CHAPTER 6: STRENGTHENING THE FINANCIAL AND REGULATORY SYSTEM

- Chapter 6 of the *Report* highlights the events leading up to the 2008 financial crisis and how it spread through the banking sector and the economy.
- Rather than acknowledge any part the government played, the Obama Administration vastly expanded its role with record-breaking levels of complex regulations based on the Dodd-Frank.
- The *Report* claims progress toward ending "too big to fail" banks but does not identify bank "runs" as the critical problem whose resolution remains elusive.
- Piling on more regulation does not make the financial system more secure but furthers agency overreach and causes unintended consequences.
- Unproductive regulatory burdens hinder lending by community banks and financial innovation, although the *JOBS Act* was a constructive step.

INTRODUCTION

The *Report* attributes the financial crisis to market failures but does not fully explain the institutional framework in which the market operated. The government created that framework and has been extensively involved in shaping the conduct of market participants. When the framework malfunctions, the government cannot pretend to bear no responsibility.

Further, the government pursued social objectives with respect to credit availability for specific segments of the population and homeownership generally by the rules governing lending and borrowing and by direct intervention as GSEs Fannie Mae and

Freddie Mac massively expanded credit to the mortgage market. These actions similarly entangled the government in the course of events. Finally, the Federal Reserve influences interest rates and affects the flow of credit through monetary policy, which has a bearing on the housing sector from which the crisis emanated.

As in other chapters, the *Report* uses what it characterizes as market failures to justify more government intervention, this time in the financial sector. That is fundamentally unhelpful. The government has legitimate functions in money and finance but how and to what extent it should carry them out is the question. The CEA does not make a sufficient case for the path the government has taken since the crisis because it fails to completely diagnose what is the key financial sector problem to be resolved and acknowledge the inherent limitations of the regulatory process, and it neglects to evaluate alternative approaches.

Too Big to Fail

For a market economy to function properly, successful firms must be allowed to earn profits and unsuccessful firms must be allowed to incur losses. Without the threat of losses, firms can take more risk than is prudent and worry less about failure. A "Too Big to Fail" (TBTF) firm is one whose failure would have widely adverse economic repercussions, and therefore would induce the government to save it. TBTF entities can enjoy higher profits from taking more risk while taxpayers help to cover the losses. TBTF firms enjoy lower funding costs as investors expect a rescue in the event of the firms' failure. The competitive advantage of such firms in the capital market can be observed by the so-called TBTF discount (also referred to as a premium), a measurable difference in the cost of borrowing, credit insurance, and credit ratings.

Firms engaged in financial intermediation and, in particular, liquidity and maturity transformation (borrowing short and lending long), face the risk of "runs," meaning that many lenders want to withdraw their money or refuse to roll over their loans as they mature, at the same time. This problem is at the heart of bank panics and financial crises and it is the problem government must contain to secure the financial system. TBTF is one manifestation of the underlying problem of initiating widespread "runs," but any institution regardless of size whose failure could motivate a general "freeze" of lending is systemically too important to fail.

Dodd-Frank promised to end TBTF; its preamble and President Obama promised "the days of taxpayer-funded bailouts are over."[i] Implicit in that statement is the contention that the government will prevent or contain runs. Dodd-Frank attempts to do so with an enormous amount of regulation; it is a legislative and regulatory behemoth.

At 848 pages, Dodd-Frank is over 16 times larger than the *Banking Act of 1933*, commonly known as "Glass-Steagall."[ii] Researchers Patrick McLaughlin and Oliver Sherhouse quantified the number of restrictive terms in Dodd-Frank's promulgated regulations and found more regulatory restrictions from the Act than all the other Obama regulatory restrictions combined.[iii] Using the regulators' cost calculations and paperwork hours required, the American Action Forum estimates the 140 finalized regulations from Dodd-Frank amount to cumulative costs of $36.5 billion and almost 75 million hours of compliance paperwork.[iv]

Six years after Dodd-Frank was signed into law, many of the regulations have yet to be written. According to the Davis Polk Dodd-Frank progress report, there are still 80 rules, or a fifth of the 390 required rulemakings, that have not even been proposed yet, and 32 of them have missed their statutory deadline.[v]

The problem of runs has not been solved. Even with all its laudatory claims about Dodd-Frank, the *Report* acknowledges the TBTF premium. As with many other claims about Obama-era initiatives that did not live up to the rhetoric, the *Report* claims success by a lower standard, namely that the chances of a firm being considered too big to fail have decreased since the 2008 crisis. But the premium will be low when financial markets are calm as they are now and rise if and when anxiety spreads (see Figure 6-x, p. 396 in the *Report*). Despite the growing mountain of regulation, there remains continuing concern that the risks of bank runs reoccurring persists, supporting the belief that very large financial institutions are safer because the government will have no choice but to rescue them in order to keep the financial system functioning.

Meanwhile, the Dodd-Frank regulatory apparatus promotes governmental overreach and causes unintended consequences.

The Financial Stability Oversight Council

"Shadow banking" outside of commercial banking started growing rapidly around the start of the new millennium, as depicted in Figure 6-6 (p. 366) of the *Report*. Entities engaged in financial activity include non-bank financial institutions that could be insurance companies, for example, or parts of conglomerates. Dodd-Frank created the Financial Stability Oversight Council (FSOC) whose mandate includes identifying risks and responding to emerging threats to financial stability, often referred to as systemic risk, whatever the source. The reason for creating the FSOC was that it is no longer necessarily straightforward to define a "financial institution," and the risk of initiating widespread runs is not necessarily quantifiable by a particular set of metrics. In the regulatory framework created that focuses on micromanaging market participants' conduct, identifying who and what needs regulating becomes a matter of judgement.

The problems are that (1) the individuals making the judgments are fallible, and (2) judgment unconstrained by strict limits and subject to due process can become arbitrary and capricious. MetLife sued the FSOC for designating it a non-bank systemically important financial institution (SIFI) and won.[vi]

An alternative would be to set certain basic, easy to monitor requirements, such as capital (i.e., equity) requirements for firms engaged in financial dealings and minimize the regulation of conduct. Unfortunately, the *Report* does not evaluate alternatives to the Dodd-Frank philosophy of financial regulation.

The Consumer Financial Protection Bureau

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) uniquely insulated from Congressional oversight and with the ability to set its own budget.[vii] Rather than establish a board or commission with a range of perspectives and experience, it gives unchecked regulatory authority to a single director. The structure has been ruled unconstitutional by the District of Columbia Circuit Court.[viii] The judges noted in their ruling that "the [CFPB Director] enjoys more unilateral authority than any other officer in any of the three branches of the U.S. Government, other than the President."[ix]

Unlike the majority of Federal agencies and the military, the CFPB is also completely outside the Congressional appropriations process. The CFPB obtains its funding from the earnings of the Federal Reserve System without any input from Congress or the Federal Reserve Chair. Normally, annual reviews and budget debates inform Americans about what priorities are adopted but without any Congressional oversight, unaccountable bureaucrats make the decisions by themselves.

At the same time that a new agency with extraordinary powers is regulating consumer credit, one wonders whether financial oversight is sufficiently vigilant in matters that potentially could be more damaging. In 2016, hackers misdirected millions from the Federal Reserve Bank of New York. Iran-linked hackers have continually attacked bank websites since 2011.[x] Although the Federal Financial Institutions Examination Council (FFEIC) attempts to raise awareness of cybersecurity risks, financial reform should look toward ever-changing new threats.

The Securities and Exchange Commission

As an independent agency, the Securities and Exchange Commission (SEC) is not required to conduct cost-benefit analysis of its rules. However, multiple Federal court cases have struck down new SEC rules in connection with Dodd-Frank directives for insufficient justification.[xi] The House of Representatives passed the *SEC Regulatory Accountability Act* in January 2017, which would require the SEC to properly identify the problems it intends to solve, calculate costs and benefits for its proposed solutions, and review the effectiveness of the rules it implements every five years.[xii]

Unintended Consequences: Small and Community Banks

Small and community banks follow the traditional banking model. They take in deposits from their community and lend it back to it in the form of small business loans, various small loans to households, and mortgages. Small banks specialize in serving their local citizens with products fitting their communities' needs and rarely engage in the complicated financial dealings that contributed to the 2008 financial crisis. In 2015, banks with $10 billion in assets or less accounted for $15.9 trillion in bank assets. These same banks provide 55 percent of small business loans and 75 percent of agricultural loans, and according to the Federal Reserve's 2015 Small Business Credit Survey, small businesses rate small banks as the most satisfactory lenders.[xiii] The importance of these institutions across the country cannot be overstated.

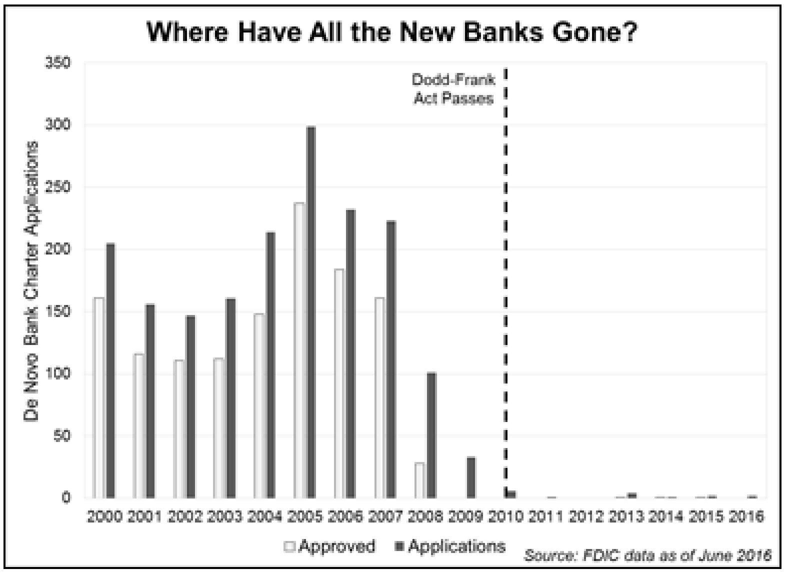
Community banks face increasing pressures from low interest rates and regulatory burdens. Small banks' market share fell from 62 percent in 1992 to 19 percent in 2015.[xiv] Dodd-Frank granted an exemption from "extra supervision" for banks holding $50 billion or less in assets. Unfortunately, this was too low and not indexed to inflation. Even former Representative Barney Frank himself now concedes that the rules are too costly for the smallest institutions and that the asset threshold for the exemption should be much higher.[xv]

Although never cited by the *Report*, there is extensive research on how community banks are faring under Dodd-Frank. A 2013 survey of small banks across 41 states reveals that over 90 percent of banks reported increased compliance costs since Dodd-Frank's passage. Even more concerning, the same survey found over 80 percent of small banks experienced compliance cost increases of over 5 percent. Such burdens force small banks to change the nature and mix of products; more than half were forced to do so in response to regulatory requirements.[xvi] In a 2016 Federal Reserve and Conference of State Bank Supervisors survey of small bankers, "regulatory burden" was the top reason that small bankers reported curtailing services. Some bankers are choosing to leave certain markets as a result. The new regulations are codifying a big-bank style that limits community banks' ability to adapt to their communities' needs. One Ohio community banker described compliance examinations as "taking away the uniqueness of institutions and creating a culture with no opportunity to make decisions."[xvii]

The results of a study conducted by Federal Reserve economists indicate that compliance costs as a percent of noninterest expense were three times as high for banks with less than $100 million in assets compared to banks with assets of $1 billion to $10 billion. Additionally, the researchers found that a higher compliance expense was not uniformly associated with better performance.[xviii]

Regulation has caused thousands of banks to close or merge and stopped new banks from opening, leaving a shrinking community bank presence across the country. Since the enactment of Dodd-Frank, there have only been three new bank charters approved (Figure 6-1).[xix] Dodd-Frank created a system that the Federal Reserve Bank of Dallas described as "too small to succeed."[xx] The first *de novo* bank since 2010 was the Bank of Bird-in-Hand serving Amish communities in Pennsylvania. The local Amish community needed farm loans. The Federal Deposit Insurance Corporation (FDIC) required the bank to appoint directors with banking experience and required initial application documents that measured 18 inches thick.[xxi]

Figure 6-1



Financial Innovation

Financial technology, also known as "fintech," was barely known in 2010 but has since skyrocketed in popularity according to Google searches.[xxii] The non-partisan Congressional Research Service states that more than $24 billion has been invested in fintech companies since 2010.[xxiii] The McKinsey Institute found that the number of fintech startups doubled between April 2015 and February 2016.[xxiv] Modern consumers, especially younger generations, readily adopt new fintech. The Federal Reserve reports that use of online/mobile banking has doubled in the past five years, and it is the primary form of banking done by millennials.[xxv] Almost three out of every four millennials believe mobile banking is very important to them.[xxvi]

Figure 6-2

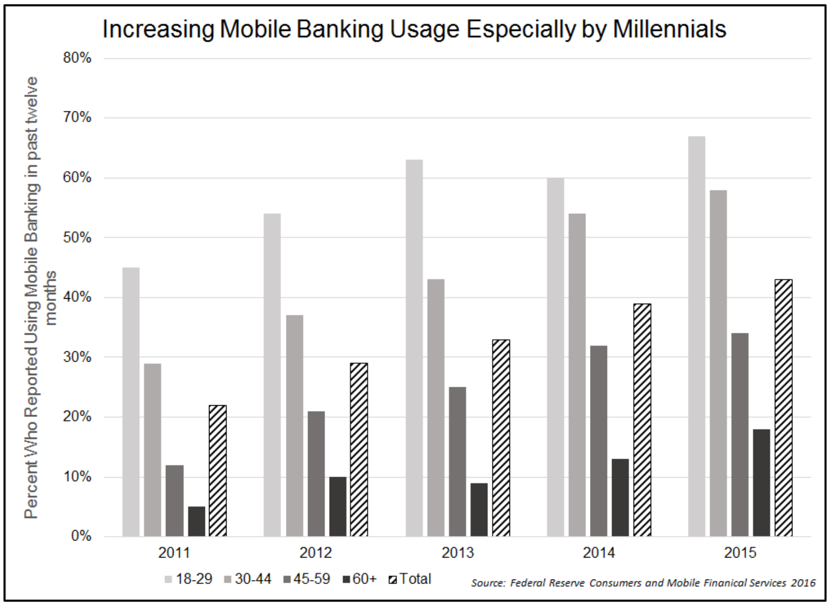
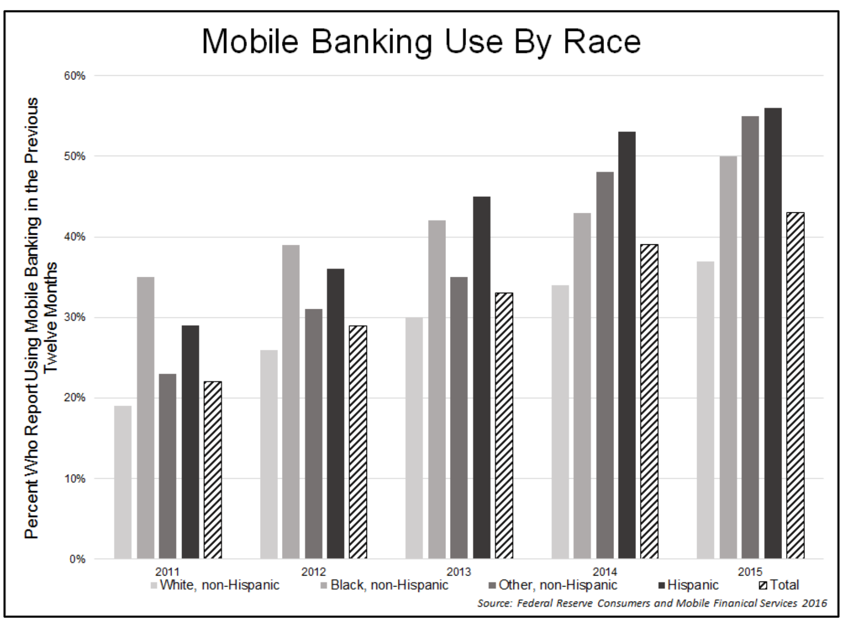
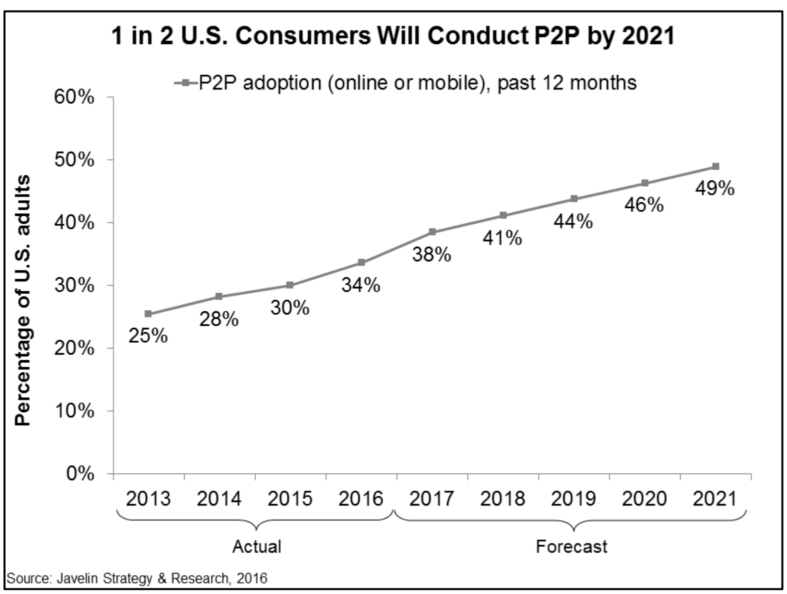


Figure 6-3



Financial innovations that improve consumers' lives are not limited to traditional banking institutions. "Peer-to-Peer" (P2P) fund transfers managed by non-financial companies like PayPal, Venmo, GooglePay and Square have increased rapidly, according to Federal Reserve experts, with minimal impact from Dodd-Frank regulation (Figure 6-4). [xxvii] More than half of millennials report using these new payment services to transfer money.[xxviii] With these new financial services, millennials lead the charge on going cashless. More than a fifth of millennials carry less than five dollars cash.[xxix] Such innovation is most important to the "underbanked," consumers with a basic bank account who use "alternative" providers for other financial services.[xxx] Approximately two-thirds of underbanked people own smart phones, and as of 2015, 55 percent of them accessed online banking services. The most common services requested are low balance alerts and payment due notices that help customers avoid overdraft and late payment fees.[xxxi]

Figure 6-4



As emerging technologies play a larger role in financial services and markets, care must be taken to protect beneficial innovation from burdensome regulation that will repress new technologies in favor of old. With the FSOC's and CFPB's broad reach, entrepreneurs can never be certain what the rules are and what impositions on their business they may face.

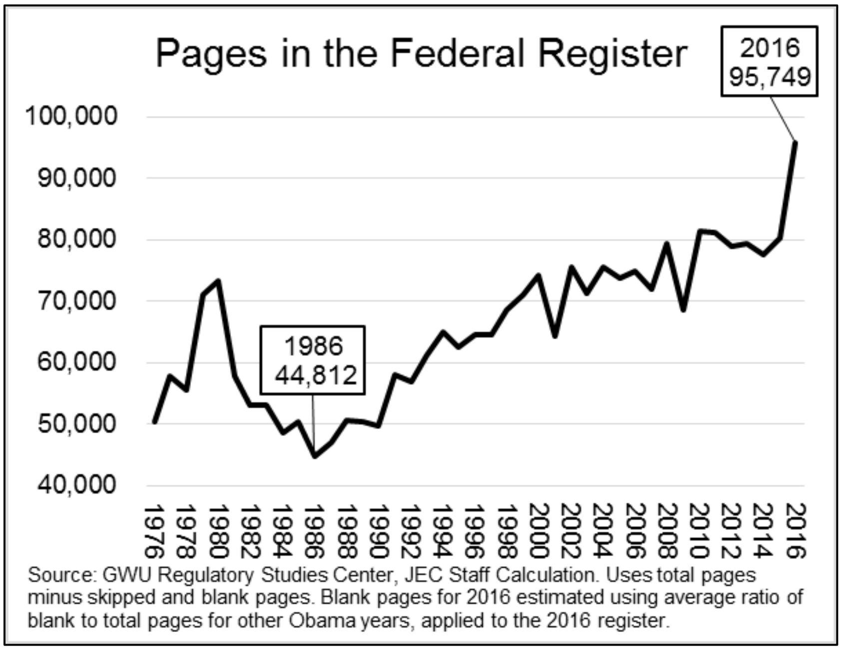
The *Report* covers the reforms and benefits of the *Jumpstart Our Business Startups (JOBS) Act*. Members of Congress, in a bipartisan fashion, worked together to craft a law that would free up capital for small business and democratize the ability for Americans to lend as equity investors through crowdfunding. The *JOBS Act*, passed by Congress in 2012, provides an example of how to assure investors access to new tools like crowdfunding by applying proper disclosure and limits without discouraging innovation.[xxxii] There is much need for more bipartisan initiatives to ease regulatory burdens, increase regulatory certainty, and encourage entrepreneurs and startups.

General Regulatory Oversight

At the end of 2016, the *Federal Register* had 95,749 (non-blank) pages of regulations, an all-time high (Figure 6-5).[xxxiii] Excluding blank and skipped pages, the Obama Administration created seven of the eight largest *Federal Registers* in history.[xxxiv] Assuming the same blank-to-substantive-page ratio from the Obama era holds for 2016, the number of substantive pages in the register grew by 19.3 percent from 2015 to 2016 alone.[xxxv] The Competitive Enterprise Institute estimated Federal regulations alone cost the economy nearly $1.9 trillion in lost output in 2015.[xxxvi]

In 2016, regulatory agencies issued 18 official rules and regulations for every law Congress passed.[xxxvii] This total does not account for "guidance documents" and other memos released by agencies. Such "guidance" purports to be advisory in nature but often proves coercive, by broadly reinterpreting previous rules in unintended ways to expand agency powers or advance an agenda without following the normal rulemaking process. These memos have been called "regulatory dark matter,"[xxxviii] and together with rampant agency rulemaking threaten to usurp Congress as the originator of the laws that govern America.

Figure 6-5



On January 3, 2017, the first day of the 115th Congress, Representative Doug Collins introduced the *Regulations from the Executive in Need of Scrutiny (REINS) Act* (H.R.26).[xxxix] The bill passed the House on January 5, and as of February 1 awaits action in the Senate. This bill is a successor of then-Congressman, now-Senator, Todd Young's *REINS Act* from previous Congresses; Senator Rand Paul is the Senate sponsor of the measure. This proposal inverts the *Congressional Review Act* (CRA) design by requiring that major rules be affirmatively approved by Congress rather than relying on the disapproval process currently in place.[xl] The bill would also establish a fast-track procedure for the approval of these rules that would allow for expedited consideration in Congress, thus ensuring that appropriate and necessary rules can be affirmed in a timely manner. The *REINS Act* restores Congressional primacy by requiring major regulatory actions directly affecting Americans be approved by their elected representatives.

Under President Trump, the CRA in its present form provides a pathway for blocking the most egregious "midnight regulations" issued by the Obama Administration in its final days, reversing regulations submitted on or after June 13, 2016.[xli]

Another proposal that allows for more direct Congressional oversight of the regulatory burden in the United States is the concept of a regulatory budget. A regulatory budget would cap the regulatory costs that agencies would be able to impose on Americans alongside the normal Congressional budget process. It would limit red-tape growth while providing agencies incentives to accomplish their goals in the least onerous way possible. Regulatory budget levels would be set by Congress, and the process would allow Congress and the President to join in direct oversight of the level and type of regulations produced by the bureaucracy.

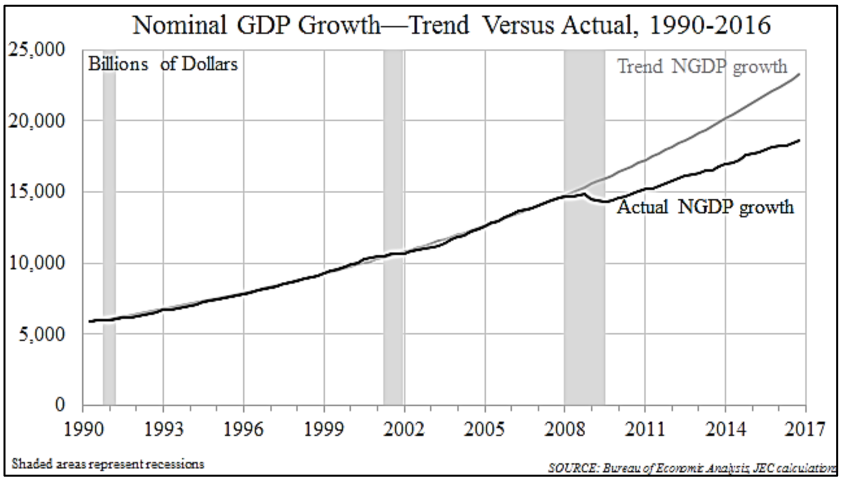
On January 30, 2017, President Trump issued Executive Order 13771 requiring that for every new regulation put into place, two old regulations must be rescinded.[xlii] The United States now joins a list of other governments using this approach to reduce regulatory burdens. The United Kingdom, Canada, and Australia have all seen success in cutting red tape through similar policies.[xliii] The "one in, two out" policy is an excellent start to address overregulation, but further reforms should be enacted to codify red-tape control into statute and return Congress to its position of primacy. To that end, in the 114th Congress, Vice Chairman Lee proposed the *Regulatory Budget Act* to allow Congress to vote on the total regulatory burden each federal agency imposes on the U.S. economy on an annual basis.[xliv]

CONCLUSION

The policies of the last eight years have had serious constraining effects on the U.S. economy that are plainly visible. The mass of

Federal regulation applied to the economy overall and to the financial sector in particular has a large role in that.

Figure 6-6



Recommendations

For the economy to recover in a true sense, meaning for it to get back to its full potential:

- The overall regulatory onslaught must be turned back and regulation of the financial sector must become geared toward the critical risk factor, which is "runs" on financial institutions that can spread widely;
- The government sponsored enterprises Fannie (Federal National Mortgage Association) and Freddie (Federal Home Loan Mortgage Corporation) must be reformed in a manner that ensures they do not return to a status as private entities that operate for profit but with implicit public guarantees (as the *Report* correctly advises[xlv]).

What can prevent or contain runs more efficiently than government micromanaging private financial intermediation? That is the central question. The regulation in place now not only is inefficient, it may actually increase the risk in certain ways, such as by continuing to encourage financial institutions to retain or acquire "TBTF" status, by providing a false sense that regulators can control events, and by thwarting more market competition from small banks and innovative financing vehicles.

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[xxxi] “Consumers and Mobile Financial Services,” March 2016, p. 25.

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