Testimony of

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Accountability, Capital and Governance of the Administrative State

Mr. Chairman, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I have spent more than four decades working in and on banking and housing finance, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago and eleven years focused on financial policy issues at the American Enterprise Institute, before joining R Street last year. I have experienced and studied many financial crises and their political aftermaths, starting when the Federal Reserve caused the Credit Crunch of 1969 when I was a bank trainee.

My discussion will focus on three key areas of the proposed CHOICE Act. All deal with essential issues and in all three the CHOICE Act would create major progress for the financial system, for constitutional government, and for financing economic growth. These areas are Accountability, Capital, and Congressional Governance of the Administrative State.

The CHOICE Act is long and complex, but there are a very large number of things to fix—like the Volcker Rule, among many others-- in the even longer Dodd-Frank Act.

A good summary of the real world results of Dodd-Frank is supplied by the "Community Bank Agenda for Economic Growth" of the Independent Community Bankers of America. "Community banks," it states, "need relief from suffocating regulatory mandates. The exponential growth of these mandates affects nearly every aspect of community banking. The very nature of the industry is shifting away from community investment and community building to paperwork, compliance and examination." I think this observation is fair.

The Community Bankers continue: "The new Congress has a unique opportunity to simplify, streamline and restructure." So it does, and I am glad this Committee is seizing the opportunity.

In November, 2016, Alan Greenspan remarked, "Dodd-Frank has been a—I wanted to say 'catastrophe,' but I'm looking for a stronger word." Although the financial crisis and the accompanying recession had been over for a year when Dodd-Frank was enacted, in the wake of the crisis, as always, there was pressure to "do something" and the tendency to overreact was strong. Dodd-Frank's something-to-do was to expand regulatory bureaucracy in every way its drafters could think of—it should be known as the Faith in Bureaucracy Act. This was in spite of the remarkably poor record of the government agencies, since they were important causes of, let alone having failed to avoid, the housing bubble and the bust. Naïve faith that government bureaucracies have superior knowledge of the financial future is a faith I do not share.

Accountability of the Administrative State

Accountability is a, perhaps *the*, central concept in every part of the government. To whom are regulatory agencies accountable? Who is or should be their boss? To whom is the Federal Reserve, a special kind of agency, accountable? Who is or should be its boss? To whom should the CFPB be accountable? Who should be its boss?

The answer to all these questions is of course: *the Congress*. We should all agree on that. All these agencies of government, populated by unelected employees, must be accountable to the elected representatives of the People, who created them, can dissolve them, and have to govern them in the meantime. All have to be part of the separation of powers and the system of checks and balances which is at the heart of our constitutional order. This also applies to the Federal Reserve. In spite of its endlessly repeated slogan that it must be "independent," the Federal Reserve must equally be accountable.

But accountability does not happen automatically: Congress has to assert itself to carry out its own duty for governance of the many agencies it has created and for its obligation to ensure that checks and balances actually operate.

The CHOICE Act is an excellent example of the Congress asserting itself at last to clarify that regulatory agencies are derivative bodies accountable to the Congress, that they cannot be sovereign fiefdoms—not even the Dictatorship of the CFPB, and not even the money-printing activities of the Federal Reserve.

The most classic and still most important power of the legislature is the power of the purse. The CHOICE Act accordingly puts all the regulatory agencies, including the regulatory part of the Federal Reserve, under the democratic discipline of Congressional appropriations. This notably would end the anti-constitutional direct grab from public funds which was originally granted to the CFPB—and which was designed precisely to evade the democratic power of the purse. It is sometimes objected that appropriations "inject politics" into these decisions. Well, of course! Democracy is political. Regulatory expansions are political, all pretense of technocracy notwithstanding.

The CHOICE Act also requires of all financial regulatory agencies the core discipline of cost-benefit analysis. It provides that actions whose costs exceed their benefits should not be undertaken without special justification. That's pretty logical and hard to argue with. Naturally, assessing the future costs and benefits of any action is subject to uncertainties—perhaps very large uncertainties. But this is no reason not to do the analysis—indeed, forthrightly to confront the uncertainties is essential.

The CHOICE Act also requires an analysis after five years of how regulations actually turned out in terms of costs and benefits. This would reasonably lead-- I hope it will--to scrapping the ones that didn't work.

To enhance and provide an overview of the regulatory agencies' cost-benefit analyses, the CHOICE Act requires the formation of a Chief Economists Council comprising the chief economist of each agency. This appeals to me, because it might help the views of the economists, who tend to care a lot about benefits vs. costs, balance those of their lawyer colleagues, who may not.

Further Congressional governance of regulatory agencies is provided by the requirement that Congress approve major regulatory rules—those having an economic effect of $100 million or more. Congress would further have the authority to disapprove minor rules if it chooses by joint resolution. This strikes me as a very effective way of reminding everybody involved, including the Congress itself, who actually is the boss and who has the final responsibility.

Taken together, these provisions are major increases in the accountability of regulatory agencies to the Congress and ultimately to the People. They are very significant steps forward in the governance of the Administrative State and bringing it under better constitutional control.

Accountability of the Federal Reserve

A word more on the Federal Reserve in particular, since the CHOICE Act devotes a title to "Fed Oversight Reform and Modernization" (FORM), which includes improving its governance by Congress. In a 1964 report, "The Federal Reserve After Fifty Years," the Domestic Finance Subcommittee of the ancestor of this Committee, then called the House Committee on Banking and Currency, disapprovingly reviewed the idea that the Federal Reserve should be "independent." This was in a House and committee controlled by the Democratic Party. The report has this to say:

-"An independent central bank is essentially undemocratic."

-"Americans have been against ideas and institutions which smack of government by philosopher kings."

-"To the extent that the [Federal Reserve] Board operates autonomously, it would seem to run counter to another principle of our constitutional order—that of the accountability of power."

In my view, all these points are correct.

The President of the New York Federal Reserve Bank testified to the 1964 committee, "Obviously, the Congress which set us up has the authority and should review our actions at any time they want to, and in any way they want to." That is entirely correct, too.

Under the CHOICE Act, such reviews would happen at least quarterly. I would like to suggest an additional requirement for these reviews. I believe that the Federal Reserve should be required to produce a Savers Impact Statement, quantifying and discussing the effects of its monetary policies on savings and savers.

The CHOICE Act requires of new regulatory rules that they provide "an assessment of how the burden imposed…will be distributed among market participants." This good idea should by analogy be applied to burdens imposed on savers by monetary actions. By my estimate, the Federal Reserve has taken since 2008 over $2 trillion from savers and given it to borrowers. The Federal Reserve may defend its sacrifice of the savers as a necessary evil—but it ought to openly and clearly quantify the effects and discuss the economic and social implications with the Congress.

<u>Accountability of Banks</u>

Let me turn to accountability in banking, under two themes: providing sufficient equity to capitalize your own risks; and bearing the risk you create—otherwise known as "skin in the game."

The best known provision of the CHOICE Act is to allow banks the very sensible choice of having substantial equity capital—to be specific, a 10% or more tangible leverage capital ratio—in exchange for reduction in onerous and intrusive regulation. Such regulation becomes less and less justifiable as the capital rises. As I testified last July, this is a rational and fundamental trade-off: More capital, less intrusive regulation. Want to run with less capital and thus push more of your risk onto the government? You get more regulation.

It is impossible to argue against the principle that there is *some* level of equity capital at which this trade-off makes sense for everybody—some level of capital at which everyone, even habitual lovers of bureaucracy, would agree that the Dodd-Frank burdens are superfluous, with costs higher than their benefits.

But exactly what that level is, can be, and is, disputed. Because banking markets are so shot through with government guarantees and distortions, there is no clear market test. All answers are to some degree theoretical, and the estimates vary—some think the number is less than 10% leverage capital--for example, economist William Cline finds that optimal bank leverage capital is 7%-- or 8% to be conservative. Some think it is more—15% has been suggested more than once. The IMF came up with a desired risk-based capital range which they concluded was "consistent with 9.5%" leverage capital—that's pretty close to 10%. Distinguished banking scholar Charles Calomiris suggested "roughly 10%." My opinion is that the fact that no one knows the exactly right answer should not stop us from moving in the right direction.

All in all, it seems to me that the 10% tangible leverage capital ratio, conservatively calculated, as proposed in the CHOICE Act is a fair and workable level to attain "qualifying banking organization" status, in other words, the more capital-less onerous regulation trade-off. The ratio must be maintained over time, with a one-year remediation period if a bank falls short, and with immediate termination of the qualifying status if its leverage capital ratio ever falls below 6%--a ratio sometimes considered very good. All this seems quite reasonable to me.

The CHOICE Act mandates a study of the possible regulatory use of the "non-performing asset coverage ratio," which is similar to the "Texas ratio" from the 1980s. The point is to compare the level of delinquent and nonaccrual assets to the available loan loss reserves and capital, as a way of estimating how real the book equity is. This study is a good idea.

To be fully accountable for the credit risk of your loans, you can keep them on your own balance sheet. This is 100% skin in the game. One of the true (not new, but true) lessons of the housing bubble was that loans made with zero percent skin in the game are much more likely to cause trouble. So Dodd-Frank made up a bunch of rules to control the origination of mortgages which feed into a zero skin in the game system. These rules are irrelevant to banks which keep their own loans.

The CHOICE Act therefore gives relief to banks holding mortgage loans in portfolio from regulations which arose from problems of subprime securitization, problems alien to the risk structure and incentives of the portfolio lender.

<u>Accountability for Deals with Foreign Regulators</u>

A challenging issue in the governance of the Administrative State are deals that the Treasury and the Federal Reserve are alleged to have made with foreign regulators and central bankers, is in the context of their participation in the international Financial Stability Board (FSB). These deals have been made, the suggestion is, outside of the American legal process, and then imported to the United States.

Were there any such deals, or were there merely discussions?

We know that the FSB has publicly stated that it will review countries for "the implementation and effectiveness of regulatory, supervisory or other financial sector standard and policies *as agreed by the FSB*." As agreed by the FSB? Does that mean a country, specifically the United States, is supposed to be bound by deals made in this committee? Did the American participants in these meetings feel personally committed to implement some agreements?

We also know that there is a letter which would shine light on this question: a September, 2014 letter from Mark Carney, the governor of the Bank of England and Chairman of the FSB, to then-Treasury Secretary Lew. This letter allegedly reveals the international discussions about American companies, including it is said, whether Berkshire Hathaway should be designated a systemically important insurer (an idea not politically popular with the Obama administration). A Freedom of Information Act request for the letter has previously been denied by the Treasury, which admits however that it exists.

I believe that Congress should immediately request a copy of this letter as part of its consideration of the "International Processes" subtitle of the CHOICE Act. While at it, Congress should request any other correspondence regarding possible agreements within the FSB.

The international subtitle rightly requires regulatory agencies and the Treasury to tell the Congress what subjects they are addressing in such meetings and whether any agreements have been made.

Accountability for Emerging Financial System Risks

The CHOICE Act makes a number of positive changes to the structure and functions of the Financial Stability Oversight Council (FSOC). Here I would like to suggest a possible addition.

I believe the responsibility for reporting to Congress on identified emerging financial system risks should be clearly assigned to the Secretary of the Treasury. As the Chairman of FSOC, the Secretary is in charge of whatever discussions are required with regulatory agencies, the Federal Reserve or foreign governments.

Forecasts of the unknowable financial future are hard to get right, needless to say, but I believe a unified, single assignment of responsibility for communications with Congress of the best available risk assessments would be a good idea.

Thank you again for the chance to share these views.