Statement before the House Committee on Financial Services

on

The CHOICE Act

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Chairman Hensarling, Ranking member Waters, and members of the Committee. I very much appreciate the opportunity to testify today on the CHOICE Act.

One way to understand the act and the need for the comprehensive reform that the CHOICE Act provides, is to recognize that the Dodd-Frank Act was completely unnecessary. It was based on a false diagnosis of the 2008 financial crisis by an administration and a Congress that didn't even try to understand why the crisis occurred. They simply assumed—or wanted to believe—that the crisis was caused by insufficient regulation of the financial system and greed on Wall Street.

Barney Frank, the chair of this committee during the period that the act was being considered, told the media, before any hearings were held, that the 2009 Congress would enact a "New New Deal." He was as good as his word. And as it often turns out when ill-considered ideas are rushed into law, the American people are the ones who suffer.

So the country has struggled through almost eight years of slow growth that has been particularly painful in our industrial heartland.

It is not an exaggeration to say that the 2008 crisis was a dangerous moment for the global financial system. For this reason, the causes of this near disaster should have been carefully studied by Congress and the administration before they acted. But that is not what happened. Shortly after the Obama administration took office, the rudiments of what became the Dodd-Frank Act were sent to Congress, and after that we were off to the races. By July of 2010, the Dodd-Frank Act was signed by President Obama.

The Financial Crisis Inquiry Commission didn't do any better. It considered only one possibility—that there was insufficient regulation of the financial system—and concluded its report six months *after* the president had signed Dodd-Frank into law. Obviously, Congress didn't expect the FCIC to draw any different conclusions, and it didn't.

Although I was a member of FCIC, I was not given access to all the information the FCIC collected in the course of its study. After the FCIC finished its work, I was able to find in the files that the commission made public a lot of materials that contradicted the FCIC's report and were never mentioned in the report.[1] These went into my book, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why it Could Happen Again*.

[1] Peter J. Wallison, "New Questions About the Financial Crisis Commission," June 14, 2016. http://www.aei.org/?s=financial+crisis+inquiry+commission.

Those who still back Dodd-Frank will of course argue that it is necessary to prevent another financial crisis, but this is based on the false idea that the 2008 crisis was the result of insufficient regulation of the financial system. They have no explanation for why we had a nationwide decline in underwriting standards, an unprecedented housing price bubble, and a financial crisis when the bubble collapsed in 2008. None of these things had ever happened in the 75 years since the Great Depression, which is the only comparable event in American history. During all these years we had the same financial regulatory system, and if anything financial regulation was tightened during this period.

In reality, the causes of the crisis had nothing to do with a lack of regulation, or even greed on Wall Street. That is why the major provisions of this destructive law should be repealed.

The crisis was caused by the government's housing policies, beginning with the enactment in 1992 of what are called the Affordable Housing Goals. The goals required Fannie Mae and Freddie Mac, when they bought mortgages from banks or other originators, to meet annual quotas of loans to low and moderate income borrowers. Initially, the quotas were 30%--in any year, at least 30% of all mortgages they acquired had to be made to low and moderate income borrowers—but through the Clinton and Bush administrations the goals were raised aggressively by HUD, so that, in 2008, 56% of all mortgages they acquired had to be made to borrowers who were at or below median income where they lived.

Before the goals were adopted, Fannie and Freddie were well-known for buying only prime mortgages, and in fact it was that policy that Congress wanted to change in 1992. The thought at the time was that it would be easier for low and moderate income borrowers to buy homes if Fannie and Freddie could be compelled by the quotas to lower their underwriting standards.

This certainly worked. By the mid-1990s, Fannie and Freddie had abandoned their policy of accepting only mortgages with 10% downpayments. They had to; they couldn't find enough borrowers among those below median income who could make a 10 % downpayment. This was followed by reductions in FICO credit scores and increases in debt-to-income ratios as Fannie and Freddie struggled to meet the increasing goals between 1992 and 2008.

The great error in this policy was the failure to understand that Fannie and Freddie—as the dominant players in the housing finance markets—set the underwriting standards for the market as a whole. Mortgage lending is a competitive business, and as Fannie and Freddie lowered their underwriting standards lenders found that the GSEs would accept mortgages that they had never accepted before. If their competitors would make these mortgages, and if the GSEs would buy them, these underwriting standards would become the minimum standards for the market as a whole. Pretty soon, and we all remember this, people who formerly had insufficient funds to buy a home were able to buy one by borrowing almost the entire cost from a bank.

The decline in underwriting standards caused housing prices to rise. If a potential buyer has $10,000 and the underwriting standard requires a 10% downpayment, the buyer can acquire a $100,000 home. But if the required downpayment becomes 5%, the buyer can get a $200,000

home. Instead of borrowing $90,000, he now borrows $190,000. This additional borrowing, which people in the field call leverage, bids up housing prices. As a result, between 1997 and 2007, an unprecedented housing price bubble grew in the United States, with home prices rising almost 10% per year.

Why would a bank make a loan with only a 3% or even zero downpayment? Two reasons: home prices were rising so fast in the late 1990s and early 2000s that a year later the home would be worth 10% more, and thus could be sold to recover the mortgage loan if the buyer defaulted. Alternatively, the bank figured it could sell that loan to Fannie or Freddie, and both of them needed loans to borrowers below median income—no matter how risky—so they could meet the Affordable Housing Goals.

By 2008, just before the financial crisis, more than a majority of all mortgages in the US financial system were subprime, required low or no downpayment, or were otherwise weak. Of those loans, 76% were on the books of government agencies, principally Fannie and Freddie. This shows, beyond question, that it was the government that created the *demand* for these mortgages.

Finally, in 2007 and 2008, when home prices had gotten so high that no amount of concessionary lending could get borrowers to take on the loans, the bubble's growth flattened and began to decline. Then, as Warren Buffett famously said, "when the tide goes out you can see who's swimming naked." A deluge of defaulted mortgages hit the financial system, buyers of mortgage backed securities that were not guaranteed by the government disappeared, and financial firms that had bought the mortgages or the mortgage-backed securities were left holding the bag. The outcome was a financial crisis in 2008 and a deep recession that ended in June 2009.[2]

This isn't to say that the banks were blameless; they were profiting from the sale of deficient mortgages, but the reason they could sell them was because Fannie and Freddie and other government agencies were buying them to meet government quotas.

To address this problem, the financial regulators did not need any more authority. They had plenty of authority and plenty of visibility into the banks to know what the banks were doing. They didn't stop the fun or take away the punchbowl because they knew Congress liked what was happening. More people were buying homes and housing prices were rising, making everyone feel richer.

But after the carnival came to an end, the only thing the Obama administration and the congressional majority could think of was to pile more regulation on the financial system. No one, either among the regulators or in Congress, wanted to take the blame, or even find out the truth, so the banks became the scapegoat and Dodd-Frank was fastened onto the American economy.

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[2] The causes of the 2008 financial crisis, from beginning to end, are detailed in my book, *Hidden in Plain Sight: What Caused the World's Worst Financial Crisis and Why it Could Happen Again*, Encounter Books, 2015

George W. Bush was the only person in authority during this period who has made an honest assessment of what happened. He said in his memoirs, "I was pleased to see the ownership society grow. But the exuberance of the moment masked the underlying risk."[3]

The winners write the history, and the incoming administration of Barack Obama and the Democratic supermajority in Congress blamed the crisis on insufficient regulation of the private financial sector. This narrative, although factually unsupported, gave rise to the Dodd-Frank Act, which imposed significant new regulation on the US financial system but did virtually nothing to reform the government policies that gave rise to the financial crisis.

Today, as a result, housing prices are rising on the same trajectory that they were on in the mid-1990s. If we don't change our housing policies, we are headed to another financial crisis.

Important Reforms in the CHOICE Act

The balance of this prepared testimony will focus on five elements of the Dodd-Frank Act that have, or I believe will have, severe adverse consequences for the US economy—(i) the compliance costs imposed on community banks that have stifled US economic growth; (ii) the authority provided to the Financial Stability Oversight Council; (iii) the Orderly Liquidation Authority; (iv) the danger inherent mandatory clearing of derivatives; and (v) the Volcker Rule.

The CHOICE Act addresses all of these important issues, as summarized below, and I urge its approval by this committee:

First, the Dodd-Frank Act has had a highly adverse effect on economic growth in the United States, primarily—although not entirely—through imposing substantial costs on small and community banks. The CHOICE Act attacks this problem in a comprehensive way—providing these banks, and potentially others, with an "off-ramp" that would allow them to avoid many of the most costly regulations if they adopt a capital position based on a 10% leverage ratio instead of the Basel risk-based capital standards. Larger banks could also take advantage of this exemption. This is an imaginative way comprehensively to address the problem of excessively costly regulations for small and community banks and restore the growth in the small bank sector that has been missing since the enactment of Dodd-Frank. A return of small and community banks, over time, will restore the growth among small business and startups that will get our economy moving where it needs the most help—at the local level.

Second, the CHOICE Act would rescind the authority of the FSOC to designate systemically important financial institutions, or SIFIs. This is certainly a much-needed reform. A federal district court in the District of Columbia, has already determined, in the MetLife case, that the FSOC's actions in designating MetLife as a SIFI were arbitrary and capricious. But it could hardly be otherwise. It is impossible for any agency, or council of agencies, to know that at some point in the future—in completely unknown market conditions—the failure of a particular firm will cause instability in the US financial system. The FSOC, already of doubtful constitutionality, also has the authority under Dodd-Frank to prohibit other firms from engaging in lawful activities that the FSOC deems to be risky for the economy. This was too much

[3] George W. Bush, "Decision Points," (Crown Publishers, 2010), p449

discretionary power to be given to any government agency, and the CHOICE Act would also eliminate that authority.

Third, the CHOICE Act would repeal Title II of Dodd-Frank, the Orderly Liquidation Authority, which would permit the secretary of the Treasury to take control of and liquidate a failing non-bank financial firm that, in the secretary's judgment, would cause instability in the US financial system if it were allowed to file for bankruptcy. The secretary is then directed to turn the company over to the FDIC for liquidation. This provision will create substantial confusion among creditors, who will not know which rule would apply—the Bankruptcy Code or the secretary's opinion—and will probably increase credit costs for all large financial firms. As important is the fact that this is a totally unnecessary provision, because there is no indication—after Lehman—that a nonbank firm can cause a financial crisis. The Choice Act, correctly, would substitute a new provision of the Bankruptcy Code as the mechanism for winding down failed nonbank financial firms.

Finally, the repeal of Title II of Dodd-Frank will prevent supporters of the act from contending, falsely, that Dodd-Frank ended too-big-to-fail. It did not. There are certain TBTF firms in our economy, but they are not bank holding companies or other large financial firms that may be covered by Title II; they are the largest commercial banks, and Title II does not apply to them. This means that the US at this point does not have any way to deal with the enormous problems that would be created by the failure of one of our largest banks. The only workable solution is to make sure that none of these banks fails, and the only way to do that is to assure that these banks have enough capital to withstand every possible adversity. The leverage ratio in the CHOICE Act may be the best solution here, as it is for small banks.

Fourth, the CHOICE Act would repeal the authority of the FSOC to allow clearinghouses to have access to the Fed's discount window. This will set up the same kind of moral hazard problem that always develops when a profit-making firm has access to government support. The availability of Fed backing will inevitably mean that the clearinghouses, which compete for clearing business, will gradually allow their financial strength to weaken in order to attract business. This will not worry their customers, because the customers will know that the clearinghouses will have access to the Fed's support if they ever get into trouble. The result, unfortunately, is likely to be a future event in which one or more clearinghouses are unable to meet their payment obligations. The Fed will have to step in, but we can only hope that a real financial crisis does not occur.

Fifth, the CHOICE Act would repeal the Volcker Rule, which has driven many bank-related financial firms out of the business of making markets in debt securities. This has resulted in a serious lack of liquidity in the debt markets, and could result in many bankruptcies—and even a financial crisis—in a stress environment where many investors want to sell debt securities to get needed liquidity.

Dodd-Frank's Harm to the Economy

The Dodd-Frank Act is the only plausible reason for the slow recovery of the US economy from the 2008 financial crisis. The US economy is a giant multifaceted organism that cannot be easily suppressed. Anything capable of doing so would have to be a very large and

comprehensive shock—something only the US government could produce. During the last eight years, there have only been three major policies that could qualify for this role—the Affordable Care Act, the Fed's Quantitative Easing program, and the Dodd-Frank Act. The first two would most likely be stimulative, because they both either pumped more money into the financial system or lowered interest rates. Accordingly, the third, the strict new financial regulations in Dodd-Frank, are the likely sources of suppressed growth. The chart below shows the degree to which the period from the end of the last recession in June 2009, through 2013, was an outlier among US recoveries since 1960.

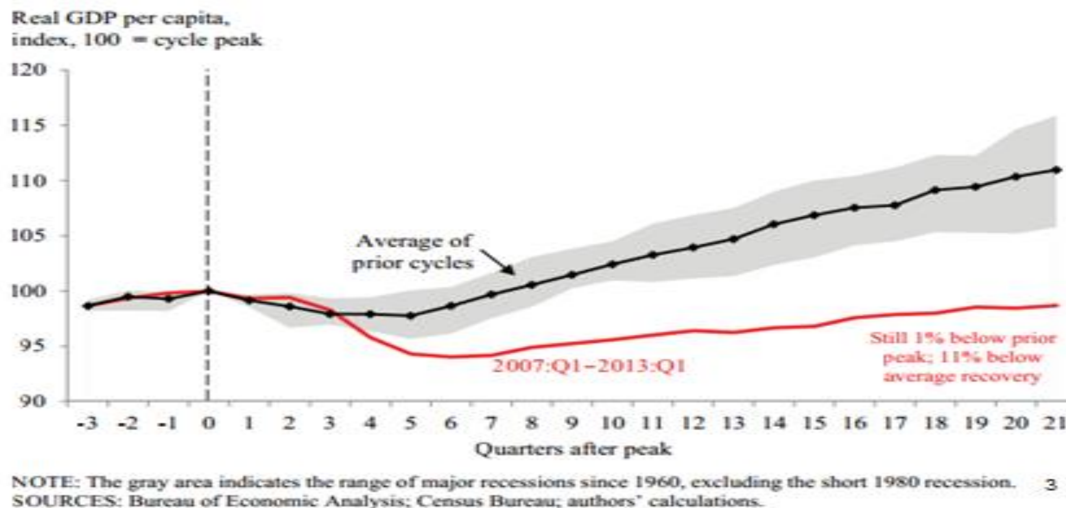
Still, exactly how Dodd-Frank has adversely affected the growth of the US economy is a legitimate question. In general, the need for many firms to adjust their business plans and strategies could certainly be one of the causes of slower growth. This is especially true when almost everything Dodd-Frank commanded had to be embodied in regulations, sometimes by several agencies acting jointly. Even seven years after the enactment of the law all the required regulations—which once numbered almost 400—have not been issued. It would have been reasonable for financial or other businesses to have waited for all relevant regulations to be adopted before making new investments.

Then there is the question of risk-taking; the whole purpose of the law was to place controls on risk-taking, so many financial firms have hung back from financing new ventures. In the consumer economy, the CFPB's refusal to define the term "abusive" left many firms fearful of making offers to customers that the CFPB might later punish. All these, and many more, are plausible reasons for the economy to slow after Dodd-Frank. However, in this testimony, I will argue that the principal mechanism for slowing the economy has been the act's effect on small and community banks.

Dodd-Frank became a law on July 21, 2010. It is important to keep this date in mind, because it is the after-effects of the law that are of interest. The chart below was prepared by the Federal Reserve Bank of Dallas[4] and shows the quarter-by-quarter growth of the US economy from before the crisis to the second quarter of 2013. The gray area is the range, and the black line is the average, of prior cycles. The chart shows that the current recovery—the line below the shaded area—is far weaker than the range and average of prior periods.

[4] Adapted from Tyler Atkinson, David Luttrell, and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-2009 Financial Crisis," *Staff Papers* no. 20, July 2013.

Dodd-Frank's Legacy: The recovery from the 2008 crisis and recession compared to previous recoveries.



Demonstrating the connection between regulation and suppressed growth is difficult; economists generally do not try to model the effects of regulation as they do with taxes. What we can do, however, is make clear how Dodd-Frank regulation could have caused or contributed to the slow growth in the economy.

In this testimony, then, I will point to Dodd-Frank's extensive regulatory burdens on small banks—the 98.5 percent of all banks that have assets of $10 billion or less—as the most important reason for the slow recovery. I will argue that these costs and the strict one-size-fits-all lending standards that have been imposed by regulators under Dodd-Frank, have reduced the productivity, raised the operating costs, and limited the amount of credit that small banks could provide to small business borrowers—especially the small business startups that are largely responsible for increased jobs and economic growth.

It is not well-known that a large proportion of the new employment in the US market has come from local start-ups, and these are the firms that often depend on local bank financing and are hardest hit by the loss of these local financial institutions. [5]

If this analysis is correct, we should see that firms that can access the capital markets—and are not dependent on bank lending—have been growing at a pace that is consistent with most other recoveries. The data shows that this is true. We should also see that small businesses—those that rely on banks for their credit needs—are growing far more slowly than larger businesses that do not have to rely on bank credit. This is also supported by the data.

Finally, there is the question whether the crisis of 2008—because it was a financial crisis—was destined to recover more slowly than any previous crisis or recession.

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[5] John Haltiwanger, Ron S. Jarmin, and Javier Miranda, "Who Creates Jobs? Small Versus Large Versus Young," The Review of Economics and Statistics, May 2013, 95(2):347-361

Defenders of Dodd-Frank sometimes argue that a slow recovery is typical after financial crises, and accounts for the slower economic growth since 2010, but recent scholarship shows that this idea can be dismissed. Michael Bordo and Joseph Haubrich studied 27 recession-recovery cycles since 1882 and concluded: "Our analysis of the data shows that steep expansions tend to follow deep contractions, though this depends heavily on when the recovery is measured. In contrast to much conventional wisdom, the stylized fact that deep contractions breed strong recoveries is *particularly true* when there is a financial crisis."[6]

The Bordo-Haubich paper also shows that financial crises have resulted in sharp recoveries, except where government has stepped in with new regulations such as Dodd-Frank. Together, these supporting elements add weight to the argument that the Dodd-Frank Act was a major cause of US economy's slow recovery from the 2008 crisis.

The Economic Growth Costs of Additional Regulations on Small Banks

As chart above shows, through the first quarter of 2013, there had been some modest economic growth, but far less than in a normal recovery. Since then, as we know, the pattern has continued. In fact, an average growth rate of about 2% continued through the end of the Obama administration.

Is there a plausible connection between this slow growth and the Dodd-Frank Act?

In developing and adopting the Dodd-Frank Act, Congress and the administration did not appear to be concerned about placing additional regulatory costs on the financial system. For example, all bank holding companies with $50 billion in assets or more were treated in the act as systemically important financial institutions (SIFIs) and subjected to "stringent" regulation by the Fed. Among many other requirements, these banking organizations must prepare so-called "living wills"—detailing how they would be broken up if they fail—and participate in annual Fed-designed stress tests.

These and other requirements add substantial additional costs to whatever "stringent" new regulation by the Fed might entail. Even if only in the form of more compliance officers than loan officers, this will mean that these banks will supply less credit to the real economy. If these firms did not have to hire any additional compliance officers, all their new hires—if any—would likely be employees who produce revenue, and hence more revenue for the bank and more economic growth for the real economy.

Moreover, placing these burdens on $50 billion banks was completely gratuitous. There is no basis for the belief that a $50 billion bank—or even a $100 billion bank—is a SIFI. The failure of a bank of that size would not cause a systemic event, and even if this were a rational fear the bank could be sold to one of the many banks larger than $250 billion. It is difficult to escape the conclusion that the Congress that imposed these unnecessary costs just didn't care about the effect on the economy.

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[6] Michael D. Bordo and Joseph G. Haubrich, "Deep Recession, Fast Recoveries, and Financial Crises: Evidence From the QAmerican Record," Working Paper 18194, National Bureau of Economic Research, June 2012, p2.

In a study of the effect of the "systemic" regulations imposed on regional banks with assets of more than $50 billion—not the largest banks that operate nationally and internationally— Federal Financial Analytics concluded that "the direct costs of systemic standards for a sample of U.S. bank holding companies (BHCs) may be at least $2 billion, resulting in a possible reduction of credit in the markets served by the largest of these BHCs of 5.7 to 8 percent. Over a five-year period, this reduction in lending by regional banks could total approximately $14 to $20 billion."[7]

A similar analysis applies to small banks, which have also been required to conform to many new regulations coming out of Dodd-Frank, especially in mortgage and consumer lending. A study by the Government Accountability Office (GAO) identified seven Dodd-Frank titles that have the potential to increase the costs or the competitive burdens for "community banks,"[8] which the GAO and many others define as banks with assets of $10 billion or less (unless otherwise stated, this testimony will use that definition). Similarly, studies by the Mercatus Center[9] and the American Enterprise Institute[10] have also shown that Dodd-Frank regulations have imposed substantial additional costs on community banks. As noted earlier, banks of this size or less are 98.5 percent of all US banks; as of 2015, there were only 98 banks in the US with more than $10 billion in assets,[11] and only 39 with assets of $50 billion or more.

The additional costs are substantial. Mercatus, in particular, based its study on a survey of approximately 200 small banks, noting that "our survey reveals increased hiring of compliance personnel, more noncompliance employee time spent on compliance, and increased spending on compliance, trends noticed in other surveys."[12] The study further reported, "[A]pproximately ninety percent of respondents reported an increase in compliance costs, and most (82.9%) of participating banks reported that their compliance costs had increased by more than five percent."[13] In effect, for these banks the median number of compliance personnel doubled—from one to two—after July 2010, and a quarter of respondents planned to hire additional compliance officers.[14] More compliance officers, or more noncompliance employees engaged in compliance activities, translates directly into higher employee costs and lower employee productivity—meaning in the end less credit or more costly credit for the small businesses that borrow from banks.

As a rule of thumb, whatever regulatory costs are imposed on banking organizations—whether they be $2 trillion banks like JPMorgan Chase, $50 billion banks or $50 million banks—the larger the bank the more easily it will be able to adjust to these costs. As Federal Reserve

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[7] Federal Financial Analytics, Inc., "The Consequences of Systemic Regulation for U.S. Regional Banks," August 6, 2015, p *i*

[8] U.S. Gov't Accountability Office, GAO-12-881, Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings (2012) Appendix II.

[9] Hester Peirce, Ian Robinson, and Thomas Stratman, "How are small banks faring under Dodd-Frank?" Working Paper, Mercatus Center, George Mason University, February 2014, p15

[10] Tanya D. Marsh & Joseph W. Norman, The Impact of Dodd-Frank on Community Banks (American Enterprise Institute May 7, 2013), available at http://www.aei.org/papers/economics/financial-services/banking/the-impact-of-dodd-frank-on-community-banks/.

[11] Mercatus study, supra note 7., p 11

[12] Id., p16

[13] Id., p 34

[14] Id., p 35 and 36

Governor Daniel Tarullo has observed, "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets."[15] William Grant, then chair of Community Bankers Council of the American Bankers Association, noted in congressional testimony in 2012, "The cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks."[16] That's most likely why, since the enactment of Dodd-Frank, the smallest banks, as we will see, have suffered the greatest losses of market share and the largest banks have continued to grow.

Ironically, then, although there has been great concern in Congress about the financial advantages of too-big-to-fail banks (TBTF), the heavy regulations in Dodd-Frank have given the largest TBTF banks even more significant competitive advantages over their smaller competitors. Indeed, Jamie Dimon, the chair of JPMorgan Chase, has referred to regulation as a "moat" that reduced competition from its smaller rivals.[17]

Consistent with these data, small banks have been losing market share to larger banks since the enactment of Dodd-Frank. In a 2015 paper, Marshall Lux and Robert Greene noted that "Community banks withstood the financial crisis of 2008-09 with sizeable but not major losses in market share—shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010…But since the second quarter of 2010, around the time of the Dodd-Frank Wall Street Reform and Consumer Protection Act's passage, we found community banks' share of assets has shrunk drastically—over 12 percent...Since Q2 2010, the smallest community banks' ($1 billion or less in assets) share of U.S. banking assets has fallen 19 percent."[18]

An important factor in this decline, according to Lux and Greene, is that community banks did not share in the 44% increase increase in commercial and industrial (C&I) loans outstanding since mid-2010: "Community banks share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks' market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall growth in the sector, these banks realized a net decrease in volume of 7.5 percent."[19]

Part of the reason that small banks have been losing market share is the decline in their numbers, because of acquisitions by larger banks and a complete collapse since the financial crisis in the chartering of new banks. Both can be attributed to Dodd-Frank. Many community banks are selling out to larger institutions, which can operate more cheaply in the costly

[15] Daniel Tarullo, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014.
[16] William Grant, Statement before the House Subcommittee on Financial Institutions and Consumer Credit, May 9, 2012.
[17] John Carney, "Surprise! Dodd-Frank Helps JPMorgan Chase," CNBC NetNet, February 4, 2013. http://www.cnbc.com/id/100431660.
[18] Marshall Lux and Robert Greene, The State and Fate of Community Banking," *M-RCBG Associate Working Paper Series*, No. 37, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, February, 2015, p3
[19] Id., pp 17-18.

regulatory environment since the enactment of Dodd-Frank. Kelly King, the chairman of BB&T, a larger bank that is aggressively seeking to acquire community banks, recently observed:

> I think a lot of banks with $5 billion to $10 billion in assets are going to recognize that it is an unsolvable problem when they look at the massive investment they have to make to comply…The cost for them to expand is enormous, and they would go through a trough of several years where their stock price would be diluted. From an economic point of view selling is almost a no-brainer.[20]

Indeed, the chartering of new banks, which at one time averaged 100 per year, has declined to less than three per year since 2010. This is almost certainly attributable to the squeeze on profits as a result of increased regulation, although low interest rates could also be a contributing factor. If existing community banks can't make a go of it in the current environment, why would anyone invest in a new one?

Another element causing difficulties for small banks is the narrative underlying the Dodd-Frank Act; in this story, the financial crisis was caused by insufficient regulation of banks and other financial firms, allowing them to take risks that resulted in the financial crisis. As discussed elsewhere, this narrative is false,[21] but blaming the failure of a large number of financial institutions on lax regulation has produced an examiner crackdowns in the past, often accompanied by a downgrading of smaller banks. Larger banks are seldom downgraded. After the recession in 1989-1991, according to a history of bank regulation, regulatory attitudes changed: "Bank examiners became too restrictive, helping to create a near credit crunch."[22]

A 2015 paper by Paul Kupiec, Yan Lee, and Clair Rosenfeld has shown that, when regulatory downgrades occur, loan growth is impaired. "[S]upervisory restrictions," they report, "have a negative impact on bank loan growth after controlling for the impact of monetary policy, bank capital and liquidity conditions and any voluntary reduction in lending triggered by weak legacy loan portfolio performance or other bank losses."[23]

The Effect of Additional Regulatory Costs and Tighter Lending Standards on Small Business

Because of the unique role of community banks in lending to small firms, increases in bank regulatory costs and tightening bank credit requirements are particularly bad news for small business. As Drew Breakspear, the commissioner of Florida's Office of Financial Regulation, pointed out in a 2015 article, "Community banks have traditionally supported local agricultural and small business needs by incorporating information about borrower' characters into lending

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[20] Kristin Broughton, "Too Costly to Grow: Why National Penn Decided to Sell," American Banker, August 18, 2015.
[21] Wallison, *Hidden in Plain Sight*, supra note 1
[22]Alan Gart, *Regulation, Deregulation, Reregulation: the Future of the Banking, Insurance, and Securities Industries.* New York: John Wiley & Sons. 1994. p 163.
[23] Paul Kupiec, Yan Lee and Claire Rosenfeld, in "Does Bank Supervision Impact Bank Loan Growth?", draft of May 7, 2015, p1.

decisions. But Dodd-Frank has standardized lending practices, which works to the advantage of large banks and punishes community banks."[24]

Indeed, anecdotal information from small business managers and small banks indicates that since the enactment of Dodd-Frank examiners have been insisting that all borrowers with similar financial standing be treated the same way, so that credit is not necessarily available anymore to borrowers that do not meet certain revenue standards or do not have suitable collateral, guarantors, or vouching materials such as audited financial statements. Character loans, as Mr. Breakspear described them, one of the strengths of community banks that know their customers, appear to be a thing of the past.

One-size-fits-all lending standards certainly reduce one of the key advantages of the small bank lending system, but it may be more important for our purposes to understand that it also reduces the availability of credit for small business borrowers, especially start-ups, which generally have few of the supporting elements for credit that regulators want to see. As one study noted, small banks can fill a niche "stemming from their ability either to successfully lend to what have been variously described as 'informationally opaque' borrowers—borrowers without long credit histories suitable for credit scoring or other model-based lending practiced by large banks—or to engage in relation-or-reputation-based lending or lending in low-volume markets."[25] In other words, small banks can be unique sources of credit both for start-ups or more mature small businesses that do not otherwise have the credentials that regulators require for larger institutions.

At this point, it is necessary to make a key distinction about the contribution of small firms to economic growth and jobs. It is generally understood by economists that small firms are the principal drivers of new growth and jobs in the economy, but most of the discussion about small firms has focused on these firms as a single category. Within this category, however, are small firms that are trying to expand, and those that are not, and start-ups that contribute to growth in employment far beyond their numbers.

The most recent Small Business Credit Survey by the 12 Federal Reserve Banks, published this month, shows that 61% of small firms experienced credit challenges of various kinds during the last 12 months, with 44% all small firms reporting credit "unavailability" or difficulty finding credit for "expansion."[26] Growing firms—firms that are succeeding in satisfying their customers—are exactly those that should be able to get credit, yet only a little over half of these firms were able to meet their credit needs. These were clearly small firms that are applying to small and community banks, because the most sought after credit amount for firms with less than $1 million in revenue was only $100,000.[27]

Of the 10,000 firms that responded to the Fed survey, 33% were between 0 and 5 years old, the usual definition of start-ups. These young firms are particularly important because they

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[24] Drew Breakspear, "Too Small to Comply: Florida Regulator on Dodd-Frank's Defects," Bank Think, August 9, 2015

[25] Tim Critchfield et al., The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects, FDIC BANKING REV. (2004), at 4

[26] 12 Federal Reserve Banks, "Small Business Credit Survey: Report on Employer Firms," April 2017, p6

[27] Id., p9

are the major drivers of growth and jobs in the US economy. In an important paper on this subject, three researchers observed: "The share of jobs created and destroyed by different groups is roughly their share of total employment. An important exception in this context is the contribution of firm start-ups: they account for only 3% of employment but almost 20% of gross job creation."[28] As the authors explain, using 2005 as an example: "About 2.5 million net new jobs were created in the U.S. private sector in 2005. Strikingly, firm start-ups (firms with age 0) created about 3.5 million net new jobs. In contrast, every other firm age class except for the oldest firms exhibited net declines in employment in 2005."[29]

For this reason, data showing that small firms in general are not having difficulty finding credit, or don't need new credit,[30] should be understood as the result of sampling older established small firms or firms that are not looking to expand, and not the growing and start-up category, which is where the economic and job growth in the U.S. economy is apparently concentrated. It is the start-up category that would be having the most difficulty getting bank credit as a result of the tightening lending standards and greater small bank regulatory costs induced by Dodd-Frank. Banks, especially small banks, are not venture capitalists; to the extent that they are willing to take venture-type risks, it's with the "informationally opaque" firms that now draw criticism from examiners.

Lux and Greene report that "[C]ommunity banks provide 51 percent of small business loans. In the decade before the crisis (Q2 1998 to Q2 2008), community banks' lending to small business doubled in volume [citing FDIC data]. Small businesses create the majority of new jobs and account or the vast majority of employers…Alarmingly, however, community banks' overall volume of small business lending has declined significantly since Q2 2010—down 11 percent."[31] While this could also be the result of lower small business loan demand, the authors also point out that the volume of small business lending by the largest banks has declined only 3 percent.

Most significantly, in the same study, the results for community banks since the enactment of Dodd-Drank are even worse in the commercial and industrial (C&I) loan market—loans made to businesses that are not agricultural loans or commercial and residential real estate loans. There, "community banks' share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks' market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall lending growth in the sector, these banks realized a net decrease in volume of 7.5 percent."[32]

These observations are supported by other data. In 2014, two researchers at the Federal Reserve used data in bank call reports to assess whether there is a difference between large banks and community banks in business lending. "Following the financial crisis," they wrote, "total outstanding loans to businesses by commercial banks dropped off substantially. Large loans outstanding began to rebound by the third quarter of 2010 and essentially returned to their

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[28] Haltiwanger, et al, "Who Creates Jobs? Small Versus Large Versus Young," supra, note 3, p 360.
[29] Id., p350
[30] See, e.g., data of the National Federation of Independent Business (NFIB) for 2015, showing that members are having no difficulty obtaining credit. NFIB Research Foundation, "Opinions of Small Employers," p.8. http://www.nfib.comsmallbizsurvey2015.
[31] Lux and Greene, op. cit., p11.
[32] Id., p18

previous growth trajectory while small loans outstanding continued to decline (Chart 1). Furthermore, much of the drop in small business loans outstanding was evident at community banks (Chart 2)."

Chart 1. Amount Outstanding on Loans to Businesses[33]

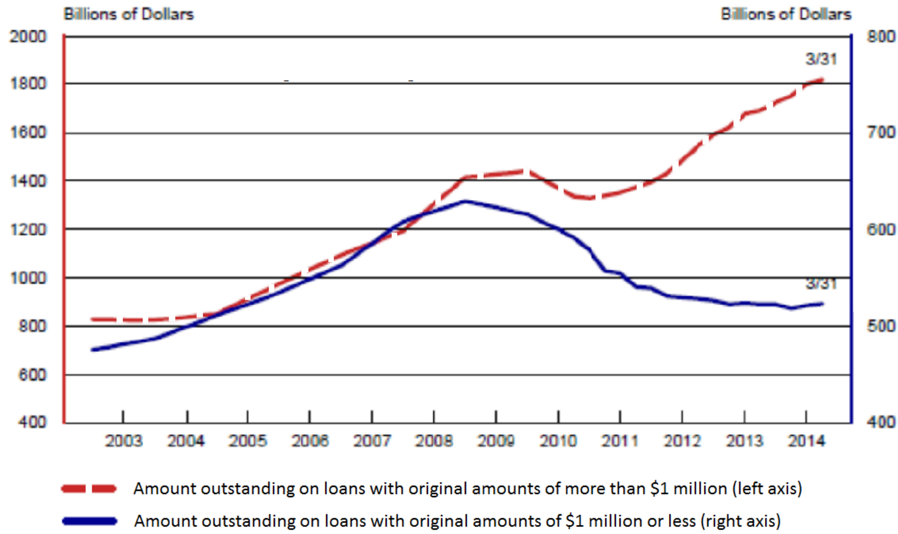
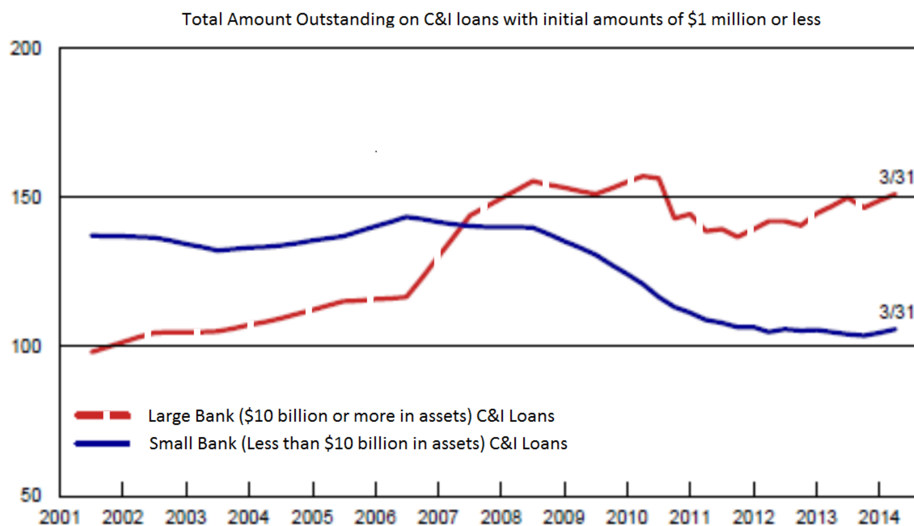


Chart 2. Small C&I Loans Outstanding by Banking Organization Size

[33] These charts appear in Dean Amel and Traci Mach, "The Impact of the Small Business Lending Fund on Community Bank Lending to Small Business," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, No. 2014-111, December 2014, p17



Source: According to the authors, these data are constructed from special tabulations of the June 30, 2002 to March 31, 2014 Call Reports.

Bank Call Reports do not provide information on the size of the business that received the loan, but as the authors of the paper note, loans up to $1 million are frequently seen as a proxy for a small business loan. So what these charts show is that small business lending by small banks, and small business borrowing by small firms, has not recovered from the post-crisis recession and has declined even more sharply after the enactment of the Dodd-Frank Act in 2010. Even banks over $10 billion have not been expanding their lending to small business. The likely reasons, as outlined above, are that higher regulatory costs and one-size-fits-all lending standards imposed after Dodd-Frank have stymied lending, particularly to start-ups which account for most of the economy's new jobs and growth.

Finally, the new and more costly regulation imposed by Dodd-Frank appears to have stalled the formation of new banks, which in turn has also affected the availability of credit for the small and medium-sized businesses that are dependent on bank lending. A Federal Reserve Bank of Richmond report in March 2015 notes that "The rate of new-bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010." Trying to assess the reasons for this sharp decline, the report continued, "Banking scholars …have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started."[34]

[34] Roisin McCord, Edward Simpson Prescott, and Tim Sablik, "Explaining the Decline in the Number of Banks since the Great Recession," Economic Brief, Federal Reserve Bank of Richmond, March 2015.

The authors suggest other possible causes, but the fact that the decline became so severe in 2010, the year of the enactment of Dodd-Frank, is strong evidence that the new requirements in the act—which have been cited again and again by small banks since 2010—are responsible. In any event, the decline in the formation of new banks caused an overall decline of 800 in the total number of small independent banks between 2007 and 2013. All these factors—increased regulatory costs, tougher lending standards, and a decline in the absolute numbers of small banks because of regulatory costs—have had an adverse effect on the small businesses, and particularly the small business start-ups, that depend on small banks for credit.

Small Business and the Bifurcated Credit Market

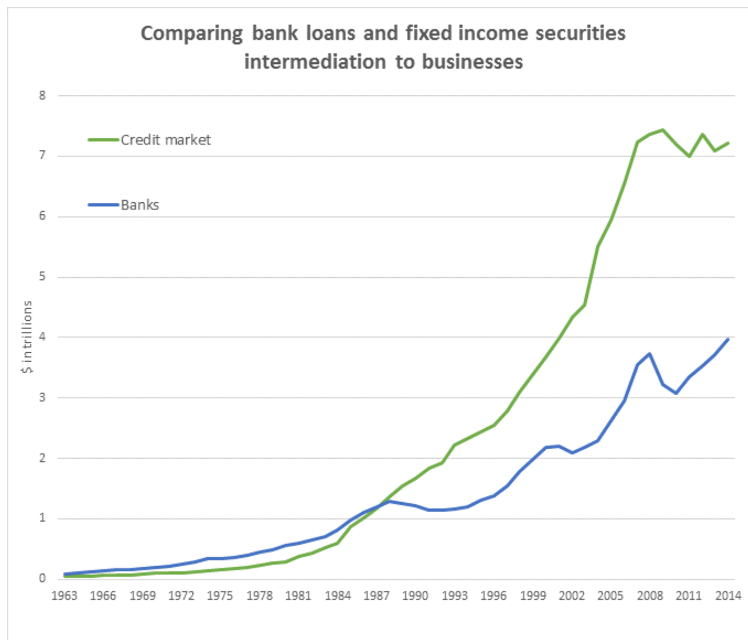
It is not generally understood that the US has a sharply bifurcated credit market. According to the Small Business Administration, in 2010 there were 28 million small businesses in the US, defined as firms with fewer than 500 employees. Of these, about 5.5 million were employers; the rest were small proprietorships (mom and pops) with no formal employees. At the same time, there were 18,500 larger businesses (less than 1 percent of all employers) with 500 employees or more.[35]

These two classes of businesses have very different sources of credit. Most of the 18,500 larger businesses are in a position to borrow from banks or to finance in the credit markets. In 2014, there were approximately 10,000 firms registered with the SEC and thus in a position to issue securities in the capital markets. However, (leaving aside the growing but limited crowdfunding market) the 28 million small businesses, including the 5.5 million that were employers, are likely to be completely dependent on banks for their credit needs. For these firms, increases in the cost, or reductions in the availability of bank lending—particularly by small banks—would have a substantial impact on their prospects for growth.

The chart below shows that since the mid-1980s the capital markets have far outpaced the banking industry as a source of credit for business firms.[36] This alternative means of financing, however, is not available to small or medium sized businesses, because they are not generally owned by public shareholders and do not report their financial results to the SEC. In addition, the considerable costs of maintaining a securities registration make registration unaffordable for smaller businesses. For these smaller firms, then, greater and more costly regulation of banks would inevitably cause either an increase in the cost of bank credit, a reduction in its availability, or both.

[35] Small Business Administration, "Frequently Asked Questions About Small Business," September 2012, p1.

[36] There are several reasons for this. Agency intermediation is more efficient than the principal intermediation of banks; banks are more heavily regulated than broker-dealers, mutual funds and other participants in the capital markets and thus have higher costs; and technological advances in information distribution have made it easy for firms to communicate their financial position directly to analysts and investors, so banks have lost their special position as the repositories of the best financial information about companies. The trend toward capital markets financing has caused a backlash from bank regulators, who now want to use the Dodd-Frank Act to regulate the capital markets—what they call the "shadow banking system."



Source: Fed Flow of Funds

There is another explanation for the difficulty of small business, particularly start-ups, in getting credit for growth. In a Goldman Sachs report published in April 2015, and titled "The Two-Speed Economy," the authors posit that new banking regulations have made bank credit both more expensive and less available. "This affects small firms disproportionately because they largely lack alternative sources of finance, whereas large firms have been able to shift to less-expensive public market financing."[37]

Using IRS data, the Goldman study finds that large firms—those with $50 million or more in revenue annually, have been growing revenue at a compounded annual rate of 8 percent, while firms with less than $50 million in revenue have been growing revenue at an average of only 2 percent compounded annually. Even more significant, using Census data, the Goldman authors found that "firms with more than 500 employees grew by roughly 42,000 per month between 2010 and 2012, exceeding the best historical performance over the prior four recoveries. In contrast, jobs at firms with fewer than 500 employees declined by nearly 700 per month over the same timeframe, although these small firms had grown by roughly 54,000 per month on average over the prior four recoveries."[38]

This accounts for the dearth of new business formations. Small firms are simply unable to get the credit that used to be available to small business start-ups, and the credit that they can get is more expensive. This would also have a disproportionate effect on employment in the recovery, because small business start-ups, as noted earlier, are the principal source of new employment growth in the US economy.

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[37] Goldman Sachs, "The two-speed economy," April 2015.p3 http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf.
[38] Id., p8

Finally, the Goldman paper expresses concern that this is not necessarily a temporary phenomenon: "Taken together, the reduced competitiveness of small firms…are reshaping the competitive structure of the US economy in ways that are likely to reverberate well into the future, and in ways that any future evaluation of the aggregate effects of post-crisis regulations should consider."[39]

It would be hard to find a better way to express the dangers of leaving the Dodd-Frank Act in place without serious reforms.

Other Specific Provisions of Dodd-Frank that Will Harm the US Economy

Apart from its damage to the economy through its harmful effects on small banks and small business, there are other serious problems with Dodd-Frank that will be corrected through the CHOICE Act. These include the authorities provided to the Financial Stability Oversight Council under Title I of the act, the Orderly Liquidation Authority under Title II, the Fed's authority to open the discount window to clearinghouses, and the Volcker Rule. The CHOICE Act is important and necessary legislation because it would eliminate all of these Dodd-Frank provisions that are harmful to the economy in themselves and in some cases could be responsible for financial crises in the future.

The Financial Stability Oversight Council

Summary of this section:

1. **FSOC's authority under Section 113 to designate nonbank financial firms as SIFIs should be repealed, including the language in Section 113 that permits the FSOC to designate SIFIs because of their "nature, scope, size, scale, concentration, interconnectedness, or mix of activities."**

2. **FSOC's authority under Section 120 to recommend "stringent" regulation of any "activity," and its authority under Section 121 to terminate certain activities by any financial company, should be repealed**

3. **The provisions of Section 165 that impose requirements for stringent regulation, stress tests and living wills should apply only to the largest insured banks.**

4. **The FSOC could be retained solely as an information-sharing resource for financial regulators, like the President's Working Group in the prior administrations.**

As noted in the earlier discussion of the causes of the crisis, the Dodd-Frank Act as a whole is founded on a false narrative—that the 2008 financial crisis was caused by insufficient regulation of the private financial sector. However, Titles I and II of the act are based on a different and narrower misconception: that the immediate cause of the crash in 2008 was the bankruptcy of Lehman Brothers, a large nonbank financial firm. As a result, Title I of the act is focused on identifying and preventing the failure of large financial firms, while Title II attempts

[39] Ibid.

to provide an alternative to bankruptcy, which the act's sponsors believed is an inherently disorderly process.

Reflecting the view that the failure or "material financial distress" of a nonbank financial firm could cause another financial crisis, Title I establishes a council of financial regulators—the Financial Stability Oversight Council (FSOC or Council)—to identify these firms. When identified, a firm (commonly called a "systemically important financial institution" or SIFI) is then turned over to the Federal Reserve for special regulation that the act specifies must be both "prudential" and "more stringent" than the regulation to which similar firms are normally subject.

As shown earlier, however, the financial crisis was caused by the collapse of an entire asset class—home values and mortgages—brought about by the government's own housing policies. Neither special stringent regulation of large firms nor a special non-bankruptcy resolution system will prevent another crisis in the future if the government continues the same policies that it pursued before 2008.

Indeed, the policies introduced in Titles I and II will have harmful potential effects themselves. Among other things, they will create moral hazard and spread to other financial sectors the too-big-to-fail problem which has previously been limited to the banking industry. Since these policies will do considerable harm to the US economy, and they do no discernible good, they should be eliminated through repeal of the FSOC's authority to designate nonbank financial firms as SIFIs. In addition, the firms that have already been designated should be released from the Fed's control.

The following discussion is organized around the sections of Title I that establish the FSOC or provide it with authority to designate nonbank financial firms as SIFIs.

Section 111

Section 111 of the act establishes the FSOC, and specifies that the voting members will be the Secretary of the Treasury, as the chair, and the chairs or heads of all the other federal financial regulators. In addition, the president is given the power to appoint an independent voting member with insurance expertise. This amounts to 10 voting members, all of whom are appointees of the president then in office, and three of whom are bank regulators.[40] Routine decisions are to be made by a majority, but decisions on SIFI designations must be made by 2/3rds vote and have the affirmative vote of the secretary of the Treasury.

This structure—which constitutes the council as a group appointed by the administration then in office and probably from the president's political party—makes the council a political body. This is a substantial break from the past, where important financial regulatory decisions

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[40] In addition to the secretary of the Treasury, the voting members of the FSOC include the chairs of the Federal Reserve, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, and the National Credit Union Administration Board; the Comptroller of the Currency; the directors of the Consumer Financial Protection Bureau and the Federal Housing Finance Agency; and an independent member appointed by the president with the advice and consent of the Senate, having insurance expertise.

were made by bipartisan commissions made up of individuals who were deemed to be experts in a specific area of financial activity. Thus, the makeup of the FSOC raises questions that go beyond whether a bank regulator should be voting on a securities issue; it imports political and partisan considerations into what have traditionally been decisions that were made on the merits, in a bipartisan regulatory process. Although the heads of the financial regulatory agencies may be experts in regulation within their respective areas of specialty, their appointment by the president then in office—and the president's ability to remove them as chairs or agency heads—makes them unusually responsive to the president's political direction.

This problem is made considerably worse by the appointment of the secretary of the Treasury as the chair of the FSOC, which places one of the principal political officers of the administration, usually a confidant of the president, at the head of the table in FSOC meetings. It would be natural, then, for the other appointees of the president's political party to look for guidance on major decisions from the secretary of the Treasury instead of using their independent judgment. While political accountability is generally good, in financial regulation Congress has determined that it is best achieved through the bipartisan balance that is inherent in the bipartisan commission structure—a structure that is upended in the FSOC.

All these elements argue for the FSOC's transformation into a purely consultative body, similar to the President's Working Group (PWG), which was established by an executive order in the Reagan administration and continued to operate in subsequent administrations.[41] In that case, the council could retain its current structure, with the Treasury secretary as its chair.

Section 113

Section 113 authorizes the FSOC to designate particular nonbank financial firms as systemically important financial institutions (SIFIs), if the Council "determines that material financial distress at the US nonbank financial company, or the nature, scope, size , scale, concentration, interconnectedness, or mix of activities" of the firm "could pose a threat to the financial stability of the United States." After designation, the firm is turned over to the Fed for what the act calls "stringent" new regulation.

This is the FSOC's most distinctive power, and flows directly from the mistaken idea that the failure of a nonbank financial firm, like Lehman, can cause another financial crisis. The sponsors of the act thought that turning these firms over to the Fed for regulation would prevent their failure and thus—to that extent—prevent another financial crisis.

This idea is wrong; as will be shown, the failure of Lehman did not cause the 2008 financial crisis, and preventing such failures will not prevent another financial crisis. Moreover, there is no support in banking history for the proposition that Fed regulation can prevent bank failure. Finally, there are reasons to believe that the FSOC is not pursuing a fair or objective investigative or decision making process when it designates SIFIs. All of these are reasons for eliminating this authority.

[41] Executive Order 12631 of March 18, 1988, http://www.archives.gov/federal-register/codification/executive-order/12631.html.

The FSOC's implementation of its Section 113 designation authority: the MetLife Case

As noted above, the FSOC's designation authority is based on the notion, adopted by the sponsors of the Dodd-Frank Act, that large financial firms are "interconnected," If one of them fails, according to this theory, its "interconnections" with other firms will drag them down, causing instability in the US financial system. This led to the conclusion that additional regulation was necessary to assure that these large nonbank financial firms did not fail. Hence, the FSOC was given the extraordinary authority to designate certain firms as SIFIs.

When MetLife challenged its designation as a SIFI in 2014, FSOC argued in both the trial court and on appeal that, as an expert group, it can predict whether the financial distress of a firm like MetLife will be likely to cause instability in the US financial system in the future. This can be done, apparently, without knowing the conditions of the market in the future or MetLife's position within it. FSOC established no standards and referred to no historical precedents for making this decision, just as it had not for previous designations of AIG, GE Capital and Prudential Insurance. Its essential position, then, was that while it couldn't define what degree of interconnection with others would make a company a candidate for designation, MetLife's evidence was insufficient to show that its financial distress or failure would *not* cause instability in the US financial system—a position that MetLife's brief called *ipse dixit* (colloquially: "because I said so"). On this basis, the council claimed that its position was entitled to deference from the courts against MetLife's argument that the council's conclusions were arbitrary and capricious.

The MetLife brief raises serious questions about what standards the FSOC has been using to make its designations. MetLife is the first case in which the FSOC's standards have been publicly revealed. Apparently, the agency was prepared to designate MetLife as a SIFI without articulating any standards by which such a judgment would be made. Without standards, almost every prediction about whether the failure or material distress of a firm will cause financial instability in the future becomes completely discretionary—nothing more than a guess—and thus arbitrary and capricious. Indeed, the trial court found that FSOC had acted arbitrarily and capriciously in designating MetLife as a SIFI.

In a sense, FSOC should not be blamed for its inability to establish standards. The problem is that the agency was empowered by Congress to make a decision that is inherently one without standards. How can any person or group decide what is likely to happen in a completely unknown future time, when the relationships between a company under consideration for designation and the many other companies its failure might injure are completely unknown and unknowable? For this reason alone, FSOC should not have the power it is granted by Section 113. It is a power to use discretion without any limit. Perhaps the courts might not strike it down, but Congress certainly should.

There are substantial negative policy consequences of designating a firm as a SIFI. Principal among these is the danger that the firm has in effect been labeled by the government as "too big to fail" (TBTF) After all, a SIFI designation is a statement by the government that allowing the firm to fail would be dangerous to the stability of the US financial system. Under these circumstances, firms that are designated as SIFIs may have financial advantages over

competitors because—other things being equal—it is less risky to lend to them than to lend to firms that have an equal risk of failure but, if they fail, will not be rescued by the government.

Another important question is the effect of a designation on competition within a market. Insurance is a good example. It is not difficult to imagine that each of the three insurance firms that have been designated by the FSOC will be able to tell potential insurance customers that they are safer sources of insurance—whether life or property and casualty—than their competitors because they have been designated as SIFIs and are likely to be protected or rescued by the government. As happened with Fannie and Freddie, these companies will be able to outcompete others in the same industry because their apparent government backing made their guarantees seem safer than those of their competitors.

Over time, SIFI designations could produce powerful and unassailable firms that can dominate a market such as insurance that never had a TBTF problem in the past. If designations continue, involving other kinds of firms—and the FSOC is arguing in the MetLife case that it has an unlimited license to designate *any* firm—this will produce unnecessary concentration in financial fields other than banking and insurance, as the firms designated as SIFIs come to dominate their markets. It may also lead to firms requesting designation so they can reap the crony capitalism advantages of their relationship with the Fed.

Finally, designation authority can have a negative effect on the economy as whole. A good example of this is what happened to GE Capital in the wake of its designation as a SIFI. GE Capital was highly successful finance company in many areas—which means that it provided financing for firms that were ultimately successful and contributed importantly to economic growth. One of the areas where GE Capital specialized was in lending to small companies with large risks but strong growth prospects. It was willing to take risks and its astute investments over the years had enabled it to grow larger than GE, its parent company.

We do not know what stringent regulations the Fed proposed to put on GE Capital, but whatever they were they so impaired its earning power that in April 2015 GE decided—in the hope of getting GE Capital "de-designated"—to shrink it down into a financing source primarily for GE's customers. In other words, the government, through the powers granted to the FSOC, removed from the economy a significant source of risk-taking finance for smaller companies with good growth prospects. And this was done ostensibly because the regulators at the FSOC thought that if GE Capital encountered "material financial distress" at some point in the future it could cause a financial crisis.

This is a powerful example of how a set of regulatory blinders can impair the growth of the US economy. Even assuming that the FSOC was able to predict what would happen at some time in the future if GE Capital were to fail, it is not a matter of speculation what FSOC did to the US economy by essentially putting GE Capital out of business. No government organization should have this discretionary power.

Is the FSOC or SIFI designation necessary to protect the financial system?

Against all these disadvantages and costs to the financial system, what evidence is there that designation is necessary to protect the financial system? The short answer is: none. First, of

course, if we look at what happened in the financial crisis, it does not appear that prudential bank-like regulation was superior to non-regulation or market discipline in protecting financial firms from failure in the financial crisis. Three large nonbank financial firms failed in the crisis—Bear Stearns, Lehman Brothers and AIG; and three large heavily regulated banks—IndyMac, Washington Mutual and Wachovia (in addition to hundreds of smaller banks)—also failed during the crisis period. One large heavily regulated banking organization, Citigroup, might have been saved from failure by government assistance, but that is disputed by its management. On this evidence, there is nothing to make anyone confident that the regulation of banks produces firms that are safer for the system than firms regulated primarily by market discipline.

But it is the failure of the "interconnections" idea—the notion that if a large nonbank financial firm fails it will drag down others—that ultimately destroys the rationale underlying the Dodd-Frank Act and the FSOC's designation power. The idea grew out of the chaos that followed the bankruptcy of Lehman Brothers, but if we take only a cursory look at that chaotic period we can see that the failure of Lehman—one of the largest financial firms in the US at the time—had no significant direct or indirect effect on other large financial firms. Despite the market's anxious state before Lehman filed for bankruptcy, no other large firm failed because it was exposed to Lehman. This is true even though Lehman was a major player in the credit default swaps market, which has been wrongly charged with "bringing the financial system to its knees," and there were many such swaps written by others on Lehman itself.

Seldom in social science studies can one demonstrate the fallacy of a major assumption on which legislation has been based, but this is one example. The Lehman case shows that—even under the adverse conditions in which it occurred—the failure of a large nonbank financial firm will not drag down other large firms. The same would have been true if Bear Stearns and AIG had been allowed to fail.

This is understandable when it is given any thought; large firms are generally highly diversified, and the failure of one counterparty is unlikely to cause a diversified firm to fail. In order to challenge the idea that large firms are dangerous in this way, MetLife commissioned a study that showed its complete collapse would not have had a significant effect on the largest banks, which are likely to be highly diversified and hold the debt securities of many different issuers.

To be sure, a money market mutual fund—the Reserve Primary Fund—"broke the buck" because of its losses on Lehman, but that is far from an insolvency or failure of a company. It is roughly equivalent to a corporation suffering a loss in a year, with a resulting decline in the value of its shares. Ultimately, the shareholders of the fund received 99 cents on the dollar,[42] so their losses in any case were small and the fund could have continued in business. The Reserve Primary Fund was not covered by the insurance system that the Treasury put in place after it

[42] Press Release, the Reserve, Reserve Primary Fund to Distribute $215 Million (Jul. 15, 2010), available athttp://www.primary-yieldplus-inliquidation.com/pdf/PrimaryDistribution_71510.pdf.

broke the buck, so the Treasury's action does not account for the small losses that the fund ultimately suffered.

If we look for the causes of the panic that occurred when Lehman failed, we can easily find them in the rescue of Bear Stearns in March 2008. That was the original sin. Once Bear was rescued, market participants assumed that the government would rescue all other large financial firms. There was no logical reason that the government would rescue Bear's creditors and not the creditors of others. This created a form of moral hazard; thereafter, the managers and creditors of large financial firms assumed that if a large nonbank firm failed its creditors would be rescued just as Bear's were rescued.

Accordingly, managers of large firms did not believe that they had to raise as much additional equity as they normally would do to reassure their creditors. Rather than further dilute their shareholders in bad market conditions, it was sensible to wait out the weakness in the market. Creditors had the same reaction; instead of selling their holdings in a weak firm—and taking a loss—it made sense to stay where they were, since they would be made whole if the firm ultimately failed. That was probably the reasoning of the Reserve Fund's management.[43] Then, when the government failed to rescue Lehman—a firm that was 50 percent larger than Bear—all these assumptions were upended and a genuine financial panic ensued.

What actually happened in the financial crisis was not that Lehman dragged down other firms; it was the collapse of an entire asset class —mortgages and private MBS backed by non-traditional mortgages (NTMs)—that were held by many financial institutions. Bear, Lehman and AIG, for example, all suffered severe losses and liquidity problems because of private MBS; Bear and Lehman had heavily invested in them. AIG, on the other hand, had guaranteed credit default swaps (CDS) issued by a subsidiary that covered others' losses on private MBS. To compound its error, AIG then used cash collateral it had received as a CDS issuer to invest in additional MBS. Because these MBS became unmarketable when the private MBS market collapsed in 2007, AIG was then unable to meet its obligations to return the cash collateral when its counterparties demanded it.

In any event, for the same reason that Lehman's bankruptcy did not cause others to fail, it is doubtful that if AIG had been allowed to fail there would have been the catastrophic collapse of the market that government officials described in justifying their actions. Even if AIG had defaulted on its CDS coverage of private MBS, the counterparties affected by AIG's inability to meet its obligations would likely have purchased additional coverage in the CDS market, which continued to function all through the financial crisis. Indeed, Goldman Sachs, the largest counterparty of AIG's CDS protection, told the Financial Crisis Inquiry Commission that it was fully covered by other CDS if AIG had failed.

It is important to keep in mind, then, that the failures of both Lehman and AIG were the result of government policies. First, the government's housing policies, which reduced underwriting standards and built an unprecedented housing price bubble. Second, capital rules—

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[43] This is corroborated in a Wall Street Journal article in December 2008, in which Bruce Bent, the chairman of the Reserve Primary Fund said, before Lehman's bankruptcy, that the firm should be saved by the government because of its importance. Steve Stecklow and Diya Gullapalli, "A Money Manager's Fateful Shift," Wall Street Journal, December 8, 2008.

which lowered the capital required to hold private mortgage-backed securities—herded banks and other financial firms subject to the Basel rules into private MBS. Third, accounting rules implemented and kept in effect by the SEC during the crisis, required all financial firms to carry their securities assets at market value. This required them to write down their assets when the market for MBS collapsed in 2007, creating the widespread impression that they were financially weak. And finally, the government's inexplicable reversal of policy on rescuing large financial firms threw the market into turmoil when Lehman failed.

Under these circumstances, it seems clear that there are few if any advantages to the financial system that arise out of SIFI designations, but many significant disadvantages. It would make sense, then, to repeal the FSOC's authority—as the CHOICE Act does—to designate SIFIs.

Other authorities under Section 113

In addition to the designation of SIFIs because of the supposed effects of their material distress, Section 113 also authorizes the FSOC to designate nonbank financial firms as SIFIs because the "*nature, scope, size, scale, concentration, interconnectedness, or mix of activities* of the U.S. nonbank financial company could pose a threat to the financial stability of the United States." [emphasis added] This is an extraordinary grant of power, even for the Dodd-Frank Act. And it is a grant of power without any inherent standards or limitations. Did Congress really intend to give the FSOC the power to designate a nonbank firm as a SIFI—and thus subject it to stringent regulation by the Fed—because of its "nature?" At least in the case of large firms, it is possible to suppose that their failure could jeopardize others—so that would be an inherent limitation—but in this list of unrelated items Congress has granted what is essentially a license to designate *any* firm as a SIFI, and subject it to stringent new regulation by the Fed, for virtually any reason at all.

Although the legal principle of an unconstitutional delegation power has fallen into disuse in recent years, this is a case where it is applicable. Unless its supporters can place some kind of standards around its exercise—some kind of limiting principle that explains what Congress had in mind—this provision should be repealed.

Ironically, many financial firms—especially in the asset management business—believe that the FSOC's focus on "activities" would relieve them of the danger of designation as SIFIs. This might be true if the only standard for designation is size. Size is not relevant when the standard is activities. However, "activities" can capture many more firms, including the small as well as the large. Section 113, as noted above, contains language that permits the FSOC to designate firms as SIFIs because of many factors.

Thus, there is a plausible argument based on the language in Section 113, that the FSOC could designate as SIFIs all firms that engage in certain defined transactions—say, buying the commercial paper of asset-backed trusts—or participating in those transactions to an extent that exceeds some dollar amount. The danger of being designated for these suspect transactions would be enough to give the Fed the ability to approve or disapprove transactions of that kind on a case-by-case basis—a plausible substitute for direct prudential regulation of firms like asset managers now active in the capital markets.

By using the "activities" language in Section 113, the FSOC and the Fed could be successful in imposing prudential regulation on asset managers, securities firms, investment funds, finance companies and hedge funds, among others, which they characterize as "shadow banking." If so, they will stifle the continued development of the securities and capital markets in the United States, with dire consequences for economic growth.

We don't know, of course, how the courts will respond to interpretations like these. Even when it is a distortion of the statutory language, courts often accord deference to agencies' interpretation of the scope of their statutory authority, especially if the court believes that the agency is attempting to address a serious problem that is within the "spirit" of the legislation.

Supreme Court decisions like the 1984 decision *Chevron v. Natural Resources Defense Council,*[44] remain binding on the lower courts and authorize substantial deference to administrative agencies' interpretations of their statutory authority. Fortunately, in the one case questioning the FSOC's designation power that has reached the courts—the designation of MetLife as a SIFI—has found a Federal District Court willing to question the FSOC's authority. The case is now on appeal to the Circuit Court of Appeals for the DC Circuit, and should be watched carefully.

With the election of Donald Trump as president in 2016, these possibilities seem remote, but once laws like this are on the books and remain there a future administration might be inclined to use them. They, and many like them, should be repealed as soon as the opportunity presents itself, and that is the CHOICE Act.

In any event, the likely decisions of the courts are not relevant at this point. It is Congress that should act to prevent the excessive accretion of discretionary power by financial regulators. Power of this kind enables regulators to obtain compliance from individual firms by threatening to invoke this unbridled discretion.

Sections 120 and 121

These sections are additional examples of the extremely broad delegation of authority to the FSOC. In Section 120, it can make recommendations to the primary regulator of particular industries, requiring regulations that restrict various activities, even though they were previously permitted. The primary regulator must implement the standards recommended by the FSOC or explain why it has not, both to the FSOC and Congress. Given that the head of the primary agency has been appointed by the same president who has appointed the secretary of the Treasury and the other members of the FSOC, this would be a difficult directive to ignore.

Section 121 not as far-reaching as the authority to regulate undefined "activities" under Section 113, and applies only to individual firms and not entire industries as is the case under Section 120, but Section 121 still provides more discretionary and unrestricted power to an administration than Congress should delegate. Among other things, it authorizes the FSOC to "restrict the ability of [a] company to offer a financial product or service." In other words, the Council on its own motion, with no apparent standards of any kind, can put a firm out of business. Again, even if unused, this authority would enable any administration to control any

[44] Chevron v. Natural Resources Defense Council, 104 S.Ct. 2778 (1984).

financial company by threatening to invoke this power. For this reason, the authority, too, should be terminated.

Section 165

Section 165 is as important in many respects as Section 113. It requires the Fed to create more stringent regulatory standards not only for nonbank firms that have been designated as SIFIs but also for all bank holding companies (BHCs) with consolidated assets greater than $50 billion. In effect, then, Section 165 designates as SIFIs all BHCs with consolidated assets of more than $50 billion (BHC SIFIs). In addition to more stringent regulation, Section 165(d) also authorizes the Fed to require nonbank SIFIs and BHC SIFIs to prepare and submit to the Fed so-called "living wills," which outline in detail how they would be wound down in the event of their financial distress. Both requirements are based on the three fallacies discussed earlier: that (i) that the failure of a large nonbank financial firm will drag down others through "interconnections," (ii) the precipitating cause of the financial crisis was the disorderly bankruptcy of Lehman Brothers, and (iii) bankruptcy is inherently a disorderly and disruptive process.

Moreover, imposing the stress test and living will requirements on all BHCs with $50 billion or more in consolidated assets is unreasonable. The total assets of the US banking system, according to the Fed's Flow of Funds accounts, is $17 trillion. A bank with $50 billion in assets has only .3 percent of the total assets of all banks and an even smaller percentage of the $85 trillion of all US financial assets. The idea that the failure of a $50 billion bank will cause instability in the US financial system is fanciful at best.

The same is true of BHCs with $200 billion (1.2% of all bank assets) and even BHCs with $500 billion (3% of total bank assets). As outlined in the earlier discussion of the costs imposed by Dodd-Frank, imposing costs for developing living wills or complying with stress tests, will only further reduce the amount of credit available to the small business firms in the US or make that credit more expensive.[45] Even as to the largest BHCs, the living will requirement provides the Fed with extraordinary authority to force divestiture if the BHC does not organize itself as the Fed desires, and this provides leverage for the Fed to bend regulated firms to its will.

As noted earlier, in the discussion about the effect of Lehman's bankruptcy on other firms, there are good reasons to believe that the failure or financial distress of banks or nonbank firms up to $500 billion in assets will not have any significant effect on other firms or create instability in the US financial system. Lehman itself was a firm larger than $600 billion and declared bankruptcy in the midst of a market on the brink of wholesale panic. If Lehman did not cause other firms to fail, and it did not, then Congress should revisit the whole question of whether smaller firms—like BHCs with assets up to $500 billion and other nonbank firms—should be subjected to the extensive costs that living wills and stress test requirements impose.

In a March 2017 paper, my AEI colleague, Paul Kupiec, set up various alternative stress test models, including some that were close to the models used by the Fed, and analyzed their success in predicting the effect of the 2008 financial crisis on banking organizations. His

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[45] Federal Financial Analytics, Inc., "The Consequences of Systemic Regulation for U.S. Regional Banks," August 6, 2015.

conclusion was that "Results show large inaccuracies in stress test model forecasts, even for models that fit the data exceptionally well."[46] Thus, these tests are not worth the added costs they impose.

The Orderly Liquidation Authority Does Not Solve the Too-Big-To-Fail Problem

Summary of this Section:

- **As discussed in connection with the reform of Title I, the bankruptcy of Lehman Brothers demonstrated that large nonbank financial firms can fail without dragging down others.**
- **Accordingly, there is no need for a government managed system such as the Orderly Liquidation Authority (OLA) in Title II to resolve large nonbank financial institutions that are headed for failure.**
- **The current bankruptcy system is sufficient to resolve failing nonbank financial firms, although it could benefit from some reforms recently proposed by the House Judiciary Committee.**
- **Therefore, Title II of Dodd-Frank should be repealed insofar as it is directed at substituting a government-run resolution system for the current bankruptcy system.**
- **Although the largest banks may pose a systemic threat if they fail, Title II is not applicable to these banks. Even if it were, Title II does not provide a workable mechanism for resolving the largest systemically important banks.**
- **Thus, despite the claims of supporters of Dodd-Frank, the too-big-to-fail (TBTF) problem has *not* been solved.**
- **The best policy for addressing the TBTF problem for systemic banks is replace Title II with a plan for substantially increasing the capitalization of systemically important banks.**
- **The CHOICE Act's proposal for a a leverage ratio may be the best solution if of sufficient size and applied to the largest banks.**

Title II of Dodd-Frank, entitled the Orderly Liquidation Authority (OLA), was enacted as a reaction to the chaos that occurred after the bankruptcy of Lehman Brothers in September 2008. The sponsors of the act, and many others at the time, believed that it was the Lehman bankruptcy filing that caused the enormous panic that we now know as the financial crisis. In a sense, then, the OLA is really the heart of the Dodd-Frank Act, because it was designed to avoid another financial crisis by preventing the disruptive and disorderly failure of large financial firms. That feature also allowed the act's sponsors to claim that it had solved the problem of financial firms that were too-big-to-fail (TBTF) because the government—in fear of allowing them to fail—would inevitably save them. With the OLA, said the act's proponents, the government had a way to liquidate or resolve these firms without disrupting the financial system.

Later analysis, however, has shown that it was incorrect to believe that Lehman's bankruptcy—and thus any large financial firm bankruptcy—would be inherently disorderly. Lehman's bankruptcy counsel told the Financial Crisis Inquiry Commission (FCIC) that the

[46] Paul Kupiec, "Inside the Black Box: The Accuracy of Alternative Stress Test Models"

firm's bankruptcy was disorderly because he was not asked to draw up bankruptcy papers until the Sunday afternoon before the Monday filing. Thus, a more orderly and prepared filing—even a debtor in possession filing under Chapter 11—was impossible in the Lehman case. And of course, Lehman's bankruptcy seemed disorderly because it came as an almost complete surprise and reflected an inexplicable and illogical reversal of what the market thought was a government policy.

Far more important, however, is the fact that, while the Lehman's failure caused huge disruption throughout the financial system, no other large financial institution failed as a result of Lehman's sudden and unexpected bankruptcy. To be sure, one money market firm broke the buck, but in the end its investors received 99 cents on the dollar. That no other large financial firm failed because of Lehman demonstrates something important: that even when the market is in a weakened and fragile condition, the failure of a large nonbank financial firm will not drag down others. In other words, as discussed earlier, nonbank financial firms are not so "interconnected" that the failure of one will cause a financial crisis—or, in the words of the Dodd-Frank's Title I, create "instability in the US financial system."

This is a serious problem for the underlying purpose of the OLA, which is to substitute a government-run resolution system for the private bankruptcy system in the case of large financial institutions. Title II contemplates that when a large financial firm is in "material distress" the secretary of the Treasury can decide, with the approval of the Financial Stability Oversight Council (FSOC), to turn it over to the FDIC for resolution.[47] The FDIC then has roughly the same powers it has under the Federal Deposit Insurance Act to liquidate the failing firm. It is questionable whether the FDIC's liquidation will be less disruptive than a liquidation in bankruptcy but, even if it is, it is unnecessary. The aftermath of the Lehman bankruptcy—where no additional large firms failed as a result of Lehman's failure—shows that there is no reason for the government to intercede in the failure of a large nonbank financial firm.

Nevertheless, the very existence of the secretary's power to direct a different form of resolution for large financial firms than for others has serious consequences, even if it is never exercised. First, the firms that might be subject to it are not known—Title II applies to all financial firms, not just those that have been designated as SIFIs. This means that creditors of any large financial firm cannot be sure of the outcome if the firm is ever in material financial distress. Will the firm go through bankruptcy, which is a known process with disclosed rules that are followed by courts, or will it be pulled into the FDIC's process, in which the agency has wide discretion and the power to prefer some classes of creditors over others?

This in itself will raise the costs of financing for the firms that are potentially within this charmed circle, and will be especially harmful when a weakening firm actually needs new financial support from the market. In that case, creditors will be reluctant to provide that support because there is no way of knowing what law will be applied if the firm ultimately fails. So, many firms are likely to fail because of this creditor uncertainty than would be the case if the path to resolution were clear.

[47] See Sections 203 and 204(b)

Thus, in order to avoid adding yet more uncertainty and risk to the credit markets, Title II should be repealed and the bankruptcy system restored as the only method for resolving nonbank financial firms. The CHOICE Act does this, and proposes to substitute a number of reforms to the bankruptcy laws, proposed by experts in the field and adopted by the House Judiciary Committee, that would tailor these bankruptcy procedures more effectively for financial firms.[48] These are beyond the scope of this testimony but are a major step forward if they eliminate the uncertainty that creditors of large financial firms will face when the firm is in danger of failure.

The Single Point of Entry (SPOE) Strategy and TBTF Banks

In 2013, the FDIC proposed a strategy for recapitalizing a large bank (not a BHC, but an insured bank) without disrupting its operations, thus saving the market from instability when a large bank fails. The FDIC plan, known as the single point of entry (or SPOE) would use the powers in Title II to take over the holding company of a failing bank, create a new bridge holding company, and leave the former BHC shareholders and all the BHC's non-secured liabilities behind. It would then use the assets of the old holding company (now in the new bridge company) to recapitalize the underlying bank. There are many legal problems with this idea, not the least of which is the fact that Title II was clearly intended to be used for *liquidating* a nonbank not *recapitalizing* a failing bank. Also, Title II is explicit that it was not supposed to apply to banks, only non-bank financial firms.

But leaving these issues aside, the plan doesn't work, anyway, for the largest banks, which are the ones that pose the greatest risk to the stability of the financial system. This is because the holding company of a failing bank cannot be taken over by the secretary of the Treasury and the FDIC unless the holding company is also insolvent. In a 2015 paper, my AEI colleague, Paul Kupiec, and I showed that the 14 largest US bank holding companies would not be insolvent—and thus ineligible for takeover under Title II—if their investment in their largest subsidiary banks were to be written down to zero. All of them had other subsidiaries that were profitable enough to keep the parent afloat even if its largest subsidiary banks were to fail.[49] Accordingly, even if SPOE were a legal strategy, which it appears it isn't, it would not work for the 14 largest bank holding companies in the US.

In other words, in the one area where it is most important—protecting the taxpayers and the economy against the failure of the largest banks—the Dodd-Frank Act has failed. There is still no way for the taxpayers to be sure that if one of the largest banks fails the government will be able to prevent another financial crisis. The likelihood is that the taxpayers will have to assume that burden. This also means that the Dodd-Frank Act has not solved the TBTF problem, as the act's proponents claim, because everyone will know that the government must step in with taxpayer funds to prevent these banks from failing.

Curing the TBTF problem

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[48] See, for example, Kenneth E. Scott, Thomas H. Jackson and John B. Taylor, eds. *Making Failure Feasible*: *How Bankruptcy Reform Can End "Too Big to Fail,"* Hoover Institution Press, 2015

[49] Paul Kupiec and Peter Wallison, "Can the 'Single Point of Entry' strategy be used to recapitalize a systemically important failing bank?" Journal of Financial Stability, October 2015.

Thus, the OLA in Title II has not cured the TBTF problem for the largest systemic banks, which means—despite the claims of its proponents—that it has not solved the TBTF problem. There is still no way at this point to assure that if such a bank fails it will not cause instability in the US financial system, requiring the government to step in with taxpayer funds. If it is still the objective of Congress to address the TBTF problem, it will be necessary to replace Title II with a resolution system that is adequate for resolving the largest banks.

How would this resolution system be structured? The FDIC's SPOE strategy is based on one important insight—that if an operating bank can be kept operating through recapitalization there would be no danger of a financial crisis. The FDIC attempted to implement this strategy in a way that did not fit within the language of the OLA, but making sure that the largest banks are always adequately capitalized may be the key to solving the TBTF problem.

This strategy would require the largest banks to have considerably more capital than they hold today, and it would require an adjustment in the prompt corrective action rules so that these banks would never fall below this high level of capitalization. Prompt corrective action, which was instituted in FDICIA in 1991, has not been effective, probably because the capital positions of thousands of small banks could deteriorate too quickly for examiners to stop the risky practices that are causing the losses. In addition, the moral hazard implicit in insured deposits, and the FDIC's history of saving all depositors and creditors when banks are sold or merged, has eroded the usual effectiveness of market discipline. This has allowed banks that are losing money to "gamble for resurrection," suffering losses from risky loans that impair their capital positions before that information comes to the attention of their regulators.

But if large systemic banks were required to maintain, say, 16 to 20 percent risk-based capital, and prompt corrective actions were to take effect when their capital had declined to 8 to 10% , taxpayers could have greater confidence that these banks are highly unlikely to fail. For the small number of banks to which these requirements would apply, it would be possible for regulators to keep accurate and current tabs on their capital positions. The CHOICE Act requires a 10% leverage ratio instead of the Basel risk-based system, and that also provides a foundation for a better and safer capital system.

In other words, rather than rely on parent holding companies to serve as sources of strength for their bank subsidiaries, the capital positions of the largest banks should be strengthened directly by infusions of capital from their holding companies, which would borrow the necessary sums. The funds invested in the equity of subsidiary banks would still appear as equity on the consolidated balance sheets of the BHCs. This would also provide a basis for eliminating the Fed's capital and other regulation of BHCs, which is another source of the widely held view—supplementing TBTF—that the Fed is willing to assist the BHCs it regulates in order to prevent them and their subsidiaries from failing.

If Congress is really interested in eliminating TBTF, there appears to be only one way to do it for the largest banks—ensuring that their capital positions never erode to a point where they are in default or in danger of default. The simplest and most effective way to do this is to require a level of capitalization that can be watched continuously by regulators, with the regulators having authority to apply prompt corrective action when the banks' losses or potential losses reach a point where they have lost, say, half their required capital. This would not put a large

bank in danger of default, but it would allow regulators and bank managements to take corrective steps that would eventually restore the bank to its required capitalization level. In this way, the taxpayers could be assured that they will never be called upon to rescue the largest banks.

The leverage ratio system of capitalization proposed in the CHOICE Act—which would replace the Basel risk-based system--could be the best start toward this result. The CHOICE Act's leverage ratio was proposed as an "off-ramp" to reduce regulations on qualifying small banks, but it is also applicable to large banks that choose to adopt it. For the largest banks, the leverage ratio should perhaps be higher, but a leverage ratio—which is much simpler than the complex Basel rules and less easily gamed by the largest banks—is easier for regulators to enforce through prompt corrective action.

Mandatory clearing of swaps

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The most important thing to understand about the clearing system for swaps—which was largely bilateral and distributed widely before the crisis—is that it functioned flawlessly throughout the crisis and right up until the time that the Dodd-Frank Act adopted new clearing standards. The fact that the system could work without difficulties in the midst of the most serious financial crisis since the Great Depression, raises questions about why it should have been modified by Dodd-Frank.

Nevertheless, Sections 723, 724 and 725 of Dodd-Frank contain the basic rules for the mandatory centralized clearing of most swaps through a system of clearinghouses known as central clearing parties (CCPs).

The success of the old system is not of course a sufficient reason to repeal the new mandatory system, but I believe the new system creates serious risks for the future that must be corrected. Most derivatives and swaps are within the jurisdiction of the Agriculture Committee, so it is not something that this committee can do on its own. However, there is at least one issue that is within the committee's jurisdiction, and its presence in the act multiplies the risks of mandatory clearing.

In addition to requiring mandatory centralized clearing of almost all swaps, Dodd-Frank authorized the FSOC to provide access by CCPs to the Fed's discount window. The FSOC authorized this shortly after it was established. Dodd-Frank's sponsors probably wanted the Fed's backing for CCPs because they feared that the loss of liquidity by a clearinghouse could have a systemic effect. Ironically, the systemic effect they were concerned about was the result of interconnections—the very danger that the act's sponsors wrongly believed would bring down the financial system if a large nonbank financial firm were to fail.

Although interconnections are not a significant factor in the case of nonbank financial firms, they are a serious problem with CCPs because interconnections are the whole purpose of clearinghouses. When two parties agree to have their swap cleared through a CCP, they are agreeing to trust the clearinghouse to have the funds necessary to make all required payments, even if one of the counterparties defaults on its payments to the CCP. However, if the clearinghouse itself fails to make one or more payments, the party that does not receive an expected payment may not be able to meet its own obligations, and this failure could have

knock-on effects throughout the economy as firms further down the line are unable to meet their own obligations. The problem is compounded if the CCP fails entirely and is not able to make a large number of payments. This could lead to a financial crisis.

This is a danger in general for clearinghouses when clearing is mandatory, but giving the clearinghouses access to the Fed's discount window does not cure the problem—it makes the problem much worse. Access to the Fed's discount window sets up a system that once again creates moral hazard, with private profit-making institutions (in this case the eight clearinghouses) competing with one another while the government is at risk for their losses.

Before the financial crisis, clearinghouses competed for business with banks and others by assuring their customers that they were safe and sound. They not only had capital, but the amount of collateral (called "margin") they required from clearing parties was sufficient to protect those who expected to receive payments from the clearinghouse even if a counterparty should default in a payment to the clearinghouse.

The same system also worked for swaps that were cleared through banks; the banks were deemed to be sufficiently well-capitalized, and insisted on sufficient collateral from counterparties, so that a default by a counterparty in, say, a CDS transaction, would not mean the other side of the transaction would not receive its expected payment. The banks would liquidate the collateral and pay the counterparty, or make the payment and then liquidate the collateral. Of course, the bank in this system (as well as the clearinghouse) would not accept as a counterparty any person or organization that was not itself sufficiently strong financially to reduce the clearing party's risks. This is the system that worked right through the financial crisis and was working up to the point that Dodd-Frank's mandatory clearing requirement took effect.

But the system was fundamentally changed by the introduction of the Fed as a guarantor of clearinghouse liquidity. Now, without saying so, neither CCPs nor their customer-counterparties have to worry about their own financial soundness in competing for business. They can reduce the margin they are requiring from members and counterparties and can accept counterparties that are not financially sound. This is because those who are choosing them for clearing no longer have to worry about the financial soundness of the clearinghouse itself. They know that if a CCP defaults the Fed will supply the necessary funds so that all counterparties can be paid. And of course, because of mandatory clearing, clearinghouses will be much larger and have much more business than under the old bilateral system.

Although the CHOICE Act does not repeal the mandatory clearing rules—those are within the jurisdiction of the Agriculture Committee—it does repeal the provisions in in Dodd-Frank that authorize the Fed to provide assistance to CCPs. That will be a major step forward in preventing financial crises in the future.

The Volcker Rule

At the heart of the Volcker Rule is a simple contradiction. The rule *prohibits* proprietary trading by banks or firms affiliated with banks, but it also *permits* these same entities and affiliated banks to continue the vital functions of market-making and hedging their risks. Market-making and hedging — principally done through buying and selling debt securities — look a lot

like proprietary trading. Drafting a rule that prohibits proprietary trading but permits market-making and hedging was devilishly difficult, and probably not possible without impairing one or the other.

The Volcker rule is highly complex, and the issues that it raises were never fully explored in public, let alone debated, while it was under consideration in Congress or among the responsible regulatory agencies. The easiest way to explain the rule's underlying concepts and effects is in a question and answer format:

What is proprietary trading?

The rule prohibits what is called "proprietary trading" — that is, a bank or bank-related entity (like a bank holding company or a subsidiary of the holding company) buying or selling securities as principal for its own account and not for the account of customers. In other words, the financial institution involved has made a business that earns profits by buying or selling securities when it sees favorable circumstances in the market.

What institutions are covered by the rule?

The rule was explained to the public as a way to prevent banks from using insured deposits to engage in "risky trading" for their own accounts. For example, after the approval of the rule, Treasury Secretary Jack Lew noted that President Obama proposed the rule "to put an end to banks' ability to engage in high-risk activities solely for their own benefit, while enjoying the advantages conveyed by deposit insurance and other government protections."

This statement might be charitably characterized as a half-truth. Because the Volcker rule was written to apply to "bank-related entities," it encompasses far more than insured banks, and covers many entities that have no access to insured deposits. Moreover, referring to proprietary trading as a high-risk activity is misleading; as outlined below, proprietary trading is less risky than lending—the activity we expect from banks that take insured deposits.

Bank-related entities such as bank holding companies (BHCs) and the BHCs' non-bank subsidiaries are all ordinary corporations that raise their funds in the capital markets. They have no access to insured deposits or the Fed's discount window. What's more, there are strong "firewalls" between banks and their BHCs and non-bank affiliates, so that these firms cannot use the bank or its insured deposits for their own purposes. Accordingly, while the public was told that the Volcker rule was intended to protect their insured deposits, it actually severely restricts the legitimate and valuable activities of non-bank affiliates of banks that pose no threat to a bank's insured deposits. These restrictions will be very harmful to the financial system and the U.S. economy.

Is proprietary trading especially risky? Was it one of the causes of the financial crisis?

The answer to both these questions is no. It's hard to see how trading debt securities is riskier than lending. When it lends, a bank commits cash to the control of another party for an extended period of time. The bank seldom has effective control over the way the borrower uses the funds — leading to the possibility of loss — and by lending the funds it has reduced the amount of cash it has on hand in case large numbers of depositors or other creditors want their

money back. Trading securities, on the other hand, is simply buying and selling from an inventory. There is of course always the danger that a bank's inventory of securities will decline in value, but at least the banking entity has control over it at all times and can sell it quickly if it foresees adverse events in the future. Lenders can seldom recall a loan when they foresee problems for the borrower or for themselves.

There has never been any evidence that the proprietary trading of securities had anything to do with the financial crisis. Indeed, it was not *trading* of securities, but *investing* in securities — particularly securities backed by subprime and other low quality mortgages — that caused the losses to the banks and other financial institutions in the 2008 crisis.

Why is the prohibition on proprietary trading so controversial?

Proprietary trading was profitable for the banks and their nonbanking affiliates. Profits make banking entities healthier and provide them with the funds and the confidence to make loans and expand their activities. If banks are expected to use insured deposits to make loans—and we certainly expect that they will do that—buying and selling fixed income securities like bonds and notes should not be considered excessively risky. Bonds and notes, after all, represent loans that others have made, and banks—as professional lenders—are uniquely qualified to evaluate the quality of these instruments when they are buying or selling for their own account.

Nevertheless, even if proprietary trading is looked upon as too risky for banks because they are funded in part by insured deposits, that is not true of their holding companies and other affiliates that have no access to insured deposits.

In fact, it may be riskier to deny bank-related entities like BHCs the opportunity to engage in proprietary trading than to permit them to continue doing it. We all recognize that the economy is constantly changing and that businesses must change in order to remain viable. Bank-related entities face the same problem of adaptation to change. They were once the major source of financing in the economy; now they are dwarfed by the securities markets. Virtually all large companies in our economy now fund themselves by issuing securities — bonds, notes, and commercial paper — not by borrowing from banks. Companies have found that issuing debt securities is more efficient than borrowing from a bank. If regulation confines banking entities to the businesses they have always been in, rather than the businesses that are likely to be growing in the future, the banks will inevitably fail.

Why did it take so long for the Volcker rule to be approved?

As noted earlier, while the Volcker rule prohibited banking entities from proprietary trading, it permitted them to continue to engage in two other vital activities: market-making and hedging transactions. Both are made far more difficult by the Volcker rule, and I suspect that the reason was the reluctance of the bank regulators to impair either of these vital activities.

Market-making is just what it sounds like: creating a place where buying and selling can occur. The stock market is an example of a market where trading occurs, but the stock market has vast numbers of buyers and sellers; when a seller appears, there are almost always buyers. However, the market for debt securities is thin. Although the debt market is much larger in dollar size than the equity markets, its trading is much thinner.

There are several reasons for this, but important among them is the fact that major investors like insurance companies and pension funds buy debt securities to hold them to maturity for the interest they receive, not to trade them. So when an offering of debt securities comes into the market, much of it disappears into investors' portfolios and is never seen again. The number of bonds or notes available for trading can be small.

Accordingly, if a pension fund decides that it wants to sell a debt security to meet a pension liability, there may not be buyers around ready to bid. Unless a market-maker is there to buy the security, there can be a very long delay before the fund receives the cash it needs to make pension or other payments. In a thin market, the fund may have to take a sharp cut in the value it expected to realize on the sale if it has to cut its price to effectuate a quicker transaction.

In acting as market-makers, banks and bank-related entities serve as important intermediaries; they buy bonds from sellers and sell bonds to buyers. In other words, banks and bank-related entities are the lubricants of the debt markets; they make it work by acting as principal intermediaries between buyers and sellers. Without them, the search costs for buyers and sellers would be very large. The "spread" between the bid and ask prices for the bond would be much wider, and that means it would cost firms more to buy a bond and they'd get a lower price when they sell it. If this becomes the regular pattern in the market for debt securities, it will be harder for companies to meet their cash needs by issuing these securities.

If we recall now that the Volcker rule prohibits banks from trading securities for their own account, we can begin to see the problem. Market-making sounds a lot like proprietary trading; the bank has a portfolio of bonds, which it is offering to buy or sell for its own account. How does one tell the difference between proprietary trading, which is forbidden, and market-making, which is vital to the markets and permitted by the rule?

The difficulty of drawing that line in a regulation was what probably stopped the regulators who were charged with drafting the rule. They realized that they could seriously impair the debt markets if they drafted a rule that impinged excessively on market-making, and were reluctant to do so. But, eventually, under criticism from the Left that a major provision of the Dodd-Frank Act was stalled, and statements in the media that the banks were weakening and delaying the Volcker rule, the White House and Treasury forced a decision in favor of a "tough" rule — one that favored prohibiting proprietary trading over permitting market-making. This should not be surprising; the Obama administration would not want a headline that said they had weakened the Volcker rule to please the banks.

The danger to the markets now comes from the chilling effect that the rule will have on market-making by bank-related entities. Imagine traders functioning as market-makers for a banking entity. Could they be certain that market-making trades would not be re-characterized by the regulator as proprietary trades? If that happens, it's likely their employer will have to pay a hefty fine and suffer bad publicity as a rule-breaker.

It's not that the banking entity or its personnel can't follow the rules; it's that the rules are inevitably ambiguous — the explanatory material that goes with the Volcker rule is almost 1,000 pages — and subject to varying interpretations. The chilling effect on banking entities and their employees will mean that the markets will move more slowly, the bid-ask spreads will be wider,

and everyone who buys a security will have to pay more when it's bought and take less when it's sold than would have been the case before the rule went into effect. This will inevitably raise costs for all companies that issue securities to finance their activities, as well as firms that buy these securities for investment.

In the worst case, so many participants will exit the market that it will be difficult for firms to raise funds by selling bonds when they need to. This would be known as a shortage of liquidity, and it could be a serious problem if some future event induces large numbers of investors to try to sell their bonds or notes at the same time. In that case, there might be no market, and many companies or funds could default on their obligations. This is how the Volcker Rule could be responsible for another financial crisis.

In this connection, in September 2016, three Fed economists published a paper that concluded: "Since Volcker-affected dealers [banks and their affiliates] have been the main liquidity providers, the net effect is that bonds are less liquid during times of stress due to the Volcker Rule." It is during times of stress, of course, that market liquidity will be most needed.

How does the Volcker rule affect hedging?

Hedging transactions are vital for banking entities and others. When a company uses a hedge it is attempting to reduce the risk of a transaction or a purchase. For example, if a banking entity buys a bond that pays a market-rate of interest, it may simultaneously enter an interest rate swap with another financial institution to protect itself against a decline in interest rates. Is the swap a hedge against the risk on the bond or is it an independent and prohibited proprietary trade? The fact that they were done simultaneously may be some evidence that one was intended to hedge the other, but what if the transactions are separated by a week?

Like the market-making example, whether what was done was a permissible transaction or an impermissible proprietary trade will often be a matter of interpretation. The rule requires that hedges "demonstrably" reduce the risk of a specific trade or transaction. That does not mean banks and bank-related entities will stop hedging; they can't, it would be too risky not to hedge. What will happen is that some transactions may not be done at all because there is no hedge that can without question be shown to demonstrably reduce the risk involved.

The entire set of "London Whale" transactions, where JPMorgan Chase lost over $6 billion, was said by the bank to be a hedge against possible losses on a large portfolio of EU securities. Others claimed that the hedge was a fake, a cover for a lot of proprietary trades that went awry. That points to the fact that hedges themselves can be subject to differing interpretations.

How many banking entities, and how many of their employees, will engage in transactions where they cannot be sure that the hedge they intend to use will demonstrably reduce the risk? The fewer transactions, the less economic activity stimulated by banks and the slower our economy will grow.

Thus, although presented as a rule that will prevent risky bets by insured banks engaged in proprietary trading, the Volcker rule will actually prevent a wide range of bank-related entities

from engaging in activities that are no more risky than ordinary lending while chilling the provision of vital services to the financial markets.

The CHOICE Act would repeal the Volcker Rule. That appears to be a necessary and prudent step to restore liquidity in the bond markets.