Fostering Economic Growth: The Role of Financial Companies

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Chairman Crapo, Ranking Member Brown and members of the Committee, thank you very much for inviting me to testify on the contribution made by financial institutions to foster economic growth and the role of regulation in that context.

Having spent most of my career in banking and related financial sectors of our economy, I had the honor of serving as a member of the Board of Governors of the Federal Reserve System, where I served as the chairman of the Committee on Bank Supervision and Regulation. Currently I am on the board of directors of Bank of Marin, a community bank located in the San Francisco Bay Area. It is my pleasure to offer the following observations.

1. The Role of the Financial System in the Economy

Every student of economics knows about the vital role played by the financial system in supporting and fostering economic growth. In the interest of time, I will focus my remarks mainly on the role of the banking system, but there are many other financial service companies that perform similar or complementary functions as well.

The variety of financial services offered by our nation's banks is truly extraordinary and ranges from simple payments and banking services to highly complex financial products.

Consumers benefit from having convenient, secure and efficient payments and depository facilities like checking, savings and money market accounts available to them. Credit cards allow them to buy now and pay later for their purchases. As people go through the various phases of their life, they may have a need to finance their college tuition, buy a car with the help of an automobile loan or lease, or take out a mortgage or home-equity loan to purchase a house and to furnish it. Over a lifetime, people also want to accumulate enough resources to provide for a secure retirement and maybe fund a trust account to provide for the needs of loved ones.

Large and small businesses also have an ever-changing need for a broad range of financial services. Small companies may need simple cash management services as well as a loan to finance inventory or to buy new equipment. Larger corporations may want to issue bonds and stocks to finance their growth and expansion. Companies that are active in international markets will also need foreign exchange and remittance services. Finally, large multi-national corporations may want to avail themselves of a myriad of complex financial services, such as swaps and derivatives, which enable corporations to shift risk from their own balance sheet to others through hedging activities carried out with the help of experienced financial intermediaries. In addition, they may need local banking services in the foreign countries around the world where they do business.

In a sense, the financial flows pulsing through our financial system and supporting the economy at large are akin to the lifeblood coursing through our body and nourishing all vital organs. Without the financial flows nourishing the economy, the rest of the economy would wither and die.

a. Loan Growth Parallels Economic Growth.

Over the economic cycle, loan growth tends to parallel economic growth as is shown in Figure 1, which depicts the growth rates of GDP and that of commercial and industrial loans made by banks since 1980.

FIGURE 1

Each recession is accompanied by a decline in loan growth and once economic growth recovers, loan growth also tends to accelerate. The relationship works in both directions: higher economic growth calls for new financing of supplies and equipment, and new loans by banks help to spur economic activity. Economic growth and financial activity go hand in hand.

b. Our Multi-Faceted Economic and Financial System. Our economic system is composed of a multitude of enterprises of various sizes. All enterprises start small and, if they are successful, they grow into huge multinational enterprises. It is truly amazing that in our dynamic economy, two companies founded during our lifetime in Bentonville, Arkansas and Cupertino, California grew into some of the largest corporations in the world. Small, dynamic companies often experience the highest growth rates and create the most new jobs.

The same holds true for our financial institutions, which range in size from small community banks to trillion-dollar strong, multi-national financial corporations that span the globe.

Community banks have always been a mainstay of the American financial system. They are generally small, community-based institutions, which tend to focus on relationship banking. They serve the banking needs of the consumers and the small to mid-sized businesses within their footprint. They know their customers well and have established relationships that often last for decades. Community bankers know their customers by name and are intimately familiar with the customers they lend to – often because they live next door to them. They do not tend to compete on price, but on the quality of the services they provide on the basis of personal relationships. Community banks that have a solid credit culture and avoid risky exposures can do very well by serving their established customers.

At the other end of the spectrum, we have a handful of large banks that offer a broad range of financial services to their customers. These trillion-dollar strong universal banks ~~offer~~ provide a broad range of depository services and loans as well as sophisticated financial products and services to their customers from coast-to-coast and indeed around the world. Their services encompass consumer-oriented products as well as products oriented towards middle-market firms. They also offer sophisticated financial services to multinational corporations that include nationwide payments services as well as all the traditional investment banking services available in today's sophisticated capital markets.

It was not always that way.

Until the 1980s, our financial system was mostly composed of community banks and even sizeable institutions consisted basically of a large number of community banks under one common umbrella.

In those days, the nation's banking system was fragmented along geographic and functional lines. In addition to the community banks, there were specialized financial institutions that served the unique needs of their customers. There were investment houses that catered to the needs of corporations wanting to issue stocks or bonds; savings banks that specialized in the issuance of mortgages; and even credit card banks to issue credit cards. Moreover, traditional commercial banks were largely prohibited from crossing state lines.

Several factors combined to lead to the elimination of these geographic and functional barriers. There were the insights of academic and financial experts that pointed to the risk-reducing advantages of diversified business activities and portfolios. While one set of activities was lagging, other sectors might be booming. Thus, the enterprise as a whole would have a more stable income stream. Asset or loan portfolios would be better balanced and able to weather unexpected risks. Diversification along both geographic and functional lines was seen as making financial institutions safer.

2. Regulations Shaping Our Financial System

Besides these fundamental academic insights on diversification, there were new laws and regulations that shaped the financial landscape as it exists today. The financial services sector has always been highly regulated, and legal and regulatory actions have fundamentally influenced the structure of the industry. Let us look at just a few seminal events in recent history.

a. Geographic Barriers. Until the 1980s, financial institutions were strictly regulated along geographic lines. The depression era *McFadden Act* of 1927 prohibited federally chartered banks from branching outside their home state. While one might argue that this was in contravention to the interstate commerce clause, it established equality between federally-chartered and state-chartered institutions, which were restricted to just that one state in their operations. Furthermore, many states were so-called unit-banking states, where branch banking was prohibited and where banks were restricted to a single locality to conduct their business.

Eventually, bank holding companies overcame some of these restrictions by combining individual banks under a bank-holding company umbrella. But these banking confederations were limited in their ability to lend by being separately capitalized and therefore severely restricted in their lending limits. Each bank also had its own separate board of directors, which was not only an expensive proposition, but also required multiple decisions made by often independently minded directors who wanted to move in different directions.

The double-dip recession of the early 1980s hit various parts of the country with different intensities. It affected many of the unit banks negatively and resulted in a record number of bank failures. It became clear that geographic diversification would add considerable strength to the American banking system and the *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994* legalized interstate banking and permitted branching across state lines. The passage of this legislation enabled many multi-state bank holding companies to consolidate and made de-novo interstate branching, as well as acquisitions across state lines, possible.

The resulting banks were safer because they were more diversified geographically and enabled to serve their commercial customers on a nationwide basis. The result was greater efficiency for the banks as well as better service for their customers – especially nationwide corporations.

b. Functional Barriers. Ever since the *Glass-Steagall Act* was passed in 1933 at the height of the Great Depression, American consumers and businesses were served separately by commercial banks and investment banks for their financial needs. This was not the case in the rest of the world, where the "universal" banking model prevailed and financial institutions were allowed to serve both the commercial and investment banking needs of their customers.

As the U.S. economy expanded during the 1970s and 1980s, both consumers and companies began to argue increasingly in favor of allowing one banking institution to serve all their financial needs. For instance, the *Employee Retirement Income Security Act* (ERISA) of 1974 enabled consumers to save tax-free for their retirement. At the same time, many corporations terminated their defined-benefit retirement plans and switched to defined-contribution plans or IRA accounts. Increasingly, consumers were in charge of their own financial destiny. But commercial banks could only offer a rather limited product range to their customers. Consumers questioned why they could not conveniently avail themselves also of investment products, such as stocks, bonds and annuities, through their own familiar banking institution.

Some commercial banks therefore tried to "follow their customers" and began to acquire brokerage firms. For instance, Bank of America acquired the Charles Schwab Company in 1983.

At the same time, commercial banks wanted to increase their investment banking services to their corporate customers as well. The regulatory agencies slowly responded to these demands by increasing the magnitude of the securities activities permitted for commercial banks from virtually nothing to 10 percent.[1] But it took legislative action in the form of the *Financial Services Modernization Act of 1999*, also known as the *Gramm-Leach-Bliley Act* (GLB Act), to give banks the power to offer both commercial and investment banking services under one roof. President Clinton signed this bill into law on November 12, 1999.

By this legislative act, commercial banks were enabled to also offer their retail customers a complete line of investment products and asset management services under one roof.

Similarly, the new universal banks could offer their corporate customers the complete line of payments,

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[1] For my own role in this process, see: Robert Heller, *The Unlikely Governor*, Maybridge Press, 2015, p. 287

loan and securities products that they needed. For instance, a bank that had helped a small start-up company grow by financing their first receivables and equipment, was now also able to introduce the growing company to the securities market and to issue stocks and bonds.

The *Gramm-Leach-Bliley Act* also made American banks more competitive with their foreign counterparts in Europe and Asia, which had always benefitted from the integrated universal banking model.

At the height of the 2007-08 banking crisis, many financial institutions were under severe stress. Those exposed to the subprime mortgage sector either through their mortgage origination activities, such as Countrywide Financial, or through their syndication and trading activities, like Lehman Brothers and Bear Stearns, were hit particularly hard.

During the crisis, which culminated in the collapse of the Lehman Brothers investment bank on September 15, 2008, all major American investment banks were either merged into commercial banks or took out bank charters themselves. For example: JPMorgan acquired Bear Stearns and Bank of America absorbed Merrill Lynch. Both Goldman Sachs and Morgan Stanley became bank holding companies. They became universal banks, subject to supervision by the Federal Reserve and gaining access to the discount window as well as other credit facilities.

Some observers have argued that the elimination of the Glass-Steagall barriers made banks more vulnerable during the financial crisis of 2007-08. I believe that nothing could be further from the truth. Without the ability to merge commercial and investment banks, the banking crisis would have been much deeper and widespread than it was and there would have been more Lehman-like failures or the government would have had to engage in many additional large bailouts.[2]

Of course, that judgment begs the question of what caused the crisis that triggered the Great Recession in

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2 President Clinton, who signed the Gramm-Leach-Bliley Act into law, also believes that the legislation helped to stabilize the American banking system during the crisis. He stated so in the following exchange between himself and Maria Bartiromo (BusinessWeek, September 23, 2008)

Maria Bartiromo: *Mr. President, in 1999 you signed a bill essentially rolling back Glass-Steagall and deregulating banking. In light of what has gone on, do you regret that decision?*

Former President Clinton: *No, because it wasn't a complete deregulation at all. We still have heavy regulations and insurance on bank deposits, requirements on banks for capital and for disclosure. I thought at the time that it might lead to more stable investments and a reduced pressure on Wall Street to produce quarterly profits that were always bigger than the previous quarter. But I have really thought about this a lot. I don't see that signing that bill had anything to do with the current crisis. Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill.*

the first place. It is evident that both subprime mortgages and mortgage-backed securities were at the center of the crisis.

Prior to the crisis, many American presidents[3] championed the idea of widespread home ownership. Much legislation and regulation promoted the idea that homeownership should be supported by our financial institutions above and beyond the levels that would result if regular market forces were left alone to determine the level of mortgage loans made. Many of these subprime loans were made to people who could not afford to service them. Subsequently, they were packaged into complex and little-understood financial securities that were then sold to third parties, such as Fannie and Freddie. Thus, a toxic brew of opaque and risky securities was created that eventually imploded when delinquencies reached unexpected levels.

But as President Clinton pointed out, if the Glass-Steagall barriers had still been in place, the crisis might well have been even worse than actually experienced.

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3 That includes President Roosevelt (*Homeowners Refinancing Act of 1934* and the *Home Owners' Loan Corporation Act*. Fannie Mae was created in 1938), President Carter (*Community Reinvestment Act of 1977*), President Clinton (*Housing and Community Development Act of 1992*) and President George W. Bush who advocated the "Ownership Society."

3. Regulation Versus Capital

Extensive legislative and regulatory rules govern the conduct of all commercial banks. Everyone will agree that our financial organizations – and especially our depository institutions - should be as safe as possible and that a repeat of the financial turmoil experienced a decade ago needs to be avoided.

There are two basic methods to increase bank safety: more regulation or more capital. Let us consider each in turn.

a. Regulation. Rules and regulations are one way in which financial institutions can be made more safe and secure. They will prohibit especially risky behavior and limit the scope of risk-taking by the institution. But as one rule is established, the drive to serve their customers and to make more profits often leads managers to develop ways to circumvent the rule and to develop new products that are not governed by the existing regulations.

The natural reaction by regulators is to counter with the imposition of even more rules. As a consequence, an ever-tighter and more cumbersome straightjacket of regulations ~~is~~ develops ~~ed~~ that ~~is ever~~becomes more and more complicated to implement and follow.

One look at the three-page contract that I signed in order to obtain my first mortgage many years ago, compared to the six-inch stack of papers and supporting documents and dozens of signatures that I had to sign to obtain my latest refinancing loan, tells the story of increased regulation over the decades.

Bank supervision is also by its very nature a backward-looking process. It looks at what has actually happened in the past and whether any transgressions or rule violations have occurred.

A friend of mine, who spent his entire career in the automobile-manufacturing sector, always espouses the mantra that “quality should be built into the production process – and not inspected-in afterwards.” By this he means that it is much more efficient to build a high-quality automobile in the first place than to try and find defective cars at the end of the assembly line through an arduous inspection process.

The same applies to financial institutions. Auditors may be able to identify bad loans, but it is much more efficient not to make any questionable loans in the first place. At Bank of Marin, we endeavor to make only solid loans and during the entire 27-year history of the bank, we have foreclosed on only one single loan that we originated. Regulators, consumers and trade magazines recognize this attention to quality. For instance, *American Banker* has consistently ranked Bank of Marin among the Top 100 community banks.

We have tried to make only solid loans in the first place and have worked diligently with the customer, if he should encounter difficulties in servicing the loan. That's what relationship banking is all about.

Nevertheless, at Bank of Marin our Compliance Department expenses have more than doubled since 2009. But these direct costs do not tell the whole story. In addition, lenders and branch personnel have to undergo costly compliance training and a great deal of compliance-related information has to be collected and documented throughout the new loan approval and boarding process. Our staff also spends considerable time in compliance working group meetings to assure that all developments and updates are communicated throughout the organization. Then there are the internal and external auditors to look over the shoulders of the line officers to make sure that all is in order and well-documented and is able to stand scrutiny by the regulators.

Since the passage of the Dodd-Frank Act, there is even a federally chartered organization to scrutinize the work of the independent auditors: the *Public Company Accounting Oversight Board* (PCAOB).

When will there be enough layers of supervision and control?

b. Capital. In a modern company, capital consists of the financial resources provided by the shareholders of the corporation. It is invested in the means of production, be that land, equipment or human resources. It is also an essential part of the financial resources that enable a company to operate. Finally, it is an important cushion to absorb any losses. Scarce capital provides a powerful incentive to management and directors to make only prudent investment and loan decisions. This will enable the institution to make profits, which will in turn accrue to the owners of the capital stock.

Capital is not cheap, and because it is the cushion that will have to absorb any losses, shareholders (as the owners of the capital) have a vital interest in making sure that the institution follows prudent policies in their lending department as well as in other risky activities, such as trading.

Higher capital levels provide important protection against failure of a financial institution. A recent study by the International Monetary Fund points out that an optimal level of capital takes into account not only the costs and benefits to bank shareholders, but also to the overall economy. The study concludes that additional bank capital is beneficial at first, but has rapidly diminishing values above a risk-weighted capital to asset ratio of 15 to 23 percent.[4] The law of diminishing returns applies to capital as well.

In the United States, the overall ratio of ~~risk-weighted assets to~~ bank regulatory capital to risk-weighted assets is now close to this 15 percent level, as shown by the solid line in Figure 2. However, the ratio of ~~total assets to~~ bank capital to total assets (shown by the dash-dot line) is somewhat lower. In any case, we may conclude that these increased capital levels have made the American banking system much safer and more

resilient.

c. The Choice Between Capital and Regulation.

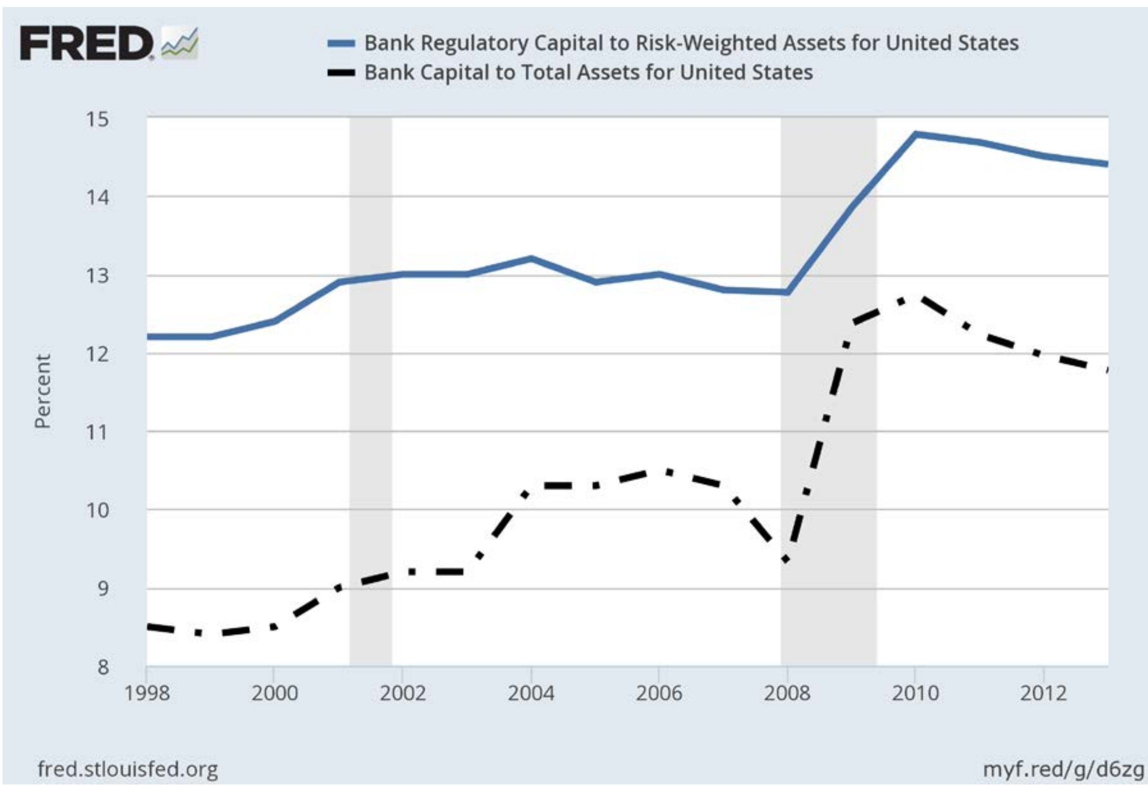
The question remains whether higher capital levels or more regulation offer a better protection for depositors, shareholders and taxpayers alike.

Based on my experience, both as the Chairman of the Committee on Bank Supervision and Regulation at

4 Jihad Dagher, Giovanni Dell'Ariccia, Lev Ratnovski and Hui Tong, "Capital Buffers," International Monetary Fund, *Finance and Development*, September 2016

the Federal Reserve Board and my banking experience, I would argue that strong capital requirements are generally much more effective than a myriad of regulations in keeping a financial institution healthy.

FIGURE 2



First of all, capital is a flexible buffer that protects the shareholder, depositor and taxpayer alike against all the activities carried on in various parts of the bank. One year, commercial loans may be experiencing particularly high losses and in another year, it may be mortgages that are stressed. A large bank may experience losses in its trading or underwriting activities, while the regular banking business flourishes.

In contrast, regulations are a straightjacket where each and every activity is constrained in its own right. It is almost impossible to take advantage of unusual opportunities that avail themselves, even if they are not particularly risky under the circumstances.

I believe that the financial sector, and thereby indirectly the entire economy, will thrive best if there are as few rules and regulations as possible. Efficiency is not obtained by having so many rules that essentially all institutions are forced to follow a similar business model. That amounts to central planning more appropriate for a command economy. One size does not fit all and leaves no room for innovation.

A centrally planned economy is certainly not immune to errors, and command economies have suffered many economic setbacks and generally low growth. Similarly, regulators are not exempt from the potential to make errors in their guidance. As recent history shows, when the governmental authorities attempted to encourage more lending than the mortgage sector could safely bear, the results were not pretty.

Furthermore, bank supervision is by its very nature a backward-looking activity that tries to catch errors and transgressions made in the past.

Regulation also results in never-ending meetings between regulators and management. It drives up staffing costs in the compliance department as well as in the operational departments that have to supply the necessary information to the compliance officers. In addition, the staff of the regulators needs to be paid.

Of course, capital is expensive, but given a choice between higher capital and more regulations, I would generally recommend the higher capital levels. This will enable financial institutions to deploy their capital in a flexible manner, so that the growth of the economy at large can be supported in an optimal manner. The economy at large will thrive if banks and other financial institutions can accommodate the needs of their customers in a flexible, but safe manner.

One such way to ease the regulatory burden for financial institutions is proposed in the *Financial CHOICE Act*, which gives regulatory relief to financial institutions that are not only well-managed, but also maintain very high capital levels. This approach will allow banks to essentially “self-regulate” if they have enough skin in the game in the form of high capital levels.[5]

Allowing banks to obtain relief from onerous micro-regulations by electing to maintain higher capital levels benefits everybody: the banks gain flexibility to manage their own affairs and have lower compliance costs; consumers and corporations will benefit from being able to deal with more flexible and responsive banks; shareholders will receive higher returns; and bank regulators will save in personnel and other oversight costs.

4. Eliminating Overlapping Regulation

There is one further improvement in the financial services sector that would considerably lower costs and thereby enhance economic growth. This is the elimination of overlapping regulatory agencies in the financial sector.

Among the federal financial regulators, we have the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the newly formed Consumer Financial Protection

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[5] I was honored that the Preamble to the Financial Choice Act cites my recommendation to that effect in: House Committee on Financial Services, *The Financial CHOICE Act*, www.FinancialServices.House.Gov/CHOICE, June 23, 2016, pp. 6-7. The citation is from: Robert Heller, *The Unlikely Governor*, Maybridge Press, 2015, p. 231

Agency, the Commodity Futures Trading Commission for institutions active in the derivatives markets. In addition, there are the state bank supervisors for state-chartered institutions. Moreover, institutions offering insurance products are also subject to the supervision of the relevant state insurance regulators.

A typical financial institution is subject to the supervision and regulation of at least two or three of these regulators and the more complex organizations may be subject to the supervision of six or even seven regulators.

In fact, there are now so many regulatory agencies that there exist even additional agencies to coordinate and streamline the regulators. The *Federal Financial Institutions Examination Council* (FFIEC) is tasked to coordinate the rulemaking by the various agencies. In addition, the *Financial Stability Oversight Council* (FSOC) is there to coordinate and, if necessary set aside, regulations of the various agencies in the interest of overall financial stability.

The time has come to simplify this regulatory jungle.[6] If we need special councils to coordinate the regulators, we have a few regulators too many and one layer of bureaucracy should be eliminated.

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6 Robert Heller, "The Time Has (Finally) Come for a Single Regulator," *American Banker*, December 7, 2016

Ideally, there should be only one federal regulator for each federally chartered financial institution. This simplification would not only result in less confusing and possibly contradictory regulatory requirements, but also bring about significant manpower and cost savings to the industry and budgetary saving to the government.

5. The Impact of Regulation on Small Banks

While the Dodd-Frank legislation was mainly aimed at the large financial institutions that were deemed as being systemically important or as "too big to fail," its impact was probably more heavily felt by the nation's community banks – those with less than $10 billion in assets.

Research has shown that the burden of complying with the *Dodd-Frank Act* was particularly burdensome for these small banks.[7] A full 90 percent of the respondents to a survey stated that their compliance costs had increased in response to the passage of the Dodd-Frank legislation, with 83 percent stating that their costs had increased by more than 5 percent.

[7] Hester Peirce, Ian Robinson and Thomas Stratmann, "How Are Small Banks Faring Under Dodd-Frank?" Mercatus Center at George Mason University, Working Paper, February 27, 2014

Nearly 64 percent of the institutions anticipated making changes to their residential mortgage offerings. Ten percent anticipated discontinuing their mortgage banking activities entirely, with 5 percent having already done so by 2014. In spite of the fact that the CFPB has no direct supervisory authority over small banks (those with less than $10 billion in assets), 71 percent of the surveyed banks reported that the Bureau affected their business activities and in particular their mortgage offerings negatively.

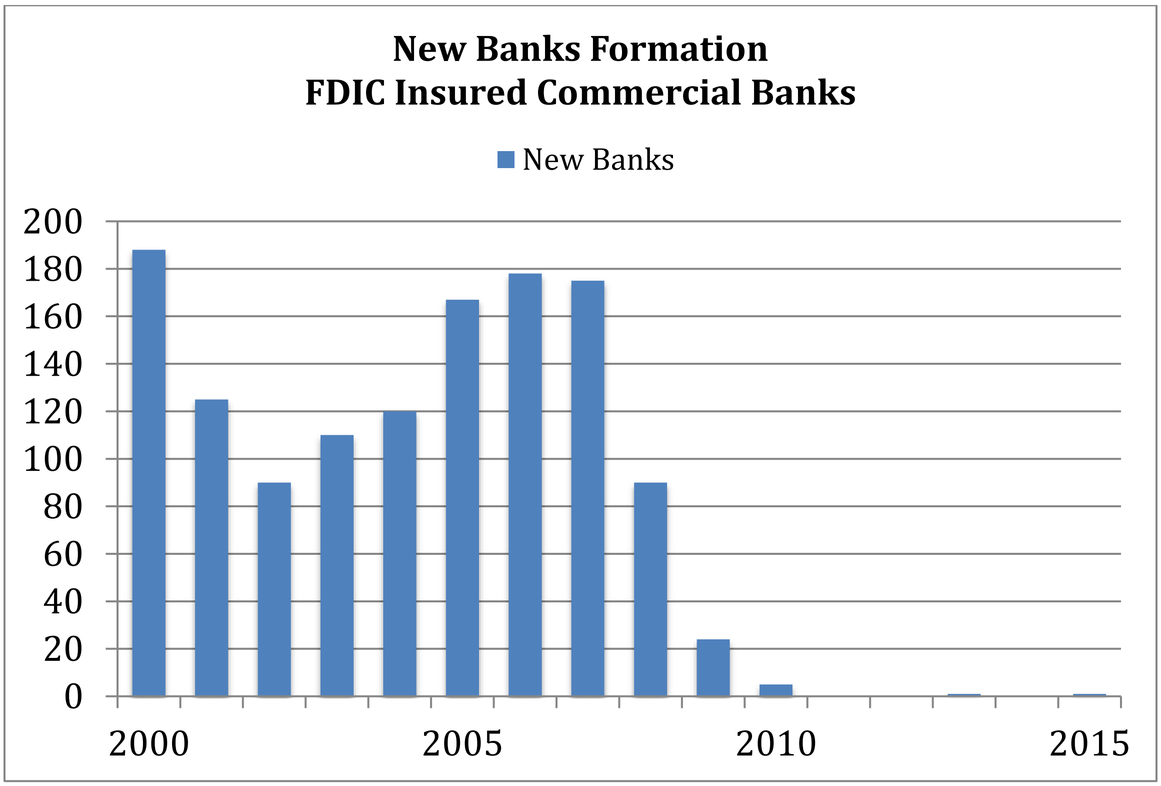
By adding approximately 20,000 pages of complex rules and regulations to the American banking system, the *Dodd-Frank Act* made it more difficult for financial institutions to operate efficiently and maybe even to survive.

Perhaps the most drastic effect of the Dodd-Frank legislation has been its impact on the entry of new banks. Figure 3 shows that in the decade before 2010, each year 100 to 200 new banks were established. In contrast, during the five years after the passage of the *Dodd-Frank Act*, only two new banks were formed.

Furthermore, the total number of FDIC-insured banks decreased from 6,533 in 2010 to 5,349 by 2015, representing an overall decline in the number of banks by approximately 19 percent.

Just last week, the House Financial Services Subcommittee held hearings on the chilling impact of the *Dodd-Frank Act* on the formation of new financial institutions. One of the key takeaways from the Hearing

FIGURE 3



was that the number of new or "de novo" banks and credit unions has declined to historic lows since the passage of the *Dodd-Frank Act.*[8]

While other reasons were also contributing to this virtual cessation in new bank formation, such as

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8 House Financial Services Subcommittee, "Subcommittee Examines Chilling Impact of Dodd-Frank on New Financial Institutions," Press Release, March 21, 2017

generally low interest rates accompanied by low net interest margins; the evidence is nevertheless very troublesome. The *Dodd Frank Act*, together with the low interest rates engineered by the Federal Reserve, which was supposed to stimulate the economic recovery, created an absolutely toxic environment for formation of new banks.

6. The Financial Sector and Economic Growth

Finally, let us turn to the relationship between growth in the financial sector and overall economic growth. In a recent study by the Federal Reserve Bank of St. Louis, the authors conclude that financial conditions do indeed affect real economic activity. As might be expected, the impact is stronger for smaller firms and for industries that depend more heavily on external financing for investment. But the authors caution that the overall effect is rather moderate.[9]

Let us examine the nexus between small community-based banks and the formation of new firms a bit more closely. Many new firms have to rely on financial resources from community-based banks.

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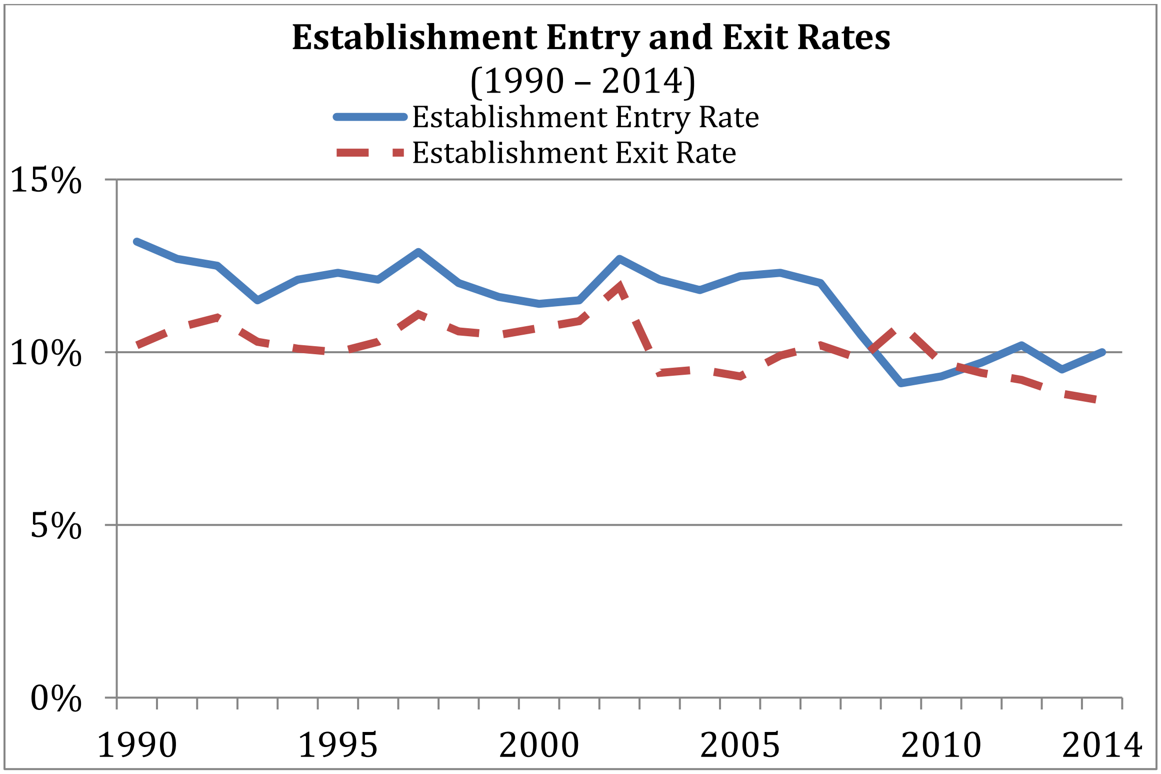
[9] Hee Sung Kim and Juan M. Sanchez, “Financial Conditions – Do the Ups and Downs Affect the Rest of the Economy?” Federal Reserve Bank of St. Louis, *The Regional Economist*, First Quarter 2017

These local banks may even know the founders or owners of the new company personally. In many cases, these new firms rely on personal loans, credit cards or home-equity lines of credit for the initial financing of their company's equipment and supply purchases because the firm itself is not yet creditworthy.

It is therefore not surprising that during the same time period that saw virtually no new bank formation, we also experienced a very low rate of entry by new establishments. As solid line in Figure 4 shows, during the four years prior to the passage of the Dodd Frank legislation (2006-09), on average 740,000 new establishments were formed. That number dropped to an average of 652,000 in the four years after the passage of the Act (2011-15).

As a matter of fact, in the years 2009 and 2010 the exit rate of new firms (dashed line in Figure 4) exceeded the entry rate (solid line) for the first time in 2009 as firms were leaving in greater numbers than new firms being formed. These were the years of the Great Recession that also saw virtually no new bank formation. While other factors were also at work, low bank formation rates and low entry rates for firms certainly go hand-in-hand, showing the nexus between the banking system and the business sector.

FIGURE 4

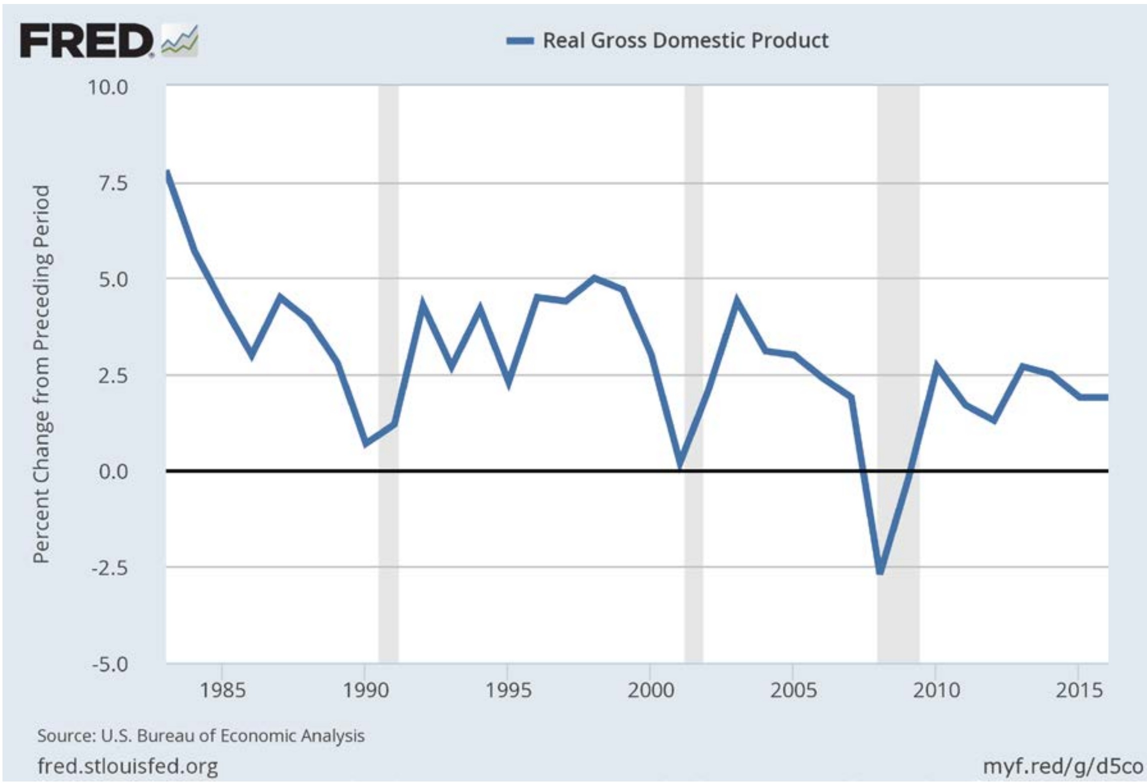


The *Dodd Frank Act of 2010* was passed one year after the Great Recession ended. It was supposed to make the financial system safer, but also resulted in many new restraints and additional costs to the financial system. As Figure 5 shows, GDP growth ranged between only 1.7 and 2.7 percent during the subsequent recovery, making it the slowest recovery on record since World War II.

During the recovery, the Federal Reserve maintained a highly expansionary monetary policy and the Federal government ran a very stimulative fiscal policy. The Federal Reserve not only kept the Federal

Funds rate at zero until 2015, but also added $2.8 trillion in Treasury and mortgage-backed securities to

FIGURE 5



its portfolio, thereby vastly expanding the lending power of banks. Federal deficits during the period of 2010-2016 ranged between $438 billion and $1.3 trillion per year, adding a total of over $4.5 trillion to the federal debt since the end of the Great Recession. Not since World War II has the nation experienced a similar period of highly expansionary monetary and fiscal policies.

As both monetary and fiscal policies were exceptionally stimulatory, the reason for the slow economic growth rate during the current expansion must be found somewhere else. It is difficult not to come to the conclusion that it was the regulatory policy focused on the financial sector that was holding the economy back.

7. Conclusion

We have examined in some detail the nexus between the financial system and the economy and have established the important role that financial institutions, both large and small, play in fostering economic growth.

The financial system is a highly regulated sector of the economy and legislative and regulatory changes play an important role in shaping the lending behavior of commercial banks as well as other institutions.

During the 1980s and 1990s, important changes allowed banks to expand across both geographic and functional barriers that had previously existed. First of all, the *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994* legalized interstate banking and permitted branching across state lines, thereby enabling geographic diversification. Second, the *Gramm-Leach-Bliley Act of 1999* gave banks the power to offer both commercial and investment banking services under one roof, thereby allowing greater product diversification and creating “universal” banks.

As a result of increased geographic and product diversification, the American banking system was made both safer and more efficient.

But at the same time, other regulations pushed financial institutions to make a large number of sub-prime mortgages that could not be served properly by the homeowners. Many of these mortgages were packaged and sold to investors in the form of mortgage-backed securities. When a large number of these often highly complex mortgages and securitized loans went into default starting in 2007, it triggered a major financial crisis.

In turn, the financial collapse sparked the Great Recession, which affected many consumers and businesses adversely and led to a sharp decline in GDP.

After the crisis had begun, the Federal Reserve did act swiftly by providing liquidity and emergency capital to the affected financial institutions. Moreover, the regulators facilitated the merger of many endangered institutions across previously existing industry barriers and an even worse financial and economic calamity was avoided with the help of the government. In the absence of these actions, the crisis could have been even worse.

But many consumers, businesses and their employees suffered greatly as a result of the Great Recession.

But it should also be pointed out that the regulatory and supervisory agencies did not see the crisis coming and did little to prevent the calamity from occurring in the first place. They only acted after the horse had bolted from the barn.

The main legislative reaction was the imposition of many more highly complex regulations through the *Dodd Frank Act*. While this legislation was largely designed to prevent large banks from failing in the future, it also affected adversely virtually all community banks that had little or nothing to do with triggering the financial crisis. The new regulations, as well as the low interest rate policy implemented by the Federal Reserve and the accompanying low lending margins, brought new bank formation to a total standstill.

These circumstances made it more difficult for many consumers and small businesses to obtain financing and the rate of new business formation dropped precipitously. The entrepreneurial spirits that drive new economic growth were severely constrained, making the recovery the slowest one on record in the post-war period.

My suggested financial sector reform solutions to restore financial vitality and thereby help to reignite economic growth are twofold: first of all, allow small banks and maybe even banks of all sizes to “opt out” from the regulatory straightjacket by holding a sufficiently large capital cushion. Second, eliminate the multiple layers of regulatory authorities that financial institutions of all sizes have to cope with at the present time. Instead, have only one federal regulatory agency be responsible for each institution under its supervision. The resulting increases in efficiency and cost savings will be beneficial to bankers, consumers, businesses and taxpayers alike.

Thank you very much for giving me this opportunity to express my views on this important topic.