regulation must make it easier for new banks to enter into existence. [Since 2010](#), only 62 new FDIC-insured banks have been chartered in the United States, which is why we have seen the number of banks decline so dramatically in the last 40 years. Another of my former coauthors, Mark Flannery, served as Chief Economist at the Securities and Exchange Commission during the Obama Administration. He pointed out a paradox in financial regulation that greater regulation may actually result in the average dollar being less regulated. The more that we make it difficult to comply with regulation, the more money goes into shadow banking. Passing on stricter mandates to our nation's banks may instead result in marginal funds going to less regulated credit unions or unregulated FinTechs without necessarily making depositors or the system safer. This is why it is appropriate that we ask our regulators to work with industry and academics to identify the impediments to de novo banking so that greater bank entry might partially offset consolidation.

With regard to the bank merger review process, I think it is important that we give greater thought to the definition of local and regional competition. Lending activities of credit unions and FinTechs should be accounted for in determining the changes in market power that may be caused by a combination of banks. Regulated depository institutions and lenders who serve a locality online without a physical footprint are likewise competitors who should be acknowledged. Additionally, I agree with maintaining the current language in the law that requires the FDIC to accept the bid that is least costly to the insurance fund when resolving a failed bank. That said, we should make sure that the prospect of [FDIC loss sharing guarantees](#) do not delay mergers of poor performing banks to the detriment of the insurance fund.

Our banking system must continue innovating the provision of financial services to improve access, lower costs, and safeguard financial information. This means that there will be numerous large institutions realizing significant economies of scale engaged in hard information lending activities. Policymakers and regulators must ensure that there are enough of these banks to maintain significant competition so that no single bank is able to exert market power. From a systemic risk management standpoint, we should not assume that regulators will have the information and sophistication necessary to stay ahead of the banks' activities. Instead, we

should require that systemically important financial institutions are highly capitalized so that they have the internal incentives to mitigate risk. Much of what regulators monitor should be left to the owners of these banks – let capital do the work of regulators. This would also greatly reduce the compliance burdens on small and regional banks who cannot afford the fixed costs of the regulatory apparatus and still compete.

While the efficiency of scale may be tempting, top-down command and control by government over what products Americans can purchase, what loans can be extended, and how companies must operate curtails the ability of entrepreneurs to serve our fellow citizens. We must return these decisions to the private sector.

I look forward to participating in this important conversation.