



Statement before the House Committee on Financial Services
On Monetary Policy and the State of the Economy

Financial regulation and the well-being of low-income Americans

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Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for inviting me to testify today on the Federal Reserve's regulatory mandate. In the testimony that follows, I will discuss the Federal Reserve's responsibilities under the Dodd-Frank Act; how new rules are impacting consumers, particularly low-income consumers; and then turn to possible policy solutions.

Before elaborating on my views, let me lead with my conclusions:

- The Dodd-Frank Act greatly expanded the regulatory and supervisory authority of the Federal Reserve. As such, it has never been more important for the Federal Reserve to be transparent and accountable in its rule-writing.
- There is growing evidence that new rules from the Dodd-Frank Act are having a regressive impact, making it more difficult for low-income consumers to access mainstream banking. Access to safe savings and affordable credit is vital for economic opportunity.
- Statutory economic cost-benefit analysis that is both prospective and retrospective should guide the Federal Reserve's rulemaking, especially as it relates to traditionally underserved populations.

I. The Federal Reserve's growing regulatory mandate

The Dodd-Frank Act substantially increased the regulatory mandate of the Federal Reserve. The Federal Reserve is responsible for more than 50 Dodd-Frank rulemakings and guidelines, as well as a number of studies.¹ From 2010 to 2012, the Board hired 964 full-time employees for Dodd-Frank implementation, more than any other regulator including the Consumer Financial Protection Bureau (CFPB), which hired 831 people during that time period.²

The Federal Reserve's new responsibilities include but are not limited to: support of the Financial Stability Oversight Council and the Office of Financial Research, coordination with the Basel Committee on Banking Supervision on standards for capital and liquidity, setting capital and margin requirements for swap dealers, setting a price cap for debit card interchange fees, and coordinating with other regulators on the Volcker Rule. Additionally, the Federal Reserve funds the Consumer Financial Protection Bureau and, through the Fed's role on the Financial Stability Oversight Council, may petition for a

¹ Bernanke, Ben, 2011. "Implementation of the Dodd-Frank Act." Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

<<http://www.federalreserve.gov/newsevents/testimony/bernanke20110217a.htm>>

² Government Accountability Office, 2013. <<http://www.gao.gov/assets/660/651322.pdf>>

review of Bureau regulations that threaten the safety and soundness of the US banking system.

Arguably the largest area of responsibility for the Federal Reserve is the supervision of financial services firms designated systemically important (SIFIs) by the Dodd-Frank Act and the Financial Stability Oversight Council. Designated firms are subject to heightened prudential standards developed and overseen by the Federal Reserve, such as stress testing, resolution planning, living wills, capital and liquidity requirements, counterparty credit limits, and risk-management requirements.

By their very nature, SIFIs play an integral role in the economy. SIFI banks account for 80.3 percent of credit card loans made by US banks, 69 percent of bank deposits in US banks, and 64.5 percent of residential real estate loans made by US banks.³ As such, rules on these institutions could impact access to and prices of financial goods and services.

The Federal Reserve appears to understand the weight of its new responsibilities not only on the Board but also on the economy. Chairman Bernanke testified before the Senate Committee on Banking, Housing, and Urban Affairs in 2011, saying:

“[A]ny sweeping reform comes with costs and uncertainties . . . [T]he Federal Reserve is committed to the promulgation of rules that are economically sensible, appropriately weigh costs and benefits, protect smaller community institutions, and, most important, promote the sound extension of credit in the service of economic growth and development.”⁴

While there may be intent to consider costs, there is no statutory requirement for the Federal Reserve to publicly disclose cost-benefit analysis, nor is the Fed’s rulemaking subject to challenge on the basis of its economic impact.⁵ This means the Federal Reserve is largely unaccountable for the economic consequences of the rules it promulgates.

The impact of new rules will be felt by businesses and consumers. My testimony will focus on only one area: the impact on low-income individuals.

II. The impact of new rules on consumers, especially low-income consumers

³ FDIC data. September 30, 2013. Independent calculation.

⁴ Bernanke, Ben, 2011. “Dodd-Frank Act.” Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.
<<http://www.federalreserve.gov/newsevents/testimony/bernanke20110721a.htm>>

⁵ The Federal Reserve does have a policy statement in place from 1979 that calls for economic analysis to accompany its rulemakings. However, the Government Accountability Office has found that such economic analysis is followed only loosely. See GAO, 2011. “Dodd-Frank Act Regulations: Implementation could benefit from additional analysis and coordination.” <<http://www.gao.gov/products/GAO-12-151>>

There is little disagreement that the Dodd-Frank Act will be costly for financial services companies. Standard & Poor's estimates Dodd-Frank will reduce the pretax earnings of the largest eight US banks collectively by \$22 billion to \$34 billion annually.⁶ Dodd-Frank has resulted in 58.1 million paperwork burden hours industry-wide, according the Federal Register estimates.⁷ People may debate if these costs are justified to offset big banks' funding advantage or a byproduct of necessary regulation, but one consequence is clear: these costs will, in some form, be passed on to consumers.

Since the passage of the Dodd-Frank Act and other related financial reforms such as the CARD Act, prices of basic financial products and services have increased, consumer choice has been restricted, and millions of low-income consumers have been priced out of the market or forced to turn to alternative financial products. There may be several reasons for these trends, but the cost of regulation appears to be a significant factor.

The cost of a basic bank account has increased considerably. In 2009, one year before Dodd-Frank was passed, 76 percent of accounts at large banks qualified for free checking. In 2012, only 39 percent did.⁸ During this same time period, the average minimum balance required to avoid fees rose from \$186 to \$723.⁹ For perspective, the latter amount is equivalent to 100 hours of work at the federal minimum wage. Bank-fees reached record highs in 2012, some increasing by more than 25 percent year-over-year.¹⁰

Fees disproportionately impact low-income consumers. Elizabeth Warren and Oren Bar-Gill write that "poor consumers lack the financial cushion that rich consumers have, and therefore they are more vulnerable to the unexpected costs of credit products."¹¹ But the poor are also more vulnerable to *expected* costs.

The Federal Reserve's rules on overdraft fees and debit interchange fees are partly to blame for rising fees. Both revenue streams were previously used to offset costs of checking accounts and other banking services.¹² Evans, Chang, and Joyce (2013) estimate the present

⁶ Standard and Poors, 2012. "Two Years On, Reassessing the Cost of Dodd-Frank for the Largest US Banks." <<http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245338539029>>

⁷ American Action Forum, 2014. "Week in Regulation." <<http://americanactionforum.org/week-in-regulation/470000-paperwork-hours>>

⁸ Bankrate, 2012. <<http://www.bankrate.com/finance/checking/checking-fees-record-highs-in-2012.aspx>>

⁹ Evans, David, Robert Litan, and Richard Schmalensee (2011), "Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses." <http://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdf>

¹⁰ Bankrate, 2012. <<http://www.bankrate.com/finance/checking/checking-fees-record-highs-in-2012.aspx>>.

¹¹ Bar-Gill, Oren and Elizabeth Warren, 2008. "Making Credit Safer," Harvard Law School Program on Risk Regulation Research Paper No. 08-3.

¹² Zywicki, Todd and Asa Skinner, 2012. "The Impacts of Overdraft Programs on Consumers," <<http://mercatus.org/publication/impacts-overdraft-programs-consumers>>

discounted loss to consumers from debit interchange regulation is between \$22 billion and \$25 billion in higher fees and lost services.¹³ Additionally, general pressure on banks from decreased revenue streams and increased compliance and litigation costs has likely led to higher prices for consumers.

Credit cards have become more difficult and expensive to access. From June 2010 to June 2013, credit card loans at commercial banks decreased by \$40 billion.¹⁴ In 2012, 39 percent of low- and-middle-income households reported tighter credit conditions, such as having their credit cards canceled, limits reduced, or being denied a new card during the previous three years.¹⁵ Access to credit allows cash-strapped households to deal with unexpected financial emergencies and smooth consumption between paychecks.¹⁶

Higher underwriting standards are a welcome development after the 2008 credit bubble. However, it is also possible that new regulatory costs are impacting credit for otherwise worthy borrowers. The CFPB found that the CARD Act, passed in 2009 by the Federal Reserve, increased interest rates and reduced access to credit, including for borrowers who would otherwise be considered creditworthy.¹⁷ Early in the regulatory reform process, one study estimated that the creation of a consumer protection agency could increase interest rates by 160 basis points, reducing consumer borrowing by 2.1 percent annually.¹⁸ In 2012, Mark Calabria, director of financial studies regulation at the Cato Institute, testified that the CFPB had increased the cost of consumer credit by at least 200 basis points based on the spread of various types of consumer credit over the Treasury rate.¹⁹

Even physically accessing a bank has become more difficult. In September 2013, the number of federally insured financial institutions fell to 6,891, according to the Federal Deposit Insurance Corporation.²⁰ That's the smallest number of banks in the United States since 1934, when federal regulators began tracking the number.²¹ Bank branches are

¹³ Evans, David and Howard Chang, Steven Joyce, 2013. "The Impact of the U.S. Debit Card Interchange Fee Caps on Consumer Welfare: An Event Study Analysis." University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 658.

¹⁴ FDIC SDI.

¹⁵ "The Plastic Safety Net: 2012," Demos Survey. <<http://www.demos.org/publication/plastic-safety-net?>>

¹⁶ See Littwin, Angela, 2008. "Beyond Usury: A study of credit card use and preference among low-income consumers." University of Texas School of Law.

¹⁷ CFPB, 2013. "CARD Act Report" <http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf>

¹⁸ Evans, David and Joshua Wright, 2010. "The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit," Loyola Law Review.

¹⁹ Calabria, Mark, 2012. "Credit Crunch: Is the CFPB Restricting Consumer Access to Credit? Testimony." <<http://www.cato.org/publications/congressional-testimony/credit-crunch-is-cfpb-restricting-consumer-access-credit>>

²⁰ FDIC, 2013. "Quarterly Banking Profile: Third Quarter 2013," <<http://www2.fdic.gov/qbp/2013sep/qbp.pdf>>

²¹ CBS, 2013. "Number of U.S. banks drops to record low," <<http://www.cbsnews.com/news/number-of-us-banks-drops-to-record-low/>>

also disappearing. US banks cut 1,487 branches last year, the highest reduction in more than a decade.²² This consolidation disproportionately impacts low-income consumers for whom convenience is a major barrier to banking. Low-income individuals may live in rural areas where only a community bank existed before and may be unlikely to have reliable access to the Internet to engage in online banking.²³

To be sure, some consolidation is unrelated to the Dodd-Frank Act. For example, the shift to online banking has reduced the need for bank branches, and increased economies of scale for the banking industry have put pressure on community banks. However, it would be a mistake to write off consolidation solely as the result of natural trends. Marsh and Norman (2013) find that new rules from Dodd-Frank are forcing community banks to consolidate and encouraging standardization of financial products, leaving “millions of vulnerable borrowers without meaningful access to credit.”²⁴ Paul Kupiec, my colleague and former director of the Center of Financial Research at the FDIC, estimates that the mortgage rules from Dodd-Frank could cause 10 percent of mortgage-issuing community banks to take losses when accounting for compliance costs.²⁵

As a result of these changes, many low-income households have been shut out of mainstream banking completely. From 2009 to 2011, the rate of unbanked and underbanked US households increased from 7.6 percent to 8.2 percent and from 18.2 to 20.1 percent, respectively, according to the FDIC.²⁶ This represents an increase of more than 3 million households who have lost or foregone access to traditional financial services, many of which are low income.²⁷ More than 1 in 10 households that had a bank account in the last year but no longer have an account cited the high fees and balance requirements as the reason they were currently unbanked.²⁸

Low-and-middle income households are increasingly turning to alternative financial products (AFP) such as payday lenders and check cashers, which can be more expensive

²² Wall Street Journal, 2014. “US Banks Prune More Branches.”
<http://online.wsj.com/news/articles/SB10001424052702303277704579347223157745640?mod=WSJ_hp_LEFTWhatsNewsCollection>

²³ See Marsh, Tanya and Joseph Norman, 2013. “The Impact of Dodd-Frank on Community Banks” Wake Forest University Legal Studies Paper No. 2302393.

²⁴ Ibid.

²⁵ Independent calculation.

²⁶ FDIC, 2012. “2011 FDIC National Survey of Unbanked and Underbanked Households.”
<http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf>

²⁷ The FDIC altered its measure of “unbanked” between the 2009 and 2011 survey, which may impact this number.

²⁸ FDIC, 2012. “2011 FDIC National Survey of Unbanked and Underbanked Households.”
<http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf>

than traditional banking products.²⁹ Increased reliance on AFP is not a problem unto itself. There is no consensus among economists that payday lending is predatory.³⁰ A consumer may make a rational choice to take out a payday loan because it is less expensive than bouncing a check. Adair Morse (2006) finds that payday lending is welfare enhancing for credit-constrained individuals, reducing their risk of foreclosure or larceny in their community.³¹ The problem is if low-income households are turning to these options not by choice, but because their other options for credit have been constrained by the government.³²

III. Policy solutions

The contraction of credit and savings choices for low-income families is an unfortunate unintended consequence of the Dodd-Frank Act, which explicitly seeks to protect consumers. Without access to safe savings and affordable credit, it will be difficult for these households to get ahead financially. "Access to a basic bank account and to financial services is a starting point for economic opportunity," said Martin Gruenberg, former FDIC vice chairman.³³

There are two main ways to increase low-income households' access to financial services: increase government intervention, or reduce it.

With respect to the first option, policymakers could hold down bank fees or interest rates to ensure that financial options remain affordable for low-income consumers. The CFPB appears to favor this strategy. The agency has studied and decried high overdraft fees and is likely to write new overdraft rules.³⁴ At first, this may seem like a positive development

²⁹ Zywicki, Todd and Robert Clarke, 2013. "Payday Lending, bank overdraft protection, and fair competition at the Consumer Financial Protection Bureau," Working Paper.

<http://mercatus.org/sites/default/files/Clarke_PaydayOverdraft_v2.pdf>

³⁰ Bertrand, Marianne and Adair Morse, 2009. "Information Disclosure, Cognitive Biases, and Payday Borrowing," MFI Working Paper Series No. 2009-007

<http://bfi.uchicago.edu/RePEc/bfi/wpaper/BFI_2009-007.pdf>

³¹ Morse, Adair, 2009. "Payday lenders: Heroes or Villains," Working Paper.

<<http://www.cfsponline.com/uploads/PaydayLendersHerosorVillans.pdf>>

³² I would be remiss to discuss the impact of the Dodd-Frank Act on low-income households without mentioning briefly the impact of Dodd-Frank on job creation and economic growth. Many independent groups have attempted to quantify the impact of new rules on the economy, but these studies are subject to significant uncertainty. Studies by the Basel Committee on Banking Supervision, IMF, and OECD have found modest negative effects on growth, whereas the International Institute of Finance has found large negative effects. While the size of the effect differs greatly, the Government Accountability Office finds general agreement that the new rules may hold back economic growth and job creation.

³³ FDIC, 2009. <<http://www.fdic.gov/news/news/press/2009/pr09015.html>>

³⁴ See "CFPB Report Raises Concerns about Impact of Overdraft Fees on Consumers," 2013.

<<http://www.consumerfinance.gov/newsroom/cfpb-report-raises-concerns-about-impact-of-overdraft-practices-on-consumers/>>

for consumer protection. However, remember that reduced fees for debit interchange transactions led to an increase in fees on basic checking accounts, which in turn led many low-income consumers to leave mainstream banking. What good are capped overdraft fees for low-income individuals if those same individuals can no longer access a bank account?

Similarly, the CFPB is expected to pass new rules on payday lenders, which would in effect limit their use. But reducing credit options for consumers does not change consumers' credit needs. According to a recent Pew survey, 69 percent of respondents use payday loans for basic expenses such as food, rent, or utilities.³⁵ Clamping down on payday lenders likely will push needy individuals to more costly alternatives. Strain, Morgan, and Seblani (2012) find that in states where payday lending is restricted, there are higher incidences of bounced checks and overdraft charges, which can be more expensive than payday loans.³⁶ If these options are not available, consumers will have to search for credit even further out of the mainstream at check cashers, pawn shops, or loan sharks. The CFPB should aim to maximize the financial services options available to the poor wherever possible, not restrict them.³⁷

Two other ways of increasing low-income households' access to financial services are subsidizing credit for low-income families or rewarding banks that offer credit to underserved populations. This is the logic behind the Federal Housing Authority, the Community Reinvestment Act, and Title XII of the Dodd-Frank Act, which gives the Treasury the authority to create "loan loss reserves" for loans not repaid by low-income borrowers. Unfortunately, this may encourage financial institutions to loan to people who are not in a position to pay back the money. Former Federal Reserve Chairman Bernanke said in March of 2007 that, "recent problems in mortgage markets illustrate that an underlying assumption of the CRA – that *more* lending equals *better* outcomes for local communities – may not always hold."³⁸

Lending to unqualified borrowers may provide temporary relief, but in the long run, it is not sustainable. It ends up saddling these households with crushing debt that is a burden, not an economic opportunity. In 2007 to 2009, the US experienced the devastating consequences of subsidized lending when the mortgage bubble burst. A similar trend appears to be happening with student loans.

³⁵ Pew Research, 2012. "Payday Lending in America: Who Borrows, Where They Borrow, and Why" <http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf>

³⁶ Strain, Michael, Donald Morgan, Ihab Seblani, 2012, "How payday credit access affects overdrafts and other outcomes," *Journal of Money, Credit, and Banking*.

³⁷ Economists Bertrand and Morse (2009) find that instead of limiting access altogether, better information disclosure may deter payday loan usage for those with alternative credit options. See Bertrand, Marianne and Adair Morse, 2009. "Information Disclosure, Cognitive Biases, and Payday Borrowing," MFI Working Paper Series No. 2009-007 <http://bfi.uchicago.edu/RePEc/bfi/wpaper/BFI_2009-007.pdf>

³⁸ Bernanke, Ben, 2007. <<http://www.federalreserve.gov/newsevents/speech/Bernanke20070330a.htm>>

There is a better alternative. Congress should seek to maximize savings and credit opportunities and choices for people at all income levels by ensuring that well-qualified consumers are not artificially constrained by the government from accessing financial services.

IV. Cost-benefit analysis for federal financial regulators

Federal financial regulators function as independent agencies and are not subject to executive orders requiring cost-benefit analysis in accordance with guidance issued by the Office of Management and Budget (OMB).³⁹ As such, regulators are not required to take the consumer impacts of their rules into consideration or determine if the benefits outweigh the costs, which arguably should be the goal of any regulation.⁴⁰ In its 2011 report on Dodd-Frank, the Government Accountability Office concluded that “little is known about the impact of the final Dodd-Frank Rules,” and implementation would benefit from economic analysis.⁴¹ Their recommendation, however, is not enforceable.

I propose a statutory requirement for cost-benefit analysis for federal financial regulators. This would apply to all new rules, including but not limited to those promulgated by the Dodd-Frank Act. The analysis could be made publicly available for comment before the finalization of the rule and used to challenge regulatory overreach. The OMB guidance on “good regulatory analysis” could serve as a baseline:⁴²

1. Explain how the actions required by the rule are linked to the expected benefits. A similar analysis should be done for each of the alternatives.
2. Identify a baseline. Benefits and costs are defined in comparison with a clearly stated alternative.
3. Identify the expected undesirable side effects and ancillary benefits of the proposed regulatory action and the alternatives.

To the third category, I propose adding a requirement to consider if a rule disproportionately impacts low-income persons or other traditionally underserved groups, such as minorities, youth, veterans, and seniors.

³⁹ GAO, 2011. “Dodd-Frank Act Regulations: Implementation could benefit from additional analysis and coordination.” <<http://www.gao.gov/products/GAO-12-151>>

⁴⁰ Rose, Paul and Christopher Walker, 2013. “Dodd-Frank Regulators, Cost-Benefit Analysis.” Stanford Law Review Online, Vol. 66

⁴¹ GAO, 2011. “Dodd-Frank Act Regulations: Implementation could benefit from additional analysis and coordination.” <<http://www.gao.gov/products/GAO-12-151>>

⁴² Ibid.

Additionally, for “major” rules, which could be classified as such by Congress, I recommend a five-year retrospective cost-benefit evaluation.

Statutory cost-benefit is especially critical at the Federal Reserve, which has an outsized role in implementing the Dodd-Frank Act. Additionally, given its mandate to preserve financial stability and its prominent position on the Financial Stability Oversight Council, the Federal Reserve could also take the lead in assessing the cumulative impact of the Dodd-Frank Act and how underserved populations are impacted.

People may raise any number of concerns with cost-benefit analysis. For example, critics argue that it is rarely done well, it may slow down the regulatory process, or it may be a veil for deregulation. The Federal Reserve expressed hesitation in response to the GAO’s recommendation, saying that “conducting benefit-cost analysis on financial regulations is inherently difficult.”⁴³

To be sure, cost-benefit analysis has its challenges.⁴⁴ But it need not be overly burdensome. Leading regulatory scholars Robert Hahn and Luis Guasch (1997) suggest that for “small” regulations, minimal to no analysis may be necessary. For regulations having potentially “large” economic impacts, more resources should be devoted to evaluation.⁴⁵

Additionally, cost-benefit analysis is one of the few checks on increasing regulatory power. For example, the SEC is not governed by explicit cost-benefit analysis; however, there are statutory provisions added by the National Securities Market Improvement Act of 1996 and the Gramm-Leach-Bliley Act of 1999, which require the Commission to consider efficiency, competition, and capital formation whenever it is engaged in rulemaking.⁴⁶ In *Business Roundtable v. SEC*, the DC Court of Appeals struck down the SEC’s first rule promulgated under Dodd-Frank for insufficient economic analysis, calling the rule “arbitrary and capricious.”⁴⁷

The risk of not doing cost-benefit analysis is that the impact of new rules on low-income consumers will be unaccounted for. Historically, economists have found that the burden of credit regulation tends to fall mostly on low-income consumers, who may be less likely to

⁴³ Ibid.

⁴⁴ See Hahn, Robert, 2004. “The Economic Analysis of Regulation: A Response to the Critics,” *The University of Chicago Law Review*, Vol. 71, No. 3, pp. 1021-1054, Summer 2004.

⁴⁵ Guasch, Luis and Robert Hahn, 1997. “The Costs and Benefits of Regulation.” *World Bank Research Observer* Volume 14, Issue 1.

<<http://elibrary.worldbank.org/doi/abs/10.1093/wbro/14.1.137?journalCode=wbro>>

⁴⁶ GAO, 2011. “Dodd-Frank Act Regulations: Implementation could benefit from additional analysis and coordination.” <<http://www.gao.gov/products/GAO-12-151>>

⁴⁷ <http://www.harvardlawreview.org/media/pdf/vol125_business_roundtable_v_SEC.pdf>

perceive the true source of their lack of credit access and less likely to be politically active.⁴⁸ Moreover, even if changes in access and price of financial services are observable – as detailed earlier in my testimony – there is very little basis to challenge rules based on their consumer impact.

In other words, cost-benefit analysis is not intended to wipe away rules that protect consumers—quite the opposite. It is the last line of consumer protection, especially for low-income consumers.

⁴⁸ Zywicki, Todd, 2013. “The Consumer Financial Protection Bureau, Savior or Menace?” George Washington Law Review. <<http://www.gwlr.org/wp-content/uploads/2013/04/Zywicki.pdf>>