THE DODD–FRANK ACT AND REGULATORY OVERREACH

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

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THE DODD–FRANK ACT AND REGULATORY OVERREACH

Wednesday, May 13, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room HVC–210, Capitol Visitor Center, Hon. Sean P. Duffy [chairman of the subcommittee] presiding.

Members present: Representatives Duffy, Hurt, Fincher, Wagner, Tipton, Poliquin, Hill; Green, Cleaver, Ellison, Delaney, Beatty, Heck, Sinema, and Vargas.

Ex officio present: Representatives Hensarling and Waters.

Chairman DUFFY. Good morning. The Oversight and Investigations Subcommittee will come to order. The title of today's subcommittee hearing is, "The Dodd-Frank Act and Regulatory Overreach."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee may participate in today's hearing for the purpose of making an opening statement and asking questions of the witnesses.

The Chair now recognizes himself for 3 minutes for an opening statement.

Good morning, and thank you for being here. This morning's hearing will critically examine a major assumption underlying the Dodd-Frank Act, that the primary cause of the financial meltdown was misbehavior by market participants exacerbated by lax regulatory oversight. This hearing will also explore the inadvisability and/or inefficiency of overhauling financial regulations, as was done in the Dodd-Frank Act, in the immediate aftermath of a financial crisis.

The Obama recovery has been the slowest recovery in modern times, and the question is, why? Well, it is simple. This Administration is more focused on growing government than growing the economy. Those who supported Dodd-Frank have been more concerned with helping special interests in Washington than their constituents back home, and the proof is in the numbers. Numbers don't lie. Fewer people have returned to the workforce than in any other modern recovery. Banks are closing every week, and the number one cause that I hear from people back in Wisconsin is the excessive, crushing regulatory burden imposed by this Administration, and Dodd-Frank is a major cause of that burden.

The crushing regulatory regime created by Dodd-Frank continues to keep people out of work, to keep businesses from hiring, and makes it harder for my constituents to get the loans they need to finance the expansion of their business or to buy their first home. Dodd-Frank makes it worse. It doesn't end too-big-to-fail. And, as Jamie Dimon put it, "Dodd-Frank is the moat that keeps new banks from entering the market. It stifles innovation, access to capital, and economic growth."

A 2014 survey by the American Bankers Association found that 80 percent of respondents expected Dodd-Frank regulations to measurably reduce their credit availability. The people hurt by this oppressive regulatory regime are the poorest among us: a student who graduates with a mountain of debt and no job prospects; a mother working two part-time jobs and still struggling to make ends meet. Dodd-Frank costs the average American $334 a year in lost wages. Unfortunately, the affected people can't see the cause of the distress, which was written right here in this building by the very people who sit in this panel and refuse to make changes to that law that are hurting the poorest among us who are struggling to make ends meet.

I hope we have a thoughtful conversation today about what kind of reform can be offered to make Dodd-Frank work better, make our markets work better, and make our banks work better to serve growing businesses and American families.

With that, I yield 2 minutes to the ranking member of the full Financial Services Committee, Ms. Waters from California.

Ms. WATERS. Thank you very much.

Before I begin, I would like to remind my Republican colleagues that after today, there will be just 23 legislative days left until the Export-Import Bank closes its doors, and this committee has yet to hold a hearing on reauthorization. I think it is important that we remind everybody that we are approaching that date.

When the market crashed in 1929, it sent shockwaves through the world economy. Stock prices plummeted. About a third of all U.S. banks failed. A quarter of Americans were out of work. Shantytowns filled with desperate roving workers sprung up, often next to soup kitchens.

Knowing that something had to be done to restore confidence, the Congress and President Roosevelt ushered in bold and smart financial reform. We created the SEC. We had to reassure depositors with FDIC insurance, and we separated speculative activity from retail banking.

In the post-war period that followed, things weren't always great, especially for African-Americans and others who were unconstitutionally denied access to the fruits of American productivity. But we didn't experience any more devastating financial crises.

In the 1980s, the deregulation of our financial system started to gain steam. Congress deregulated thrifts. Banking regulators slowly allowed retail banks to encroach into more investment banking. And Congress sealed the deal by passing legislation, tearing down that wall completely, legislation I voted against. Eventually, these many small actions, combined with regulators' failure to act, culminated in the largest financial crisis since the 1929 crash.

I won't be able to finish my statement here today. But, of course, Dodd-Frank was all about reform. It was about protecting consumers, and so we created the Consumer Financial Protection Bureau (CFPB). We dealt with making derivatives more transparent, and on and on and on. And this is what we have people railing against: the fact that we created reform in the financial system.

I yield back the balance of my time.

Chairman DUFFY. The gentlelady yields back.

The Chair now recognizes the gentleman from Virginia, Mr. Hurt, for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you for holding today's hearing. I am pleased that this subcommittee has taken the time to analyze regulatory overreach in the Dodd-Frank Act.

I am also pleased that this subcommittee has extended an invitation to a constituent of mine, Paul Mahoney, dean of the University of Virginia School of Law, to testify before us today on this critical issue. And I am pleased to have the privilege to introduce him.

I am certain that his expertise in the field of securities regulation will provide insight into the financial crisis of 2008 and the ongoing effects of the regulatory response implemented with Dodd-Frank.

Mr. Mahoney received his bachelor's degree in electrical engineering from the Massachusetts Institute of Technology in 1981, and his law degree from Yale in 1984. Before his career in academia, Mr. Mahoney worked in private practice and clerked for the United States Supreme Court. He has been published in several law reviews, as well as finance and economics journals, and recently had his book, "Wasting a Crisis: Why Securities Regulation Fails," published this year by the University of Chicago Press. He joined the University of Virginia law school faculty in 1990 and became its dean in July 2008.

I hope that today's hearing bears testimony that provides guidance on potentially harmful regulatory overreach and ideas on how to best promote safe and efficient financial markets. I look forward to Mr. Mahoney's testimony and the testimony of our other two distinguished witnesses today. I thank them for their appearance.

Mr. Chairman, I thank you for the time, and I yield back the balance of my time.

Chairman DUFFY. The gentlemen yields back.

The Chair now recognizes the ranking member of the subcommittee, the gentleman from Texas, Mr. Green, for 3 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

The title of the hearing is, "The Dodd-Frank Act and Regulatory Overreach," which begs the question—because indicated in the title is the conclusion. So the hearing is really not about acquiring empirical evidence. It is really about substantiating a proposition that has already been assumed.

"How Soon We Forget" is probably a more appropriate title for this hearing. How soon we forget, because there are some lessons that we should have learned from the 2008 Great Recession/Depression that we seem to be forgetting. How soon we forget.

Let's talk for just a moment about some of the lessons that we should have learned. One, capital markets don't regulate themselves. The Great Depression/Recession would not have occurred if capital markets regulated themselves. If we had had self-regulation, we wouldn't have had 327s, 228s, liars loans, no-doc loans. If they regulated themselves, we wouldn't have had teaser rates that coincide with prepayment penalties. Capital markets don't regulate themselves.

Two, too-big-to-fail is the right size for constant observation to spot potential crises. That is why we have FSOC, so that we can watch, so that we can do what we did not do that allowed the 2008 Great Recession/Depression to occur without our catching it and preventing it. Prudential regulation to protect the consumer and the economy is necessary. You have to have prudential regulation because, if you don't, you will end up with another Great Recession/Depression. This is why we have the CFPB. This is why we have FSOC. We have to find ways to not only catch but also to regulate.

Three, judicious elimination to prevent economic chaos is important. We have to make sure that we are constantly, constantly looking for a means by which we can prevent this economic chaos that occurred before.

And finally, I would say this, that success of legislation does not prevent the elimination of legislation because if it did, we wouldn't be about the business of trying to eliminate the Ex-Im Bank. The Ex-Im Bank is a great American success story. Jobs have been created, money sent to the Treasury, a great American success story. Yet, we are on the eve of the elimination of the Ex-Im Bank. So there are some lessons learned that we ought not repeat.

My hope is that the title of the hearing will not cause us to focus solely on what we already believe to be the case, but rather let us look for empirical evidence so that we can have logical reasoned arguments about the status of Dodd-Frank.

I yield back.

Chairman DUFFY. The gentleman yields back.

Thank you, Ranking Member Green.

We will now turn to the witnesses.

Our first witness is Mr. Paul Mahoney. I would give you a great introduction, but you have already had one from your Member of Congress, Mr. Hurt.

But just to reiterate, Mr. Mahoney is the dean of the University of Virginia law school, with a very long and accomplished record. Thank you for being here today.

Our second witness, Ms. Hester Peirce, is the director of the Financial Markets Working Group and a senior research fellow at the Mercatus Center at George Mason University. Before joining Mercatus, Ms. Peirce served on Senator Richard Shelby's staff on the Senate Committee on Banking, Housing, and Urban Affairs. In that position, she worked on financial regulatory reform following the financial crisis of 2008, as well as oversight of the regulatory implementation of the Dodd-Frank Act.

Ms. Peirce also served at the U.S. Securities and Exchange Commission as a Staff Attorney and a Counsel to Commissioner Atkins. Before that, she clerked for Judge Roger Andewelt on the Court of Federal Claims and was an associate at a Washington, D.C., law firm. She earned her B.A. in economics from Case Western Reserve University, and her J.D. from Yale Law School.

Thank you for being here, Ms. Peirce.

Our third witness, Dr. Marcus Stanley, is the policy director of Americans for Financial Reform. Dr. Stanley has a Ph.D. in public policy from Harvard University and previously worked as an economics and policy advisor to Senator Barbara Boxer; as a senior economist at the U.S. Joint Economic Committee; and as an assistant professor of economics at Case Western Reserve University.

Thank you, too, for being here.

The witnesses will now be recognized for 5 minutes to give an oral presentation of their testimony.

And without objection, the witnesses' written testimony will be made a part of the record.

Once the witnesses have finished presenting their testimony, each member of the subcommittee will have 5 minutes within which to ask the witnesses questions.

On your table, there are three lights: green means go; yellow means you are running out of time; and red means stop. The microphones are very sensitive, so please make sure you are speaking directly into your microphone.

And with that, Dean Mahoney, you are recognized for 5 minutes.

STATEMENT OF PAUL G. MAHONEY, DEAN AND PROFESSOR OF LAW, UNIVERSITY OF VIRGINIA SCHOOL OF LAW

Mr. MAHONEY. Chairman Duffy, Ranking Member Green, and members of the subcommittee, I appreciate the opportunity to speak with you about regulation and financial crises.

Effective and cost-efficient regulation is essential to the health of financial markets. Unfortunately, the way in which major financial reforms are created almost guarantees ineffective and inefficient regulation that curtails competition and thereby harms investors.

Major reforms always follow a stock market crash. Elected officials and regulators hoping to avoid blame for the crash claim that misbehavior by market participants created the problem and that more regulation will solve it. They ignore the unintended consequences of prior regulations and policies.

The Dodd-Frank Act fits this description. Bad policy likely contributed to the subprime crisis. From 2002 to 2006, the Federal funds rate was lower than recommended by the Taylor Rule. Federal housing policies encouraged mortgage lending to homeowners with poor credit. And the government's history of stepping in to protect certain creditors of insolvent financial institutions from loss to avoid systemic risks, a phenomenon called "too-big-to-fail" created moral hazard.

Dodd-Frank's proponents, however, argued that the crisis was a consequence of too little regulation. They did so by selectively focusing on over-the-counter derivatives, which were less regulated than exchange-traded derivatives, and on the so-called shadow banking system, consisting of non-bank financial intermediaries.

But the crisis, in my opinion, was largely the consequence of large and highly leveraged investments in mortgage-related assets by heavily regulated commercial and investment banks. Many commentators have noted that the implicit government guarantee of the too-big-to-fail banks created moral hazard, but the way in which that guarantee interacted with securitization and derivatives has not gotten the attention it deserves.

Financial innovation reduces the cost of transferring risk from one party to another. In a normally functioning system, this would disperse risks, but our system was not functioning normally. The implicit government guarantee enabled large banks to take on risks that their creditors would otherwise not have stood for. After all, the creditors believed they would be protected in the event the bank became insolvent.

Thus, risks in the form of mortgage-related assets became concentrated in the too-big-to-fail banks in the run-up to the subprime crisis. Dodd-Frank's proponents, therefore, have the causation wrong. Financial innovation was not the primary cause of the build-up of risk. The implicit guarantee was the primary cause. The use of securitizations and derivatives to concentrate risk was not mindless gambling facilitated by lax regulation but a purposive and rational attempt to maximize the private benefits of the implicit government guarantee. Choosing to see the origins of the financial crisis in insufficient regulation rather than in the unintended consequences of prior government policies has important practical consequences.

Dodd-Frank subjects non-deposit-taking institutions to regulation by the Federal Reserve, which, in practice, may mean that they will be regulated like banks or bank holding companies. If so, a likely consequence is that there will be fewer and larger financial intermediaries in the United States. Some insurance companies, private equity funds, and institutional asset managers operate under the umbrella of a bank holding company, but most do not.

If the stand-alone entities are regulated as if they were banks, a possible result is that bank holding companies will begin acquiring them to economize on regulatory costs. This would be good news for the largest U.S. banks and for the regulatory agencies that oversee them, both of which would become larger and more powerful. But there is no reason to think it would be better for investors, depositors, and taxpayers. And it is exactly the opposite of the model that many Dodd-Frank proponents say they favor, which is a model of smaller, more focused banks.

Time and again, regulated industries and their regulators have used financial crises to pursue their private goals, which are not congruent with the public interest and often result in decreased competition and innovation. My recently published book describes how this occurred in the aftermath of numerous past financial crises.

To avoid this phenomenon, financial reform should be made incrementally, preferably during noncrisis periods. For example, careful observers of the financial markets warned about excessive leverage for many years before the subprime crisis. It would have been useful to focus regulatory attention on capital requirements for commercial banks and their holding companies and to impose appropriate capital requirements on investment banks and other financial intermediaries.

Instead, Congress waited until after the crisis and designed a statute that increases the reach of bank regulators and will likely increase the market share, size, and political clout of the too-big-to-fail banks.

[The prepared statement of Mr. Mahoney can be found on page 30 of the appendix.]

Chairman DUFFY. Mr. Mahoney, thank you for your testimony.

Ms. Peirce, you are now recognized for 5 minutes.

STATEMENT OF HESTER PEIRCE, DIRECTOR, FINANCIAL MARKETS WORKING GROUP, AND SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY

Ms. PEIRCE. Chairman Duffy, Ranking Member Green, and members of the subcommittee, thank you for the opportunity to be here today.

The crisis was a welcome wake-up call that what happens in the financial sector affects the rest of the economy. The crisis was built on flawed regulation, and the response to the crisis is built on a flawed narrative that regulation—that market failure was to blame. And so the flawed narrative led to a solution that was built on additional flawed regulation.

The consequences are serious. Not only is a future crisis likely, but in the interim, our economy is not living up to its full potential. A well-regulated financial system is the key to a strong economy. It directs funds to individuals and businesses that could best use them, and it disciplines those that fail.

Poor government regulation can distort the financial system's ability and inclination to respond to the signals that it gets from consumers, Main Street companies, and investors. We saw the results of that kind of distortion with the crisis in 2007–2009. And when the bubble burst, many people suffered tremendously as they lost their homes, jobs, and retirement savings. But even before the dramatic failures of 2008, think of all the sectors that didn't get funds because funds went into the housing market because of regulatory inducements.

As the last financial crisis unfolded, there was understandable outrage. We needed to do something fast, and the result of that was Dodd-Frank. Dodd-Frank was developed on a false narrative that the crisis was the product of inadequate regulation. If only we had regulated the financial system more tightly, the story goes, we wouldn't have had the crisis. But the role of the regulatory system in provoking and deepening the crisis was ignored in the post-crisis frenzy to set things right.

Regulations played an important role in the crisis. As Dean Mahoney just outlined, there are multiple government policies, from government housing finance policy to the regulation of credit rating agencies to bank regulation, that helped to encourage markets to look to regulatory signals instead of to market signals to dictate their behavior. The result of the false narrative, as one might expect, was a statute that doubles down on regulation. A blanket of new regulatory agencies and new regulations was thrown around the financial system, from the CFPB to the Volcker Rule to a whole new regime for credit rating agencies to the Financial Stability Oversight Council.

The post-Dodd-Frank regulatory system makes regulators even more important movers and shakers in the financial system than they were before the crisis. They are determining how financial firms are structured, what activities they are engaged in, and how they are funded. They are even trying to attend bank board meetings.

Strategic decisions are being made by regulators, not by firms, their managers, and their shareholders. Our financial sector is turning into a set of public utilities with the characteristic high prices, poor service, lack of creativity, and lack of entry. Government regulators are removed from day-to-day reality. No matter how much data they collect, they cannot receive the important signals that the marketplace offers. These regulators have good intentions, but so did the pre-crisis regulators.

So what can we do to make the regulatory system provide clear, strong rules without inhibiting the market's unique ability to reward success and punish failure? First, we should ensure that regulators are looking back to see what worked and what didn't in the past. It is often easier just to slap on a new rule rather than to look at whether the ones in place are working.

Second, when regulators adopt new rules, they should understand what problem they are trying to solve. It is not enough just to make the assertion that this rule will prevent another crisis.

And third, we should rethink the approach taken by Dodd-Frank. The desire to place key decisions in the hands of regulators is a natural reaction to a narrative that markets failed. But the new system depends so heavily on regulators to get things right that if they don't, things could go terribly wrong.

As it is played out, for example, the systemic designation approach is designed mostly to give the Fed more regulatory power rather than to address systemic risk, which was its purpose. If we really wanted to address systemic risk, there would be clear guidance for firms to get out of the systemic risk designation.

Another example is derivatives clearinghouses. We assume that pushing lots of derivatives into highly regulated clearinghouses would be an easy way to de-risk the derivatives markets. But more and more, people are recognizing that these clearinghouses themselves might be the source of future troubles or even of a future crisis.

Dodd-Frank was built on a false narrative about the crisis. It failed to deal with key issues in the last crisis that covered many unrelated topics, and it created a new set of problems. If we are willing to rethink it, we will be rewarded with a strong, dynamic economy.

[The prepared statement of Ms. Peirce can be found on page 39 of the appendix.]

Chairman DUFFY. Thank you, Ms. Peirce.

And Mr. Stanley, you are recognized for 5 minutes.

STATEMENT OF MARCUS M. STANLEY, POLICY DIRECTOR, AMERICANS FOR FINANCIAL REFORM (AFR)

Mr. STANLEY. Chairman Duffy, Ranking Member Green, and members of the subcommittee, thank you for the opportunity to testify before you today.

I would like to make several broad points in my testimony. First, the Dodd-Frank reform should create very large benefits. The

2007–2009 financial crisis led to over $10 trillion in lost economic output and 8 million lost jobs.

My written testimony includes a report that is based on a comprehensive regulatory review of all existing studies of the costs of financial crises. Based on this study, we conclude that financial regulations, which reduced the probability of a systemic crisis by 50 percent, would produce $2.9 trillion in economic benefits over the next decade. Reducing the probability of crisis by just 25 percent would produce almost $1.5 trillion in benefits. These figures include only financial stability benefits and do not even count the benefits of improved fairness for consumers and investors due to Dodd-Frank reforms. We believe that the Dodd-Frank Act will succeed in reaching these goals and that the benefits will far exceed its costs.

Second, the 2008 crisis revealed comprehensive issues in our financial system that demanded a comprehensive solution. This financial crisis was the first crisis of the post-Glass-Steagall era. It revealed that the fusion of commercial banking and capital market activities created major new issues in the oversight of financial risk. These included the creation of an originate-to-distribute model that concealed poor underwriting, abusive lending, and securities fraud; the growth of large universal mega-banks that combined commercial and investment banking and had become both too-big-to-fail and too-big-to-manage; and a failure by both regulators and bank management to track, understand, and control financial risk.

Due to the post-Glass-Steagall interpenetration of lending securities and derivatives markets, the crisis also featured a prominent role for non-bank entities. The American political system, with its many veto points, creates strong reasons for legislators to pursue comprehensive change through the vehicle of a single bill.

Third, while the Dodd-Frank Act is lengthy and comprehensive, it is a product of compromise and pursues incremental improvements in our regulatory system. Mr. Mahoney has stated his belief that it is wiser to engage in incremental rather than radical improvements. Examining the actual regulatory tools used in Dodd-Frank, tools such as increased capital requirements, stress testing, the use of central clearinghouses to manage risks, greater regulatory reporting and transparency, and better enforcement of consumer protections shows that they are traditional elements of financial regulation that have been used for many decades, if not centuries. These tools have been tested over many years and are hardly radical departures. In fact, if one looks at the three major financial crises over the last century—the 1907 crisis, the 1929 crisis, and the 2007 crisis—Dodd-Frank is probably the most moderate and incremental response to a crisis out of those three.

Furthermore, Dodd-Frank grants very extensive discretion to regulators to adjust the use of these regulatory tools as they are applied to different segments of the market.

Finally, we believe that rolling back Dodd-Frank would be a serious error. We have supported changes in the Dodd-Frank Act where we believe such changes are called for. We have particularly supported changes to address one of the areas Mr. Mahoney highlights in his testimony: ending too-big-to-fail and the associated practice of government bailouts.

While we believe that elements of Dodd-Frank, such as graduated capital standards and Title I resolution planning, if forcefully implemented, can themselves address too-big-to-fail effectively, we have also supported additional changes. For example, AFR has joined Representatives Hensarling and Garrett in criticizing the Federal Reserve's implementation of new restrictions on emergency lending, and we have supported Senators Warren and Vitter in their call for Congress to act if the Federal Reserve does not place stronger conditions on these loans. However, changes that roll back Dodd-Frank rules or create major new exemptions to them would, in most cases, have a negative impact on financial stability or consumer protection.

Dodd-Frank also grants regulators extensive discretion to accommodate reasonable concerns without statutory change, and they have shown great willingness to use this discretion. In practice, the great majority of the statutory changes we have seen proposed to the Dodd-Frank Act would not build constructively on the advances made by the legislation but would instead roll back the clock by stopping regulators from responding to the issues revealed in the financial crisis as well as new emerging issues in the financial markets. We believe that interfering in the regulatory process in this way would be a grave error and would restore the failed status quo that gave us the 2007–2009 crisis.

In conclusion, I would also like to point out, just in response to some of the things that Ms. Peirce said, that significant parts of the Dodd-Frank Act are, in fact, instructions to regulators to do their jobs better and to do a better job handling issues like leverage, with which they have traditionally been entrusted. Most of Title I does this, essentially.

Thank you for the opportunity to testify. I am happy to answer further questions.

[The prepared statement of Dr. Stanley can be found on page 65 of the appendix.]

Chairman DUFFY. Thank you, Mr. Stanley.

The Chair now recognizes himself for 5 minutes.

Mr. Stanley, I would have to disagree with calling a 23-page Dodd-Frank bill moderate reform. I think that is pretty extensive, even when all the rules have not been written.

At the time that Dodd-Frank was written, we weren't in the middle of a financial crisis. The crisis had passed. We had time, as a Congress, to sit back and reflect on what the root causes of the crisis were and to try to address the root causes. Instead of reflecting and waiting and thinking, there was a rush to judgment in this institution to pass a massive bill, and I would argue that a lot of folks in this town opened up their drawers, dusted off 30 years of old folders of bills that they wanted passed that they knew they could get into a package that was going to move through the Senate and the House, which gave us the Dodd-Frank bill, which has, I would argue, wreaked havoc on our financial sector.

I guess to you, Mr. Mahoney, I get concerned when I hear my friends across the aisle talk about how we have ended too-big-to-fail. Do you think that the Dodd-Frank Act has ended too-big-to-fail?

Mr. MAHONEY. I don't, unfortunately. I think that—and this is a point Ms. Peirce made in her written statement—Dodd-Frank really puts bank regulators in the driver's seat in a lot of decisions that the largest financial institutions will make. It is going to be very hard for the government the next time to step back and say, "This wasn't our doing, this wasn't our problem," when the regulators are driving so much of what is going to happen in the market.

It is also, I think, important to note that by, in effect, pre-identifying the too-big-to-fail institutions in the guise of declaring them systemically important, the government is going to encourage the markets to think of them in the way the markets thought of Fannie Mae and Freddie Mac before the crisis, that is to say, as institutions that are government-guaranteed in all but name. And it is going to be extremely difficult for the government, again, to say "not our problem" when a crisis comes.

Chairman DUFFY. So with this new package, if it is not the fault of the markets, arguably, the markets could come and say, "Listen, this is the fault of the regulators. They didn't get it right."

Is it fair to say that those institutions that may fail will come to the regulators and say, "Well, it is your fault; we want a bailout?"

Mr. MAHONEY. Absolutely. Yes. I agree.

Chairman DUFFY. Okay. In regard to the financial crisis, was it your testimony that two portions of the root cause were from housing and monetary policy? Was that your testimony?

Mr. MAHONEY. I think both certainly contributed.

Chairman DUFFY. And what did Dodd-Frank do to address monetary policy?

Mr. MAHONEY. Dodd-Frank really does not address monetary policy.

Chairman DUFFY. I would agree with that.

When we have more rules and regulations in the financial sector, does it help small startups get into the marketplace or does it help keep larger institutions at the top? Do more rules and more regulations help small businesses or help large businesses?

Mr. MAHONEY. My research—and I have looked at a lot of regulations, primarily in securities markets, but I don't think the insight is limited to securities markets—shows that if you look at the actual effects, often what happens is that the regulated industry, particularly after a crisis, is able to, in effect, cut a deal. They come to hearings like this one, hang their heads in shame, and are pilloried. And meanwhile, their lawyers and lobbyists are working with the people who are writing the new regulations, whether it be Congress or regulators. And they write them in ways that entrench the position of leading firms and make it very much harder for new firms to enter the market, and often drive out smaller firms from the market.

Chairman DUFFY. Okay.

Mr. MAHONEY. This is very clear, I think, in the case of the New Deal financial reforms. They were great for the leading investment banks. They were great for the leading stock exchanges. They were great for the leading mutual fund complexes. They drove smaller regional stock exchanges out. They drove smaller broker-dealers out.

Chairman DUFFY. Wonderful. Thank you.

I don't have time to fully get your answer. But, Mr. Stanley, you talked about the cost of the financial crisis, and I share your concern in that cost. Maybe we can follow up later to see if you have calculated the cost of overregulation, putting the clamps down on our financial sector and what that does to growth and opportunity in the country, and also, what does it do if we send our capital markets from America to other parts of the world, what does that do for the security of the country if you have calculated that as well? But I am out of time.

With that, I yield 5 minutes to Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman.

Ms. Peirce, I am just curious, and this is a serious question, what do you think we should have done in this committee when the Secretary of the Treasury came in, and the head of the SEC, and the FDIC, and explained where we were headed, if nothing was done?

Ms. PEIRCE. I agree with you that was a terrible time, and it was a terrifying time. And having them come in and say, "We need to do something," was a big weight toward pushing Congress to do something. But they did not have a clear plan on what to do, and things were bad, even though there was a rescue put in place. Things would have been bad if there hadn't been a rescue put in place. But I argue that not having the government step in at that time would have made for a shorter crisis and a healthier recovery.

Mr. CLEAVER. So, because we took action, we lengthened the recession?

Ms. PEIRCE. Yes.

Mr. CLEAVER. Now, I am really a little confused.

So what did we do to the housing market? I mean, the housing market actually collapsed. And I think you and Mr. Mahoney both were saying that we misread the state of affairs, and we played—we actually responded to a narrative that was incorrect. Did I understand you correctly?

Ms. PEIRCE. Yes, sir.

Mr. CLEAVER. Okay. So there was nothing going on in the housing market?

Ms. PEIRCE. I'm sorry if I was unclear on that. What I meant to say was that the problems in the housing market were driven by regulations and not only housing policy that encouraged people to lend to people who couldn't afford the size houses they were buying, but it also—

Mr. CLEAVER. Excuse me. Say that one more time. I don't want to misunderstand you.

Ms. PEIRCE. So there are different elements of government policy that led to the housing crisis.

Mr. CLEAVER. Okay.

Ms. PEIRCE. One was that we encouraged loose underwriting standards, but a second—

Mr. CLEAVER. How?

Ms. PEIRCE. —important one—there were—I should actually have put the other one first because the first thing is bank regulations that encouraged banks to hold certain types of securities, in this case mortgage-backed securities, which drove a demand for mortgages, which then drove to the writing of a lot of subprime mortgages and so that would have been done right then—

Mr. CLEAVER. The large banks were heavily invested—

Ms. PEIRCE. Yes.

Mr. CLEAVER. —into mortgages.

Ms. PEIRCE. They were.

Mr. CLEAVER. And so when the housing crisis—you do agree that we had a housing crisis?

Ms. PEIRCE. I agree with that.

Mr. CLEAVER. Okay. So that impacted the balance sheets of the banks. Am I correct?

Ms. PEIRCE. It did. Right.

Mr. CLEAVER. So you are saying that, with that going on, the responsibility of this committee was to do nothing?

Ms. PEIRCE. If you are asking me whether TARP was a good idea, I don't think that TARP was a good idea. It was a bailout that perpetuated this notion that the government would step in when there is a problem. It—

Mr. CLEAVER. I'm sorry. Go ahead.

Ms. PEIRCE. It perpetuated the idea that people who make bad decisions are not responsible for the consequences. And I am talking about the banks who made bad decisions. They should have been responsible for the consequences of their decisions.

Mr. CLEAVER. Yes. I agree with you on that, but I am not sure that I understood the answer.

Either you or Mr. Mahoney, what I am getting at is, so the response we had was to walk into the committee room where we met and say, "We are in the midst of the greatest financial crisis since the Great Depression and let us together hold hands and do nothing?"

Ms. PEIRCE. Restraint is sometimes the best indicator of wisdom.

Mr. CLEAVER. So you are saying that is what we should have done?

Ms. PEIRCE. I am not saying that the crisis wouldn't have been bad, but the crisis was bad even with the emergency programs that were put in place. There are certain things that could have been done to help homeowners, for example, to soften the blow. But to take this big action of putting money into banks was not a wise response. And I understand what drove it, but I would argue that it perpetuated the problems that we have.

Mr. CLEAVER. Thank you.

Chairman DUFFY. The gentlemen yields back.

The Chair now recognizes the gentleman from Virginia, Mr. Hurt, for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Dean Mahoney, I was intrigued by your testimony and what you have to say as you sit before a committee of Federal policymakers—that your study has shown, over the course of history, that so often the effect or the underlying problems that we have had in terms of stock market crashes, that so often Federal policymakers respond in a big, bold way in order to, frankly, cover themselves politically. And I think that is interesting when you consider

Dodd-Frank and why it was passed in the way that it was and what the consequences have been.

And I guess what I would ask you to comment on is sort of the irony that Federal housing policy was, in my mind—and, I think, in the minds of many well-respected people—very much the cause of what happened in 2008. And what an irony it is that here we are, 7 years later, and we still haven't put a glove on Federal housing policy and Fannie Mae and Freddie Mac. Dodd-Frank does not do anything about that. And I was wondering if you could comment on that irony, and why is that? Is that consistent with what you have found as it relates to policy responses to previous crises?

Mr. MAHONEY. Yes. Thank you.

I think that there are two underlying problems, and I think they are surfacing in some of the discussions we are having here. First is the notion that it is just about the quantity of regulation; should we have more or less? And that is a very easy way for policymakers to avoid responsibility and just say, "Well, we layered on more stuff and so we have done what we are supposed to do."

The second big problem is to see regulation as, in some sense, a punishment of the financial industry for what it did in the past as opposed to looking forward at, how do we prevent problems in the future? And that makes it very easy for the regulated industry, again, to come in, hang its head in shame but in the meantime work on shaping the regulations in ways that benefit them.

If you want to punish banks that are too-big-to-fail, don't layer on more authority for bank regulators.

Mr. HURT. Thank you.

I come from a district, a rural district in Virginia. I think that, if you look at the trends over the last 30 years, you see that community banks have taken a real—have seen real losses. I think we have gone from somewhere around 15,000 community banks to today about 6,000, and a lot of that decline has happened in the last 7 years, 6 years since Dodd-Frank was enacted and, I guess, enacted with the idea that it was going to end too-big-to-fail. I would suggest that it has only enshrined it.

And I was wondering, Mr. Stanley, if you could—when you hear community banks talk about the tremendous and profound challenges that they face in implementing Dodd-Frank, do you think they are lying, or do you think that they are being sincere?

Mr. STANLEY. I think that there has been a long-term trend toward a decline in the number of community banks that dates back to the 1980s, that is driven by many different factors. I think that—

Mr. HURT. Do you think it is specifically the effect of Dodd-Frank?

Mr. STANLEY. I think it is too early to conclude as to whether Dodd-Frank has actually changed that trendline. I do think that—

Mr. HURT. Do you think that having fewer community banks contributes to a healthy economy where there is more competition, where you have more innovation, and consumers have more choice and lower costs?

Mr. STANLEY. No. We are supportive of the community banking model and the relationship lending that is included in the community banking model. We believe in assisting community banks to comply with regulations. It can be more burdensome on smaller entities to comply with regulation. We understand that.

We do also feel, however, that competition with large banks and changes in economies of scale have both contributed to the decline in the number of community banks.

Mr. HURT. Okay.

Mr. STANLEY. And we feel that Dodd-Frank makes many accommodations to community banks. Regulators have been willing to exempt community banks in many cases. And Dodd-Frank does specifically call for regulators to be tougher on larger banks than smaller banks, and we support that.

Mr. HURT. Thank you, Mr. Stanley.

My time has expired.

Chairman DUFFY. The gentlemen yields back.

The Chair now recognizes the gentleman from Minnesota, Mr. Ellison, for 5 minutes.

Mr. ELLISON. Thank you, Mr. Chairman. And, Ranking Member Green, I appreciate the time.

I would also like to thank you, Dr. Stanley, because this committee is thankful to receive the incredibly important feedback that Americans for Financial Reform provides .

Mr. STANLEY. Thank you.

Mr. ELLISON. And I also want to say publically that your colleagues and your partners have been reliable and responsive to legislation and hearings on topics that would help and weaken consumer protection and investor protections. And I am glad to be able to benefit from the work that you all do by knowing a little bit more and being a little more informed.

The Americans For Financial Reform budget is tiny, particularly compared to other players in this space, but you all still show up every day and try to look out for the consumer. And I just want to say publically that I appreciate it.

Mr. STANLEY. Thank you.

Mr. ELLISON. So I wonder if you would offer your views on a New York Times editorial from yesterday entitled, "The Title Insurance Scam." I don't know if you saw this article. It is actually not really fair for me to spring it on you, but I know you review the literature. And so I wonder, did you have a chance to see this particular article?

Mr. STANLEY. I did see it, yes.

Mr. ELLISON. I wonder if you wouldn't mind just offering your candid views on how title insurance is routinely handled?

Mr. STANLEY. I think that editorial was citing new evidence from New York that, frankly, adds to a mountain of evidence that title insurance, particularly affiliated title insurance, is a broken market, that it is marked by kickbacks between the lender and the title insurer, that consumers don't and often aren't able to shop around for less expensive title insurance so they are exploited through title insurance that is massively overpriced and that charges excessive fees. And I think that this really underlines the importance of controls on title insurance and not making exemptions for title insurance in the legislation in the consumer protections that we have.

Mr. ELLISON. Thank you.

Before Dodd-Frank—and I know we are talking about Dodd-Frank around here quite a bit—what we saw quite a bit was predatory lending. We saw securitization. We saw a lot of problems in the consumer market. And I just hope that some of our critique of Dodd-Frank keeps in mind what Dodd-Frank was passed to try to fix.

We now have a Consumer Financial Protection Bureau taking steps to lower costs, provide access to high-quality mortgages, and ensure that home buyers get early notice of their actual closing costs. Yet we—I am sure you are aware and many people in this room are aware that Congress voted to weaken those protections recently and most recently to enable steering to affiliated title insurance firms to hire cost manufactured home loans. And that is a concern of mine.

Let me ask you this, Dr. Stanley: Are you concerned that if we do not try to step into the affiliated title space, that consumers and home buyers could be hurt?

Mr. STANLEY. Yes. As I said, the New York Times editorial highlighted evidence of precisely that kind of harm that came out of New York State. The GAO has highlighted some of the same issues at a national level. I think the cap on points and fees that was associated with the Qualified Mortgage rule would have done a great deal and should do a great deal to protect consumers from this kind of exploitation. But if we put in exemptions for some of the most problematic areas, such as title insurance, it is going to lose its effectiveness.

Mr. ELLISON. Now I have a little while, so I just want to ask you a question. I have a bill out there called the Ensure Fair Prices in Title Insurance Act. It is H.R. 1799. Have you had a chance to review it?

Mr. STANLEY. I regret to say I have not had the chance to review that bill.

Mr. ELLISON. Fair enough.

Mr. STANLEY. But some of my colleagues in AFR may have.

Mr. ELLISON. Okay. Well, no problem. I am not going to ask you to offer an opinion on it. And, by the way, I wouldn't be sensitive if you didn't like it. But if you knew anything about it, I thought I would ask.

And, with my last moments, can you offer your views on some of the investor protections put in place by Dodd-Frank?

Mr. STANLEY. Yes. I think the registration of private equity and hedge funds, which creates a fiduciary duty—we saw when the SEC did a follow-up investigation based on that, they found violations at up to 50 percent of private equity funds. I think there are other protections in the securities markets in terms of asset-backed securities and the underlying data there that are valuable, though I think they could be better—

Mr. ELLISON. That was—I think that little click noise means—

Mr. STANLEY. Yes. Sorry.

Mr. ELLISON. —that I am way out of time, so I do want to thank you again and thank the Chair.

Mr. HURT [presiding]. The gentlemen yields back.

The Chair now recognizes Mr. Fincher from Tennessee for 5 minutes.

Mr. FINCHER. Thank you, Mr. Chairman.

I appreciate you having this important hearing, addressing the concerns we all have about Dodd-Frank and the impact it is having on our districts across the country.

I was just making a few notes listening to the testimony of the witnesses and listening to the conversations from the other Members as to how many problems that Dodd-Frank has actually solved since it has been passed.

When I go back home to my district every week and talk to my local community bankers, they tell me, "You know, Stephen, Washington just doesn't get it because the people at the top are not being harmed as much as the folks at the bottom." They are the ones who can't get loans anymore because Dodd-Frank has made it impossible for the banks to be able to loan these guys money.

Crushing banks through unnecessary regulation crushes the consumer. This is not about making community banks pay for something they had nothing to do with back a few years ago.

And to reiterate something that Mr. Hurt said a few minutes ago, government had a big hand in what happened with telling banks who to loan money to and who not to loan money to, to loan money to people who couldn't pay it back. They had a heavy hand in how all of this started and how all of this unfolded. And it is almost to the—I don't want to read too much into it. But some of the comments that the opponents or the proponents of Dodd-Frank make, it is almost like they want to do away with the community banking industry and all of the competition and just have one or two big banks run everything.

Back home in our districts, something that is the overall theme is that "Big Government" is good for "Big Business," but it does nothing to help the small guy. It crushes the small guy.

And then you look at Dodd-Frank and how it is being carried out. Congress doesn't appropriate money. It gets its money from the Fed. We have very little when it comes to holding them accountable for what they are doing. They make the rules. They write the rules themselves. They regulate how they see fit with almost no oversight—at the CFPB, it is Director Cordray who actually makes the decisions on what is happening and who is it affecting—not a panel of people but one guy.

So, what is wrong with trying to fix all these unnecessary burdensome regulations that are hurting our constituents on both sides of the aisle? We have a bill, a manufactured housing bill, something that was unintended in Dodd-Frank that former Chairman Barney Frank addressed, that needed to be taken care of. Ranking Member Waters also, just a few months ago, signaled that we needed to fix this problem. But now it has become a very partisan issue. We can't touch it because it is part of Dodd-Frank. This is the problem. We need to do what we can to make sure we are working for our constituents, not more government and more burdensome regulation.

Mr. Maloney, would it be beneficial—and I know the answer, but I want to hear your feedback—if we allowed these rules and these regulations to sunset a lot of it? So we could go back—we had a jobs bill last Congress, and it was dealing with the IPO process and Sarbanes-Oxley. And if some of that would have been allowed to sunset, we would not have had to do what we did to fix that problem. So comment, please.

Mr. MAHONEY. I agree with that. And I recognize the pressure that any policymaker feels in a time of crisis to do something. I agree with Ms. Peirce that it is often the right thing not to give into that pressure, but I understand the pressure.

One way of reducing the cost would be to have automatic sunset provisions in legislation so that once things have cooled down, we can go back and say, what is it that actually needs to be done here.

And I just want to make the observation that one of the things that Dodd-Frank clearly does is it increases the authority of the bank regulators over non-bank entities.

But if you say, okay, so let's go back to roughly, say, 2006, what did the Fed know at the time? It could see that the default rate on subprime loans was rising. It could see that housing prices were beginning to fall in many areas of the country. Why didn't it do something at that point? Was it because there was no statute that said, "think about systemic risk?" Or was it that the Fed, just like the banks that it regulates, figured the ultimate experience with losses here is going to look like it has always looked and that is not going to be—

Mr. FINCHER. My time has expired, but the answer is more government is not the answer.

I yield back.

Chairman DUFFY. Thank you.

The gentleman's time has expired.

The Chair now recognizes Mrs. Beatty, the Congresswoman from Ohio, for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman. Thank you, ranking members, and thank you to our witnesses for coming in today.

In reviewing the testimony, and in my short time here listening to both sides of the aisle, it is very interesting to me that one document, the Dodd-Frank Act, has so many different interpretations and opinions and purposes. But one common thread that I have listened to from my colleagues on both sides of the aisle is, going back to our districts, how do we explain this? Consumers have been mentioned by everyone, so—and problems.

So for me, I put in achievements of Dodd-Frank. I am not sure if you are aware of this, but since the passage of it in February of 2010, nearly 12.3 million private sector payroll jobs have been created. That is something pretty good to take back to your districts. Further, our economy has added 3 million new jobs over the past 12 months, nearly the fastest growth in more than a decade. Yes, those are achievements of Dodd-Frank because I think it also created the Consumer Financial Protection Bureau. Since its inception, the Bureau has returned $5.3 billion to 15 million consumers who have been subjected to unfair and deceptive practices.

So where I am going with this, since I repeatedly hear attempts to block the appointment of having a Director or to move it toward an independent funding source, Mr. Stanley, first with you, as this committee moves forward with its oversight and financial regulatory agency in drafting financial services legislation, what do you think we can do to ensure that the CFPB is able to continue its legislative mandate and be fully funded?

Mr. STANLEY. Frankly, I think the structure that currently exists in the Dodd-Frank Act, which provides it with dedicated funding from the Federal Reserve, as the other financial regulators receive, with the exception of the CFTC, they are self-funded and not within the appropriations process; I think maintaining that is very important. And, frankly, I think that structure of a single director helps the CFPB act quickly and forcefully when it sees problems. So I think that maintaining that structure in the Dodd-Frank Act would be—is very valuable.

Mrs. BEATTY. And to the other witnesses, if there were no Dodd-Frank Consumer Protection Bureau as it is, how would you counter these achievements and wonderful statistics that it has been provided to do?

Mr. MAHONEY. It is, of course, hard to run the experiment and go back and say, "What would the economy look like today without Dodd-Frank?"

We, unfortunately, lack the ability to do that. And I would just say that everyone believes that it would be wonderful if we could come up with a way to reduce the likelihood of future financial crises.

Mr. Stanley, I think, did a very good job of quantifying what it would be like if we could reduce the likelihood of future financial crises.

Mr. MAHONEY. Unfortunately, I see no evidence whatsoever that Dodd-Frank is going to do that. I think, in fact, there is a very good chance that it will make future financial crises more likely because it is concentrating risk, for example, of derivatives transactions in a new too-big-to-fail entity, a centralized counterparty. It is going to, I think, inevitably force more activities under the umbrella of the too-big-to-fail banks.

And I think by doing that—

Mrs. BEATTY. Because my time is short, let me piggyback and ask you a question on that.

I think you said in your testimony that Dodd-Frank misunderstands the causes of the financial crises and particularly blames monetary policy, Federal housing policy, and moral hazards created by government bailouts.

So, in your opinion, what were the main causes of the recent twin housing and financial crises?

Mr. MAHONEY. I think the cause of the housing and financial crises had, in part, to do with government policy. They had, in part, to do with the fact that banks that tried out new forms of mortgage loans that were not very well-tested, which turned out to not work as effectively as the banks thought they would. And in a well-functioning market, the banks that did that would have been allowed to fail. That wasn't what happened here.

Chairman DUFFY. The gentlelady's time has expired.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner, for 5 minutes.

Mrs. WAGNER. Thank you very much, Mr. Chairman.

And thank you, panelists, for being here.

I would like to discuss the Dodd-Frank Act and the regulatory overreach that has resulted from it. Now that we are 5 years out from the law's enactment and have seen many of the over 400 separate rulemakings required under the law go into effect with many more in queue, we are starting to be able to more accurately see the long-term consequences from such a massive piece of legislation. I believe many of the consequences are unintended.

A recent research paper released last week from the American Action Forum estimates that the burden of compliance under Dodd-Frank will result in a reduction of nearly $900 billion in GDP over the next 10 years. The study goes on to say that this will, in turn, result in a cost of over $330 per year for each working-age person over the next decade: $330 per year per working-age person. For families, this is a—for many of them, it is a car payment. It is a whole month's worth of groceries.

Mr. Mahoney and Ms. Peirce, these are some general questions. Has how regulatory overreach from Dodd-Frank contributed to increased costs for working Americans?

Ms. PEIRCE. I think that is a great question. And the focus on compliance costs is one thing to look at, but there are actually costs that are deeper than compliance costs—

Mrs. WAGNER. Correct.

Ms. PEIRCE. —which are the structural problems that the changes are creating in the economy. And so I think what we are seeing is we are seeing—we had the example of community banks. We are seeing a lot of community banks close their doors, and it is, in part, due to Dodd-Frank and, in part, due to other regulations.

And that means that a local community who depended on that bank for loans to their small businesses, for example, is going to be in trouble. They are going to have to go somewhere else for that funding, and it is more difficult to get outside of the community.

So that is one example of how Dodd-Frank has affected the economy.

Mr. MAHONEY. I agree with that.

And I would also just point to another cost that I think really has not been quantified and would be very hard to quantify, and that is the notion that because we have now given the regulators the power to look for systemic risk, this is a solved problem and that we have banished systemic risk from the market.

We have not done that. When it comes back, it is going to come back even more vigorously, and that will impose substantial costs.

Mrs. WAGNER. And this leads almost exactly into my next question, Mr. Mahoney, which is: Despite the adverse effects of Dodd-Frank both on costs and economic growth, has it fully protected us from future financial crises?

Mr. MAHONEY. No. I think not at all. Again, I think it does some things that could make a crisis more probable, as I mentioned, the provisions on over-the-counter derivatives—

Mrs. WAGNER. Right.

Mr. MAHONEY. —and the designation of systemically important institutions. I think that the regulators ought to focus on risks rather than institutions. And I think Ms. Peirce made the very important point that by just identifying these institutions and accepting them as too-big-to-fail rather than trying to reduce their risk, the statute goes in the wrong direction.

Mrs. WAGNER. And speaking of new institutions, as both of you know, Dodd-Frank created a number of new institutions also within itself, such as FSOC, the OFR, and the CFPB, that have very little oversight and operate with very, very limited transparency.

What further unintended consequences could these new institutions pose in the future beyond what was included in Dodd-Frank?

Ms. PEIRCE. One concern that I have, for example with the CFPB, with the lack of accountability, is that consumers are actually losing out on opportunities. It is really important for—I think Mr. Stanley mentioned that competition can be very helpful for consumers. It ensures that they get a better deal.

And if you have an agency that is focused on putting a lot of regulations in place, it keeps new entrants out, and that limits competition and it limits options for consumers and it can hurt the consumers who are most deeply in need of options.

Mrs. WAGNER. Thank you.

I believe my time has run out. I yield back, Mr. Chairman.

Chairman DUFFY. The gentlelady yields back.

The Chair now recognizes the gentleman from Washington, Mr. Heck, for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman.

I would like to use my time today to talk about markets. Markets are great and powerful, and I firmly believe that the strength of our markets is what led us to win World War II and the cold war and served as a shining example for a lot of other countries who set up their post-war economies.

But just because the markets are better—and they are—in a command economy does not mean they are perfect or 100 percent reliable. And no reading of history could conclude thusly. Frankly, I feel like that is being lost in the service of ideology.

When we were contesting a philosophical battle with the Soviet Union, we were very aware of market shortcomings. In the early days of communism spread a century ago—I remember it well—we recognized that financial markets are prone to panics. And so we set up commissions to regulate the futures market and stock markets.

We recognized that money markets are the same way and that they drive boom and bust cycles in the broader economy. So we set up the Federal Reserve to smooth out the money supply and try to promote economic stability.

We set up the FDIC to try to bring an end to bank runs that happen in a free market for deposits. We set up a whole host of agencies to smooth out the market for home mortgages, and the list goes on and on.

It took a while for all those systems to evolve and be put in place and work, but 75 years after the Great Depression, it is fair to say, and it is accurate to say, that economic growth has been steadier and more broadly shared than it was in the 75 years prior to the setting up of some of those entities to help.

We recognize now that there is inherent volatility and to, in fact, harness the power of markets and to enable growth that is shared by the masses, if you will, we need to have these entities functioning. And I miss those days.

We are having a fight lately over another one of those agencies that was set up to address market failures 80 years ago. We all agree, everybody in this room, that in a perfect world, the Export-Import Bank wouldn't exist.

Of course, in a perfect world, neither would the FDIC, neither would the Federal Home Loan Banks. In a perfect world with perfect markets, we wouldn't need to respond to market failures, but markets aren't perfect.

In our world, we recognize that even if we could somehow get China and Russia to play by the same rules as everybody else so that we had a level playing field internationally, trade financing markets would still fail in predictable ways. International financing markets would still have panics and would still freeze from time to time.

Good customers in countries with poor legal systems would still struggle to get loans to buy products. Small companies who use community banks would still not be able to get working capital for products to be sold out of country. Private credit insurance would still only be available at scales too large to be useful to small manufacturers.

These are predictable market failures, and they will reappear if the Export-Import Bank goes away. Even the banks that compete and function in trade financing acknowledge it.

We used to be dedicated to addressing the failures of market so that everyone could benefit from capitalism strengths. Maybe we did this because we were committed to helping all Americans share in capitalism's success. Maybe we did this because we were worried about being embarrassed by communist propaganda. Either way, we seem to have lost our way.

The Export-Import Bank is good for capitalism, but capitalism's self-appointed defenders frankly seem to have lost sight of that. And I frankly hope we can reverse that mistake before it is too late. And to put a fine point on it, "too late" is defined here today, now, in this moment, as 23 more legislative days. I pray that does not happen.

With that, Mr. Chairman, I yield back the balance of my time.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman.

I would like to thank our panelists for joining us here today. It has been interesting hearing your comments.

I come from the private sector, a small businessman. And the best definition of that, I guess, is you are working on a high wire without a net. There is nobody there to catch you. And that is actually the best incentive to be able to perform and to be accountable and responsible with the dollars that you currently have.

And I share, I think, a great concern with many of my colleagues that with the institutionalization of Dodd-Frank, we are seeing an incredible overreach that is going to be impacting the freedom that this country has been built upon to be able to have great entrepreneurialism, to be able to create jobs. When I am hearing comments that we are having a recovery, I am strictly reminded that we have the lowest labor participation rate in 4 decades.

We are seeing $2 trillion in costs now that are coming onto businesses nationwide. For the first time since we have kept records, we are seeing more small businesses shut down than there are new business startups in this country. And are we seeing the government becoming a platform off of which to be able to launch entrepreneurialism, to be able to put people back to work, or has it become a stumbling block?

That is my concern and something, Mr. Mahoney, I would like you to be able to speak to when we are looking at the FSOC.

Given the broad definitions that are put forward for the FSOC—that they can work on anything that is a threat to the financial stability of the United States—do you have some concerns that we could see the Federal Government moving into a variety of different areas, instruments, in terms of financial liquidity, that can hurt economic growth in this country and something that is critically important in my district for young people to be able to live that American dream?

Mr. MAHONEY. Yes. I agree with that.

And I think that the very vagueness of the concept is itself going to be a problem. Because, ultimately, when you have something affect the financial stability of the United States that does not have any recognized meaning, its meaning is going to be determined ultimately by lobbying, to put it bluntly.

Because businesses that want to see their competitors harmed are going to go to the regulators and say, "What that person is doing is a bad idea. What we do is the best practice."

And I think it is very important to note that a lot of regulation, a lot of discretion exercised by regulators, tends to be because, obviously, they are not involved in the markets day to day.

They have to get their information from somewhere else. So they turn to so-called best practices, which typically are just what the very largest firms do because they can afford to do it. And smaller businesses can't afford to do it, and they are the ones that are harmed.

Mr. TIPTON. I appreciate that comment, and I think it comes to a specific point.

And, Ms. Peirce, you might want to speak to this as well.

We often talk about the big institutions, we need to be able to regulate them so they are autonomous from the rest of the economy. And I am worried about the folks back home who are trying to put food on the table for their families.

As we increase these regulations—and no one argues that there shouldn't be some regulations; I think many of us are just hoping we can find some sensible, commonsense regulations to be able to apply—are these costs impacting the people who are ultimately paying the bills?

Ms. PEIRCE. Yes, absolutely. When we talk about imposing costs on financial institutions of any size, ultimately, a lot of those will get passed on to the consumers and companies that rely on those financial institutions. So it is something that we really do need to be concerned about.

And if we focus on—I think, as Dean Mahoney laid out really nicely, one of the problems is that regulation can entrench certain regulatory schemes that work very well for certain institutions and keep out new entrants. The best way to lower prices for consumers and to increase their options is to have more competition.

Mr. TIPTON. More competition.

Mr. Mahoney, you were pointing out and have spoken to the fact that we are seeing more small banks being shut down. I have cited in this committee a bank in Delta, Colorado, $50 million, a small bank, saying that they don't know if they want to continue because they are working not for their customers, but for regulators and for the Federal Government.

Is this helping the American consumer?

Mr. MAHONEY. Not at all. And I would just note in the few seconds left that virtually all of the bank failures since 2010 have been small institutions. Only a handful of those have had assets of more than $1 billion.

Mr. TIPTON. Thank you.

I yield back, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

Please allow me to address the notion that the "do nothing" solution was the best or better solution. The "do nothing" solution assumes that things couldn't have gotten worse. The recession of 1929, which was the Great Depression, disproves this.

Things could have been worse. How soon we forget Bear Stearns, Lehman, AIG. Banks were not lending to each other. I was here. I saw it unfold before my very eyes. Banks refused to lend to each other. How soon we forget. Rush to judgment. Somehow we went to bed one night, came to work the next day, and created Dodd-Frank. Not so.

Amendments: 120 Republican amendments considered, 46 roll call votes for Republican amendments, 51 Republican amendments accepted, 134 Democratic amendments, 24 bipartisan amendments, debate time a total of 15 hours and 41 minutes, and this is with reference to the Financial Stability Improvement Act. There was careful, considerable deliberation before this legislation passed.

Small banks: There is a deep abiding affinity for small banks among the members of this committee. Unfortunately, when we try to do something for small banks—by the way, 90 percent of all banks in this country are small banks. 90 percent plus, and they are under $1 billion. We could pass legislation for small banks but for the fact that, when we try to do something for the small banks, it becomes legislation that will also impact $50-billion banks, huge banks.

I support doing something for small banks and will work with anyone who wants to do something for small banks, but I refuse to allow the facade of small banks to become what is called a community bank that is worth $50 billion to $100 billion or even more. We have had one witness who said that any bank could be a community bank. So I no longer use the term "community bank" because we are not talking about the mega-banks.

I agree with the concern for small banks, and want to do something about it. But we can't do it if we continue to allow the mega-banks to drive the legislation. And that is what is happening here.

The mega-banks want legislation. So they use the small banks to accomplish their end. This is the real deal. This is what is going on. How soon we forget.

I think another appropriate title for the hearing would be, "Let's Get Back to Business as Usual." Let's get back to no Financial Stability Oversight Council. It is not perfect. What is? But it does provide us at least an opportunity to look for the next crisis.

Ending too-big-to-fail? Why not have a means by which you can wind down the next AIG? That doesn't mean that you won't have a bank that is so big or some institution that is so big that it can't have an impact, but it does mean that we have a way now to deal with it. We didn't have that before Dodd-Frank. Let's get back to business as usual.

Stock market's at an all-time high. Big investment banks and the companies are making lots of bucks. We are here trying to help them make more money when we have people working at minimum wage who can't take care of their families.

When are we going to hear something about raising the minimum wage? We take care of those at the top at the expense of those at the bottom.

I yield back, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Arkansas, Mr. Hill, for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman.

And thanks to the panel for participating in this hearing. I appreciate it very much.

Mr. Mahoney, I am interested in your thoughts. And the panel, please join in as well.

The Financial Crisis Inquiry Commission was well-conceived and well-designed right after the 2008 crisis, and it put forward a very thoughtful report and yet, Dodd-Frank was passed 6 months before that report ever came out, which really struck me, as a business guy, as putting the cart before the horse.

But, of course, the President asked for a deficit panel to be impaneled when he first became President to try to reduce our chronic budget deficit and our chronic debt, and he ignored that report as well.

So I am interested in what your thoughts are that were contained in that commission that were ignored or not contained in Dodd-Frank that are good ideas and should have been considered.

Mr. Mahoney, do you want to start?

Mr. MAHONEY. I think I would just start by saying the report tried to have a little something for everyone in the sense that it pointed out some of the policy issues that we have discussed today, the monetary policy questions, the government housing policy questions, but it also pointed out some of the market issues that have widely been blamed for the crisis: securitization; over-the-counter derivatives; combining banking and capital markets activities into the same institution.

The thing that has always puzzled me is, if those things were so destabilizing, it is a little bit strange that the financial crisis didn't occur much sooner. Those things were all under way in the 1980s. The financial crisis happened in 2007, 2008. Why did it take so long if those things were so incredibly destabilizing? So I find the sort of smorgasbord approach of the report a little bit puzzling.

Mr. HILL. Ms. Peirce?

Ms. PEIRCE. I would point to Peter Wallison's dissent, which talked about housing policy. And while I don't think housing policy was the only cause of the crisis, I do think that he does a nice job explaining the roles that Fannie and Freddie played in the crisis. And that, of course, was left out of Dodd-Frank entirely.

Mr. HILL. Mr. Stanley?

Mr. STANLEY. I do think that many elements of the FCIC report were addressed in Dodd-Frank, and many of the people who testified before the FCIC also testified before Congress in helping to frame the Dodd-Frank Act.

And I also think that Dodd-Frank included many things in it that came directly out of the regulatory response to the crisis. For example, the regulators were already working on the new Basel capital rules, which contained many changes in the rules to respond to the problems that were seen in the crisis.

And a lot of the time, when people talk about Dodd-Frank, they are actually referring to those new Basel capital rules. They are referring to the continuation of the Federal Reserve stress testing started in the crisis. A lot of things in Dodd-Frank emerged directly out of what was learned in the crisis in that response.

Mr. HILL. I would like to ask each of you: Would you support a single prudential regulator that was not the Federal Reserve, that was a separate independent regulator that had bank authority—I'm not talking about securities, but bank authority—and put it in the hands of one non-Fed prudential regulator?

Mr. Mahoney?

Mr. MAHONEY. I think either a single prudential regulator or simply ending the problem that we did have—and it was a regulatory problem that we should have solved before the crisis, which is that you had holding companies that had individual functional regulators at various regulated entities.

But there may not have been a single regulator that had a complete picture of everything that was going on within the holding company. I think that was particularly true in the investment banks.

And I think having a regulator at the holding company level that is looking at everything is a perfectly fine idea. Now, that could be the Fed for banks, the SEC for investment banks. It could be a new prudential regulator. But I do think that is a sensible reform.

Ms. PEIRCE. I think pulling the regulatory responsibility out of the Fed is a very important step. Putting it in one prudential regulator for banks could be a good idea.

Of course, the structure would matter. You would want to make sure that it was subject to appropriations and had the proper oversight, not that it had a commission structure, for example. I think that would be very important.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much.

And thank you, folks, for sitting through this for a couple of hours now—or going on that. I appreciate it.

Part of the American dream is everybody wants to own a home. That is good. However, up until roughly 2006 or 2007, it seemed like there were Washington regulators who were putting lots of pressure on banks to make sure they enticed families to buy homes even though they couldn't afford those homes.

Sometimes they pressured banks to offer no money down. Some folks who applied for homes didn't have jobs, but they were still given credit in order to entice them to take on more than they could chew off.

And then, when these folks couldn't make their mortgage payments, the housing market collapsed. And with that, it took the financial services industry of the financial markets that collapsed.

So here you have these families who are now going through this process of losing their homes. They are going through bankruptcy, and some of the reasons for this happening were the bank regulators here in Washington.

Now, in my district, which is western, central, northern, and Down East Maine, some of the hardest working people you could possibly find, they saw the value of their homes plummet 40, 50 percent subsequent to the market crash. And folks who were saving for their kids' college education or their retirement saw their savings and mutual funds and 401(k) plans plummet 20 or 30 percent.

So now they are in a position where they have to work longer, the nest egg has shrunk, and now they are more and more dependent on the government, not to say that we have a Social Security system that is a $15 trillion unfunded defined benefit pension plan with no real plan to take care of that.

So, of course, after this happened—Washington knows best—the big brother government sort of ran to everyone's rescue. Even though they helped create the problem, they imposed this huge Dodd-Frank net over the entire financial services industry.

I come from Maine, and we do a lot of fishing up there. And sometimes a net should have holes in it big enough for the small fish to get through.

So we have a real problem here in our district with small banks. And as my colleague, Mr. Green, mentioned, he may not want to call them small banks. I call them community banks.

But whatever it is, we have a lot of small credit unions and small financial institutions, small banks, that are the backbone of our economy. And they want to lend money to individuals who want to buy a new truck or maybe put a new diesel in a lobster boat, and they are unable to do it because some of these regulations.

So what happens is the cost of regulations goes up. Bank fees go up. You talk to Larry Barker, who runs the Machias Savings Bank in Down East Maine, and they have about 100, 120 employees, and they are putting more people on the payroll to deal with regulations instead of lending money to folks who need it.

So I am really concerned about this Dodd-Frank net, which has started to smother our small banks that are the backbone of our community. Jobs are being lost. Credit is not being extended. And then, if you go over to the investment management space, you have fees going up and rates of return on retirement savings going down.

So I would like to ask you, Ms. Peirce, first, if you don't mind: Do you think and can we agree that this is happening, there should be reforms to this regulatory burden? And, specifically, what would you recommend? How can we help our small community banks keep money flowing to our families, grow businesses so they hire more people?

Ms. PEIRCE. The Mercatus Center did a study a couple of years ago on small banks and found that, indeed, they were suffering very heavily, and it was this concept that you mentioned of spending a lot more time on compliance, trying to hire more compliance employees.

But even more important than that is the manager's time is now going towards thinking about compliance and regulation instead of consumers.

The answer, I think, lies in simplifying bank regulations. You could have a simple capital standard, for example, and then, in return for that, you eliminate the other regulations that require a lot more time to think about complying with.

So I think the simple regulations can benefit banks of all sizes, but I think especially small banks will benefit from that chain.

Mr. POLIQUIN. So you do believe that there should be and could be reforms to Dodd-Frank?

Ms. PEIRCE. I believe that reforms are necessary to make the economy work better.

Mr. POLIQUIN. Mr. Mahoney, what do you think?

Mr. MAHONEY. I agree with that.

I have been struck by the number of bankers that I have spoken to from banks of all sizes who now say, "My primary constituent is no longer my customer. It is Washington, D.C."

Mr. POLIQUIN. I hope you folks speak up. You have a tremendous amount of authority and influence here in Washington with your experience in this area. So I hope you speak up. And I am very grateful that you are here today. Thank you.

My time has expired. Thank you. I yield back.

Chairman DUFFY. The gentleman yields back.

I believe that concludes all of our questions for today. I want to thank the witnesses for their testimony, and for taking time out of their busy schedules to provide their insight on this important issue.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Without objection, this hearing is adjourned.

[Whereupon, at 11:08 a.m., the hearing was adjourned.]

A P P E N D I X

May 13, 2015

PREPARED STATEMENT OF PAUL G. MAHONEY

Chairman Duffy, Vice Chairman Fitzpatrick, Ranking Member Green, and members of the committee, I appreciate the opportunity to speak with you about the connection between financial crises and regulatory reforms, a topic I on which I have written at length.

Effective and cost-efficient regulation is essential to the health of financial markets. Unfortunately, the way in which major financial reforms are prepared and enacted works strongly against effective and efficient regulation. Instead, it tends to produce excessively costly regulation that curtails competition and thereby harms investors. While my academic focus is on securities regulation, the same lessons can be applied to the broader financial reforms contained in the Dodd-Frank Act.

Major securities reforms always follow a stock market crash, which accounts for their counterproductive features. Elected officials and regulators are highly motivated to avoid blame for financial downturns that occur on their watch. The easiest way to do so is to claim that the crash was caused by the misbehavior of market participants and that more regulation will solve the problem. Incumbent officials will strongly resist the alternative argument that prior regulations had unintended and adverse consequences, which would put them in line for criticism.

The strategy is effective in part because of the statistical phenomenon of mean reversion, which tells us that because extreme events are rare, one extreme event is not likely to be followed by another. Thus new regulations adopted after a stock market crash will typically not be followed by another stock market crash and therefore will always appear to make things better no matter what their content. This creates a built-in bias toward over-regulation.

The tendency for regulatory proponents to describe the problem as a simple, binary question of "less" or "more" regulation also creates a built-in bias toward regulation that benefits leading firms in the regulated industry at the expense of the public. In the wake of a stock market decline, proponents of new regulation use phrases like "get tough," "crack down," and "hold accountable" that make it sound like regulation is a form of punishment for broker-dealers, banks, or other relevant industries. If so, the only question is how much punishment (in the form of regulation) to apply. But of course this is not accurate; regulation is a set of rules of the road that encourage some business practices and make others illegal or more costly.

Counterintuitively, speaking of regulation as a form of punishment makes it easier for the industry to get what it wants. Regulated firms can publicly hang their heads in shame and "accept" the new regulations while working behind the scenes to shape the rules to make them more costly to new entrants and less politically-connected firms. Under the guise of "best practices," leading firms seek to enshrine their own practices in law at the expense of their competitors. The largest and best-connected firms systematically win.

The Dodd-Frank Act fits this description. It followed a stock market crash that was connected to a broader financial crisis. There are reasonably strong arguments to be made that bad policy contributed to the financial crisis. From 2002 to 2006, monetary policy was looser than a simple Taylor rule would have recommended. Federal housing policies encouraged mortgage lending to borrowers with limited ability to repay in the event of an economic slowdown. And the tendency for the government to step in and protect certain creditors of large insolvent financial institutions from loss under the guise of avoiding systemic effects created enormous moral hazard.

To emphasize the last point, the phenomenon of government-assisted resolution of large and interconnected financial firms that are "too big to fail" seems likely to have contributed to the build-up of risk within the largest financial institutions prior to the subprime crisis. Proponents of the deregulatory theory of the financial crisis point to the fact that banks and other financial institutions grossly underestimated their potential losses from falling house prices because they believed the losses would be uncorrelated across geographical areas and types of borrowers, whereas the phenomena of securitization and credit default swaps helped create highly correlated losses. In short, the financial system created risk rather than mitigating it.

The counterargument is that this buildup of risk was a rational reaction to the "too big to fail" phenomenon. The implicit government guarantee creates a strong incentive for risk to become concentrated in too big to fail institutions. The problem is not just, as many commentators note, that it creates an incentive for big banks to get bigger. It also creates an incentive for the big banks to take risks off the hands of institutions that are not too big to fail.

Shareholders and managers may be willing to take large risks in pursuit of large returns. But short-term creditors and counterparties constrain risk-taking in a well-functioning market. Short-term creditors are typically not obligated to continue funding the debtor after their current loans mature and can refuse to roll over these loans if they believe the debtor has taken on too much risk. Similarly, depending on the contractual terms, counterparties may be able to demand collateral if the debtor's risk profile changes. But these constraints work imperfectly, if at all, with too big to fail banks because short-term creditors and counterparties assume that in the event of failure the bank will be acquired or recapitalized in a way that protects their interests. The typical government-assisted resolution of large financial institutions, which often occurs through a purchase and assumption transaction, protects short-term creditors and counterparties against loss or delay in accessing funds. Once a financial institution appears too big to fail, therefore, there is no need for short-term creditors to monitor it on an ongoing basis.

This fact creates substantial scope for small financial institutions to transfer risks, such as the risk that a bond will decline in value if housing prices fall, to a too big to fail bank. In effect, taxpayers subsidize that transaction, making it attractive to both parties and creating excessive transfers. In the run-up to the financial crisis, the risk of large losses on CDOs and credit default swaps was highly concentrated in several too big to fail institutions. Indeed, one can see the rise of securitization and credit default swaps not as mindless gambling facilitated by lax regulation, but as a purposive and rational attempt to maximize the private benefits of the implicit government guarantee.

In my opinion, this is the best explanation for the severe market reaction to the Lehman bankruptcy. Prior to the bankruptcy announcement, short-term creditors of the largest financial institutions believed there was an unwritten rule that no large and interconnected financial institution would be permitted to go through a regular bankruptcy process (which could delay repayment of short-term credit). Instead, the government would broker, and help finance if necessary, a purchase and assumption or similar transaction. Lehman's bankruptcy filing shattered this belief and woke the short-term creditors of all the too big to fail banks from their slumber, causing them to reduce their exposures and thereby causing immediate liquidity problems at the other too big to fail commercial and investment banks.

But the Dodd-Frank Act's proponents did not, by and large, attach any significant blame for the crisis to the unintended consequences of government attempts to avoid a recession, expand credit to low-income households, and avoid systemic risks. Instead, they chose to argue that the most heavily-regulated markets in the history of capitalism were in fact under-regulated. They did so by focusing on over-the-counter derivatives, which were less regulated than exchange-traded and centrally-cleared derivatives, and on the so-called "shadow banking" system consisting of financial intermediaries that extended credit and often relied on short-term financing but were not regulated as banks.

Choosing to see the origins of the financial crisis in the less-well-lit corners into which regulation had not penetrated deeply rather than in the unintended consequences of prior government policies and actions has important practical consequences. Dodd-Frank doubles down on the notion that large and interconnected financial institutions must be protected from so-called "disorderly" failure, which should lull short-term creditors back to sleep after their brief awakening. The statute puts great faith in the notion that systemic risks can be objectively identified and that the Financial Stability Oversight Council, dominated by bank regulators, will identify those risks and regulate systemically important financial institutions so as to reduce the potential costs they could impose on the rest of the financial system. Finally, it subjects non-bank financial institutions to regulation by the Federal Reserve, which in practice could mean they will be regulated like banks.[1]

A likely competitive consequence of these decisions is that there will be fewer and larger banks in the United States. After the acute phase of the financial crisis but before enactment of Dodd-Frank, Professor Joseph Stiglitz said, in testimony before the Joint Economic Committee, "There is no good case for making the smaller, competitive, community-oriented institutions take the brunt of the down-sizing, as opposed to the bloated, ungovernable, and predatory institutions that were at the center of the crisis."[2] But that is exactly what Dodd-Frank does, by layering on costly new regulations that the large banks can afford but smaller ones cannot. Since Dodd-Frank's enactment, the rate of bank failures has remained high by historical norms, but all of the failures have been of smaller banks, with only a handful having assets in excess of a billion dollars.

The competitive landscape will be altered even more fundamentally if the Federal Reserve imposes bank-like regulation on all large financial intermediaries as it sometimes seems inclined to do. Insurance companies, broker-dealers, private equity funds, and institutional asset managers serve a different purpose than commercial banks and their balance sheets do not look the same as that of a commercial bank. If regulated like banks they will be unable to continue

[1] For simplicity, I refer to "bank" regulation as an umbrella term that includes the Federal Reserve Board's oversight of bank holding companies as well as the functional regulation of commercial banks.
[2] "Too Big to Fail or Too Big to Save?: Examining the Systemic Threats of Large Financial Institutions", Hearing before the Joint Economic Committee, 111th Cong., 1st Sess., April 21, 2009, at 53, 54 (prepared statement of Dr. Joseph E. Stiglitz).

under their existing business models. Instead, they will become banks or be acquired by banks. And the U.S. financial system could then become like the system that Europe is slowly abandoning, in which a handful of large universal banks dominated financial intermediation, bundling commercial and investment banking and asset management. All of this would be very good news for the largest U.S. banks and for the regulatory agencies that oversee them, both of which would become more powerful. But there is no reason to think it would be better for investors, depositors, and taxpayers. And it is exactly the opposite of the model that many Dodd-Frank proponents, including Professor Stiglitz, say they favor, which is a model of smaller, more focused banks. But bank regulators and the Congressional committees that oversee them have a vested interest in expanding bank regulation to more and more financial institutions.

Policy makers' and regulated industries' use of a financial crisis to serve private goals that are not congruent with the public interest is not a new phenomenon. Indeed, we can see the same dynamics at work in prior major securities reforms, including the Sarbanes-Oxley Act and the New Deal financial reforms. Indeed, we can even see the same pattern in England as far back as the bursting of the South Sea Bubble in 1720 and the run on the Bank of England in 1696.

Consider the first of the New Deal financial reforms, the Securities Act of 1933. It has been almost universally hailed as the quintessential example of "good" regulation, but largely because lawyers, economists, and historians have paid insufficient attention to how markets operated before the Securities Act. We lawyers typically describe the Securities Act as a "full disclosure" statute and speak as if public offerings prior to 1933 were made with no disclosure at all. This is simply incorrect. In fact, the Securities Act brought about only modest changes in disclosure practices, a point on which I will elaborate below.

In fact, the statute was in many respects a secrecy statute. As initially enacted, it prohibited any disclosure about a pending offering prior to the filing of a registration statement and any sales efforts before the effective date of that registration statement. While traditionally spoken of as mere technical details of the "full disclosure" apparatus, these features had important consequences that played directly into the hands of the leading investment banks.

During the 1920s, the top investment banks saw their preferred way of doing business undermined and their market share diminished. Prior to that time, the leading investment banks, such as J.P. Morgan & Co. and Kuhn, Loeb & Co., were exclusively wholesalers. They bought newly-issued securities from companies and distributed them through retail broker-dealers. The managing underwriter exercised tight control to prevent competition among those broker-dealers, restricting where, to whom, and at what prices they could sell.

During the 1920s, these syndication practices came under attack by new entrants such as the National City Company that competed for business on the basis of more rapid distribution. They encouraged broker-dealers to fight for business by turning a blind eye to price-cutting or poaching another broker's customers. They also created their own retail distribution networks to help them sell even faster. The result was dramatic—the new entrants took substantial business away from the three leading wholesale houses and by 1928 had displaced them as the top underwriters.

The Great Crash and the Great Depression had a silver lining from the perspective of investment banking's old guard. President Franklin Roosevelt and the Congressional supporters of securities reforms argued that the Great Crash was the result of fraud by investment bankers and stock exchange members and that the Crash was itself the principal cause of the Great Depression. The evidence points strongly against both claims. But they opened the door for all parties to get what they wanted—Roosevelt became President on the strength of his pledge to clean up the financial markets, Congress avoided blame, and the leading investment banks took their ritual punishment during Congressional hearings but simultaneously helped craft the statutes out of the public eye.

The Securities Act reversed the top investment banks' decline by slowing down the offering process and re-establishing firm managing underwriter control over it. Making it illegal to sell a security prior to an "effective date" that could not occur without the managing underwriter's acquiescence guaranteed that retail brokers could not take orders before the managing underwriter gave the OK. The suppression of information prior to registration statement filing ensured that retail brokers were as much in the dark as their customers until the managing underwriter was ready to begin the sales campaign. Any violation of the syndicate agreement described in the statutory prospectus subjected the issuer and syndicate members to potential liability for making a misleading statement. The cumulative effect of these provisions was to resuscitate a firm separation between the wholesale and retail phases of an offering, which had become blurred in the 1920s. This was precisely what the leading investment banks wanted.

The statute accordingly revived the fortunes of the old investment banking aristocracy. They re-established their dominance of the underwriting market while the upstart firms that had taken market share during the 1920s lost business and in some cases disappeared altogether. The result was a loss of competition in the investment banking industry. By my estimate, the Securities Act increased the aggregate market share of the top five investment banks by 12%. And the domination of underwriting by a handful of investment banks became a structural feature of the U.S. securities market.

Major reforms enacted in the aftermath of a financial crisis do not work. What does work? Successful securities law reforms are incremental—that is, they do not try to do too much at one time. They also draw on established legal concepts and terminology, which makes it easier for regulated entities to understand their obligations and for courts to resolve disputes.

The Securities Act again provides an excellent example. I pointed out above that the statute brought about only modest changes to disclosure practices. But these modest changes were the most useful thing in the statute. Prior to the Securities Act, sellers of securities made narrative and financial disclosures about the company's business. But they did not always give investors adequate information about conflicts of interest to which the sellers might be subject.

One obvious issue was underwriting fees and discounts. Investors want to know whether their brokers are recommending investments that generate unusually high fees for the broker. They can determine this in the case of public offerings if the prospectus discloses all commissions and discounts to underwriters and selling group members and all reallowances to broker-dealers. Another conflict arises when corporate insiders are important suppliers or customers of the issuing company, which poses the danger that their dealings with the company will be on less favorable terms to the company than it could receive from independent third parties. Again, disclosure of material contracts and other insider interests reveals these problems.

The lack of conflict of interest disclosures was a problem in both England and the United States from the late nineteenth to the early twentieth centuries. In England, courts fashioned disclosure obligations as a matter of fiduciary duty, but Parliament decided to codify these duties in the Companies Act 1900 and then again in the Companies Act 1929. The United States followed a similar pattern. Investors who thought they had been disadvantaged by conflicts of interest sued under state contract, corporate, or tort law and courts tried to formulate appropriate disclosure standards. This was a messier process than in England because the resulting standards could vary from one state to another. In the Securities Act, Congress followed the English precedent and relied on the Companies Act 1929 as a model. The Securities Act required disclosure of underwriters' and dealers' compensation and insiders' ownership and contractual interests in the company.

Those provisions of the Securities Act were a model of how securities law should be made. Congress took up an issue that had been percolating in state courts and built on the principles that courts and the English Parliament had already established. It was, in short, an incremental reform that used existing legal concepts. The anti-fraud and civil liability provisions of the Securities Act are similar. State law gave a remedy of rescission to a buyer who was defrauded in the sale of a good or service, but jurisdictional and conflicts of law issues along with the basic administrative difficulty of hiring lawyers and maintaining actions in distant places made these remedies less effective than they should have been for purchasers of securities. Congress responded by providing a federal anti-fraud rule and a federal cause of action for misleading statements. One can quibble with Congress's decision to shift various burdens of proof from the buyer to the seller in the Securities Act's civil liability provision, but anyone familiar with contract and fraud law would readily understand the contours of the cause of action.

Congress in 1933 could have stopped there and the Securities Act would have been the most successful regulatory statute in the history of financial markets. But the Securities Act's drafters believed that they needed to do more. So they added detailed micromanagement of the conduct of public offerings. Those provisions took what would have been a clear win for investors and made it arguably a net loss by curtailing competition among investment banks and driving newer, more innovative investment banks out of the market to the benefit of their old, established rivals who won out in the legislative process.

Looking at Dodd-Frank in the same way, we can note that careful observers of the financial markets had been concerned about rising levels of leverage in financial firms for many years before the crisis. A simple and useful reform would have been to rethink capital requirements for commercial banks and their holding companies and to impose appropriate capital requirements on investment banks and other financial intermediaries.

A more ambitious statute could have provided a separate chapter of the bankruptcy code for financial services companies that would have been more tailored to their typical capital structures but still followed the fundamental principle of bankruptcy law that pre-bankruptcy entitlements (such as the contractual right of one creditor to priority over another) are strictly respected. Congress could then have limited the authority of the Federal Reserve and Treasury to engage in ad-hoc resolution of failing financial firms. Both of these reforms would have fit the paradigm of incremental improvements that build on existing legal principles.

Dodd-Frank is nothing like what I've described. It creates multiple new regulatory bodies and confers on them broad discretion untethered to recognized legal concepts. How can a court meaningfully determine whether the Financial Stability Oversight Council has overreached in concluding that a particular non-bank financial firm should be subject to regulation by the Federal Reserve? The standard the FSOC is supposed to apply is whether the firm's activities "could pose a threat to the financial stability of the United States." This has no objectively determinable meaning and so must in practice mean whatever the FSOC wants. The statute also creates a new "orderly liquidation authority" under which the Federal Deposit Insurance Corporation may be appointed receiver of a non-bank systemically important financial institution. The FDIC's mission is to minimize systemic effects rather than to make sure pre-bankruptcy entitlements are protected.

In short, Dodd-Frank is designed in significant part to enhance the regulatory reach of bank regulators. Inevitably, that will mean increasing the size, market share, and political clout of the largest banks. Congress can do better than this and should aim to do so in the future.

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TESTIMONY

THE DODD-FRANK ACT AND REGULATORY OVERREACH

HESTER PEIRCE

Testimony Before the Oversight and Investigations Subcommittee of the Committee on Financial Services of the US House of Representatives

May 13, 2015

Chairman Duffy, Ranking Member Green, and members of the Subcommittee: thank you for the opportunity to appear before you today.

The financial crisis of 2007 to 2009 shook this country deeply. It upended the lives of Americans, many of whom found themselves without jobs and homes. As the crisis unfolded, the desire to do *something* in response was thick in the air in Washington, DC. The general sentiment in favor of action was *not* matched with specifics about what the problems were and how they could best be solved. People were angry and scared and understandably wanted to do what was necessary to prevent a similar crisis from happening again. The hastily crafted response—the Dodd-Frank Wall Street Reform and Consumer Protection Act[1]—does not make another crisis less likely. To the contrary, it sets the stage for another, worse crisis in the future.

Government regulation—from bank regulation to housing policy to credit rating agency regulation—played a key role in the crisis.[2] These policies shaped market participants' behavior in destructive ways. Dodd-Frank continues that pattern.

I will focus on three principal problems of Dodd-Frank:

- First, Dodd-Frank—built on the premise that markets fail, but regulators do not—places great faith in regulators to identify and stop problems before they develop into a crisis. Regulators have an important

1. Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).
2. *See, e.g.*, Emily McClintock Ekins & Mark A. Calabria, *Regulation, Market Structure, and the Role of Credit Rating Agencies* (Cato Policy Analysis, Aug. 1, 2012), *available at* http://object.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf; Arnold Kling, *Not What They Had in Mind* (Mercatus Ctr. at George Mason Univ. Working Paper, Sept. 2009), *available at* http://mercatus.org/sites/default/files/NotWhatTheyHadInMind(1).pdf; Stephen Matteo Miller, *Why Are CDOs and Structured Notes Making a Comeback?*, U.S. News & World Report, June 23, 2014, *available at* http://mercatus.org/expert_commentary/why-are-cdos-and-structured-notes-making-comeback; Russell Roberts, *Gambling with Other People's Money: How Perverted Incentives Caused the Financial Crisis* (Mercatus Ctr. at George Mason Univ. Working Paper, Apr. 28, 2010), *available at* http://mercatus.org/publication/gambling-other-peoples-money; Peter J. Wallison, Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again (2015) (discusses of the role of government regulation in other areas).

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role to play in establishing and maintaining the financial markets' regulatory parameters, but centralizing financial market decision-making in regulatory agencies risks sparking an even deeper future crisis.

- Second, Dodd-Frank, despite language to the contrary, keeps the door open for future bailouts.[3]
- Third, Dodd-Frank includes many provisions that are not related to financial stability, but fails to deal with key problems made evident by the crisis.

The flaws of Dodd-Frank are not surprising; the drafters were working quickly under difficult circumstances without full information. Rather than relying on its own investigative powers, Congress delegated much of the legwork for determining what had gone wrong to the Financial Crisis Inquiry Commission.[4] That commission produced its report six months after Dodd-Frank became law.[5] Commission member Peter Wallison points out in his dissent to that report that "the Commission's investigation was limited to validating the standard narrative about the financial crisis—that it was caused by deregulation or lack of regulation, weak risk management, predatory lending, unregulated derivatives and greed on Wall Street."[6] That popular but inaccurate narrative[7] undergirds Dodd-Frank and continues to misinform debates about whether Dodd-Frank is working.

DODD-FRANK'S DANGEROUS RELIANCE ON REGULATORS

Partly as a matter of expedience, Dodd-Frank's drafters chose to leave many key decisions to regulators. The contours of systemic risk, for example, were left to regulators to define. Moreover, because the prevailing narrative of the crisis focused on market failure, Dodd-Frank expanded regulators' authority to shape the financial system. In addition to their substantial rule-writing responsibilities, under Dodd-Frank regulators now play a central role in monitoring, planning, and managing the financial markets. Relying on regulators in this way is unlikely to prevent another financial crisis and, in fact, threatens to destabilize the financial system.

Dodd-Frank responded to concerns that regulators were not properly coordinating with one another before the crisis with the formation of the Financial Stability Oversight Council (FSOC). Along with the Office of Financial Research (OFR), FSOC reflects an expectation that regulators, working together and armed with adequate information, will be able to spot and respond to "emerging threats to the stability of the United States financial system."[8] OFR and FSOC can play a helpful role in regulatory coordination,[9] standardizing government information collections, and keeping regulators informed of developing trends in the financial markets. No matter how well run, however, OFR and FSOC will never be as effective at collecting, analyzing, and reacting to information

3. These concerns are laid out in more detail in DODD-FRANK: WHAT IT DOES AND WHY IT'S FLAWED (Hester Peirce and James Broughel eds., 2012), *available at* http://mercatus.org/sites/default/files/publication/dodd-frank-FINAL.pdf.
4. Fraud Enforcement and Recovery Act, Pub. L. No. 111-21, § 5, 123 Stat. 1617, 1625–31 (May 20, 2009).
5. FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (Jan. 2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.
6. *Id.* at 452 (Peter J. Wallison, Dissenting Statement).
7. For a graphic illustration of the growth—not decline—of regulation leading up to the financial crisis, *see* Patrick McLaughlin & Robert Greene, *Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank* (Mercatus Ctr. at George Mason Univ., July 19, 2013), *available at* http://mercatus.org/publication/did-deregulation-cause-financial-crisis-examining-common-justification-dodd-frank. *See also* Mark A. Calabria, *Did Deregulation Cause the Financial Crisis?*, 31 CATO POLICY REPORT 1 (July/Aug 2009), *available at* www.cato.org/pubs/policy_report/v31n4/cpr31n4-1.pdf.
8. Dodd-Frank § 112(a)(1)(C).
9. Even with regard to regulatory coordination, there are potential pitfalls. Dodd-Frank's drafters did not adequately consider the implications for the independence of financial regulators of allowing FSOC effectively to force the hand of independent regulators through the issuance of recommendations that demand an agency response. Dodd-Frank § 120. For an example of how this has worked in practice, see Hester Peirce & Robert Greene, *Money Market Maneuvering* (Mercatus Ctr. at George Mason Univ. Expert Commentary, Sept. 19, 2012), *available at* http://mercatus.org/expert_commentary/money-market-maneuvering.

as competitive markets.[10] Instead, if the existence of these super-regulators provides false confidence, FSOC and OFR could be detrimental to financial stability.

Dodd-Frank gives FSOC broad powers to designate nonbank financial institutions and financial market utilities (such as derivatives clearinghouses) systemically important.[11] These systemically important entities are subject to special regulatory oversight. Upon designation, the Board of Governors of the Federal Reserve System steps in to supervise the designated nonbank financial institutions alongside their existing regulators.[12] The Federal Reserve Board also plays a primary or backup role in regulating designated financial market utilities.[13]

Dodd-Frank thus empowers FSOC to create a two-tier system—systemically important entities are subject to an additional layer of regulation, but they are also likely to enjoy funding and competitive advantages. It is too early to tell whether the additional regulatory costs will outweigh the benefits to designated firms. Designated firms are likely to be perceived as the firms the government is likely to rescue, should that be necessary.

In addition to its new responsibility for systemically important nonbanks, Dodd-Frank otherwise expands the role of the Federal Reserve Board. It has supervisory authority over, among others, a large array of bank holding companies, savings and loan holding companies, and insurance companies.[14] FSOC is looking closely at the asset management industry, so the Board's supervisory mandate could expand further.

A consequence of the Federal Reserve Board's broad authority over a wide range of institutions is homogenization across the financial industry. Although the Board likely will make some adjustments to accommodate industry differences, similar liquidity, capital, and risk management requirements could lead firms to hold similar assets. This homogenization could increase the likelihood that a problem at one firm would spread to other firms. Stress testing and resolution plans may further enforce a system-wide uniformity, which could prove harmful, particularly in a time of market stress.

Dodd-Frank stress testing and resolution planning, while useful mechanisms to help firms identify and plan for potential difficulties, can also be a dangerous distraction. Regulated firms may divert resources from their own risk management efforts to respond to regulatory stress tests, revise resolution plans, and comply with other regulatory demands. Firms can tailor their risk management programs to their unique circumstances and risks, while regulators are likely to employ more standardized approaches that are comparable across multiple firms. Firm-specific information is likely to be missed.

Firms' ability to act to safeguard themselves is further constrained by regulators' post–Dodd-Frank embrace of macroprudential regulation. Under this approach, regulators think holistically about the financial system;[15] they

10. Friedrich A. Hayek's explanation in his Nobel Prize lecture makes the point:

> We are only beginning to understand on how subtle a communication system the functioning of an advanced industrial society is based—a communications system which we call the market and which turns out to be a more efficient mechanism for digesting dispersed information than any that man has deliberately designed.

Friedrich A. Hayek, *Nobel Prize Lecture: The Pretence of Knowledge* (Dec. 11, 1974), *available at* http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html.

11. In addition to designated financial market utilities, the "SIFIs" designated to date are American International Group, GE Capital, Prudential, and MetLife. FSOC, Designations, http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank (last visited May 6, 2015).

12. Dodd-Frank §§ 113 and 115.

13. Dodd-Frank § 805.

14. *See, e.g.*, Bipartisan Policy Center, *How the Federal Reserve Became the De Facto Insurance Regulator* (July 30, 2014), *available at* http://bipartisanpolicy.org/blog/how-federal-reserve-became-de-facto-federal-insurance-regulator/; Hester Peirce & Robert Greene, *The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank* (Nov. 13, 2013), *available at* http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank.

15. *See, e.g.*, Andrew Crockett, General Manager, Bank for International Settlements, Chairman, Financial Stability Forum, *Marrying the Micro- and Macro-prudential Dimensions of Financial Stability, Remarks Before the Eleventh International Conference of Banking Supervisors* (Sept. 21, 2000) (transcript available at http://www.bis.org/speeches/sp000921.htm). Crockett explains, "To bring out

may override a firm's decision, for example, to protect itself from exposure to a counterparty, if they believe that the counterparty should be protected. Thus, firms are hamstrung in their efforts to protect themselves. This macroprudential approach places too much confidence in the regulators to always get things right, and it inhibits market mechanisms from responding organically to problems as they arise. The last crisis taught us that regulators do not always get things right, and markets absorbed in regulatory compliance are very poor at disciplining themselves. The result is a less stable financial system.

DODD-FRANK'S OPEN DOOR TO BAILOUTS

Dodd-Frank was supposed to mark the end of taxpayer bailouts of financial firms. This pledge is undermined in several ways by the statute's other provisions and the regulatory-centric approach that cuts across the whole statute.

First, the intensive, post-Dodd-Frank role that regulators are playing in managing financial stability means that when there is a problem, firms will feel justified in asking the regulators that caused—or at least did not prevent—those problems to bail them out. The pressure on regulators to conduct bailouts is likely to be particularly strong with respect to systemically important institutions. By announcing that these institutions are important to the financial system, the government implies that it will step in to prevent them from failing.

Second, Title II of Dodd-Frank establishes the Orderly Liquidation Authority (OLA) as an alternative to bankruptcy for financial institutions. Regulators have broad discretion to choose this alternative to wind down troubled financial companies. Once regulators have decided that a company will be resolved under the OLA, the company or its creditors have little power to prevent the use of this alternative, and the Federal Deposit Insurance Corporation (FDIC) has broad authority to manage this alternative resolution process. Depending on how the FDIC exercises its authority, the OLA could be used to bail out favored creditors of the company.[16]

Another key pillar of Dodd-Frank that raises the possibility of a future bailout is Title VII, which imposes a detailed regulatory framework on the over-the-counter derivatives markets. The new regime forces many derivatives into central counterparties (also known as clearinghouses). As a result, large financial firms will no longer be exposed to one another through these derivatives transactions, but to the clearinghouse. The hope is that these clearinghouses will be consistently strong counterparties, even during a period of financial stress. Dodd-Frank makes the already difficult task of managing clearinghouses more difficult by increasing the number and type of products they must clear and constraining the steps they can take to manage their risk. Failing clearinghouses would be likely candidates for bailouts because of their central role in the financial system and ties to large financial firms. Dodd-Frank allows for the possibility of a bailout by authorizing the Board of Governors to give systemically important clearinghouses access to the discount window and deposit account and payment services.[17]

The Board of Governors also retains its emergency lending authority under section 13(3) of the Federal Reserve Act, which it used to bail out American International Group. Dodd-Frank pared back this authority by requiring any lending to be through a broad-based program rather than an institution-specific program.[18] This limitation will not serve as a much of a constraint on emergency lending unless it is also paired with other limitations, such as tighter solvency requirements.[19]

the contrast, think of the financial system as a portfolio of securities, i.e., the individual institutions. The macro-prudential perspective would focus on the overall performance of the portfolio; the micro-prudential vision would give equal and separate weight to the performance of each of its constituent securities."

16. Dodd-Frank § 214 prohibits taxpayer losses under the OLA, but the opacity of the process will make this difficult to enforce.

17. Dodd-Frank § 806. For a discussion of the implications of this authority, *see* Norbert J. Michel, *Financial Market Utilities: One More Dangerous Concept in Dodd-Frank* (Heritage Found. Backgrounder, Mar. 20, 2015), *available at* http://www.heritage.org/research/reports/2015/03/financial-market-utilities-one-more-dangerous-concept-in-doddfrank.

18. Dodd-Frank § 1101.

19. The Board of Governors has proposed, but not adopted, a rule, as required by Dodd-Frank, to "prohibit borrowing from programs and facilities by borrowers that are insolvent." Dodd-Frank § 1101(a) [amending 12 U.S.C. § 343(3)(B)(ii)]. Commenters are concerned

DODD-FRANK'S MISPLACED FOCUS

As further evidence that Dodd-Frank does not effectively shore up financial stability, it covers the wrong topics. On the one hand, Dodd-Frank fails to deal with issues central to the last crisis. On the other hand, many Dodd-Frank provisions have nothing to do with addressing the past crisis or averting a future financial crisis.

An issue central to the crisis—the government's role in housing finance—is almost entirely absent from Dodd-Frank. Fannie Mae and Freddie Mac remain intact in conservatorship. Dodd-Frank deferred the issue by directing the Secretary of the Treasury to conduct a study of reforming the housing finance system.[20] Congress missed an opportunity to address the government's role in housing finance, and the government continues to crowd out the private market in this space.[21]

Items unrelated to the crisis got more pages in Dodd-Frank than housing finance, even though the consequences of some of these provisions were not fully evaluated. An egregious example is the conflict minerals provision, which requires the Securities and Exchange Commission (SEC) to draft rules governing disclosure by public companies of their use of minerals such as coltan, cassiterite, gold, and wolframite.[22] A similar example is a provision requiring public companies that engage in resource extraction to disclose payments made to further commercial development.[23] Both provisions are costly to public companies (and, by extension, their shareholders) and have consumed considerable SEC resources.[24] Neither relates to the stability of the financial system.

Another provision unrelated to financial stability authorizes the SEC to introduce a fiduciary duty for broker-dealers.[25] The debate over the proper standard of conduct for broker-dealers working with retail customers, particularly as it compares to the standard for investment advisers, predates the financial crisis.[26] The controversial issue warrants careful congressional consideration because its resolution will affect many retail investors. The issue did not get adequate attention since it was only a small part of the much larger Dodd-Frank deliberations and was not a contributor to the crisis.

CONCLUSION

As the failures and bailouts of the financial crisis accumulated, so too did the calls for a quick and thorough rewriting of the financial regulatory rulebook. The resulting Act was the product of fear and fury, not of careful analysis. Grounded in an inaccurate market failure narrative, Dodd-Frank expands regulators' authority to enable them to play a more central role in managing the financial system and identifying and mitigating systemic risks. This approach to financial regulation, while a natural response to a market failure narrative, only increases the vulnerability of financial system to regulatory failure.

that the Board's proposed approach is too lax. *See, e.g.*, Marcus Stanley & Mark Calabria, *Fed Proposal to End Bailouts Falls Short*, The Hill, Congress Blog, July 24, 2014, *available at* http://thehill.com/blogs/congress-blog/economy-budget/213175-fed-proposal-to-end-bailouts-falls-short.

20. Dodd-Frank § 1074. That report came out in February 2011. Department of the Treasury and Department of Housing and Urban Development, Reforming America's Housing Finance Market: A Report to Congress (Feb. 2011).

21. At the end of 2014, the Congressional Budget Office reported that, through Fannie Mae, Freddie Mac, and the Federal Housing Administration, "the federal government now directly or indirectly insures over 70 percent of all new residential mortgages." Congressional Budget Office, Transitioning to Alternative Structures for Housing Finance, at 2 (Dec. 2014), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/49765-Housing_Finance_0.pdf.

22. Dodd-Frank § 1502 [15 U.S.C. § 78 m].

23. Dodd-Frank § 1504 [15 U.S.C. § 78 m].

24. *See, e.g.*, Daniel M. Gallagher, Commissioner, SEC, The Importance of the SEC's Rulemaking Agenda—You Are What You Prioritize, Remarks at the 47th Annual Securities Regulation Seminar of the Los Angeles County Bar Association (Oct. 24, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543283858.

25. Dodd-Frank § 913 [15 U.S.C. §78 o note].

26. For example, the SEC commissioned a study in 2006 of how investment advisers and broker-dealers interact with their customers. *See* Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (RAND Inst. for Civil Justice Report 2008), *available at* https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

Regulatory failure played an important role in the last crisis by concentrating resources in the housing sector, encouraging reliance on credit-rating agencies, and driving financial institutions to concentrate their holdings in mortgage-backed securities. Dodd-Frank gives regulators more authority and broad discretion to shape the financial sector and the firms operating within it. When the regulators fail at this ambitious mission, they will again face internal and external pressure to cover those failures with a taxpayer-funded bailout.

Appendices to Testimony

1. Hester Peirce, "No, Mr. Tarullo, We're Not All Macroprudentialists Now," *Real Clear Markets*, February 25, 2015.

2. Hester Peirce, "Dodd-Frank Most Likely to Be at the Root of a Future Crisis," *Real Clear Markets*, January 14, 2015.

3. Hester Peirce, "A New Congress Must Perform Major Surgery on Dodd-Frank," *Real Clear Markets*, November 19, 2014.

4. Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank" (annotated infographic, Mercatus Center at George Mason University, November 2013)

5. Patrick McLaughlin and Robert Greene, "Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank" (chart, Mercatus Center at George Mason University, July 19, 2013)

6. CV for Hester Peirce

7. Truth in Testimony

EXPERT COMMENTARY

No, Mr. Tarullo, We're Not All Macroprudentialists Now
Real Clear Markets
By Hester Peirce | Feb 25, 2015

Federal Reserve Governor Daniel Tarullo began a speech last month by saying, "Standing in front of this audience I feel secure in observing that we are all macroprudentialists now." Having been a member of that audience, I can assure Mr. Tarullo that his statement was inaccurate. Macroprudentialists' intensifying focus on the asset management industry offers the latest glimpse into how such an approach could undermine financial stability.

Mr. Tarullo explained that the macroprudential approach to regulation "focuses on the financial system as a whole, and not just the well-being of individual firms." Regulators are central to the macroprudential approach; only they have the breadth of vision to know how and when-for the good of the collective-to override careful decisions made by individual firms.

The focus of Mr. Tarullo and other macroprudentialists has turned most recently to the asset management industry. Asset managers include the investment advisers and mutual fund companies that manage the investment portfolios of institutions and households. Asset managers control a lot of money-$63 trillion according to a recent speech by Mary Jo White, chair of the Securities and Exchange Commission, which oversees the asset management industry.

Ms. White's colleagues on the Financial Stability Oversight Council-a collection of top financial regulators-are not confident that SEC oversight is adequate. The FSOC and its international cousin-the Financial Stability Board-are on the lookout for particular asset managers and asset management activities that might put the financial system at risk. Dodd-Frank gives the FSOC authority to make recommendations to the SEC about how it should regulate the asset management industry. The FSOC also can designate asset managers for regulation by the Federal Reserve.

The FSOC is soliciting input on a document that runs through worst-case scenarios in asset management. What if asset managers don't manage their funds "in a way that prevents or fully mitigates the risks to the investment vehicle and the broader financial system"? What if asset managers are forced to conduct fire sales, which could drive asset prices down? What if a key industry service provider goes out of business?

The risks the FSOC described pale in comparison to the risks it could create by adding a new macroprudential regulatory layer to asset management. Attempts to centrally mitigate risk likely would create new risks by narrowing the differences in the way assets are managed. There are thousands of asset managers and mutual funds. Even very large mutual fund complexes employ many managers, each of whom takes her own approach to investing. More prescriptive regulation will eat away at that system-strengthening diversity.

Mr. Tarullo envisions a macroprudential regime that "builds on the traditional investor protection and market functioning aims of securities regulation by incorporating a system-wide perspective." Asset managers will have the impossible task of balancing their fiduciary duties to their own funds and investors with regulatory obligations to do what's best for their competitors and the rest of the financial system.

Using tools like stress tests and liquidity requirements, regulators would corral asset managers into similar strategies, assets, and risk management techniques. If regulators make bad choices, the entire industry will be affected. But even if regulators make good choices, making asset managers follow a single formula makes it more likely that the actions of one manager-such as asset sales to meet redemptions-would reverberate throughout the industry.

Moreover, as bank regulators play an increasingly central role in regulating asset managers, the differences that distinguish the banking industry from the asset management industry will start to disappear. Shocks will more easily transmit across the entire financial sector. Imagine the scene as banks and asset managers all fight during a crisis for the safe assets that their common regulatory frameworks permit. When problems arise, taxpayer money will flow to all macroprudentially regulated corners as regulators seek to mask their mistakes.

Regulators are not wrong to think about the stability of the whole financial system. They are wrong, however, to assume that centralized risk management will foster systemic stability. Instead, it will introduce new

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vulnerabilities into the financial system. These vulnerabilities likely will manifest themselves when the financial system is already under stress. Rather than seeking to extend macroprudential regulation, regulators should emphasize microprudential responsibility. Asset managers, governed by their legal responsibilities to their clients, need to plan for bad events. This is not a task that can be outsourced to government regulators.

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Dodd-Frank Most Likely To Be At the Root Of a Future Crisis
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In an **op-ed** last week, Treasury Secretary Lew defended Dodd-Frank against efforts by the new Congress to reform the financial law. In his view, changing-or even suggesting changes to-Dodd-Frank seems to be tantamount to inviting another financial crisis. Far from being the cornerstone of a new era of financial stability, however, Dodd-Frank is more likely to be at the root of a future crisis.

Secretary Lew argues that Dodd-Frank has "made our financial system safer and more resilient, and consumers, investors and taxpayers are now protected from the types of abuses that helped cause the crisis." Before we kick back and enjoy this new Dodd-Frank era of financial stability, let's take a closer look at whether the new financial regime will work.

Dodd-Frank builds upon the crisis prevention mechanisms that failed us last time. Contrary to the deregulation mythology, the financial industry was **highly regulated** prior to the crisis. Some of those regulations gave banks a financial incentive to invest in securities that ran into deep trouble during the crisis. Others encouraged financial institutions to make loans to borrowers that would have difficulty repaying. Still other regulations caused investors to rely on credit ratings rather than looking at underlying credit quality. Meanwhile, the industry's many regulators failed to identify building problems at the financial institutions under their watch.

Dodd-Frank's approach to financial stability simply intensifies the pre-crisis dependence on governmental regulators to shape the financial industry through regulatory prescription and proscription. In weakening the ability of market participants to make their own decisions, the law makes it less likely they will reap the consequences of bad decisions. I.e., If regulators are pulling most of the strings, the industry will expect a taxpayer bailout if there is a problem.

Dodd-Frank puts regulators in the driver's seat in numerous ways. Under Title I of the Act, for example, the Federal Reserve makes decisions regarding risk-based capital, liquidity, concentration, and risk-management at systemically important firms. Under Title II of the Act, regulatory whim is enough to force a company to be wound down outside of the standard bankruptcy process. Under Title VII of Dodd-Frank, regulators decide whether, how, and where over-the-counter derivative products are traded and cleared. The Consumer Financial Protection Bureau, established by Title X of the Act, has changed the mix of products that financial services firms offer to consumers.

Enhancing regulatory powers may seem like a good way to prevent people at financial companies from doing stupid or greedy things. Regulators, however, also do stupid and greedy things. The stakes are higher when regulators make mistakes because regulatory influence is not limited to one firm.

If a firm relies on a flawed model to estimate its vulnerabilities or incompetent risk managers to assess a new product, it might get itself into trouble. It will lose money, and the responsible individuals may lose their jobs. If allowed to fall on the responsible parties, such consequences breed a healthy caution.

When regulators apply a flawed model to assess firms' resilience or give their blessing to a bad product, they can put an entire industry or the whole financial system at risk. Widespread failure, government bailouts, and calls for yet more regulation are likely to follow. That's what happened in the last crisis, and we got Dodd-Frank, which only intensifies our regulatory addiction.

Dodd-Frank supporters take comfort in the fact that the regulatory powers are now housed in purportedly more capable hands than they were prior to Dodd-Frank. For example, the Office of Thrift Supervision (OTS)-AIG's much maligned consolidated regulator (meaning the regulator charged with overseeing the whole company, as opposed to an individual piece of it) is gone. The Fed is AIG's replacement consolidated regulator.

A recently released **redacted report** by the Fed's Office of Inspector General in connection with the Fed's failure to prevent JPMorgan's notorious "London Whale" derivatives losses a couple years ago illustrates the Fed's susceptibility to the same the problems that plagued the OTS. The Inspector General explains that the New York Fed-JPMorgan's consolidated supervisor-ran into a number of problems during the critical time period that prevented it from stopping the Whale. Among these, the New York Fed was busy with other

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priorities. It made significant structural changes to the way it oversaw large financial institutions. The team overseeing JPMorgan changed, and the institution-specific knowledge was not transferred to the new team. The New York Fed's coordination with JPMorgan's primary supervisor, the Office of the Comptroller of the Currency, was lousy. As a result of these problems, the New York Fed did not follow up on the Whale-related concerns it identified.

The New York Fed's problems in overseeing JPMorgan were remarkably similar to the OTS's **AIG oversight challenges**. OTS identified AIG's derivatives unit as a potential source of problems, but failed adequately to follow up. The OTS faced competing priorities, structural changes to its large firm consolidated supervision program, changing team members, inadequate knowledge transfer, and poor coordination with other regulators.

The New York Fed pledges to correct the problems identified by the Inspector General, but reform efforts will be no match for human and organizational obstacles to perfect monitoring. There's a better way than relying on regulators to get their supervisory houses in order. Faced with the fear of losing their own money, we should look to the AIGs and JPMorgans of the world and their creditors to watch for problems. As long as Dodd-Frank stands in the way of this natural form of supervision by promising to keep companies up and running through regulatory measures, the financial system is at great risk.

Hand-wringing over tweaks to Dodd-Frank is warranted, but not because the tweaks will destroy an effective law. The real cause for concern is that these tweaks are inadequate to address the fundamental flaw at the heart of Dodd-Frank-the displacement of market discipline by regulatory oversight. Tweaking the law-if done properly-can help to lessen the law's costs and unintended consequences, but only more sweeping changes will stop Dodd-Frank from undermining the nation's financial stability.

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EXPERT COMMENTARY

A New Congress Must Perform Major Surgery On Dodd-Frank

Real Clear Markets

By Hester Peirce | Nov 19, 2014

In the four years since the passage of Dodd-Frank, the financial regulators have written a lot of new rules. Throughout the implementation period, at least one of the chambers of Congress has been under the control of the party that passed Dodd-Frank. Agencies therefore have been spared some painful scrutiny of their Dodd-Frank implementation programs. This month's election changed that, and agencies are likely to face a lot more uncomfortable oversight in the upcoming Congress. But the new Congress, not as wedded to Dodd-Frank as its predecessors, could also make life more bearable for regulators by eliminating some of Dodd-Frank's extraneous statutory mandates.

The Securities and Exchange Commission is a prime candidate for mandate trimming. Dodd-Frank assigned the SEC responsibilities that are far from its core mission. For example, Dodd-Frank directed the SEC to require companies to assess and report their use of minerals tied to the violence in and around the Democratic Republic of the Congo. Companies have spent many hours and dollars trying to identify whether they are using minerals that fund the conflict, but the task appears to be futile. The Department of Commerce recently published a **list** of facilities that process the minerals at issue, but stated that it could not determine "whether a specific facility processes minerals that are used to finance conflict in the Democratic Republic of the Congo or an adjoining country." In other words, the government cannot do what it is asking companies to do.

Another mandate that imposes tremendous burdens on the SEC and companies without proportionate benefit for investors is the so-called pay ratio rule. Under Dodd-Frank, the SEC is working on the rule, which requires companies to disclose the ratio of their median employee compensation to the CEO's pay. Writing such a rule might be a simple task if all companies had no more than ten full-time employees working in a single location, but it is quite a bit more complicated to write such a rule for multinational companies that employ thousands of employees working a mix of full- and part-time schedules.

The conflict mineral and pay ratio mandates do not further the SEC's tripartite mission-protecting investors; facilitating capital formation; and maintaining fair, orderly, and efficient markets. Rather they distract from the considerable work the SEC has to do in these areas. For example, the economy's precarious health depends on the ability of financial markets to direct investable funds to the parts of the economy that need it most. Would-be entrepreneurs and growing small businesses face many obstacles to getting the money they need-obstacles that the SEC could work on removing if it were not so preoccupied with pointless Dodd-Frank mandates.

The Financial Stability Oversight Council is another agency that could use some congressional refocusing. The FSOC, a creation of Dodd-Frank, had the potential to play the important role of bringing regulators together to share information, ideas, and concerns about the financial system. Congress, however, loaded the agency down with the responsibility of identifying companies that are systemically important. This function has absorbed considerable regulatory time and has caused undue angst in the market; designated companies will face substantial regulatory costs and are likely candidates for future taxpayer bailout. If Congress were to eliminate this responsibility, the FSOC could focus on the more important task of bringing regulators together to think holistically about financial system regulation. Eliminating the designation exercise would have the added benefit of preventing the emergence of a new category of too-big-to-fail entities.

Removing the FSOC's power to designate also would free the Federal Reserve of the responsibility of regulating entities like insurance companies about which it has no expertise. Congress could further refocus the Fed on its role as a lender of last resort by quashing the Fed's Dodd-Frank-fueled ambitions of being the regulator of last resort. The Fed will be able to focus on its core central bank functions if Congress shifts its regulatory responsibilities to other bank regulators.

Regulators are not looking forward to heightened congressional oversight of their activities, but the new Congress offers them something to offset the pain. Unencumbered by having voted for Dodd-Frank, the incoming Congress can jettison unnecessary statutory mandates so that agencies can get back to their core missions.

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THE FEDERAL RESERVE'S EXPANDING REGULATORY AUTHORITY INITIATED BY DODD-FRANK

BY HESTER PEIRCE AND ROBERT GREENE

November 2013

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THE FEDERAL RESERVE'S EXPANDING
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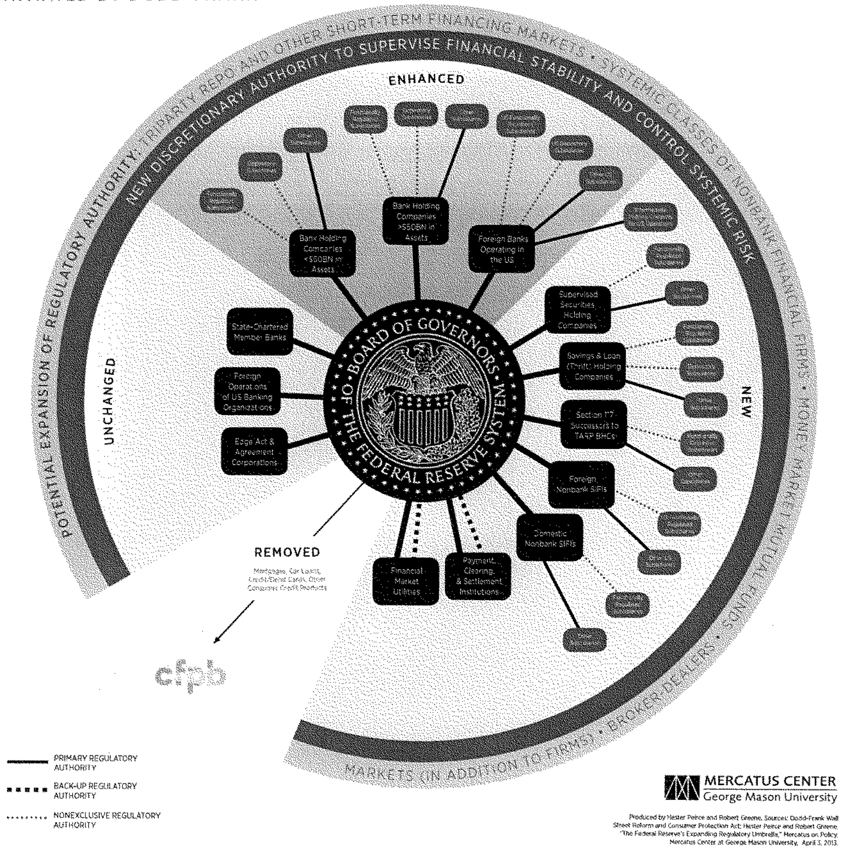

2 THE FEDERAL RESERVE'S EXPANDING REGULATORY AUTHORITY INITIATED BY DODD-FRANK

INFOGRAPHIC EXPLAINED

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) significantly expanded the regulatory authority of the Federal Reserve Board of Governors (the Board) over banking institutions, financial firms, and their subsidiaries.

Dodd-Frank **enhanced** the Board's authority over bank holding companies (BHCs), foreign banks, and subsidiaries of these entities.

Dodd-Frank gave the Board **new authority** over several types of institutions. The Board now has direct or back-up authority over certain financial market utilities (FMUs) and payment, clearing, and settlement institutions designated as systemically important by the Financial Stability Oversight Council (FSOC), an entity created by Dodd-Frank. It also now has authority over nonbank firms "predominantly engaged in financial activities" that are designated as systemically important financial institutions (SIFIs) by the FSOC, including subsidiaries of these firms. Authority to regulate thrift holding companies, supervised securities holding companies, and the subsidiaries of these entities was also transferred to the Board.

Dodd-Frank **removed** some of the Board's regulatory authority, primarily its supervisory authority over consumer credit products such as mortgages, car loans, credit/debit cards, etc. This authority was transferred to the newly created Bureau of Consumer Financial Protection (CFPB).

Dodd-Frank left **unchanged** the Board's regulatory authority over state-chartered member banks, foreign operations of US banking organizations, and Edge Act and agreement corporations.

The Board's mandates are overlaid with a new responsibility for the stability of the US financial system.

The chart above depicts the growth of the Board's regulatory powers. Below is an overview of the main ways in which Dodd-Frank augments the Board's regulatory authority.

ENHANCED AUTHORITY

Bank Holding Companies (BHCs)

- Expands the Board's examination capacities over, and requires that **BHCs** serve as a source of strength for, depository subsidiaries.[1]
- Broadens the Board's ability to write rules for, impose reporting obligations on, examine the activities and financial health of, and bring enforcement actions against subsidiaries, including functionally regulated subsidiaries (those already regulated by the SEC or the Commodity Futures Trading Commission (CFTC) and state-regulated entities).[2]
- Requires the Board to examine certain activities of subsidiaries that do not have another financial regulator.[3]
- Subjects **BHCs with $50 billion or more in assets** to "more stringent" prudential standards including liquidity and risk-based capital requirements, leverage limits, risk-management requirements, resolution plan and credit exposure report requirements, and limits on credit exposure; grants Board authority to impose other heightened prudential standards, including contingent capital requirements, enhanced public disclosures, and short-term debt limits.[4]

Foreign Banks Operating in the US

- Broadens the Board's authority to impose prudential regulations, such as liquidity and risk-based capital requirements, leverage limits, and risk-management requirements on large **foreign banks operating in the US.**[5] As part of implementing this authority, the Board proposed to require large foreign banks with a significant US presence to form intermediate holding companies to consolidate US operations for easier Board oversight.[6]

NEW AUTHORITY

Discretionary Authority to Supervise Financial Stability and Control Systemic Risks

- Expands the Board's discretionary authority with a nebulous mandate to consider risk to the financial system in different contexts, such as examinations, merger and acquisition approvals, and divestitures.[7]

Supervised Securities Holding Companies

- Provides the Board consolidated supervision authority over companies that own or control one or more SEC-registered brokers or dealers.[8] Authority reaches subsidiaries, including functionally regulated subsidiaries.[9]

- Ensures, as implemented by the Board, that a supervised holding company will "be supervised and regulated as if it were a bank holding company."[10]

Section 117 Successors to Troubled Asset Relief Program (TARP) BHCs

- Ensures the Board retains regulatory authority over BHCs with more than $50 billion in assets as of January 1, 2010, that participated in the Capital Purchase Program under TARP. Section 117 of Dodd-Frank directs the Board to treat these firms like designated nonbank SIFIs if they cease to be BHCs.[11]

Savings and Loan (Thrift) Holding Companies

- Shifts regulatory authority over these companies from now defunct Office of Thrift Supervision to the Board.[12]

- Requires that **thrift holding companies** serve as a source of strength for depository subsidiaries.[13]

- Grants the Board ability to write rules for, impose reporting obligations on, examine the activities and financial health of, and bring enforcement actions against thrift holding company subsidiaries, including functionally regulated subsidiaries.[14]

- Requires the Board to examine certain activities of otherwise unregulated subsidiaries.[15]

Foreign/Domestic Nonbank SIFIs

- Subjects nonbank companies "predominantly engaged in financial activities" and designated as **SIFIs** by the FSOC because they could pose "a threat to the financial stability of the United States" to prudential standards, including liquidity and risk-based capital requirements, leverage limits, risk-management requirements, resolution plan and credit exposure report requirements, and limits on credit exposure.[16]

- Gives the Board the ability to write rules for, impose reporting obligations on, examine the activities and financial health of, and bring enforcement actions against subsidiaries, including functionally regulated subsidiaries.[17]

FMUs and Entities Engaged in Payment, Clearing, and Settlement Activities

- Subjects designated **FMUs** and financial **institutions engaging in payment, clearing, and settlement activities** determined by the FSOC to be or likely to become "systemically important" to enhanced regulatory standards—for example, rules that govern risk-management policies, margin and collateral requirements, and counterparty default policies and procedures.[18] The Board has direct authority or—in the case of FMUs and financial institutions regulated by the SEC or CFTC—back-up authority.[19]

REMOVED AUTHORITY

Mortgages, Car Loans, Credit/Debit Cards, and Other Consumer Credit Products

- Transfers authority to regulate these products to the **CFPB**.[20] The Bureau is officially independent from the Board, but it is technically housed within and funded by the Federal Reserve System.[21]

UNCHANGED AUTHORITY

- The Board continues to supervise and regulate **state-chartered member banks** of the Federal Reserve System.

- Dodd-Frank did not alter the Board's supervisory authority over **Edge Act and agreement corporations**, which are chartered by the Board and states respectively to engage in international banking transactions.

- Dodd-Frank also did not affect the Board's oversight of **domestic banks' foreign operations.**

POTENTIAL EXPANSION OF REGULATORY AUTHORITY

The Federal Reserve's performance as a regulator in the years leading up to the 2007–08 crisis earned it widespread criticism. Dodd-Frank, instead of responding to these criticisms, greatly enhanced the Fed's regulatory authority. Recent comments by Federal Reserve officials indicate an institutional eagerness to expand this authority further into all corners of the financial markets, even those already overseen by other regulators.

Triparty Repo Markets

Federal Reserve System officials have highlighted the Federal Reserve's efforts with respect to the triparty repurchase agreement ("repo") markets and have expressed a desire for additional authority over these markets. One potential idea includes creating a liquidity facility with a government backstop and attendant prudential regulation by the Board.

> A second phase of triparty reform is now underway, with the Federal Reserve using its supervisory authority to press for further action not only by the clearing banks, who of course manage the settlement process, but also by the dealer affiliates of bank holding companies, who are the clearing banks' largest customers for triparty transactions. But this approach alone will not suffice. All regulators and supervisors with responsibility for overseeing the various entities active in the triparty market will need to work together to ensure that critical enhancements to risk management and settlement processes are implemented uniformly and robustly across the entire market, and to encourage the development of mechanisms for orderly liquidation of collateral, so as to prevent a fire sale of assets in the event that any major triparty market participant faces distress.[22]
>
> *—Daniel Tarullo, Governor, Federal Reserve Board. Speech at the Conference on Challenges in Global Finance, June 12, 2012*

> One could imagine a mechanism that was funded by tri-party repo market participants and potentially backstopped by the central bank. . . . Because no single market participant has a strong incentive to develop such a mechanism, however, sustained regulatory pressure may be required to reach such a solution.[23]
>
> *—William Dudley, President, Federal Reserve Bank of New York. Speech at New York Bankers Association's 2013 Annual Meeting and Economic Forum, Feb. 1, 2013*

Other Short-term Securities Financing

Other short-term securities financing transactions, besides triparty repo transactions, have been targeted by Federal Reserve officials for further regulation.

> A major source of unaddressed risk emanates from the large volume of short-term securities financing transactions (SFTs)—repos, reverse repos, securities borrowing and lending transactions, and margin loans--engaged in by broker-dealers, money market funds, hedge funds, and other shadow banks. . . . SFTs, particularly large matched books of SFTs, create sizable macroprudential risks, including large negative externalities from dealer defaults and from asset fire sales. The existing bank and broker-dealer regulatory regimes have not been designed to materially mitigate these systemic risks.[24]
>
> *—Janet Yellen, Vice-Chairman, Federal Reserve Board. Speech at the International Monetary Conference, June 2, 2013*

Systemic Classes of Nonbank Financial Firms

Governor Daniel Tarullo views "systemic classes" of nonbank financial firms as a source of potential threats to financial stability and has expressed the belief that additional regulatory oversight is needed.

> The threats to financial stability from the shadow banking system do not reside solely in a few individual nonbank financial firms with large systemic footprints. Significant threats to financial stability emanate from systemic classes of nonbank financial firms and from vulnerabilities intrinsic to short-term wholesale funding markets. . . . we need to increase the transparency of shadow banking markets so that authorities can monitor for signs of excessive leverage and unstable maturity transformation outside regulated banks. Since the financial crisis, the ability of the Federal Reserve and other regulators to track the types of transactions that are core to shadow banking activities has improved markedly. But there remain several areas, notably involving transactions organized around an exchange of cash and securities, where gaps still exist.[25]
>
> *—Daniel Tarullo, Governor, Federal Reserve Board. Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, July 11, 2013*

Money Market Mutual Funds (MMMFs)

Many Federal Reserve officials have called for further reform of money market funds.[26] Eric Rosengren, president of the Federal Reserve Bank of Boston, has been one of the most outspoken. By emphasizing financial stability—now part of the Board's mandate—Rosengren suggests that money market funds ought to be within the Board's regulatory sphere.

> Prime MMMFs remain a very important source of financing for short-term debt instruments—and thus any disruption in the MMMF sector could again impede the provision of stable funding to financial intermediaries. Many of the tools used to offset the 2008 run by MMMF investors have been ruled out by legislation. And once again, some MMMFs are beginning to take riskier positions. Thus, the financial stability concerns surrounding MMMFs remain real, five years after the financial crisis.[27]
>
> *—Eric S. Rosengren, President & CEO, Federal Reserve Bank of Boston. Speech at the Conference on Stable Funding, Sept. 27, 2013*

Broker-Dealers

Federal Reserve Bank of New York President William Dudley raised the possibility of extending the Federal Reserve's lender of last resort function to nonbanks with attendant prudential regulation.

> We have banking activity—maturity transformation—taking place today outside commercial banks. If we believe these activities provide essential credit intermediation services to the real economy that could not be easily replaced by other forms of intermediation, then the same logic that leads us to backstop commercial banking with a lender of last resort might lead us to backstop the banking activity taking place in the markets in a similar way. . . . However, any expansion of access to a lender of last resort would require legislation and it would be essential to have the right quid pro quo—the commensurate expansion in the scope of prudential oversight. Substantial prudential regulation of entities—such as broker-dealers—that might gain access to an expanded lender of last resort would be required to mitigate moral hazard problems. . . . Extension of discount window-type access to a set of nonbank institutions would therefore have to go hand-in-hand with prudential regulation of these institutions.[28]
>
> *—William Dudley, President, Federal Reserve Bank of New York. Speech at New York Bankers Association's 2013 Annual Meeting and Economic Forum, Feb. 1, 2013*

Markets (in Addition to Firms)

Governor Daniel Tarullo has hinted at a new regulatory paradigm in which markets, in addition to firms, are regulated by the Board.

> As we make more progress in reorienting the regulation of large financial firms toward more macroprudential objectives, we will need to watch carefully for such leakage of financial transactions. This concern returns us to the larger project of macroprudential regulation, which implicates a more complicated set of issues around legal authorities and institutional capacities for prudential regulation of markets, as well as firms.[29]
>
> *—Daniel Tarullo, Governor, Federal Reserve Board. Speech at the Yale School Conference on Challenges in Global Financial Services, Sept. 20, 2013*

The pursuit of new regulatory power is a troubling manifestation of the Board's embrace of macroprudential regulation in which every aspect of the financial system is monitored and controlled by regulators. This approach not only displaces market discipline, it also displaces other regulators. In the process, it may undermine financial stability by ensuring that regulatory mistakes by the Board reverberate through the entire financial system.

ENDNOTES

1. Dodd-Frank §§ 604(b) and 616(d).
2. Dodd-Frank § 604.
3. Dodd-Frank § 605.
4. Dodd-Frank § 165.
5. Ibid.
6. Board of Governors of the Federal Reserve System, 77 Fed. Reg. 76628, 76637 (Dec. 28, 2012) (proposing to "apply a structural enhanced standard under which foreign banking organizations with total consolidated assets of $50 billion or more and combined U.S. assets of $10 billion or more (excluding U.S. branch and agency assets and section 2(h)(2) companies) would be required to form a U.S. intermediate holding company").
7. See, for example, Dodd-Frank §§ 121, 163, 173(b), and 604.
8. Dodd-Frank §§ 617 and 618.
9. Dodd-Frank § 618. Dodd-Frank mandates some deference to other regulators. See, for example, ibid. at (c)(2)(B).
10. Board of Governors of the Federal Reserve System, Supervised Securities Holding Company Registration, 77 Fed. Reg. 32881, 32882, (June 4, 2012).

11. Dodd-Frank § 117.

12. Dodd-Frank § 312(b).

13. Dodd-Frank § 616(d).

14. Dodd-Frank § 604.

15. Dodd-Frank § 605.

16. Dodd-Frank §§ 113 and 165.

17. Dodd-Frank §§ 113 and 162(b).

18. Dodd-Frank §§ 804, 805, 807, and 808.

19. Dodd-Frank §§ 805, 807, and 808.

20. Dodd-Frank § 1061(b).

21. See, for example, Dodd-Frank §§ 1017, and 1012(c).

22. Governor Daniel Tarullo, Speech at the Federal Reserve Bank of San Francisco Conference on Challenges in Global Finance (June 12, 2012), available at http://www.federalreserve.gov/newsevents/speech/tarullo20120612a.htm.

23. William Dudley, President, Federal Reserve Bank of New York, Speech at New York Bankers Association's 2013 Annual Meeting and Economic Forum (Feb. 1, 2013), available at http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html.

24. Vice-Chairman Janet Yellen, Speech at the International Monetary Conference (June 2, 2013), available at http://www.federalreserve.gov/newsevents/speech/yellen20130602a.htm.

25. Governor Daniel Tarullo, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 11, 2013), available at http://www.federalreserve.gov/newsevents/testimony/tarullo20130711a.htm.

26. See, for example, Letter from 12 Federal Reserve Bank Presidents to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Sept. 12, 2013), available at http://bostonfed.org/news/press/2013/pr091213-letter.pdf.

27. Eric S. Rosengren, President & CEO, Federal Reserve Bank of Boston, Speech at Conference on Stable Funding (Sept. 27, 2013), available at http://www.bostonfed.org/news/speeches/rosengren/2013/092713/092713text.pdf.

28. William Dudley, President, Federal Reserve Bank of New York, Speech at New York Bankers Association's 2013 Annual Meeting and Economic Forum (Feb. 1, 2013) (footnote omitted), available at http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html.

29. Governor Daniel Tarullo, Speech at the Yale Law School Conference on Challenges in Global Financial Services (Sept. 20, 2013), available at http://www.federalreserve.gov/newsevents/speech/tarullo20130920a.htm.

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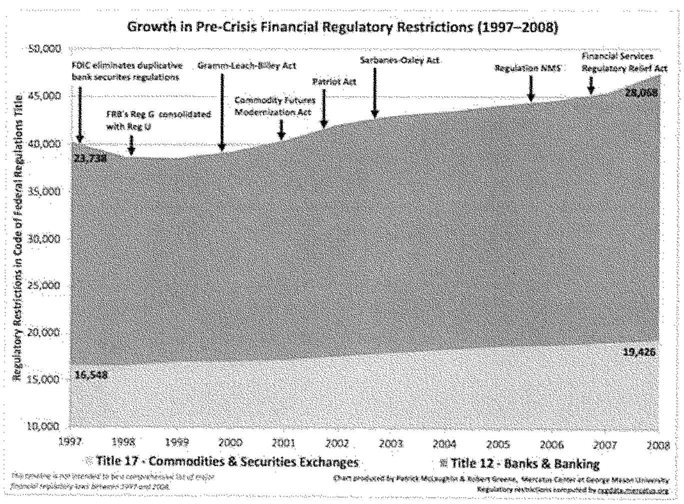
Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank

Patrick McLaughlin [1], Robert Greene [2] | Jul 19, 2013

Three years ago the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. Deregulation of the financial services sector in the years leading up to the 2008 crisis was—and still is—used to justify Dodd-Frank's substantial regulatory burdens. But financial regulation did not decrease in the decade leading up to the financial crisis—it increased.



[3]

Using the Mercatus Center at George Mason University's RegData [4], we find that between 1997 and 2008 the number of financial regulatory restrictions in the Code of Federal Regulations (CFR) rose from approximately 40,286 restrictions to 47,494—

an increase of 17.9 percent. Regulatory restrictions in Title 12 of the CFR—which regulates banking—increased 18.2 percent while the number of restrictions in Title 17—which regulates commodity futures and securities markets—increased 17.4 percent.

RegData [4] measures regulatory restrictions by counting the number of restrictive words and phrases—such as "may not," "must," "shall," "prohibited," and "required"—in each title of the CFR. Developed by Patrick A. McLaughlin and Omar Al-Ubaydli, RegData is computer-based and thus only able to calculate regulatory restrictions for 1997 and subsequent years because electronic copies of the complete, annual CFR are publicly available from the Government Printing Office for only that time period.

Total regulatory restrictions pertaining to the financial services sector grew every year between 1999 and 2008, increasing 23 percent during this time. The Patriot Act, the Sarbanes-Oxley Act, and Regulation NMS all contributed to this growth. The repeal of parts of the Glass-Steagall Act via the Gramm-Leach-Bliley Act did not result in noticeable deregulation of the financial services sector. Nor did the Commodity Futures Modernization Act facilitate overall financial deregulation. Not even the Financial Services Regulatory Relief Act of 2006, legislation intended to decrease regulatory burdens on the financial industry, reversed the ever-growing burden of regulatory restrictions faced by the financial services sector in the years leading up to the financial crisis.

Net decreases for Title 12 regulatory restrictions between 1997 and 1999 largely reflect an effort to streamline regulatory text. Only the FDIC portion (volume 4) of Title 12 experienced a significant decrease in pages between 1997 and 1998, and it was almost entirely isolated within 12 C.F.R. § 335, which was shortened from 136 to 7 pages in an effort to streamline FDIC regulations with pertinent SEC Securities Exchange Act regulations. Similarly, the comparatively small decrease in overall regulatory restrictions in Title 12 between 1998 and 1999 is in large part attributable to the Federal Reserve's 1999 consolidation of Regulation G—which pertained to nonbanks' extension of leverage for the purpose of purchasing certain securities—with Regulation U, which was revised to be applicable to both banks' and nonbanks' extension of leverage. Without this consolidation, Title 12 pages would have increased between 1998 and 1999. Neither of these episodes had any relation whatsoever to Gramm-Leach-Bliley or the Commodity Futures Modernization Act.

As we show in this analysis, financial regulatory restrictions increased 17.9 percent in the years leading up to the crisis. Without the streamlining efforts of the late 1990s—which reduced duplicative regulatory text and were unrelated to the acts of Congress typically blamed for alleged deregulation—this figure would likely be even higher. In Dodd-Frank: What it Does and Why it's Flawed [5], we used the RegData methodology to estimate that Dodd-Frank will cause a 26 percent increase in financial regulatory restrictions. Policymakers should reexamine the presumption that Dodd-Frank's substantial regulatory restrictions are necessary to offset previous deregulation of the financial services sector. On net, RegData [4] shows that no such deregulation occurred. In fact, the financial sector was increasingly regulated over the decade leading up to the financial crisis.

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Op-Eds and Blogs
Regulator contributor to Real Clear Markets and The Hill. My work has also appeared in other publications, including City AM, The American Banker, The Guardian, Point of Law, and U.S. News & World Report. Many of these pieces are available at http://mercatus.org/person/expert-commentary/1163700.

EXPERIENCE

Mercatus Center at George Mason University (Arlington, VA) January 2012-Present.
Senior Research Fellow.

George Mason University School of Law, Adjunct Professor, Spring 2014 and Spring 2015, *Perspectives on Regulation.*

United States Senate Committee on Banking, Housing, and Urban Affairs (Washington, D.C.) August 2008-December 2011. Counsel/Senior Counsel on Staff of Ranking Member Richard Shelby.

United States Securities and Exchange Commission (Washington, D.C.) 2000 – 2008.
June 2004-August 2008: Counsel to Commissioner Paul S. Atkins.
April 2000-June 2004: Staff Attorney, Division of Investment Management.

Wilmer, Cutler & Pickering (now WilmerHale) (Washington, D.C.) Oct. 1998 – March 2000. Associate.

U.S. Court of Federal Claims (Washington, D.C.) Fall 1997 – Fall 1998.
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PROFESSIONAL AFFILIATIONS
Member of the Investor Advisory Committee to the Securities and Exchange Commission (2014 to present)

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TESTIMONY OF

MARCUS M STANLEY

Policy Director, Americans for Financial Reform

On behalf of

AMERICANS FOR FINANCIAL REFORM

Re

"THE DODD FRANK ACT AND REGULATORY OVERREACH"

Before the

OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE

HOUSE FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

Wednesday, May 13, 2015, 9:30 AM

HVC-201 Capitol Visitor's Center

AMERICANS
FOR FINANCIAL REFORM
ACCOUNTABILITY • FAIRNESS • SECURITY

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Chairman Duffy, Ranking member Green, and members of the Committee, thank you for the opportunity to testify before you today.

I would like to make several broad points in my testimony:

1) *The Dodd-Frank reforms should create significant benefits.* Attached to my testimony is a report that Americans for Financial Reform recently produced in response to claims by the American Action Forum regarding the costs of the Dodd-Frank Act. In this report, we document that financial regulations that reduce the probability of an economic crisis by 50 percent should produce $2.9 trillion in economic benefits over the next decade in financial stability benefits alone. Reducing the probability of crisis by 25 percent would produce $1.46 trillion in benefits. These figures do not even count the benefits of improved fairness for consumers and investors due to Dodd-Frank reforms. We believe that the Dodd-Frank Act will succeed in reaching these goals, and that these benefits will far exceed its costs.

2) *The Dodd-Frank Act should not be characterized as 'regulatory overreach'.* While the Act is indeed significant in its scope and length, examining the actual regulatory tools used in Dodd-Frank shows that they are traditional elements of financial regulation that have been used for many decades if not centuries. These tools have been tested over many years and are hardly radical departures. The Dodd-Frank Act is the product of compromise and incrementally advances past regulatory practices by increasing their stringency and applying them to additional areas of the financial sector. Furthermore, Dodd-Frank grants very extensive discretion to regulators to adjust the use of these tools as they are applied to different segments of the market.

3) *Rolling back Dodd-Frank would be a serious error.* We have supported changes in the Dodd-Frank Act where we believe such changes are called for. However, changes that roll back Dodd-Frank rules or create major new exemptions to them would in most cases have a negative impact on financial stability or consumer protection. Furthermore, regulators have extensive discretion to accommodate reasonable concerns without statutory change. Overall, the Dodd-Frank Act represents a valuable and long overdue strengthening of our regulatory system in basic ways.

Dodd-Frank Reforms Will Create Significant Benefits

The attached report by Americans for Financial Reform draws on a comprehensive survey of the costs of post-WWII financial crises performed by the international regulatory community over the 2008-2010 period. Based on the results of this survey, financial and banking crises were found to create average costs of 63 percent of annual economic output – a figure that amounts to approximately $10 trillion in the U.S. The survey also found that financial crises occurred every 20 to 25 years, for an annual probability of 4 to 5 percent. Taken together, these figures imply that improvements in financial regulation which lowered the probability of financial crises by just one-quarter would create $1.46 trillion in financial stability benefits alone over the next decade. If such reforms lowered the probability by half they would create $2.9 trillion in financial stability benefits. These figures are both far in excess of the Dodd-Frank costs estimated by the American Action Forum (AAF). Furthermore, as explained in the attached report, we also find that the costs estimated by the AAF were significantly inflated.

The financial stability benefits referred to above do not even include the distributional and fairness benefits created by improved consumer and investor protections. The Consumer Financial Protection Bureau has already returned billions of dollars to wronged consumers, and new and in progress rules should create tens of billions in additional savings.

It is important to note that the benefits documented here do not rely on the Dodd-Frank Act being flawless or working perfectly. Financial crises are so expensive that any significant reduction in their frequency produces very large benefits. And there is every reason to believe that the Dodd-Frank Act is having and will continue to have a positive effect on financial stability. The basic reforms in Dodd-Frank, ranging from the move to a forward looking stress testing approach to capital supervision and planning, to improved mortgage underwriting requirements, to new data reporting and risk management requirements in derivatives markets, to new attention to possible failures at credit rating agencies, are common sense measures that will significantly improve regulatory vigilance concerning potential financial instability. In many cases Dodd-Frank reforms simply formalize and institutionalize common sense lessons concerning the dangers of excessive leverage and poor risk management.

The Dodd Frank Act Should Not Be Characterized As 'Regulatory Overreach'

The Dodd-Frank Act is frequently described as the most significant set of financial reforms since the New Deal reforms of the 1930s. Simply by virtue of its broad scope and comprehensive nature, this is a reasonable description. But it is important to realize that the tools used in Dodd-Frank are hardly radical. Instead, they are generally the product of compromise and reflect a great deal of incremental continuity with past regulatory practices. The prudential requirements for banks in Title I of Dodd-Frank, including heightened capital standards, credit exposure limits, and stress testing, are familiar tools that have been used in bank risk management for decades if not centuries. Formal liquidity requirements are perhaps more novel but reserve requirements, which played a similar role for commercial banks, are also long-familiar tools. The new central clearing and exchange trading requirements for over the counter derivatives markets are modeled on long-familiar institutions in the listed derivatives markets, and only for those over-the-counter swaps that are sufficiently liquid to make such requirements feasible.

Even Dodd-Frank regulatory changes that appear more novel are generally the result of compromise. For example, the Financial Stability Oversight Committee is certainly a new innovation in U.S. regulation. But it is a compromise solution. The financial crisis made clear that greater regulatory coordination was necessary, but beyond the elimination of the Office of Thrift Supervision Congress was unwilling to undertake major consolidation of U.S. regulatory agencies. Thus the creation of a coordinating council made up of heads of existing regulatory agencies. The delegation of designation authority to the FSOC reflects a compromise between the understanding that emerged from the 2008 crisis that non-banks had become central to financial stability, but a lack of consensus on exactly which if any entities should be designated for Federal supervision.

Likewise, the Volcker Rule, while novel, also represents a compromise solution, in that it separates banking and hedge-fund like proprietary trading activities without returning to the full Glass-Steagal separation between commercial banking and all financial market and trading activities.

Another key element of the Dodd-Frank Act is the very substantial role played by regulatory discretion in the actual implementation of new rules. In almost every case, Congress delegated authority concerning key details of the new rules to the various regulatory agencies, and granted these agencies substantial ability to provide exemptions to the rules where they felt it was justified. This extensive regulatory discretion means that the Dodd-Frank framework is in fact extremely flexible. It reflects and will continue to reflect the learning process engaged in by regulators as they examine the lessons of the financial crisis and the changes that have occurred in the financial sector since the crisis.

A notable element of this regulatory flexibility is the exemption from Dodd-Frank regulations, or the easing of such regulations, for community banks (generally defined as those banks with under $10 billion in assets). Not only does the Dodd-Frank Act statutorily exempt community banks from numerous requirements mandated for larger banks, but regulators have frequently used their discretion to exempt community banks from regulation or to modify such regulations for smaller banks. Examples include regulatory exemptions from margin and clearing requirements for derivatives for smaller banks, as well as small bank exemptions in CFPB rules for loan servicing and ability-to-repay standards for lending.

Rolling Back Dodd-Frank Would Be A Serious Error

Even post-financial crisis, between 25 and 30 percent of corporate profits come from the financial sector. There are often major profit incentives for financial companies seeking to roll back new regulations, even at the cost of financial stability and consumer protection benefits for the broader public. But it would be very dangerous for Congress to yield to these pressures.

This does not mean that changes in the bill may not be reasonable in particular circumstances. We have supported changes in the law and its implementation when we felt it was called for to better protect the public. For example, AFR has joined Representatives Hensarling and Garrett in criticizing the Federal Reserve's implementation of new restrictions on 13(3) emergency lending, and we have supported Senator Warren in her call for Congress to act if the Federal Reserve does not place stronger pre-conditions on these loans. We have also supported higher capital requirements on banks and have criticized regulators for inadequate capital levels in new Basel rules. We have supported legislation that would create stronger divisions between commercial banking and financial market trading than are required in the Volcker Rule. We have also criticized regulation of credit rating agencies as inadequate given the scope of the problems revealed in the financial crisis and since. Other examples could be given.

But criticism of imperfections in Dodd-Frank should not blind us to the great value of the reforms made in the bill. The 2007-2009 financial crisis was marked by glaring failures in financial risk management by both government regulators and private banks. Very basic forms of financial risk, including poor underwriting and excessive leverage, were systematically overlooked for years. The Dodd-Frank Act contains numerous provisions designed to force attention to these issues, ranging from minimum ability-to-pay requirements for new mortgages to requirements for regulators to improve capital requirements and engage in forward-looking stress testing. The Dodd-Frank Act also institutes basic transparency and risk management requirements for over-the-counter derivatives, an enormous area of potential financial risk, replacing the plainly inadequate system of informal private regulation that previously governed them. Although these requirements were inspired by the hard-won lessons of the 2007-2009 crisis, they are so essential to effective risk management that if they are effectively implemented they will almost certainly prove useful in addressing future systemic risks as well.

In practice, the great majority of the changes we have seen proposed to the Dodd-Frank Act would not build constructively on the advances made by the legislation, but would instead roll back the clock by restricting new regulatory authorities and preventing regulators from effectively implementing the risk controls called for by the legislation. We believe this would be a grave error and would work to restore the failed status quo that gave us the 2007-2009 crisis.

Thank you for the opportunity to testify. I am happy to answer further questions, and in the future can be contacted at marcus@ourfinancialsecurity.org or (202) 466-3672.

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AFR Response to American Action Forum Study on Costs of Dodd-Frank Act

The American Action Forum has released a study claiming that the Dodd-Frank Act will reduce total U.S. economic output by $895 billion between 2016 and 2025.[1] But the study has multiple significant flaws. These include:

- **A failure to incorporate any of the benefits of improved financial sector regulation**. Extensive economic research shows that the benefits of greater financial sector stability alone will exceed the costs claimed by the AAF. As explained below, if Dodd-Frank cuts the annual probability of a financial crisis in half, it will create $2.9 trillion in economic benefits over the next decade. This figure alone is more than triple the costs claimed in the AAF study, and does not even count the substantial benefits that will accrue from improvements in consumer protection and economic fairness.

- **Exaggerating the growth impacts of regulation**. The AAF study exaggerates the cost of regulation in several ways. The study assumes that all regulatory costs will be subtracted from capital investment, even though some regulatory costs themselves involve capital investment and some compliance costs will be funded by spending reductions (e.g. cuts in top executive compensation) at financial institutions. The study also appears to assume that temporary transitional regulatory costs extend permanently. Finally, the study assumes that increases in bank capital (higher equity vs. debt in bank funding) are identical to a tax on investment, which is highly questionable.

In sum, the AAF study both exaggerates the growth costs of regulation and fails to include benefits from regulation that would substantially exceed even these exaggerated costs.

The Benefits of Financial Regulation

Studies have found that the 2007-2009 financial crisis created over $10 trillion in economic costs to the U.S. economy.[2] In their consideration of new capital rules, global regulators at the Basel Committee also performed an extensive analysis of the costs of financial crises and the benefits

[1] Holtz-Eakin, Douglas, "The Growth Consequences of Dodd-Frank", American Action Forum, May 6, 2015.
[2] Luttrel, David, Tyler Atkinson and Harvey Rosenblum, "Assessing the Costs and Consequences of the 2007-2009 Financial Crisis", Federal Reserve Bank of Dallas, Economic Letter Volume 8, Number 13, September, 2013.

of reduced financial instability.[3] The analysis was based on a complete literature review on the impact of financial and banking crises in advanced economies since WWII. It found that[4]:

- Banking crises occur roughly once every 20 to 25 years, implying that each year there is a 4 to 5 percent chance of a crisis.

- The median or average estimated economic cost of a financial crisis is roughly 63 percent of economic output. This includes both the initial impact and the discounted cost from the loss of future growth over many years.

- Reducing the annual probability of a financial crisis by just one percentage point (i.e. from 4-5 percent to 3-4 percent per year) would lead to annual benefits of .63 percent of economic output. Reducing the probability of crisis by two percentage points would lead to annual benefits of 1.26 percent of economic output per year.

These figures imply that if the Dodd-Frank Act and associated regulatory changes reduced the annual probability of financial crisis by just one percentage point, this would create $1.46 trillion in increased economic output over the next decade (2016-2025). A two percentage point decline would create $2.9 trillion in economic benefits.[5]

It is important to understand that these estimates do not require that the Dodd-Frank Act completely eliminate the probability of financial crisis. A one percentage point decline in the probability of financial crisis corresponds to cutting the chance of a financial crisis by 20-25 percent (from 4-5 percent each year to 3-4 percent each year). A two percentage point decline in the probability of financial crisis corresponds to cutting the chance of a financial crisis roughly in half (from 4-5 percent each year to 2-3 percent each year).

The benefits from either scenario substantially exceed the costs estimated in the AAF study. For example, the benefits of a 20-25 percent reduction in financial crisis probability would create economic benefits that exceed the costs estimated by AAF by over 60 percent. *If Dodd-Frank cuts the probability of financial crises in half, then it will create economic benefits more than triple the costs estimated by the AAF*.

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[3] Basel Committee on Banking Supervision, "An Assessment of the Long-Term Economic Impacts of Stronger Capital and Liquidity Requirements", Bank of International Settlements, August, 2010.
[4] The figures cited below can be found on pp. 8-15 and Tables 1-2 of the BIS report cited above.
[5] These figures are calculated by multiplying the BIS estimates of percentage losses in economic output given above by CBO estimates of U.S. GDP between 2016 and 2025. See Congressional Budget Office, "CBO's Economic Projections For 2015 to 2025". Table F-1

Furthermore, these financial stability benefits do not even include any of the benefits to consumers or investors created by greater fairness in the financial system. Such benefits can occur in many areas, and they cannot easily be summarized in a single total figure. But some quick examples can show their potential magnitude:

- A team of economists recently estimated that just one consumer protection law now enforced by the Consumer Protection Bureau – the 2009 CARD Act, which put new limits on credit card fees and interest rate increases – produced $11.9 billion in annual net savings to credit card consumers. The study found no evidence of increases in provider cost shifting that would have eroded those savings.[6]

- Research by the Center for Responsible Lending finds that abusive practices in the charging of overdraft fees cost consumers over $16.7 billion per year.[7] This is an area that falls under CFPB jurisdiction.

- Gains to investors from improvements in securities market regulation can also be considerable. During the financial crisis, even supposedly sophisticated investors took large losses due to deceptive practices in the markets for complex securities, another form of loss that reflects unfairness in the markets.[8]

If the lower costs to consumers and investors were also counted as benefits, the benefit-cost ratio for improved financial regulation would be even more lopsided.

Exaggerated Costs In The AAF Study

In addition to ignoring benefits, the AAF study exaggerates costs in several ways. It is first important to note the extreme sensitivity of these cost estimates to various assumptions made by the author. The U.S. economy is projected to generate $230 trillion in economic output over the 2016-2025 period.[9] The AAF estimate of $895 billion represents less than four-tenths of one percent of this total output (less than 40 cents per $100 of output). Even small assumed changes in growth will, when multiplied against this vast $230 trillion in projected output, generate large dollar figures. The AAF study appears to have made several assumptions that exaggerate the growth costs of financial regulations.

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[6] Agarwal, Sumit and Chomsisengphet, Souphala and Mahoney, Neale and Stroebel, Johannes, "Regulating Consumer Financial Products: Evidence from Credit Cards", Quarterly Journal of Economics, Volume 130, Issue 1.
[7] Center for Responsible Lending, "The State Of Lending: High-Cost Overdraft Fees", July 30, 2013.
[8] Taub, Jennifer, "The Sophisticated Investor and the Global Financial Crisis" (April 1, 2011). CORPORATE GOVERNANCE FAILURES: THE ROLE OF INSTITUTIONAL INVESTORS IN THE GLOBAL FINANCIAL CRISIS, James P. Hawley, Shyam J. Kamath, and Andrew T. Williams, eds., University of Pennsylvania Press, 2011.
[9] Congressional Budget Office, "CBO's Economic Projections For 2015 to 2025". See Table F-1

The first problematic assumption is that all compliance costs of the Dodd-Frank Act will be extracted directly from productive investment in the economy. One issue with this assumption is that some part of Dodd-Frank compliance costs are themselves productive investment. The financial crisis revealed severe weaknesses in the ability of large banks and other financial market actors to aggregate and understand their financial risks. Recent reports show that these weaknesses continue.[10] A substantial portion of Dodd-Frank costs involve additional investments in information technology and data reporting to better understand these risks. Such improved understanding of risk should permit the industry to be better operated across the financial cycle. The Dodd-Frank Act also sets up new market infrastructure such as derivatives exchanges and data repositories that will permit more competition and market openness, but involve significant technology investment.

While a part of compliance costs are oriented simply toward regulatory reporting, some portion of these investments will also be productive improvements. According to a 2012 survey by Accenture Consulting, "Many companies see beneficial results from Dodd-Frank; for example, 64 percent of respondents believe the Act will strengthen their competitive position, especially within the capital markets industry, and a strong majority believe Dodd-Frank will lead to greater profitability across the lifetime of the program.".[11] This was true even though a majority also felt that Dodd-Frank would lead to some increased costs.

Another issue with the assumption that compliance costs directly reduce investment is that not all increased costs to banks or financial institutions are directly transmitted to real economy investors through reduced lending. Some compliance costs will be absorbed in the form of reduced compensation for top executives or other cost cutting measures. The assumption that every dollar of compliance costs represents a dollar of reduced investment by end users is an extreme one that would require much more justification than it is given in the study.

Second, the study seems to assume that transitional costs in the initial adoption of new regulations will extend permanently, or at least for the entire next decade. The study apparently takes the total regulatory costs reported in the Federal Register, converts this total cost into a tax rate, and projects costs over ten years based on the assumption that this tax rate will divert from capital investment. However, many of the regulatory costs reported in the Federal Register are temporary transitional costs that are projected to last for only a few years.[12] The assumption that these costs will last indefinitely is not justified.

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[10] Bank of International Settlements, "Progress In Adopting The Principles For Effective Data Aggregation and Risk Reporting", January, 2015.

[11] Accenture Consulting, "Coming to Terms With Dodd-Frank: Balancing Strategic Considerations With Tactical Implications", 2015.

[12] To take a typical example, the Securities and Exchange Commission, in their cost estimates for the rule on swaps reporting requirements, states that "The Commission believes that, once a respondent's reporting infrastructure and compliance systems are in place, the burden of reporting each individual reportable event will be *small* when compared to the burdens of establishing the reporting infrastructure and compliance

Finally, the AAF study assumes that increases in bank capital requirements are identical to taxes and directly reduce productive investment. This is a highly questionable and unusual assumption. Bank capital requirements do not by themselves restrict bank lending or asset growth; they only require that some minimum fraction of bank assets be funded with the bank's own equity. Such a requirement operates very differently from a tax and does not directly reduce investment. Indeed, bank capital requirements likely only reflect what the market itself would demand in the absence of government safety net support for banks such as deposit insurance and access to Federal Reserve liquidity. While banks claim that higher equity requirements will increase their funding costs relative to debt, it is also likely that equity investors will reduce their minimum return expectations as they see that banks are better capitalized. The assumption that bank capital requirements are identical to a tax drives over 20% of the assumed costs in the AAF study, accounting for almost $200 billion in the $895 billion cost estimate.

systems.". See Securities and Exchange Commission, "Regulation SBSR – Reporting and Dissemination of Security Based Swaps Information, Final Rule", 80 FR 15463, 14563-14737, Securities and Exchange Commission, March 19, 2015.

Editorial

Saddling Homeowners With Risky Loans

By THE EDITORIAL BOARD, The New York Times

April 29, 2015

House Republicans, with the help of several Democrats, recently passed two bills to weaken new rules against predatory mortgage lending. Senate Republicans are now trying to win support for the same measures, arguing that the rules would impose "regulatory burdens" that unduly restrict credit.

That is way off base. The rules, called for in the Dodd-Frank financial reform law of 2010, require that lenders provide borrowers of complex, high-cost loans with written disclosure of the loan rate and maximum monthly payment as well as the consequences of default. They also require lenders to give mortgage applicants a list of counseling organizations that can educate them on risks, rights and responsibilities.

The rules seek to curtail the use of the riskiest loan features, like balloon payments, and to reduce conflicts of interest, like the use by lenders of affiliates in insurance and other related fields, that can result in borrowers being steered into overpriced loans.

The rules generally do not apply to loans with straightforward terms or prohibit risky loans to qualified, well-informed borrowers. Their purpose is to help prevent lenders from peddling deceptive and high-cost loans to unsuspecting borrowers.

One such lender, according to a recent article by The Seattle Times and the Center for Public Integrity, a nonprofit investigative group, is Clayton Homes, headquartered in Maryville, Tenn. Clayton is the nation's biggest builder and seller of manufactured homes — basically mobile homes permanently affixed to their sites. It is also the biggest lender to buyers of manufactured homes, having increasingly dominated the industry since 2003, when it was acquired by Berkshire Hathaway, the conglomerate led by Warren Buffett. The report, which Clayton Homes claimed was misleading, said the company uses high-pressure sales tactics, exorbitant fees and excessive interest rates to bolster profits on loans that borrowers cannot afford for homes they often cannot sell or refinance.

One of the two bills approved by the House would effectively exempt loans for manufactured homes from the new anti-predation rules. The bill's architect was Representative Stephen Fincher, a Republican from Clayton's home base in Tennessee. Its potential victims are the kinds of consumers the law is meant to protect — the mostly older, lower-income buyers of manufactured homes in rural areas where affordable housing is scarce.

The White House has said it would veto the bills if need be, though the Republican tactic of passing piecemeal rollbacks to Dodd-Frank raises the possibility that the bill could be added to a larger measure.

In the meantime, shareholders who gather this week for Berkshire Hathaway's shareholder meeting could ask Mr. Buffett what it is about basic consumer protection that Clayton Homes finds so threatening.

http://mobile.nytimes.com/2015/04/30/opinion/saddling-homeowners-with-risky-loans.html http://www.wsj.com/articles/harboring-doubts-on-bank-home-loan-rules-1431709105

Harboring Doubts on Bank Home Loan Rules, *The Wall Street Journal*

Easing qualified mortgages rules could add risk to balance sheets

By John Carney
May 15, 2015 12:58 p.m. ET

Risky mortgages shouldn't be anchored in a safe harbor.

The draft of a sweeping regulatory reform bill unveiled this week by Senate Banking Committee Chairman Richard Shelby would water down limits on which mortgages receive legal protections afforded to "qualified mortgages," so long as lenders hold on to them. While investors might hope banks win some regulatory relief, this goes in the wrong direction. It trades a bit more leeway in lending for what could be a lot more risk.

The Dodd-Frank Act sought to shore up underwriting by requiring banks to assess whether a borrower can afford a home loan. It created a category of "qualified mortgages" for those that meet pre-established standards deemed safe for consumers. Lenders are free to use their own standards to assess affordability. But these don't get the automatic protection against legal challenges alleging predatory lending that qualified mortgages get.

The boundaries of the qualified-mortgage safe harbor were set by the Consumer Financial Protection Bureau in 2013. The loans must be fully amortizing and have a term no longer than 30 years. Lenders must verify a borrower's expected financial position. Affordability is measured against the maximum payments due during the first five years. Plus, the rule limits the points and fees that can be charged, and caps the borrower's ratio of debt to income at 43%.

The draft legislation relaxes those rules so long as the lender keeps the loan on their own balance sheet or sells it to someone who does. Both the five-year affordability test and the limit on points and fees are dropped. Most strikingly, the debt-to-income cap is eliminated.

Why give banks extra legal protection for the loans they hold on their books? The underlying assumption is that banks won't engage in irresponsible lending if they can't push the risk off to others. Since any losses on the loan will sit with lenders—rather than get bundled up as mortgage-backed securities and sold off—they will act as stewards of their own underwriting. In other words, they will have to eat their own cooking.

That assumption, though, fails the test of recent history. The financial crisis showed banks will sometimes take on short-term risks in the hope of immediate reward even if it risks their long-term health. And in euphoric markets, banks can underestimate their risks. That can have disastrous consequences for the firms, their investors and the broader economy.

Recall that nearly all the largest banks not only owned subprime mortgage originators, they also held huge mortgage portfolios and suffered sometimes-devastating losses when home prices plunged. Even if banks learned their lesson, another risk to them and their investors lurks in Mr. Shelby's proposal.

This involves the illiquidity of qualified-mortgage loans. A bank facing financial distress wouldn't be able to sell these to investors without losing the legal shield. This would make them far less valuable to outside investors than the banks themselves.

That in turn means they could only be sold at a loss—perhaps a big one. This illiquidity would be bad enough for performing mortgages; a rule that forces banks to hang on to distressed assets is potentially toxic. Banks might be forced to sell better-performing assets while holding on to worse ones—a recipe for disaster, especially in a time of stress.

Just how at odds with the interests of both creditors and equity investors this would be is highlighted by the one scenario where the bill allows for mortgages to retain their protected status in a sale: when a bank has failed and is being resolved by regulators. That would preserve the value of a failed bank's qualified mortgages, reducing the cost of resolution.

But that would come too late for creditors and investors. Given that, they would be better off if banks were never encouraged to take on a new class of illiquid loans in the first place.

1. Wall Street Vampires, *New York Times*

May 11, 2015
Paul Krugman

Last year the vampires of finance bought themselves a Congress. I know it's not nice to call them that, but I have my reasons, which I'll explain in a bit. For now, however, let's just note that these days Wall Street, which used to split its support between the parties, overwhelmingly favors the G.O.P. And the Republicans who came to power this year are returning the favor by trying to kill Dodd-Frank, the financial reform enacted in 2010.

And why must Dodd-Frank die? Because it's working.

This statement may surprise progressives who believe that nothing significant has been done to rein in runaway bankers. And it's true both that reform fell well short of what we really should have done and that it hasn't yielded obvious, measurable triumphs like the gains in insurance thanks to Obamacare.

But Wall Street hates reform for a reason, and a closer look shows why.

For one thing, the Consumer Financial Protection Bureau — the brainchild of Senator Elizabeth Warren — is, by all accounts, having a major chilling effect on abusive lending practices. And early indications are that enhanced regulation of financial derivatives — which played a major role in the 2008 crisis — is having similar effects, increasing transparency and reducing the profits of middlemen.

What about the problem of financial industry structure, sometimes oversimplified with the phrase "too big to fail"? There, too, Dodd-Frank seems to be yielding real results, in fact, more than many supporters expected.

As I've just suggested, too big to fail doesn't quite get at the problem here. What was really lethal was the interaction between size and complexity. Financial institutions had become chimeras: part bank, part hedge fund, part insurance company, and so on. This complexity let them evade regulation, yet be rescued from the consequences when their bets went bad. And bankers' ability to have it both ways helped set America up for disaster.

Dodd-Frank addressed this problem by letting regulators subject "systemically important" financial institutions to extra regulation, and seize control of such institutions at times of crisis, as opposed to simply bailing them out. And it required that financial institutions in general put up more capital, reducing both their incentive to take excessive risks and the chance that risk-taking would lead to bankruptcy.

All of this seems to be working: "Shadow banking," which created bank-type risks while evading bank-type regulation, is in retreat. You can see this in cases like that of General Electric, a manufacturing firm that turned itself into a financial wheeler-dealer, but is now trying to return to its roots. You can also see it in the overall numbers, where conventional banking — which is to say, banking subject to relatively strong regulation — has made a comeback. Evading the rules, it seems, isn't as appealing as it used to be.

O.K., why do I call them that? Not because they drain the economy of its lifeblood, although they do: there's a lot of evidence that oversize, overpaid financial industries — like ours — hurt economic growth and stability. Even the International Monetary Fund agrees.

But what really makes the word apt in this context is that the enemies of reform can't withstand sunlight. Open defenses of Wall Street's right to go back to its old ways are hard to find. When right-wing think tanks do try to claim that regulation is a bad thing that will hurt the economy, their hearts don't seem to be in it. For example, the latest such "study," from the American Action Forum, runs to all of four pages, and even its author, the economist Douglas Holtz-Eakin, sounds embarrassed about his work.

What you mostly get, instead, is slavery-is-freedom claims that reform actually empowers the bad guys: for example, that regulating too-big-and-complex-to-fail institutions is somehow doing wheeler-dealers a favor, claims belied by the desperate efforts of such institutions to avoid the "systemically important" designation. The point is that almost nobody wants to be seen as a bought and paid-for servant of the financial industry, least of all those who really are exactly that.

And this in turn means that so far, at least, the vampires are getting a lot less than they expected for their money. Republicans would love to undo Dodd-Frank, but they are, rightly, afraid of the glare of publicity that defenders of reform like Senator Warren — who inspires a remarkable amount of fear in the unrighteous — would shine on their efforts.

Does this mean that all is well on the financial front? Of course not. Dodd-Frank is much better than nothing, but far from being all we need. And the vampires are still lurking in their coffins, waiting to strike again. But things could be worse.

http://www.nytimes.com/2015/05/11/opinion/paul-krugman-wall-street-vampires.html