Barriers to Entrepreneurship: Access to Credit

Statement for the Record

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"Encouraging Entrepreneurship: Growing Business, Not Bureaucracy"

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Chairman Coats, Ranking Member Maloney, and members of the committee, thank you for the opportunity to submit written comments about the barriers to entrepreneurship and access to credit. I am Pamela Villarreal, a senior fellow at the National Center for Policy Analysis. We are a nonprofit, nonpartisan public policy research organization dedicated to developing and promoting private alternatives to government regulation and control, solving problems by relying on the strength of the competitive, entrepreneurial private sector.

Before the financial fallout of 2008, the process of entrepreneurs accessing credit was fairly simple. A potential entrepreneur would design his pitch and take it to the loan officer at his local bank. The bank would stand to gain the most if the loan was repaid and thus would not give out a loan unless they believed it would be repaid. Then the originator of the loan would likely sell it to a master servicer within minutes of completing the underwriting process. If the borrower defaulted, the master servicer would then sell the loan to a special servicer, who could renegotiate terms or seize the collateral. This model generally worked.

With community banks, the loan process is built on familiarity between parties. Creditors have better knowledge of those they loan to; while borrowers understand the stigma earned and the hardship they would cause to the bank by not paying their debts. Because of this culture of trust, there are lower default rates, and banks are able to serve clients who wouldn't make it through a more corporate vetting process.

Since the 2008 Financial Crisis and the implementation of Dodd-Frank in 2009, sources of business capital for low-income innovators and entrepreneurs have diminished. In the 2014 survey of 1,242 companies conducted by the Kauffman Foundation, 45 percent of new companies cited lack of credit access as a business challenge. This number remained unchanged from 2013 and 2012. Supporters of the Dodd-Frank Act sold it as promoting soundness and stability by reining in Wall Street and the big banks. Instead, much of Dodd-Frank is broad enabling act grating power to executive – agency bureaucrats to write specific regulations that reduce the access to credit for entrepreneurs through these community banks. How did this happen?

Dodd-Frank placed a massive burden on financial institutions. Title I of Dodd Frank implemented the Financial Stability Oversight Council (FSOC), a regulatory agency with the power to designate firms as Systemically Important Financial Institutions (SIFIS). This set up a dangerous system where big banks were rewarded at the expense of smaller institutions. Title II created an Orderly Liquidation Authority, responsible for supposedly winding down a failed SIFI without the need for taxpayer bailout. This puts investors and shareholders in jeopardy based on the whims of bureaucrats.

In response to Dodd-Frank, consumers have been left to pick up the tab for the increase in government regulation. While large banks can absorb the costs of burdensome new regulations, smaller banks have limited resources to accommodate changes. In 2011, 94 percent of banking organizations were community banks according to Harvard Study by Lux and Greene. Yet, from 2010 to 2015, 2,000 community banks or credit unions have closed or merged.

Most small banks were absorbed by the big five banks: JP Morgan Chase, Bank of America, Wells Fargo, Citigroup and Goldman Sachs. These banks are more likely to rely on mathematized risk-analysis procedures to determine who receives a loan, thus reducing the amount of credit available to start-up entrepreneurs. Further, Lux and Greene report that "Alarmingly…community bank's overall volume of small business lending has declined significantly since Q2 2010- down 11 percent." Small business lending by small banks, and

small business borrowing by small forms has not recovered post-crisis recession and Dodd-Frank Act in 2010.

Since then, entrepreneurs have sought for alternative tactics for financing a business venture. Businesses have resorted to venture capital, crowdfunding, and private equity groups as substitutes to the dwindling force of community banks. However, the many of the rules issued under Dodd-Frank still manage to restrict many of those alternative venues. Increased insurance, reduced banking choices, and increased bank fees have continued to cast an unnecessary burden on entrepreneurs. Agencies like the Financial Stability Oversight Council, Consumer Financial Protection Bureau and the Orderly Liquidation Authority need to be repealed and their currently unparalleled authority restricted. There needs to be stronger penalties for individuals and firms that violate securities laws and engage in insider trading. The Federal Reserve's emergency lending authority must be restricted to reduce the monopolization of big banks. Until Dodd-Frank is reformed, there will continue to be damaging barriers to entrepreneurs' in their pursuit of credit.

Thank you for the opportunity to submit written comments.