THE DODD-FRANK ACT FIVE YEARS LATER: ARE WE MORE PROSPEROUS?

HEARING

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THE DODD-FRANK ACT FIVE YEARS LATER: ARE WE MORE PROSPEROUS?

Tuesday, July 28, 2015

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:06 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Garrett, McHenry, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hurt, Stivers, Fincher, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Barr, Rothfus, Messer, Schweikert, Guinta, Tipton, Williams, Poliquin, Love, Hill, Emmer; Waters, Maloney, Sherman, Hinojosa, Clay, Lynch, Scott, Himes, Carney, Delaney, Sinema, Beatty, and Heck.

Chairman HENSARLING. The Financial Services Committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

Today's hearing is entitled, "The Dodd-Frank Act Five Years Later: Are We More Prosperous?" This is the second of three hearings examining the impact of the Dodd-Frank Act. The first was entitled, "The Dodd-Frank Act Five Years Later: Are We More Stable?" and the third hearing will be entitled, "The Dodd-Frank Act Five Years Later: Are We More Free?"

The Chair wishes to alert all Members that the Chair intends to close the hearing and adjourn at 1 p.m.

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

Under the Obama economic strategy, of which Dodd-Frank is a central pillar, our economic—our anemic recovery, rather—has created 12.1 million fewer jobs than the average recovery since World War II. For more than a year now, the share of able-bodied Americans in the labor force has hovered at the lowest level in nearly 40 years. Small business startups are at the lowest level of a generation.

Had this recovery simply been as strong as average previous ones, middle-income families would have nearly $12,000 more in annual income, and 1.6 million more of our fellow Americans would have escaped poverty. This is simply unacceptable.

But more than the numbers, my constituents' angst tells me all I need to know. One wrote me not long ago, "There are part-time jobs around my area, but always jobs with no benefits and less than 40 hours. My son is a disabled Iraqi Freedom combat veteran who has lost hope of finding a decent full-time job."

I suspect most Members of Congress unfortunately still receive letters just like these. The painful truth is that Dodd-Frank and the hyper-regulated Obama economy are failing low- and moderate-income Americans who simply want their fair shot at economic opportunity and financial security.

As we know, a recent Federal Reserve report stated that within a few years, roughly one-third of all Black and Hispanic borrowers may find themselves disqualified from obtaining a mortgage to buy a home because of Dodd-Frank's qualified mortgage rule, which is based solely on a rigid debt-to-income requirement.

Because of Dodd-Frank, free checking at banks has been cut in half. Furthermore, according to the FDIC, more than 9 million households don't have a checking or a savings account principally because account fees are too high or unpredictable, another consequence of Dodd-Frank.

Dodd-Frank's 2,300 pages launched a salvo of consequences that have crippled growth. It was advertised to target Wall Street, but instead it has hit Main Street. It has had pernicious effects on small businesses and community financial institutions, which are the lifeblood of the Main Street economy.

Community banks and credit unions supply the bulk of small business and agricultural loans. The combined weight of Dodd-Frank's 400 regulations is dragging them down. We are losing one community financial institution a day.

But Dodd-Frank goes far beyond banks and credit unions. Its corporate governance provisions hit every public company in America including grocery chains, cable TV servers, and bowling alley chains.

They didn't cause the financial meltdown but still must comply with regulations imposing wage controls, salary ratios, and private compensation disclosures made for big Wall Street firms. Every dollar these businesses are forced to spend on hiring lawyers and accountants to help explain this gibberish is taken out of working people's wages and capital expansion.

No wonder the economy limps along at 2 percent GDP growth—far below its historic norm. And no wonder low- and moderate-income Americans lose sleep at night worrying about their stagnant wages, smaller bank accounts, and childrens' future.

Hardworking Americans deserve better than Dodd-Frank.

The Chair now recognizes the ranking member for 5 minutes for an opening statement.

Ms. WATERS. Thank you, Mr. Chairman.

And welcome, witnesses.

I would like to acknowledge two distinguished former Members of Congress who are with us today: Congressman Brad Miller, our long-time colleague on the Financial Services Committee; and former Banking Committee Chairman, Senator Phil Gramm.

Today's hearing is focused on whether or not we are more prosperous 5 years after Dodd-Frank, which was enacted after our Nation suffered the greatest destruction of wealth in 80 years. Just as the Sarbanes-Oxley Act was enacted in reaction to several corporate and accounting scandals—most notably Enron—so, too, was

Dodd-Frank enacted as a reaction to years of deregulation, lax enforcement, and zero accountability for the Nation's financial institutions.

Even the legendary champion of the free market, Alan Greenspan, has now acknowledged that he made a mistake and that the market did not and cannot police itself. The crisis left an indelible mark on our financial system, our housing market, and our way of life.

We all know the numbers: 9 million Americans lost their jobs; 5 million homeowners lost their homes to foreclosure; and $16 trillion in household wealth was destroyed.

We have come a long way since those dark days. A new staff report released by committee Democrats shows unequivocally that Dodd-Frank has made our financial system more transparent, more stable, and more accountable.

The Consumer Financial Protection Bureau (CFPB) has returned $10.8 billion to 17 million defrauded consumers. Over-the-counter derivatives, once traded in the shadows, are now more transparent, and regulators are getting tougher on banks to ensure that their failure doesn't endanger the wider economy.

The stability created by Dodd-Frank has allowed us and our Nation to once again prosper. The housing market is improving, the economy has added nearly 13 million private sector jobs over 64 consecutive months of job growth, and the unemployment rate has plunged down to 5.3 percent. Moreover, the average 401(k) balance reached a record high last year, and the S&P 500 has risen by more than 250 percent since February 2009.

So we are more prosperous, but there is much more work to be done.

The crisis exacerbated what was already an unacceptably large wealth gap between white and minority households. The current wealth gap between African-Americans and whites has reached its highest point since 1989. The current white-to-Hispanic wealth ratio has reached a level not seen since 2001.

We need to make sure that it is not just Wall Street bankers who are becoming more prosperous, but also the millions of Americans who are worried about a roof over their head, worried about getting a job that pays a living wage, and worried about being able to afford the high cost of college.

Let me be clear: Recent history demonstrates that deregulation of our largest financial institutions, coupled with systemic disinvestment from low-income, middle-class, and minority neighborhoods is no way to ensure that prosperity is widely shared.

In fact, later today we will mark up 14 proposals which, in many cases, loosen the rules for large banks whose prosperity doesn't need any more assistance from this committee. Instead, we should be focusing on the residents of public housing, the cities and towns still devastated from the foreclosure crisis, and the community banks and credit unions that need relief.

Finally, Senator Gramm, you are the namesake of the so-called Gramm-Leach-Bliley Act, which you don't mention in your testimony, but which turned our Nation's biggest banks into megabanks and dramatically intensified the effects of the crisis. Opposing that measure is among the proudest votes I have taken as a Member of Congress. And in the aftermath of the crisis, some of that law's most fervent supporters very publicly reconsidered their support.

So I am very interested in hearing you discuss, after watching the harm and heartache of the 2008 crisis, if your views have at all changed.

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

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, chairman of our Monetary Policy and Trade Subcommittee.

Mr. HUIZENGA. I am very pleased to have this conversation. As a former licensed REALTOR®, I have seen firsthand the effects of Dodd-Frank in a lot of areas where frankly, people kind of said, "Wait a minute. How did this Wall Street collapse come about through our community banks, our insurance companies, our small local lenders, our local REALTORS® when we are dealing with some of the mortgages?"

But I want to touch on a couple of things today.

First and foremost, as I sort of dub them, the window-dressing provisions of Dodd-Frank, and things like pay ratio. The Wall Street Journal had an article today stating that the SEC looks like it is imminent in its execution of one of its duties that had been foisted—a priority foisted upon them by Dodd-Frank, which was to come out with rules regarding pay ratio.

And as we look at this—I have a bill to try to address that—we wonder, who does it cover, how is it calculated, why is it even in there, does it tell us why the collapse happened, and is it going to keep us from—keep it from happening again? Nobody has been more critical of the shortsightedness of business when it comes to dealing with their stock price being more of a focus than their long-term health, but it seems to me and so many others that this absolutely does nothing to get us further down that path.

Another one of those window-dressing provisions would be conflict minerals. I chair our Monetary Policy and Trade Subcommittee, where we deal with the conflict minerals. And I think the question is, is it working, and is it workable, especially as we look at things like gold that are affecting our manufacturers? And maybe more importantly, is it helping those whom it was intended to help?

And we have had continued testimony that, no, it is not. It is not actually helping those folks in those conflict areas throughout the world.

So I look forward to having those conversations today, talking about qualified mortgages and what is or isn't happening there. And as we look into this, I think many of us are convinced that Dodd-Frank was more of an agenda waiting for a crisis than an actual solution to a problem.

With that, Mr. Chairman, I yield back.

Chairman HENSARLING. The gentleman yields back.

I ask unanimous consent that the gentleman from Missouri be yielded 1 minute. Without objection, the gentleman is recognized for recognition.

Mr. CLAY. Thank you, Chairman Hensarling, and Ranking Member Waters.

Today, I am in a different kind of role. I am playing tour guide today and I brought a group of St. Louisians here—young ladies between the ages of 14 and 15 years old who are part of the St. Louis Eagles Basketball Club, and are here this week for a tournament. I understand they did pretty well.

But they come from the St. Louis region and I will be taking them on a tour. I wanted them to get some exposure to what we do on a day-to-day basis in this committee, and if the committee could welcome them, I would appreciate it. Thank you.

[applause]

Thank you, Mr. Chairman. I yield back.

Chairman HENSARLING. The gentleman yields back.

Today, we welcome the testimony of three distinguished panelists.

I am especially happy to recognize and introduce the Honorable Phil Gramm, who is a senior partner at U.S. Policy Metrics. He served with distinction in the House for 3 terms, and in the United States Senate for 3 terms, where he authored such landmark laws as Gramm-Latta, Gramm-Rudman, and Gramm-Leach-Bliley.

Previous to his public service career, he taught economics for 12 years to Texas Aggies, including yours truly. He holds a Ph.D. in economics from the University of Georgia.

Next, the Honorable Brad Miller, who is Of Counsel at Grais & Ellsworth, LLP.

We welcome you back, sir.

Brad Miller served in this committee room as a Member of the House for 10 years, including as a member of our committee. He is a former chairman of the House Science Committee's Investigations and Oversight Subcommittee.

Prior to his election to Congress, Congressman Miller practiced law for more than 20 years. He holds a J.D. from Columbia, a master's degree from the London School of Economics, and a B.A. from the University of North Carolina at Chapel Hill.

Last but not least, Peter Wallison is the Arthur Burns Fellow in Financial Policy Studies at the American Enterprise Institute (AEI). He is the author of many scholarly works, including his latest book, "Hidden in Plain Sight," which I believe to be the definitive work on the cause of the 2008 financial crisis.

Prior to joining AEI, Mr. Wallison practiced banking and corporate and financial law at Gibson, Dunn, and Crutcher. And from June 1981 to January 1985, he was General Counsel at the U.S. Treasury Department.

He received his undergraduate degree from Harvard and his law degree from Harvard Law School.

For you two former Members of Congress, just in case you are a little rusty on the lighting system: green means go; yellow means you have a minute to go; and red means the Chair would really prefer for you to stop.

Mr. Wallison, we know that you have been a frequent witness before us.

So at this time, Senator Gramm, welcome once again. You are recognized for 5 minutes to summarize your testimony.

STATEMENT OF THE HONORABLE PHIL GRAMM, SENIOR PARTNER, U.S. POLICY METRICS; AND FORMER UNITED STATES SENATOR

Mr. GRAMM. Chairman Hensarling, Ranking Member Waters, it is quite an honor for me to be here today.

I had the distinct pleasure of having a long and rich relationship with your chairman. Long ago and far away at Texas A&M I taught him money and banking. And as any old teacher would, I have taken great pride in what he has accomplished and the man he has become.

Let me begin by answering the question about the economy. By any measure, we are experiencing the poorest recovery in the post-war history of America. If we had simply equaled the average of the 10 previous recoveries in the post-war period, 14.4 million more Americans would be working today, and the average income of every man, woman, and child in the country would be over $6,000 higher.

Five years after the enactment of Dodd-Frank, the cause and effects of the failed recovery can be seen throughout the banking system. Monetary easing by the Fed has, in fact, inflated bank reserves, but it has hardly had any impact on bank lending.

Remarkably, today banks hold $29 of reserves for every $1 they are required by law to hold. I don't know of a single instant in American history when we have remotely approached this situation.

According to the FDIC, there are 1,341 fewer commercial banks today than there were when Dodd-Frank became law. Remarkably, only 2 new bank charters have been granted in the last 5 years. By comparison, even in the depths of the Great Depression, 19 bank charters a year, on average, were issued.

As regulatory burden has exploded under Dodd-Frank, community banks have hired 50 percent more compliance officers while total employment in the industry has grown by only 5 percent and, in fact, is still below the pre-crisis level.

According to a study by the American Bankers Association that was issued last week, increasing regulatory burden has led almost half of all commercial banks in America to reduce their offering of financial products and services.

In the Securities Exchange Act of 1934, and most subsequent banking law prior to Dodd-Frank, the powers granted to regulators by Congress were fairly limited, and were generally exercised by bipartisan commissions where major decisions were debated and voted on in the clear light of day. Precedents and formal rules were known by the people who were regulated, and regulators were generally responsive to Congress, which, after all, still controlled their appropriations.

These checks and balances weren't perfect, but they produced a general consistency and predictability in Federal regulations.

All of that changed under Dodd-Frank.

The Consumer Financial Protection Bureau (CFPB) was structured with no bipartisan commission. It had automatic funding as an entitlement, which virtually eliminated any real ability for lawmakers to have any check on its actions. In the process, consistency and predictability were replaced by uncertainty and fear.

Since the Financial Stability Oversight Council (FSOC) meets in private and is made up exclusively of the sitting President's appointed allies, bipartisanship and sunshine, the historic checks on regulatory abuse, have been lost.

What constitutes a systemically important firm or what is a passing grade on a living will are not defined in law and, in fact, the regulators have almost total discretion in deciding what "systemically important" means and what is a passing grade on a living will.

What does the stress test test? Not only does no one know, but regulators see the fact that no one knows as a virtue.

You probably saw the statement that was made by the Vice Chair of the Fed that if you gave people a roadmap as to what was being tested, it would be easier to game the test. Does nobody realize that the fact that compliance is easier when you know what the law is, is why we have laws in the first place?

To limit the abuse of rulers, the Romans long ago instituted the revolutionary practice of writing the law down so that people could go and read the law. Under Dodd-Frank today, the conditions of Roman law no longer exist in the United States of America.

The rules are now whatever regulators say they are. This is not the rule of law; this is the rule of government. It is shackling economic growth. And what is even more important is that it is threatening our freedom.

Thank you, Mr. Chairman.

Oh, by the way, I still have a minute and 43 seconds.

Chairman HENSARLING. No, you are a minute and 43 seconds over.

Mr. GRAMM. Darn. I'm sorry.

[laughter]

Mr. GRAMM. All right. Well, it was a good effort.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Gramm can be found on page 54 of the appendix.]

Chairman HENSARLING. But as far as this chairman is concerned, you were on a roll.

Congressman Miller, again, welcome back to your home. It is good to see you again. You are now recognized for your testimony.

STATEMENT OF THE HONORABLE R. BRADLEY MILLER, OF COUNSEL, GRAIS & ELLSWORTH LLP; AND FORMER MEMBER OF CONGRESS

Mr. MILLER. Thank you, Mr. Chairman. I never quite regarded this as my home.

But as the chairman said, I did serve for an eventful decade as a member of this committee. I introduced legislation in 2004 to prohibit predatory subprime mortgage lending.

According to the industry and their many allies on this committee, I probably meant well, but dreary rules like those I proposed were relics from a distant time when the financial industry did not perfectly understand and manage risk, and would deny low-income and minority borrowers the dream of home ownership.

Subprime mortgages, they said, and many of you said, were the triumph of the innovation that comes from unfettered capitalism. I have not heard that argument since the financial crisis.

But since then, I have heard another argument that I never heard before, that liberals bullied innocent banks into giving foolish mortgages to low-income and minority borrowers. It was government, they said, that caused the crisis.

Scholars have repeatedly demolished that argument, but I did not believe it the first time I heard it because of what I know about the law of evidence. When a witness' statement is self-serving, the witness made prior inconsistent statements, and the witness cannot or will not explain the inconsistency, you can decide not to believe a word the witness said.

The Dodd-Frank Act is the response to the worst financial crisis and the worst economic downturn since the Great Depression. The Act includes a version of the home mortgage rules that I first introduced in 2004. The Act created the Consumer Financial Protection Bureau to protect against other abusive practices and to skeptically examine industry arguments that new lending practices that may appear predatory are really marvels of innovation.

The Act requires banks to have more capital and gives regulators authority to require large financial institutions to show that they won't bring the entire financial system down if they get in trouble—if they fail, and to make changes if they can't. Trading in derivatives is more transparent than it was before, although that is a pitifully low standard.

Dodd-Frank was a compromise and probably the most that was possible at the time, given the industry's continued enormous clout in Washington, even while the industry stood in complete disrepute among the American people. We are better off and more prosperous than we would have been without it.

But we have a financial system that still needs reform. The industry is too crooked, too large, and takes too much of the economy at the expense of people trying to make an honest living. Instead of a smooth flow of money from savers to people who can put money to productive use, far too much money coagulates on Wall Street.

First, there has been no end to scandals: pervasive misrepresentation of the mortgages that backed mortgage-backed securities; manipulation of LIBOR and the other BORs; manipulation of electricity and other markets; rigging foreign exchange markets, and on and on.

According to a recent survey, almost half of financial industry professionals said they thought their competitors were cheating, and 22 percent said they had personal firsthand knowledge of misconduct in the workplace.

According to a 2012 poll, 68 percent of Americans disagreed with the statement, "In general, people on Wall Street are as honest and moral as other people."

William Dudley, the head of the New York Fed and a Goldman Sachs alum, said last year that the repeated scandals were not the work of a few bad apples but the product of the culture of Wall Street, and were a threat to financial stability.

And some, to quote the Republican frontrunner, I assume are good people.

Second, the financial sector has more than doubled in size as a percentage of the economy since 1980. Largely because of the desperate mergers during the crisis, on top of the deregulation of the 1990s, including Gramm-Leach-Bliley, the biggest banks are even bigger.

Some on this committee have pointed to that consolidation as evidence that Dodd-Frank has made the system less stable, but have not supported any legislation to break up the biggest banks. I introduced legislation to break up the 6 biggest banks into at least 30 banks by capping the overall size.

I do not recall any support for that proposal among critics of the banks. Instead, Congress repealed the provision of Dodd-Frank that required the riskiest swaps to be traded in a separately capitalized subsidiary to protect taxpayer-insured deposits and our economy's payment system.

Most of the debate on the size of the financial system have been about what would happen if things go wrong, like the London Whale trades. What happens when things go right is just as big a problem. When things go right, there is a harm that often goes undetected, like a patient with a parasite who does not understand why he is always tired.

The Whale trades were in JPMorgan Chase's synthetic credit portfolio. Synthetic credit is a bet whether a borrower defaults on a debt to someone else. The contribution to the economy of synthetic credit appears to be approximately the same as the nutritional value of plastic fruit.

After the financial reforms enacted in the New Deal, the economy grew by 8 percent a year for the first 4 years of the Roosevelt Administration before the recession of 1937 and 1938. That will be hard to replicate.

But the reforms ended frequent financial crises, and America had a steady growing economy that lasted for well more than a generation and created widely spread prosperity. The prosperity extended to many Americans who had been left out before.

Yes, I want to avoid another financial crisis, but I also want an economy that grows and creates more prosperity for more Americans. To accomplish that, we still have work to do.

[The prepared statement of Mr. Miller can be found on page 60 of the appendix.]

Chairman HENSARLING. Mr. Wallison, you are now recognized for a summary of your testimony.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Chairman Hensarling, Ranking Member Waters, and members of the committee.

As Senator Gramm noted, the recovery of the U.S. economy since the financial crisis has been by far the slowest since the mid-1960s. The slide now on the screen shows how the recovery since 2009—that is the red line—lags the average of all recoveries since the mid-1960s.

We can find the reason for this slow growth in the excessive regulation that the Dodd-Frank Act imposed on the banking system beginning in 2010. One example is the requirement that banks with more than $50 billion in assets be treated as systemically important financial institutions (SIFIs). SIFIs not only receive stringent regulation by the Fed but are also required to file living wills and participate in stress testing.

These add substantial costs, particularly by requiring these banks to hire more compliance officers and fewer lending officers. The result is less credit and more expensive credit for business firms that borrow from banks.

The reason for requiring $50 billion banks to absorb these costs was the fear that if such a bank failed, it would cause another financial crisis. This seems highly implausible.

The U.S. banking system has assets of $17 trillion. A $50 billion bank has 0.3 of 1 percent of all U.S. banking assets, which is a tiny amount. Indeed, a $200 billion bank has only 1.2 percent of all banking assets, and a $500 billion bank has only a little more than 3 percent.

It is absurd, I think, to believe that the failure of an institution or institutions of this size will cause instability in the U.S. financial system, which itself has $85 trillion in assets.

In enacting Dodd-Frank, Congress sought to create stability through additional regulation, but they seriously overshot. The cost-benefit calculation was wrong.

Very little benefit in the form of stability was gained by forcing more costly regulation on banks between $50 billion and $500 billion in size, but a lot of economic growth has been lost.

The same is true for banks smaller than $50 billion and for community banks. They have also been hit with new and costly regulations under Dodd-Frank, and that has caused them to reduce their lending and to charge more for what they do lend.

How did this additional regulation reduce economic growth? The reason is the cost of reduced bank credit fell disproportionately on small business. Smaller firms need bank credit.

Larger firms have access to the capital markets. They are able to register their shares with the SEC and file regular financial reports. They can obtain the financing they need by issuing bonds, notes, and short-term credit instruments in the capital markets.

In fact, about two-thirds of all credit—I have another slide there—for businesses in the United States comes through the capital markets. This slide shows that only about one-third comes through the banking system, and that percentage is declining relative to the capital markets.

Because smaller firms can't access the capital markets, they are dependent on bank credit. The result has been what we might call a bifurcated economy. Larger firms are growing at a pace consistent with past recoveries, but smaller firms are not growing much at all.

The combination of the two has created this very slow recovery.

In my prepared testimony, I reported on a recent Goldman Sachs study. This showed that firms with $50 billion or more in revenues have been growing at a compound rate of about 8 percent, well in line with past recoveries, but firms with less than $50 billion in revenues were growing at about 2 percent a year.

Also, all firms with more than 500 employees added an average of about 42,000 jobs a month between 2010 and 2012, while firms with fewer than 500 employees declined by about 700 employees a month during the same period.

Since we know that it is small business and business startups that provide most of the growth in our economy and most of the new employment, the inability of smaller firms to get sufficient credit from banks has had a disproportionate effect on overall economic growth.

To change this situation and restore economic growth, Congress should make sure that Dodd-Frank's excessive regulatory burden applies only to the very largest banks.

Thanks very much. I look forward to your questions.

[The prepared statement of Mr. Wallison can be found on page 63 of the appendix.]

Chairman HENSARLING. The Chair now recognizes himself for 5 minutes.

Senator Gramm, you are the coauthor of the budget that helped ignite the Reagan recovery, and I know that you have written on the subject of the Reagan recovery versus the Obama recovery.

If we could go back to Mr. Wallison's first slide, we know that during the recession of 1982 we had deeper unemployment, we had an even greater recession, as far as negative GDP was concerned. And yet, we know that the Reagan recovery came back quicker and stronger.

What is the difference? What is the tale of the two recoveries?

Mr. GRAMM. Mr. Chairman, first of all, the difficulties went beyond unemployment and the depth of the recovery because we had very tight monetary policy trying to break the inflation of the 1970s, so interest rates peaked at 21.5 percent. Inflation was 13.5 percent. Those were the headwinds faced by the Reagan recovery.

Reagan's basic approach was that the problem was government. That was his diagnosis. And his solution to the problem was to have less of it.

He reduced government spending except to defense. We were at that point losing the Cold War, which changed. He cut taxes. There was strong bipartisan support for his budget and his tax cut.

He reduced the regulatory burden. And, as they say in the history books, the rest was history.

If the Obama recovery had matched the Reagan recovery during the same period of time—that is, over a 7-year period—we would have produced 19.9 million more jobs than the Obama recovery created, and per capita GDP would be $9,100 higher. That is $9,100 a year for every man, woman, and child in America in the Reagan recovery, as compared to the Obama recovery.

In the Obama recovery, not only did the poor, working, middle-income Americans, including women and minorities, lose in the recession, but they have lost in the recovery as well, something that has no precedent in the post-war period. The Reagan recovery, on the other hand, caused a decline in poverty and every one of those groups benefitted.

So, I guess the difference was I think Reagan had the prescription right that the problem in the 1970s was the government was too big, too powerful, too expensive, and exerted too much control over the economy.

I think the problem in the Obama recovery has been that the diagnosis was false. Sure, there is greed on Wall Street and everywhere else.

But what caused the financial crisis was the pressure on banks to make subprime loans through CRA, and the fact that there were HUD housing quotas on Freddie Mac and Fannie Mae requiring that they hold subprime loans starting out at 25 percent of their portfolio and going up to 57 cents of every dollar they held. When the bubble finally broke, what happened was described accurately in President Obama's economic analysis in each of his budgets in 2010, 2011, 2012, and 2013, and I quote: "In August of 2007 the United States subprime market became the focal point of a worldwide crisis. Subprime mortgages are provided to borrowers who do not meet the standard criteria for borrowing at the lowest prevailing interest rate because of low income, poor credit, lack of downpayment, and other reasons. In the spring of 2007 there was $1 trillion dollars of such outstanding mortgages and, because of falling home prices, many of these mortgages were on the brink of default."

Now if you were counting, and of course I was, he mentions mortgages six times, subprime twice, but he never mentions deregulation, Glass-Steagall, Gramm-Leach-Bliley, credit default swaps, or Wall Street greed. And this is not a campaign document. This is the budget of President Obama.

So I think the diagnosis was wrong and it produced this massive increase in regulation, which choked the recovery.

Chairman HENSARLING. The time of the Chair has expired.

The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Brad Miller, back in 2005, joining with former Congressman and now Federal Housing Financial Agency Director Mel Watt, and former Chairman Barney Frank, you attempted to end predatory mortgage lending by putting forth a bill modeled on North Carolina law that would have curtailed abuses in the subprime mortgage market.

At the same time, Republicans opposed that bill with members like my chairman, Chairman Hensarling, noting, and I quote, "With the advent of subprime lending, countless families now have their first opportunity to buy a home or perhaps be given a second chance."

How did Republicans feel about subprime lending back in the first half of the last decade when they were in control of the House? Did any Republicans help you to advance your bill? Were any Republicans worried about the growing abuses in the subprime mortgage market?

Can you discuss the tremendous amounts of lobbying that took place in opposition to your bill at the time? Specifically, how and why did companies like Bear Stearns, shortly before the collapse, lobby in opposition to your bill? Help us understand what was going on.

Mr. MILLER. Yes. There was a great deal of lobbying against it. There were not many Republicans who favored it. I did have some discussions with Spencer Bachus that appeared to make progress for a while, which kind of fell apart.

But the arguments that we have heard since then, we never heard at the time. And what we heard at the time was also not true. What we have heard since then is not true, but what we heard at the time was not true either.

Subprime mortgage lending was never about home ownership. The subprime mortgage model was to lend to people who already owned their own homes—70 percent were refinances and had a lot of equity in their home—and the mortgages were designed to catch them in a cycle of borrowing and borrowing again with tricky little things buried in the legalese to strip their equity in their home.

It also was not about helping people who otherwise could not have gotten a prime loan. Every study of subprime mortgages during that period shows that people who got subprime mortgages qualified for prime mortgages but got talked into subprime mortgages.

That is why the foreclosure crisis has been so much worse on the African-American community and on the Latino community. It has almost been an extinction event of the African-American and Latino middle classes because of the extent to which they were targeted by subprime mortgages.

The typical terms would be a 2/28 or 3/27. There would be a teaser rate at the beginning, which was probably the only thing that the home owner understood when they walked out of the closing or settlement, as it is called in a lot of States. They walked out knowing what their monthly payment would be. Well, 2 years later or 3 years later it jumped by 40 percent.

And then to get out of it—which they couldn't begin to do because they couldn't afford to pay a 40 percent increase in their mortgage—they had to pay a prepayment penalty, which was 3 percent.

And it all worked fine for the lenders and for all the mortgage establishments, including Wall Street, including Bear Stearns, including all the banks that brought that stuff and put them in mortgage-backed securities and sold them to guileless investors in the United States and all over the world.

The explanation at the time was not true. The explanation since then is not true.

Yes, this was caused by greed. This was caused by the lack of regulation. This was caused by the lack of agility of the Federal Government in responding to new practices.

Congress did pass legislation designed to get at predatory mortgage lending in 1994, the Home Ownership and Equity Protection Act (HOEPA). And sure enough, the industry stopped those particular practices, but the requirement of that statute that the Federal Reserve issue new regulations to address new practices never happened.

Yes, it was the result of greed. It was equity-stripping. As the bubble inflated, as when the bubble collapsed, home owners could not begin to pay their mortgages, could not sell their houses because they owed more than the houses were worth. And then it started a continuous spiral that has still not been completely broken.

Ms. WATERS. Mr. Miller, you described some of what was going on. The no-doc loans, the interest-only loans, all of these exotic products were part of the predatory lending scheme, isn't that right?

Mr. MILLER. Yes. They were all part of predatory lending.

There were some non-prime loans that were not so unwholesome that really did seem to be designed to address differences in borrowers' creditworthiness, but those got into a lot of trouble too when the entire—when home values collapsed.

Ms. WATERS. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, chairman of our Monetary Policy and Trade Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And I would love to continue the housing discussion but I need to hit on a couple of things. I want to talk a little bit about pay ratio and conflict minerals and what I would describe as these window-dressing provisions of Dodd-Frank.

I want to start off with a quote from SEC Chair Mary Jo White, where she was talking about conflict minerals and about how the Commission's mandatory disclosure powers seemed more directed at exerting societal pressure on companies to change behavior rather than to disclose financial information that primarily informs investment decisions.

After she said she may, as a private citizen, wholeheartedly agree with some of these objectives, she added, "But as Chair of the SEC, I must question as a policy matter using the Federal securities laws and the SEC's power of mandatory disclosure to accomplish these goals."

She is talking specifically about conflict minerals, which I want to touch on, but it seems to me that also applies to the pay ratio situation and the requirement that, as was mentioned earlier, The Wall Street Journal said was imminently coming out of the SEC.

And Dr. Gramm was talking about those who have been left behind—minorities and women and so many others. And in that Wall Street Journal article, the AFL-CIO's study is quoted: "In 1980, 42 times was the ratio of, typically, the average worker to the CEO; it is now in 2014, 373 times."

Let's assume that those numbers are right. Some of that has been what I have been very critical of, performance based on stock price versus a long-term view, oftentimes is it, or maybe the options have grown that ratio.

I think we have agreed that there are maybe some things out of balance, but isn't this more of a symptom rather than the root cause of this? And if it is not the root cause, why in the world are we having the SEC go through all the machinations of this?

Mr. Wallison, I am going to give you first crack at this, specifically in these two areas.

Mr. WALLISON. I think one of the problems that we face here is that enormous costs were placed on the financial system by the Dodd-Frank Act, and these two you mentioned, the pay ratio issue and also conflict minerals, are examples of costs that are added to the financial system and added to the economy in general.

And every time you add these additional costs, you reduce the amount of credit that is going to be available for businesses to—or you are requiring businesses to respond to costs which mean that they cannot then produce the kinds of goods and services that they are supposed to be producing.

Mr. HUIZENGA. It strikes me that the question we really need to have is, "To what end and to what benefit? And who is this benefitting?"

And it seems to me that we are just surely generating paperwork to generate paperwork. We know that the costs of this—the SEC itself has estimated that the pay ratio rule would impose 545,000 annual hours of paperwork, and that this could add up to annual costs on the private sector of $710 million with an annual compliance time of 3.6 million hours.

Dr. Gramm, would you care to comment on this?

Mr. GRAMM. Look, it goes way beyond paperwork. What all this is about is demagoguery. It is the one form of bigotry that is still allowed in America, and that is bigotry against the successful.

Why do people pay executives a lot of money? Why do CEOs make these huge salaries? Because they add value.

If somebody takes over a company and it succeeds, they get rewarded. If it fails, they get fired.

It is not the government's business. As a shareholder, I own the company, not the government. It is my money, not the government's money.

So if I just want to give it away, then I ought to be free to do so. Now, maybe the government should assess a gift tax. I don't want to suggest that to anybody.

But the point is, people pay for performance. And there are some people who are able to add tremendous value.

Joe Namath did as quarterback for the New York Jets. He is the most exploited football player in history even though he made the highest salary, because he added more value than he got.

My friend Ed Whitacre at AT&T, if there has ever been an exploited worker—even though they made a big deal about him getting $75 million when he retired, the man added billions of dollars of value. He was exploited. It was an outrage.

But nobody is raising hell about it. They are raising hell about the fact that he made a lot of money and other people would like to have the money. And even if they don't want it, they don't want him to have it. I don't get it.

Mr. HUIZENGA. Mr. Chairman, I think most of us have concluded that Dodd-Frank—or the SEC needs to deal with much more important issues than some of these window-dressing items. So with that, I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney, ranking member of our Capital Markets Subcommittee.

Mrs. MALONEY. Thank you so much, Mr. Chairman, for calling this hearing.

And I welcome our distinguished panelists. It is good to see two former Members here.

Welcome back.

Dodd-Frank was a landmark bill that overhauled the regulation of financial services in this country. But it was not written in a vacuum.

It was a response to a devastating crisis which cost this economy $16 trillion in household wealth. Unemployment reached 10 percent, the highest level in 25 years, 9 million people lost their jobs, and 4 million Americans lost their homes.

And while there were many factors that led to the financial crisis, it had its roots in predatory subprime mortgages. And these were loans that never should have been made and that ended up harming the consumers and the lenders and the overall economy.

Because so many of these toxic mortgage loans were made, and so many of them were packaged into securities and sold to investors all around the world, the implosion of the subprime mortgage market had ripple effects throughout the global economy.

Now, 5 years after Dodd-Frank was passed, those kinds of toxic predatory mortgage loans are prohibited, and it is hard for me to see or understand how this is anything other than a benefit for consumers, banks, and the overall economy. So I, for one, think that the fifth anniversary of Dodd-Frank is a reason for celebration.

There was a chart up here earlier which showed what I call the deep red valley, where we were losing 750,000 jobs a month when President Obama took office. And Christina Romer, the former head of the Council of Economic Advisors for the President, testified before this body and others that the economic shocks from the economic downturn were at least 3 times worse than the Great Depression.

This particular chart—I wish they would put it up there again—shows that when Dodd-Frank was put in place, the blue starts growing, which is jobs and a growing economy.

So I would like to ask my former colleague, Brad Miller, who was very active in this subprime battle, and had his own legislation, and took leadership in all the debates, Congressman Miller, as you know, many of our colleagues on the other side of the aisle like to say that the sole cause of the 2008 crisis was the fact that far too much credit was extended to low-income people. And yet, they also opposed the CFPB's rule that requires lenders to verify a borrower's ability to repay a mortgage loan before they extend credit—the so-called qualified mortgage.

Shouldn't they support such a commonsense proposal? If this proposal had been in effect prior to the crisis, would so many toxic mortgage loans have been made?

Mr. MILLER. Pointing out hypocrisy by politicians is too easy. It is almost not fair.

But yes, if we had had sensible regulations in place to prevent subprime mortgage lending, and particularly the kind that we had which created an unsustainable mortgage that people could not get out of when property values declined, we would not have had the bubble, we would not have had the burst of the bubble, we would not have had so many—liquidity is frequently praised but liquidity just means the ability to borrow money freely. And when you borrow money freely to buy an asset that goes down in value, a lot of liquidity proves to be a problem a little bit later on. And that is essentially the problem we had.

It was the same problem. The bubble in the Great Depression, or that led to the Great Depression was the bubble in the stock market.

Liquidity is a really good thing to have until it isn't.

Mrs. MALONEY. We also heard many testimonies from economists who said this was the first economic downturn in our history that could have been prevented because it was created by the mismanagement of the financial system. I, for one, believe markets run more on trust than on capital. And Dodd-Frank imposed regulation that put more trust back into our markets, which is one of many reasons why our economy is improving.

My time has expired. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, chairman of our Capital Markets Subcommittee.

Mr. GARRETT. I thank the chairman.

I will start with Mr. Wallison.

Would you agree with this premise or statement that it is intolerable when any class of people—minorities or the poor—are intentionally discriminated against, when they are unfairly targeted in the financial markets, in the housing markets, by illegal, unconscionable, unfair practices in that marketplace? Do you agree—

Mr. WALLISON. Yes. Of course, I agree with that.

Mr. GARRETT. And is it for that reason that this committee meets regularly to make sure that we do have adequate laws both on the Federal level and also on the State level to target those bad actors—and you agree that there are bad actors in this marketplace?

Mr. WALLISON. Absolutely.

Mr. GARRETT. And that is why we meet to target—have legislation to target those bad actors, and to address those unfair practices. Do you agree with that?

Mr. WALLISON. Yes, I do.

Mr. GARRETT. All right.

Now, Mr. Miller, I am bad at quotes, but there is a quote by Winston Churchill that goes something like, "History is going to be kind to me because I intend to write it." I don't know what history you are writing, but you wrote today's statement so it would be kind to past practices of the Obama Administration in this area.

One of your comments was that scholars have said that there was no problem with forced regulation—or regulation forcing the banking industry to commit these or execute these subprime loans. That may be what scholars wrote from their ivory towers, as far as whether regulation was a cause of this or not, but I can tell you this committee had numerous hearings where we didn't listen to scholars but we listened to the actual people in the field—the actual bankers—who told us repeatedly that regulation was a driving force behind their writing of subprime loans, that regulation told them how to do the underwriting, starting way back whether it was the Boston Fed describing what income and assets would be considered, to the actions of the Fannie Mae and Freddie Mac, all the way along the line, and the other regulators as well.

I think the actual people on the front line best describe what effect a regulation had on a marketplace.

So we know that—well, I will close on this, Mr. Wallison—you admitted—or you say that there were some bad actors in the marketplace, but you also in your testimony, and also your report after the last crisis indicated that regulation was a factor, as well, if you would like to comment on that briefly?

Mr. WALLISON. Yes, I would. If I have the time, I would like to say a number of things about this subject, but you are questioning it, so go ahead.

Mr. GARRETT. Your report indicated that regulation played a role. That is history. Now we have to look to see what effect our current laws will have going forward, both on the minority and the poor populations, as well.

So let me just ask this: The E.U. commissioner for financial services, Jonathan Hill, said that he would look at the combined effect of all the laws that have been passed to make sure we have the balance right between reducing risk and fostering growth, and where we haven't got it right, we should have the self-confidence to make changes.

Has anyone in this Administration, to the best of your knowledge—or Senator Gramm, you can comment on this, as well—said that this Administration is going to do a review of all the laws on the books to see that there will not be a negative impact upon the minority population or the poor population, to see the cumulative effect that it may be degrading their ability to get a loan and get a mortgage?

Both gentleman may respond.

Mr. GRAMM. Let me respond in the following way: There was one provision of Dodd-Frank related to mortgages that I thought was a very good provision, and it was what I would call the skin-in-the-game provision. It basically said if you make a mortgage, you have to hold a certain percentage of that mortgage, and you had to take the first loss, generally discussed at the 5 percent level.

What happened to it? What happened to it is that this Administration would not enforce that law.

Now, I thought it was a good law—that provision—because it basically said if you make a bad loan and it goes bad, even though it is securitized and some retirement fund has borrowed it—bought the security, you are going to take the first 5 percent of the loan.

I don't see any evidence that this Administration has taken the lessons of the subprime crisis seriously. They are pushing CRA again and requiring banks to make loans. They are lowering downpayments.

It seems to me they are determined to go back to the same system that created the problem. And forgive me for—there were bad actors. There were predatory loans. But there were 100 predatory borrowers for every one predatory lender.

The law required the loans to be made. It required people to make subprime loans. It required Freddie and Fannie to hold subprime loans. If these loans were so good, why did you have to make them make them?

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Chairman Hensarling and Ranking Member Waters, for holding this important hearing.

And thank you to my former and distinguished colleagues and the other panel member for your testimony and appearance here today.

In the wake of the worst financial crisis since the Great Depression, the whole of our financial banking system teetered on the brink of collapse. To prevent such a calamity from happening again, we enacted the Dodd-Frank Act.

This Act has strengthened oversight of Wall Street, given regulators the tools to end too-big-to-fail banks, and brought much-needed transparency to markets by eliminating loopholes that allowed risky and unfair and abusive practices to go unnoticed and unregulated.

Importantly, Dodd-Frank restored confidence in our markets and has brought our economy back from the depth of the deep recession. In the longest-running job creation streak in our history, we have added millions of jobs, lowered the unemployment rate, and added back $30 trillion to our Nation's wealth.

My first question goes to my good friend, Congressman Bradley Miller. It is undisputed that the widespread use of predatory and subprime mortgage products like adjustable rates, coupled with lax underwriting, caused a mortgage crisis when borrowers began defaulting in mass. However, many contenders like to ignore the fact that the mortgage crisis became a financial and economic crisis of epic proportion only because of a completely unregulated and opaque world of derivatives, such as credit default swaps.

How did the Commodity Futures Modernization Act of 2000 create a situation which fueled that financial crisis of 2008, and what rationale was used to pass said law?

Mr. MILLER. I wasn't around when that was enacted; I was in the State legislation of North Carolina dealing with entirely different issues. But the Commodity Futures Modernization Act prohibited any regulation of derivatives either at the Federal or State level, and in the first 6, 7 years I was a member of this committee, there was never a hearing that talked about derivatives at all.

According to the testimony in the recent trial about the AIG bailout, if AIG had not been bailed out, if they had not paid 100 cents on the dollar without getting anything for it on credit default swaps, which galled me at the time, and I said so, as a member of this committee, that Morgan Stanley would have gone down immediately, and Goldman Sachs would not have been long behind. It would have brought the entire financial system down.

And then Morgan Stanley and Goldman owed a lot of people money, and if they couldn't pay that a lot of people were going to be—a lot of financial participants—industry participants would have been out of business.

Derivatives also create both a motive and a mechanism for a great deal of gamesmanship in the economy that is entirely useless, that really—I have yet to hear a remotely persuasive explanation of the benefit that they bring—that the physical markets for the referenced data assets are like this; the paper markets, the derivative markets are like this, and there is a huge amount of gamesmanship.

There is now in the bankruptcy—

Mr. HINOJOSA. Time is running out on me.

Mr. MILLER. All right.

Mr. HINOJOSA. I like what I hear from you. I agree with you.

Tell me, how has the Dodd-Frank Act addressed these two issues of proper underwriting of the mortgages and the transparency and safety in the derivatives market?

Mr. MILLER. On the underwriting of mortgages, there are now rules that require that mortgages be—that there is an ability to repay not just in the first 2 years, not just in the first little bit, but across the life of the mortgage. That will prohibit a lot of the worst practices of the last decade. And there are other provisions that are real reforms in the kind of practices we have.

With respect to derivatives, there is now more of a requirement of transparency. They are traded mostly on exchanges.

That means that you can—someone who wants to buy a derivative—God only knows why anybody would want to, but if you want to buy a derivative you can call up on your computer screen and see what the yields—what the spread is. And there is a great deal more transparency about it and real market forces.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, chairman of our Housing and Insurance Subcommittee.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Wallison, I am in the process of reading your latest book, and it is quite informative and I certainly enjoy it. It makes the long hours back to Missouri on a plane more bearable.

But a quick question for you with regards to the GSE situation that you discuss and the history of it there. It looks to me like Dodd-Frank is steering the mortgage lending away from banks and private lenders back into the GSEs, which we have tried to get away from, but it looks like we are going the other direction.

And so, I would like for you to comment on what effect you think Dodd-Frank has had with regards to that, and is that a good thing or a bad thing?

Mr. WALLISON. First of all, there has been so much myth recited here. I would like to just go back and say one thing about the financial crisis so that we understand a little bit more about it.

Now, predatory lending now doubt occurred, but the Financial Crisis Inquiry Commission was unable to find enough data to show that it was significant. What we learned from the financial crisis is that in 2008, more than half of all mortgages in the United States were subprime. And of those, 76 percent were on the books of government agencies—primarily Fannie Mae and Freddie Mac, FHA too.

The point is that the government had required certain quotas to—of mortgages to be made to people below median income. Now, there was no reason why that was a bad idea except for the fact that if you make those quotas too high, then the GSEs had to reduce their underwriting standards, which they did. That is why 81 percent of all of the losses that Fannie suffered, they reported as coming from subprime and other low-quality mortgages.

So in any event, the important point here is that we have to keep our underwriting standards high, and what we have done recently was to reduce those underwriting standards again, because it is always in the interest of the government to reduce underwriting standards. It increases home purchases and that improves the market. But in the end, we ultimately always have a crash.

Mr. LUETKEMEYER. Thank you.

Senator Gramm, you, in your testimony a while ago, talked about SIFIs and living wills. You made the comment that they are not defined in law, and I thought that was an interesting comment from the standpoint that we had Barney Frank in here a little over a year ago, and he was the author of Dodd-Frank, and the problem with SIFIs, in his own words, was an unintended consequence. He believed he wanted the biggest banks to be regulated, but it seems the regulators are allowing these regulations to flow downhill now to the mid-sized and regional banks, and even to the community banks, in a very negative way.

And so I was wondering if you would comment—it seems like the regulators are creating law instead of enforcing existing law, and trying to make stuff up here, and your—and the effects that it is having on the banking system.

Mr. GRAMM. Let me first say, you asked about Dodd-Frank, was it a good law. The biggest problem with Dodd-Frank is it didn't write the law. The biggest problem with Dodd-Frank is the same problem with Obamacare. When the speaker said, "We need to pass it so we can find out what is in it," she misspoke. She really should have said, "We should pass it so we can decide what is in it."

Dodd-Frank grants broad powers. It doesn't define its terms. And so as a result, the regulators decide.

Now, our system works that you write the law and then the regulators implement the law through a process, generally bipartisan, in sunshine, where there is debate, where people know what the rules are in general, and they basically implement them. What happened here was the law was never written in the first place. It granted huge powers to the regulators who make all of these decisions, and so you have become a bit player in the process.

How many people thought that they were giving the regulators power to implement international regulatory standards that were written in Basel in the United States without Congress ever approving them? I don't believe Democrats thought that. But they are doing it today because they do whatever they want to do.

And in the case of the good provision of Dodd-Frank about the 5 percent skin in the game, they just decided not to implement the law.

The Constitution says that the President should faithfully execute the laws, but in this case and many other cases, this President does not execute the law.

Mr. LUETKEMEYER. Thank you. And we now seem to have a regulatory system instead of a shadow banking system. I thank you, Senator.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now declares a 5-minute recess.

[recess]

Chairman HENSARLING. The committee will come to order.

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

Mrs. BEATTY. Thank you, Chairman Hensarling, and Ranking Member Waters.

And thank you, to our witnesses today. I was getting ready to say I am a freshman member, but now that I am a sophomore member of this committee, I certainly appreciate the varied history that we have had here, and especially from the two witnesses who have served here.

We have talked a lot about history, and in some of the opening remarks from my ranking member, she gave us a history. So let me fast-forward to where we are today, hearing that history on housing, and certainly, we have heard many people talk about that crisis and what happened in the 2008 financial crisis.

But as we talk about housing now, just this past week Bloomberg News reported that America's housing market recovery is in full swing; there are sources across the Internet saying that housing ownership has dropped to a 48-year low.

So my question to the three of you is, when we look at housing today, either in full swing or in the last 24 hours dropping, my concern is, what do we do as it relates to communities that are represented by minorities or those who are living in poverty? We know what happens to the communities that many of our constituents or that we live in, but what do you think we should be looking at to help the recovery of this lagging market for minorities?

Mr. WALLISON. I think the data that you cited can be consistent, and that is there is a return of the market. There are many more sales going on right now, and the reason for that, unfortunately, is that the government is continuing to reduce underwriting standards.

This is not good for minority buyers. It is not good for non-minority buyers. Because in the end, what happens when you are selling homes to people who cannot afford to carry those homes over an extended period is that we are going to have the same kind of crash we had in 2008.

My solution for solving this problem is to get the government out of the housing market because it has an incentive to reduce underwriting standards, and as long as the government is in control of the market, that is what it will do.

Mrs. BEATTY. Mr. Miller?

Mr. MILLER. I have been critical of the efforts at addressing the housing market. Perhaps the Republicans on this committee don't know that, but the RNC does. When I wrote an article in Salon in 2012 that criticized the lack of real policy urgency about the collapse of home values and the foreclosure crisis, the RNC trumpeted excerpts from my article all over their website. State Republican parties trumpeted it also on their websites, as if Mitt Romney would have done anything different.

This recovery was going to be hard. It was going to be hard for a number of reasons.

One is it was a balance sheet recovery. Americans—households and businesses, but especially households, were deeply in debt and had to get out of it and were going to consume less until they were in better shape.

We had a bubble in the housing market, which led to a great deal of overbuilding, and so when we have had recessions in the past, usually housing—residential real estate, residential construction—dips, there is enough demand, and then that sort of gives extra juice to the recovery. That was not going to happen in this recovery.

The natural demand for new housing during that period was probably about 1.4 million units. Instead we had a couple of years when we built 2 million. So that wasn't going to happen.

Protecting against the kind of predation we saw will help a lot. It will help preserve the wealth, because that is one of the ways that middle-class families have built wealth is by faithfully paying off a mortgage—getting a mortgage on a home, buying a home, paying off a mortgage over time, and not allowing the kind of predation that we saw in the last decade.

Mrs. BEATTY. Okay.

And I don't have enough time, Senator Gramm, to ask you to comment.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, chairman of our Oversight and Investigations Subcommittee.

Mr. DUFFY. Thank you, Mr. Chairman.

I am going to take a stab at Mrs. Beatty's question. I think the way we help out lower-income and minority communities is by growing the economy, and making sure that they can access opportunity and access jobs.

In my community, two of the biggest employers—one is regional and one is nationwide, and they started their businesses in the late 1960s and early 1970s—have separately said, "If I wanted to start my business today, I couldn't do it because of all the rules and all the regulation. I couldn't get a bank to partner with me in our community to give me a loan to start the business that now employs tens of thousands of people with good-paying jobs."

And so, when we have a debate today, where is the next Menards? Where is the next Ashley Furniture? Where is the next Google, if you can't start your business and employ people in Mrs. Beatty's community and in my community?

There was a graph that we had at the Joint Economic Committee—I used to serve on that committee—and it compared the historic declines, and then the historic recoveries.

So if you had a slow-sloping decline, you would have a slow-sloping recovery. The decline would match the recovery. And if you had a steep recession, you would have a steep recovery. They would mirror each other.

But if you look at this decline—which was very steep—and you look at this recovery, they don't match the prior examples of recoveries.

To the panel, have you noticed that this has been a lackluster recovery compared to others? Shouldn't we have had, with a steep decline, a steep economic recovery, but we haven't experienced that?

Dr. Gramm?

Mr. GRAMM. We have had a bad recovery because we had a dramatic change in policy, and the policy was one of more taxes and more government control. You saw the graph that they had at—the chart they had at the Joint Economic Committee about new business starts. It is a perfect example.

And let me say on the home ownership question, I think one of the things we could do that could help home ownership is to let banks make character loans again. Everything now is so rule-based that we don't give the banker the ability to figure out who will pay this money back and who won't.

My mama didn't graduate from high school. She was a widow. And she got a subprime loan, and no government guaranteed it. But by the time she died, any banker in Columbus, Georgia, would lend her money. Anybody.

Why? Because she paid the money back.

And I think we go too far now on these formulas. We don't help people when we lend them money that they can't pay back or they won't pay back, but there are a lot of people who would work and struggle to make sure they paid the loan back, and I think getting back to some character lending would be a good idea and it would help deal with the problem that the Congresswoman from Ohio raised.

Mr. DUFFY. We have now gone to check-the-box banking.

Mr. GRAMM. We have not had a good recovery because we have implemented policies that have stifled the system which created the prosperity we have known.

Mr. DUFFY. I would just note that—I am going to go to Mr. Wallison in a second—means we have 14.4 million less jobs and $6,000 less per family, Mr. Gramm.

But Mr. Wallison, you—

Mr. WALLISON. Yes. I would like to put up the chart that I had, my first chart. If you can find that again and put that up on the screen, because I think it tells us something very important.

While we are waiting for it, it shows the recovery that we have had since 2010—actually, since 2009, and in comparison to all recoveries we have had since the mid-1960s. The important thing about it is that for the first three-quarters of the recovery from 2009, it was in line with the usual recoveries, as you can see. When the Dodd-Frank Act was passed in 2010, you can see what happens to the red line, which is the line that shows the current recovery.

So the market was recovering in the usual pattern after 2009, but once the Act was passed, everything stopped. And that is the point that I think you were trying to make and what I think is important for the committee to understand.

Mr. DUFFY. That is a very good point, and I thank you. And I just want to point out that my friends across the aisle have been wearing pins in celebration of Dodd-Frank, and I would just note that is a celebration of a racist and sexist CFPB, a CFPB that is now setting rates in the auto industry. It is collecting data against the knowledge of consumers.

Lack of oversight for this—I am getting gaveled down so I am going to yield back, Mr. Chairman.

Chairman HENSARLING. He was regrettably gaveled down.

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

Mr. HECK. That is quite an act to follow.

Thank you, Mr. Chairman.

I guess I want to begin by just registering my heresy here. I, frankly, as a relative newcomer here, have grown unbelievably tired of the finger-pointing. We seem to have points of view that suggest it is all the government's fault—for incenting, cajoling, and strong-arming those poor, weak-kneed bankers into making loans they didn't want to make.

At the same time—here comes the heresy from my side of the aisle—we seem to be suggesting that every consumer was somehow duped into doing this and had no capacity whatsoever to make a well-informed decision for themselves.

So it is all the government's fault, or all the consumer's fault, or all the banker's fault. And I don't know why it is so hard around here just to acknowledge that there is plenty of guilt to go around.

The fact of the matter is there were consumers who were getting loans, who should have known better, did know better, but bet that the real estate increase in values would continue. The fact is that there were some bankers applying the can-you-fog-a-mirror rule to making loans. And the fact is that the government was compliant in some fashion with this big run-up and this big crash.

I don't know why that is so hard for us to acknowledge. And I don't know what the proportion of that culpability is, but I am convinced that there is some to go around to everyone.

Now, with that preface, I want to ask a question of all of you and ask Congressman Miller to begin. There are two people here who don't like Dodd-Frank and one person who largely does, all right?

I am not from Missouri, but show me. Can you cite another country in the world that during the midst of the Great Recession took actions, and adopted policies that better benefitted their economic growth curve than the United States did with the adoption of Dodd-Frank? If Dodd-Frank wasn't perfect—and even you, Congressman Miller, suggest it wasn't perfect—who did it better? What country did it better?

Mr. MILLER. Actually, we did better. I have been critical of the policies that made the priority protecting banks from the consequences of their own conduct, of allowing them to privatize profits and socialize risk, of not taking them through receivership when they were, in fact, insolvent, which has been the standard playbook for dealing with a financial crisis.

And none of the recessions since the Second World War began with a financial crisis. This is the only one.

Around the world usually crises that, again, in the financial sector are a lot harder to get out of, and the standard playbook since the late 19th Century is take insolvent banks through insolvency and get them back operating with a new set of owners so they are not really being bailed out, and a clean set of books so they can actually do sensible things and not pretend to be solvent until—

Mr. HECK. So you don't know of another country that had a better response which helped their economy?

Mr. MILLER. Most of the developed world, certainly Europe, has done less well than we have.

Mr. HECK. Senator Gramm, do you know of another country whose policy response—

Mr. GRAMM. Yes, I know several. Poland was instituting a major move toward private property and a market-based system. Their economy was growing so strongly that they actually did not have a recession, and their growth has been strong since.

If you compare growth prior to the recession to growth after the recession, I think you could make a case that both Germany and Britain did a better job than the United States.

Mr. HECK. But their growth after the beginning than the recession was no better than ours.

Mr. GRAMM. But their growth before was a lot worse. So if you are going to look at the impact of the financial crisis, I think you have to look at what they were doing before and what they did after. The hallmark of our disappointing recovery has been that it was so different than our previous recoveries, and I do think that policies which were implemented had a lot to do with it.

Now, look, there are two sides of every story. As Jefferson said, good men with the same facts are prone to disagree.

But my basic view in looking at this is that we instituted a bunch of policies which affected investor confidence, and we did not get the good recovery that we should have. First of all, the recession came on very slowly—I'm sorry.

Mr. HECK. I have the same trouble with my mentor too, Mr. Chairman. I understand.

I would just conclude by saying if we want to go where there is no government regulation, that country exists. It is Somalia, and I am not trading places with them for anything.

Chairman HENSARLING. The time of the gentleman has expired.

Mr. GRAMM. I shouldn't have cut him off all those years in the classroom.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman.

Just a little bit of housekeeping here. We heard the statement earlier in an answer to a question that derivatives are entirely useless and Mr. Miller could see no reason to have them.

Senator Gramm, do you see positive reasons for any derivatives?

Mr. GRAMM. Yes, I see lots of positive reasons for derivatives. I think it is a way that people can hedge, for example, if you are an airline and have to buy jet fuel, it is a way of protecting yourself. If you are in the insurance business, you can partially protect yourself by buying derivatives which have value based on what happens with the weather.

It is a vehicle whereby you can get risk in the hands of people who are capable of bearing it and they get a profit for bearing it. So I think there is a reason for it.

And if I could, let me just straighten something out. A lot of people point to the Commodity Futures Modernization Act as being some terrible law that deregulated derivatives. Nothing could be further from the truth.

You had a Commodity Futures Trading Commission (CFTC) Chair who got it in her head that derivatives were futures, and by raising the question, since it is illegal to trade futures off an exchange, she created legal uncertainty in all of these markets. President Clinton and every financial regulator in the government begged the Congress to pass a law making it clear that derivatives were not futures.

Derivatives were never regulated, so this idea that somehow we deregulated derivatives in the Commodity Futures Modernization Act is just totally wrong.

Mr. PEARCE. Thank you.

Mr. GRAMM. And it got 300 votes in the House and only 60 people voted against it.

So the point is that we never regulated derivatives before. We now regulate them. It will be interesting to see what the net result will be. My guess is it will not be good.

Mr. PEARCE. Okay.

Mr. Wallison, you had mentioned that one of the great problems was the—and the move toward 2008 was the relaxing of the underwriting standards, and you said that we are doing it again. Can you flesh that out just a bit? I have another question, so if you could—so we are doing exactly the same thing that put us in position—

Mr. WALLISON. Two things, Congressman, that I would mention, and that is a few months ago the regulator of Fannie Mae and Freddie Mac, which is the Federal Housing Finance Agency, told them that they weren't taking enough risk on mortgages, so he wanted them to reduce their downpayment standards from 5 percent, which is already too low, to 3 percent. That substantially increases the risk.

The second thing is that the President himself said he was going to reduce FHA's mortgage insurance premium by half a point, about 50 basis points. What that does is put more of the taxpayers at risk and allows much riskier mortgages to enter our financial system.

So in both cases, the government has been going back to exactly the same policies that preceded the financial crisis.

Mr. PEARCE. Okay. Now, the basic narrative that we get from our friends on the other side of the aisle is that the system was teetering on collapse and that we have strengthened the oversight. And yet, the people who reduced the underwriting standards, Fannie and Freddie, it is my understanding that they are not touched at all by Dodd-Frank. Is that more or less correct, Mr. Wallison?

Mr. WALLISON. That is exactly right.

Mr. PEARCE. So this narrative that comes from our friends on the other side is probably completely bypassing the lynchpin of the entire problem, and yet we never hear that.

Lastly, the effect on the community banks. Community banks, in my opinion, were not greatly responsible for any of the problems—the subprime, the predatory practices—and yet they get the bulk of the regulation under Dodd-Frank. Again, Mr. Wallison, I would like your comment on that.

Mr. WALLISON. Exactly. They are suffering much greater regulation than they need, and as a result of that additional regulation, they are not making the loans that local communities need and small businesses need.

Mr. PEARCE. Okay. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you. Mr. Chairman, the topic of this hearing is, are we more prosperous. I would point out that Dodd-Frank is just one of many things that have happened in the last few years.

The harm to our prosperity done by our current trade policy swamps any benefit that Dodd-Frank was intended to provide. And I don't think we will be as prosperous as we should be until we eliminate a trade policy which has given us the largest trade deficit in history.

Dodd-Frank gave an awful lot of power to the regulators, which they are not using. First, we had the Franken-Sherman amendment which dealt with credit rating agencies.

It continues to be the fact that if you are issuing a major debt instrument, you can decide which credit rating agency rates you, you can pay them a million bucks, and they have every reason to give you a good rating because you will be back to them with another issue or someone else will be back to them with a similar issue the next week.

So as long as credit rating agencies are rating dead issuances, we will have the same result that we would have in the American League if the home team got to select and pay the umpire.

We also were trying to pass a law that said we shouldn't have too-big-to-fail. We still have too-big-to-fail. The reason for that is the regulators under Dodd-Frank were given the authority but were not required to break up those that are too-big-to-fail. So the only way you don't have too-big-to-fail is if you are too-big-to-fail, you are too-big-to-exist.

But I only have one House cosponsor on that bill. Maybe we will pick up some more if any of my colleagues are listening to this. And of course, Bernie Sanders is, I believe, the only person on that bill in the Senate.

So to ask us whether we are more prosperous when we still have the debt instruments rated by a credit rating agency selected and paid by the issuer, while we still have too-big-to-fail and, in fact, they are bigger, the one thing that saves us from a meltdown this year is that we remember 2008, and nobody plays with matches for the first few years after they burn down their house.

So I think investors are going to be careful for a while. Maybe for another year or 2 years. And after that, if we give AAA to Alt-A, we will have this kind of meltdown.

Finally, on the CFPB, we on the Democratic side passed a bill which creates a single regulator. We may rue the day. I do not know who is going to win the next Presidential election, and we have a panel here who could advise us but they don't know either.

If a Democrat wins, Mr. Cordray may continue to be there. I know some Republican candidates who would appoint somebody to that position whose first act would be to repeal everything Mr. Cordray has done.

And if we have a panel of three or five, we—some of us are very sure that we will not lose the Presidential election, and Donald Trump is doing everything possible to help us.

But we could still lose the next Presidential election, so I think the CFPB got a good start because we guaranteed a Democrat would be in complete control. And now, having enjoyed that for a while and until we know who is winning the next election, it might be good to get a board in there that will reduce the swings to the left and the swings to the right that you would expect if there was just one person from one party appointed by one President.

Mr. Miller, do you have any comments for us?

Mr. MILLER. I commented on that at the last hearing. That is one of the potential downsides of having a single commissioner is that presumably that will change—a more dramatic change. But if you have a five-member commission, that can change pretty quickly too. The SEC and the CFTC are pretty much three-to-two all the time. You swap out one commissioner and you have it three-to-two the other way.

Mr. SHERMAN. Yes. But I have never seen the SEC change where they repeal all their existing regulations, or a big chunk of them, when a new Administration takes office. I hope I don't see that because we will win the Presidency.

And I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

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

Mr. HURT. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you for continuing to focus on this important issue 5 years post-Dodd-Frank.

I want to thank each of the witnesses for appearing and participating in today's hearing.

I represent Virginia's 5th District. It is a very rural district, mostly agricultural in nature. There is a lot of history—Jefferson's home and Madison's home are in the 5th District.

Main Street Virginia 5th District is a long way from Wall Street, and I think about this in the context of the big picture, which is that since the founding of our country, I think that all Americans, whether you live in the big city or you live in the rural areas, have benefitted from this marriage between free market principles, a robust free market, and a democratic republic as a political system.

And I think we have all benefitted from that across the country, and it has built the greatest economy—I think that we would all agree—the world has ever seen.

My question is really for all three of you. I would like to start with Mr. Miller, and then go to Mr. Wallison, and then finish up with Mr. Gramm.

But 5 years after Dodd-Frank we see the Federal Reserve Bank of Richmond reports now that 60 percent of all liabilities in our financial markets are either explicitly or implicitly backed by the

U.S. Government, backed by the U.S. taxpayer. And I guess my question for you all is, is that a good thing?

What is the current effect of that? What is the current effect of that in today's economy? And more important, what does it portend for the future of the American economy? And if you have time, how do we fix it?

That is a whole lot for just a couple of minutes, but maybe we could start with you, Mr. Miller.

Mr. MILLER. I have not seen that statistic or that study. I would certainly be interested in analyzing it. It is kind of hard for me to imagine that is the case, but I have heard a lot of statistics thrown around in the time that I was in Congress and since that, upon closer examination, there were asterisks that explained them.

Obviously, I don't think that 60 percent of assets should be guaranteed by the government. I said just a moment ago that I think the great mistake in responding to the financial crisis was not to take the financial institutions that were insolvent through an orderly receivership, come out of that—continue to maintain this—the economy's payment system, prevent disruption, which is possible to do, offload their suspicious—their suspect assets into something like the Resolution Trust Corporation, deal with those in a sensible way, which often would mean reducing the principal to try to make them payable rather than forcing people into foreclosure.

No. I think that the sensible thing during the financial crisis would have been, again, what has been the standard playbook of dealing with financial crises around the world—and they happen with surprising frequency—is to take banks through receivership.

Mr. HURT. Thank you, Mr. Miller.

Mr. Wallison?

Mr. WALLISON. Yes. Government does guarantee much of our financial market today, and I suppose the worst example of all is the Government-Sponsored Enterprises, which are not only regulated now by the government but also backed by the government. The result of that is that they can take much more risk.

And this is true of any institution that is backed by the government. It can take much more risk because people assume that they will not suffer any losses if they make loans to such an institution. And as long as that is happening, as long as we have institutions like that, we are going to have much more risk and much more failure in the economy.

Mr. HURT. Excellent. Thank you.

Mr. Gramm?

Mr. GRAMM. First of all, I don't doubt your number is right. The Federal Government backs loans to preempt the capital market. And I object to it not just because it puts the taxpayer at risk, but because it changes the order of the credit line and puts people at the front of the line who have low-priority uses for capital and pushes further down in the line people who have high-valued uses that would create jobs and growth and opportunity.

And if you look at the preemptions that are occurring with these Federal guarantees, they are in areas where the rate of return is low. Not to pick on wind power, but it is such a beautiful example. With the Federal guarantees and the subsidies, you can make money generating electricity with wind by giving the power away practically for free.

Now, clearly that kind of incentive creates waste, inefficiency, and misallocation of capital, and you see it all through the capital market. So we go around the world advising all these underdeveloped countries, "Let the market system allocate capital," and yet we are not doing it.

Mr. HURT. Right.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman.

And I thank each of you for being with us today.

In 1983, I started a business. I had an idea, and went to a banker in Dallas, Texas, at Mercantile Bank, and asked if he would loan me $150,000. And for some reason, he loaned me the money. He thought I had a good idea, and I think he thought I would pay it back.

It turned out to be a good idea. We had about 300 employees. It was a very successful company.

He got paid back ahead of schedule. The people we hired were a broad spectrum of America who came and enjoyed that business. I later sold it to my partner.

In later years, I started another company, a real estate investment business that I no longer own, and those raw land properties, undeveloped properties, are now being purchased by developers, and those developers have to go to private equity to find money because they can't go to the market. They can't go to the commercial lenders. They don't have access to that capital again.

What do you see, Senator Gramm, as the long-term implications? America became the great economic power we are today not because of the great government but because of real opportunity that people had to take an idea and build on that idea.

And that access to capital, as I had in 1983, isn't there today. I was on a bank board. We knew who to loan money to. We knew who was creditworthy, as you said, by character alone. And yet, you can't borrow money on that basis anymore.

If we are a country which was built because of those entrepreneurs, what is going to happen to the future of this country?

Mr. GRAMM. Basically, growth is not some kind of formula where you get a multiplier based on the government spending money. Growth comes from somebody who has a new idea, a new vision, a better product, a better way of doing things, and then they go to the capital market and the capital market is where these ideas, these dreams, get translated into reality.

I always said when I went to the old New York Stock Exchange that I thought I was standing on holy ground. When you look at what that institution and the capital market have done for mankind, you look at what it has done in the last 20 years in terms of people who were living on less than $1 a day, and when capitalism and markets started to grow, people started to prosper.

If we think we can remain the greatest country in the history of the world by giving up the system that made us the greatest country in the history of the world, I think we are fundamentally wrong. And I think one of the reasons this recovery has failed so miserably is because of the expansion and the preemption of capital in these areas where we are subsidizing people to do things that would never be done on an economic basis. This increasing capital cost falls squarely on small business and the entrepreneur, and finally, we have a regulatory system that is now stifling the very functioning of the capital market—where you had a banker who had a good sense of what a good idea was, a good sense of people's character, and his job was to make good loans.

I never have understood how you make money by making loans that people don't pay back. I have never been able to do it. I have never worked at any place that could do it.

So I think we are in danger of getting away from the thing that made us great.

Finally, let me say that Britain is no longer a great country in terms of its ability to produce goods and services. I think it is below Belgium in the export of goods and services. But Britain is still a great country because it has a great banking system.

We let New York and Chicago, the hubs of our financial system, deteriorate at our own peril. We need to dominate the world in banking and finance. It is something we do well. It is a source of power. It ultimately is a source of military power. And I think we ought to be very concerned about it.

And this idea that all these people on Wall Street are a bunch of crooks—I worked for a big investment bank for 9 years, and I think I have about as good a sense for when people are proposing something as anybody else. I never heard anybody propose to do anything illegal. I never saw anybody set out to violate the law.

Now—

Chairman HENSARLING. The time of the gentleman—

Mr. GRAMM. Maybe they did and I didn't see it, but—

Mr. PITTENGER. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

And thank you, to our witnesses here today.

I wanted to talk to you all a little bit about what I think everybody acknowledges was the core cause of the financial crisis: mortgages. You talked about that today.

Dodd-Frank has a number of titles that deal with issues extraneous to the core cause of the financial crisis, so let's get at what I think there is general consensus about the subprime mortgage crisis, which precipitated the economic collapse in 2008. Obviously, two of our panelists here make the case that government policy produced the subprime meltdown. One of the panelists here disagrees and says it was greed that caused subprime.

Can you elaborate a little bit on your differing positions on that?

And let's start with Mr. Gramm.

Mr. GRAMM. Look, we set out in a law that in order to open a teller machine, much less acquire another bank or merge with another bank, you had to meet a test called CRA. And that basically boiled down to, as Alan Greenspan said in testimony before this committee, "If you want to know the source of subprime lending, you need to go back and look at CRA." That is a direct quote.

And as bank mergers occurred, as bank growth occurred, the pressure to make CRA loans got bigger and bigger and bigger. We set out in law that Freddie and Fannie had to hold 25 percent of their whole portfolio in subprime loans, and then we increased it until when the wheels came off it was 57 cents out of every dollar.

We know now from the records of Freddie and Fannie that they knew they were taking huge risk in making these loans and guaranteeing these loans and holding this paper. We know that they told their superiors that they were taking big risks. And we know they struggled to meet their goals.

And what was the net result? As Peter has told the world in the most convincing terms, the net result was a huge volume of loans that had been made to people who either couldn't or wouldn't pay them back.

Mr. BARR. And just to follow up on your observation that the skin-in-the-game concept is actually a potential remedy to this—in other words, portfolio loans, risk retention—at least partial risk retention from mortgage originators. Contrast a policy like that to what the Administration is doing now to continue to incent taxpayers to bear that risk, and what is the difference between the originate-to-distribute model, where there is not an alignment of incentives between the mortgage originator and the borrower, where they sell to the government, versus a system in which mortgage originators retain the risk and the risk is on shareholders as opposed to taxpayers. Which is the better system?

Mr. GRAMM. Look, if mortgage lenders have to retain risk, they are not going to make a lot of the loans that were made. It wouldn't have happened.

Secondly, we are going back to exactly the same system that existed before. We are lowering downpayments; we are pushing CRA again; I don't doubt that we are going to move back to some kind of quota at Freddie and Fannie.

And look, I understand wanting loans to be made, wanting houses to be built, but if there is anything we know, it is that if you foresaw housing you are going to end up lowering home ownership, not raising it. That is what the financial crisis proves.

Mr. BARR. So to conclude, Senator—my time is expiring—what is the cause of subprime lending? Is it portfolio loans, where there is risk retention, or is it government policy that encourages originate-to-distribute, where the taxpayer is on the hook?

Mr. GRAMM. Look, some subprime lending would occur because people figure out that somebody would be a good risk. I am not against subprime lending, but I don't think the Federal Government ought to guarantee it. I think we ought to take a hard look at securitizing subprime loans with very low downpayments because of the inherent risk that it injects into the system.

Chairman HENSARLING. The time of the—

Mr. GRAMM. Why did we get where we were? There is no plausible explanation for it other than government mandates that mandated a bunch of loans that couldn't or wouldn't be paid—

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from—

Mr. GRAMM. I'm sorry. I took the whole time.

Chairman HENSARLING. The Chair now recognizes the gentleman from Connecticut, Mr. Himes.

Mr. HIMES. Thank you, Mr. Chairman.

And thank you all for being here. It is terrific to have the opportunity to chat with some people who have been so important to the last 15 years on this issue.

Reflecting on the title of the hearing, "Are We More Prosperous?" at some level that is a no-brainer. There is simply no question or no point of fact to suggest that we are not dramatically more prosperous as a country, in the aggregate, than we were 5 years ago—certainly than we were 7 years ago.

And by the way, this is not what we were promised. I was there when we started writing Dodd-Frank, and just as we started writing Dodd-Frank we were promised that, like the Affordable Care Act, this would be job-killing legislation. Frankly, everything we did was going to be job-killing.

Twelve million new jobs later and a fairly reasonable recovery, of course, we don't hear job-killing much. Now we hear the criticism that the recovery is not what it might have been, and Mr. Wallison and Senator Gramm are making that case fairly strongly here. It is not what it might have been.

They are arguing a hypothetical. They are arguing a counterfactual, which is always challenging to do, and not the strongest platform on which to criticize some work that was done.

We were also promised, of course, that credit markets would seize up and stop the critical function of providing credit to American households and businesses.

I did a little work. I am not going to go through it, but what you see up on the screen there is commercial and industrial loans up fairly dramatically in the last 5 year; venture capital investment up really quite dramatically in the last 5 years; total consumer credit up—actually concerningly up in the last 5 years; and, of course, the stock market there in the lower left is not exactly availability of credit but it is certainly a proxy for the confidence that our—that people have in our capital markets.

So we are left with the idea—and this is where I have some questions—that the recovery is not what it might have been.

Mr. Wallison, you say, "I believe all the new regulation added by Dodd-Frank is the primary reason for the slow growth that this country has experienced." And you open your testimony with a chart which shows that this recovery has been less strong than the average of the other 10 recoveries.

With all due respect, the economic analysis there—there was absolutely nothing even near average with the meltdown that we suffered in 2008, 2009. Fourth quarter 2008 GDP growth was at negative 8 percent annualized. We had not seen the kind of asset destruction that we saw.

Is there any reason, Mr. Wallison or Senator Gramm, why we should expect that the recovery from what we have come to call the Great Recession, acknowledging that it is probably the second-biggest economic dislocation we have seen in 100 years—is there any reason to believe that just basic analysis would suggest that maybe it would be very much at the low end of the kinds of the recovery? Is there anything average about what happened in 2008 and 2009?

Mr. WALLISON. Yes. Actually, in my prepared statement you will see a study that was done of the 27 recoveries that we have had since the late 1800s done by 2 scholars, and what they showed was that in almost every case, the recovery is as fast as the decline that preceded it.

In three cases, that was not true. One was in the Great Depression. The second was in 1989 to 1991. And the third is this current recovery we have today.

The reason that I think you might assign to this is that when the government gets involved in trying to improve the economy in some way, creates more regulation, as they did during the Great Depression, as we did in 1989 to 1991, and as we have just done, we interfere with the natural return of the economy which usually occurs after a severe recession. So yes, there is a lot of history that is behind exactly what Senator Gramm and I have said.

Mr. HIMES. I have to respectfully disagree, and I think you yourself point out that actually in the Great Depression, which of course led to regulation which tamped down the cycle of boom and bust that we had seen prior to the 1930s—it was the 1933 and 1934 Acts and associated regulation that fairly dramatically changed the volatility in the business cycles in our economy—that I think also stands as counterpoint to this idea that it is government interference that causes this stuff.

But I am really taken by your statement: All the new regulation in Dodd-Frank is the primary reason for the slow growth this country has experienced.

I have asked the Fed that every time they have been there. They have pretty good economists. I have certainly read the economic literature.

Do you really believe—because no one else does, that I am aware of anyway—that Dodd-Frank is the primary reason, and it is not reduced aggregate demand, it is not uncertainty in Europe, it is not continued dislocation in the housing market? Dodd-Frank is the primary reason?

Mr. WALLISON. Here we have a Q.E. by the Fed, we have the ACA, the Affordable Care Act—

Mr. HIMES. Which is different than Dodd-Frank, right?

Mr. WALLISON. I am just talking about the three things in the last 5 years that are really significant activities by the government. Q.E. by the Fed hasn't substantially improved growth; Obamacare, the ACA, hasn't substantially improved growth. But if anything, both of those should have been stimulative.

The third is Dodd-Frank. And in that case, of course, we see what we have seen, which is very slow growth—historically slow growth.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you all so much for being here, especially Senator Gramm.

It is good to see you. As a 1996 Gramm-for-President delegate from Illinois, I appreciate your work and—

Mr. GRAMM. You were in a distinct group.

Mr. HULTGREN. And I'm very proud of that.

Five years after the passage of the Dodd-Frank Act, a cornerstone of President Obama's liberal economic agenda, this overreaching law has unquestionably made Americans worse off. We are now less financially independent and we are now increasingly subject to the demands of bureaucrats in Washington.

Dodd-Frank has nearly 400 rulemaking requirements. Only 235 of these rulemakings have been finalized.

At the same time, we are seeing community banks, the drivers of economic growth, continue to struggle under this crushing regulatory onslaught. We have 500 fewer community banks since the passage of Dodd-Frank. And with no end to regulations in sight I am fearful we will continue to see the big banks get bigger and the community banks be fewer.

At the same time, American workers are facing stagnant wages and reduced economic opportunities because of the failed economic policies and regulatory overreach of this Administration. No one should be celebrating an economy where growth is so weak, feeble, and slow that more than 17 million Americans are still unemployed or underemployed 6 years after the recession ended.

The Dodd-Frank Act has done nothing to create jobs in my home State of Illinois, where the unemployment rate stands at 5.9 percent.

Senator Gramm, I think everybody agrees that our Nation's community banks were not the cause of the financial crisis. However, I noticed in your testimony that community banks have hired 50 percent more compliance officers, while overall industry employment has expanded by only 5 percent, and I quote you there.

Are compliance costs such as these one of the reasons why we are continuing to see fewer and fewer community banks? And for the industry as a whole, what does this mean for financial services, innovation, and the ability of companies to focus on the evolving needs of their customers?

Mr. GRAMM. I don't think you can dispute the fact that a growing regulatory burden has induced banks to terminate their activity in various kinds of businesses. Consumer credit, commercial credit, and housing credit have fled the banking system.

New innovations still occur in finance but they occur outside the banking system. And so we have a huge banking system with all of its capital and with all of its talent that is basically being thwarted and is not being put to work, putting America's money to work, and putting America to work.

I think that is part of it, but I think it goes beyond that. I think that Dodd-Frank, by creating all of this regulatory power, has created uncertainty and fear in the business community which has induced people not to take risks that would have been productively undertaken in the absence of the situation.

It is not just that Dodd-Frank did bad things. Not everything in Dodd-Frank was bad.

But the problem is it gave so much discretionary power to regulators that now we are ruled by regulation. It is not you writing the law and them implementing it. For all practical purposes, they are the law.

And this is not the system that created the American miracle. And it is a dangerous system. I know it is your next hearing, but it is dangerous for freedom and democracy.

And I would just like to say to our Democrat colleagues, someday Republicans are going to win an election for President, I hope soon. And all of these things that were done by regulation can be undone. There is nothing permanent about this.

This Consumer Product Safety Commission has so much power that the new Director could in essence eliminate it by his own power and order. So it is just a bad way to make law.

We need to define what laws mean. We need to control regulators within the constraint of what you say.

And I think that is where Dodd-Frank got way off track. Part of it was community banks, for example, they weren't part of the problem, but the desire had always been there to have the government play a greater role, and so community banks that had nothing to do with the problem, hedge funds that had nothing to do with the problem, insurance companies that were in traditional lines of insurance that had nothing to do with the problem, money managers that were simply caught in a bankruptcy were not the cause of the problem, and yet they have all been brought under the grasp of the government. And in doing so, you have created tremendous inefficiency in the marketplace, in my opinion.

Chairman HENSARLING. The time of the gentleman has expired.

Mr. HULTGREN. I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman.

Yesterday, I endured something that I think many consumers in this country have endured as a result of Dodd-Frank, and that was going through a closing after I refinanced my house. I had done this years ago, had gone from a 15-year to a 30-year mortgage in an effort to fund my children's education—a cash loan, if you will. And I did. The oldest has graduated; the youngest is just about done.

So I decided to take advantage of the rates, as low as they have been. And before the Truth in Lending changes come about now in October, I wanted to get this done.

It was a grueling 2-month process. I met with my community banker, and the community bank has been in existence in my community since 1920. It has endured a lot.

But I was told that this has been probably one of the least expansive—in fact, they have shrunk their mortgage business significantly. One community bank will only write their own paper, and they will do so only on their terms, which is usually a balloon note that may be adjustable but it is outside Freddie and Fannie.

And for 2 months, we went through a process of disclosure, and disclosure, and ultimately did close. But it was an experience that I can't imagine that the general public can not only not endure but may not qualify.

And my banker told me, "The qualified mortgage rule is killing us. What did we do wrong to cause the proscriptive regulatory burden that we have on community banks?"

And so, Senator Gramm, I would just ask you, what did the community banks do wrong that led to this restrictive policy on them that I think has been an unintended consequence, to the detriment of the consumers out there who desperately need their capital not only for their businesses but for their children's educations and for their own livelihoods?

Mr. GRAMM. I think we all know that in any society, people have a political agenda.

Mr. ROSS. Right.

Mr. GRAMM. And since the turn of the century, the progressive political agenda has been to have government basically control the commanding heights of the economy. And when the financial crisis occurred and the people who had had this agenda for 100 years were in control of the government—

Mr. ROSS. They imposed it.

Mr. GRAMM. —they decided this was a crisis that shouldn't be wasted, and even if community banks had nothing to do with it, they could be improved by having government as a partner.

And so now, if you are unlucky enough to be designated one of the systemically important banks you have government bureaucrats embedded in your executive offices to report and advise. And it reminds me of the old Soviet system where you had political officers in every military unit and in every factory.

Mr. ROSS. Which we do. We now have more compliance officers than we have ever had.

Mr. GRAMM. So I don't know. Some people this doesn't bother, but it bothers me.

Mr. ROSS. And it bothers me, too. Let's take, for example, the payday lending industry. The CFPB has just come back down with some extensive regulations that are going to essentially put the payday lending business out of business. Now, banks don't want this. But we are not going to eliminate the demand for payday lending.

And in fact, what would be the consequences? Would they not have to go to Lenny the loan shark? There is still going to be a demand. Just because government thinks they can control the supply of capital doesn't mean they are going to be able to control the demand. Is that correct?

Mr. GRAMM. What has happened, of course, is that the regulatory burden and the uncertainty have basically caused bankers and other people in the financial sector and other parts of the economy that are affected to basically become very cautious.

Mr. ROSS. Yes.

Mr. GRAMM. And as a result of being very cautious, they don't want to make a mistake.

Mr. ROSS. And they are being very—

Mr. GRAMM. And to do something, you have to take action. And I think that is a big factor in this failed recovery.

Mr. ROSS. I agree.

Mr. GRAMM. And it is going to be difficult to fix. But I think a good starting point is to go back and look and see, what did we learn from the financial crisis, and try to fix the things that we learned were a problem and know after the fact, and the things that weren't part of it, let them operate.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman.

I would like to talk a little bit about the concentration we see going on in the financial services industry.

Mr. Wallison, Senator Gramm testified that according to the FDIC, 1,341 banks have disappeared since 2010, and only 2 new banks have been chartered in the last 5 years. There seems to be no doubt that assets in the financial sector are becoming more concentrated in the Dodd-Frank era.

I am seeing it in Western Pennsylvania as institutions merge, and I also recall a conversation I had with a community bank where they had to have an individual, or a group of individuals, spend a cumulative 2,000 hours going through some CFPB regulations. Mind you, it wasn't this community bank that was responsible for the financial crisis.

The big banks are getting bigger and the small banks are becoming fewer. What does this mean for families and small businesses on Main Streets across America?

Mr. WALLISON. This is a very serious problem because these small businesses depend entirely on banks in order to find financing. And as we know, it is small businesses that provide most of the growth and most of the employment in our economy.

These small businesses cannot go to the capital markets, as larger businesses can, so they—their dependence on banks means that if we put more burdens on the banks and as a result of those burdens—these are small banks I am talking about—as a result of those burdens they cannot make as many loans as they could before, that means there will be less growth in our economy. It is as simple as that.

Mr. ROTHFUS. So you think there is a direct correlation between the regulatory burdens on our community banks and the ability of small businesses to receive capital and credit from community financial institutions?

Mr. WALLISON. Yes. That is the entire burden of my prepared testimony today. There is a relationship there.

Mr. ROTHFUS. I also wonder about the concentration of liabilities and what that means for systemic risk. Does industry consolidation as a result of what I call trickle-down government's higher relative regulatory burden on smaller institutions make the system more or less risky?

Mr. WALLISON. Yes. First, let me step back and say I have grave doubts about systemic risk coming from any single institution. The very, very largest banks—the $1 trillion banks—perhaps. But any bank smaller than that, the failure of such a bank would not, I think, cause systemic risk.

But is perfectly true that as these institutions get larger and larger, the losses that they would cause—not necessarily systemic, but the losses they would cause would be much more substantial if they were to fail. And so we are always better off—as any system is, including our own gene pool—if we have much more diversity in the gene pool.

Mr. ROTHFUS. And if we keep going down this road over the next 10, 20, 30 years, could we get to a point where we have far fewer banks in the country, far fewer community banks, and what does that mean for Main Street?

Mr. WALLISON. It is going to be disastrous if we have far fewer because it will be very hard for local businesses to get credit. And—

Mr. ROTHFUS. I just want to—

Mr. WALLISON. —under those circumstances, we would have much slower growth, as we have.

Mr. ROTHFUS. Senator Gramm, during consideration of the Dodd-Frank Act, there was a lot of talk about moving toward government-mandated plain vanilla credit products. Congress expressly rejected this approach in the final version of the bill, yet I am concerned that actions by regulators, particularly the CFPB, are instituting a plain vanilla approach in contravention of congressional intent.

What regulations do you think are moving us toward homogenized, plain vanilla credit allocation?

Mr. GRAMM. I am against credit allocation of any kind. I think it is very harmful to the economic system.

And at its root, many of the reforms of Dodd-Frank are about credit allocation, about getting government involved in determining who gets loans and who doesn't, who gets access to capital and who doesn't. And I think that is a very dangerous thing for government to be doing because it promotes inefficiency and it lowers the growth capacity in the economy.

Mr. ROTHFUS. If I could just quickly go to Mr. Miller, were you on this committee in 2003?

Mr. MILLER. I was.

Mr. ROTHFUS. Do you have any recollection of Barney Frank suggesting that the Federal Government was doing too little rather than too much in pushing Fannie and Freddie to meet affordable housing goals?

Mr. MILLER. He may have said the same thing that Mr. Wallison said. There was a great deal of criticism of Fannie and Freddie during that period that they were—

Mr. ROTHFUS. Do you remember Barney Frank, during the fall of 2003, saying he wanted to roll the dice?

Mr. MILLER. I do not recall that he said that. I do remember Mr. Wallison's column in American Banker that said the same thing.

Mr. ROTHFUS. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Arizona, Mr. Schweikert.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

And, gentleman, I want to see if I can distill down part of this conversation. If we look back to late 2007–2008, ultimately do we all agree that as home prices moved against the markets, the securitized products had impairments, MBS began to turn negative in its value, and that created the cascade?

When we look at something like Dodd-Frank, was it floor plan, was it credit card securitization, automobile securitization? We have a bill that regulated huge portions of our financial sector, but we constantly circle back here saying, "Okay, it was this portion of our mortgage market."

Have we done something, allowed something that is absolutely irrational on saying, "Here is the problem. Here is what we wanted to deal with. Here is what we wanted to improve. Oh, by the way, there is a grab-bag of desires that have been around this place for decades. There is a crisis. Let's load them in. Let's burden the financial markets up and down."

Was there a dramatically more elegant, simple solution to actually what went wrong? This is half statement and half question.

And the second side is you just said diversity in markets. Are we actually seeing a creativity, a diversity because of Dodd-Frank being forced to, we will say, alternative sectors. When I am reading article after article that Silicon Valley is now much of the future of financial markets, whether it be peer-to-peer type lending platforms, is that where the velocity of markets are going to come from?

Mr. Wallison, is diversity away from the traditional banking sector now?

Mr. WALLISON. That could actually be happening because I happen to think that banks intermediation is much more expensive than agency intermediation that is in the securities markets, and maybe more expensive than the intermediation that is occurring in the V-to-B kind of market. So, it is entirely possible that is true.

The cure for that is to, of course, allow banking organizations—not the banks themselves, which are insured; much of that is bank holding companies—to get into much more financial activities rather than freezing them, as current law does.

Mr. SCHWEIKERT. That would be a situation of my community bank could act as an aggregator, collect investors and put them out on a loan product, therefore there is no cascade threat to the rest of the banking system. If something goes wrong, it is those investors, not even that institution.

Mr. WALLISON. Yes.

Mr. SCHWEIKERT. Is that an easy way to phrase it?

Mr. WALLISON. That would be a good way to phrase it, yes.

Mr. SCHWEIKERT. Senator, if I were to look at a solution—let's live in a pretend world where Dodd-Frank did not exist. I am fixated on the concept that information would have been a much grander regulator of good practices.

In a previous life, I bought billions and billions and billions of dollars of agencies, some MBS, and my risk officer was someone who picked up the phone, called over to Moody's and said, "What was the rating on this?" instead of having flow of information from that securitization saying, "Hey, here is our impairment; here is our geographic distribution; here is"—is information ultimately a much more efficient solution to ever avoid such a event again?

Mr. GRAMM. I think the answer is "yes." I think the government helped promote the idea that a rating agency rating was all you needed; it protected you.

I don't think it should. I think a lender ought to be liable for their decisions no matter what a rating agency does.

Much of subprime credit and almost all subprime securitized paper was AAA rated. I don't think bankers should have been let off the hook for that.

I don't like the idea of banks settling and taking stockholder money. If somebody violated the law, convict them. Take them to court. Send them to jail.

I don't like the idea of taking out of somebody's pension fund because somebody did something wrong. I have never understood that.

Mr. SCHWEIKERT. In the last few seconds, because I know you are sort of a price theory allocation economist—Dodd-Frank, is it creating a massive distortion of where capital gets allocated and intense inefficiencies?

Mr. GRAMM. The net result was it did, and it was agenda-laden because it was not bipartisan. The advantage of bipartisan legislating is that both sides are forced to throw out their agenda.

Chairman HENSARLING. Tht time of the gentleman has expired.

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

Mr. TIPTON. Thank you, Mr. Chairman.

And I thank the panel for taking the time to be here.

This is an interesting conversation. I am just a small business guy, and I like to be able to look at actual outcomes.

Right now, we have a real unemployment rate—our colleagues have been putting up charts about the recovery of the American economy—real unemployment rate now of 10.6 percent. We are seeing $2 trillion in regulatory costs. We are seeing the lowest labor participation rate in 4 decades. And coming out of the rural part of America, we are seeing real challenges economically because it is access to capital issues.

And, Mr. Wallison, you were speaking to some of the challenges we are seeing with our community banks, and as we are seeing that pool of banks, that access to capital, shrink up, labeled that as "disastrous."

Would it be a good idea—and because I haven't heard anyone say no regulations, and I don't think that is coming from our side of the aisle; just sensible regulations—would it be a good idea really to be looking at cost-benefit analysis when we are looking at rules and regulations moving forward?

Mr. WALLISON. Sure. And there is a difference between the largest banks and the smallest banks in that, because the largest banks can handle a large amount of regulation because they have the staffs to do it; the smallest banks cannot. So if you are going to make regulations, you ought to taper them to the ability of the institution to handle the regulations.

Mr. TIPTON. When we are talking about having that tailored to actually the institutions, we just introduced out of our office the TAILOR Act for small community banks, and for credit unions, as well, to be able to have regulations that actually meet the risk portfolio, the size of the bank, to be able to have a sensible policy, to be able to create opportunity for the banks to be able to prosper, and still to make sure that they are secure. Does that sound like a good step in the right direction?

Mr. WALLISON. I think that is an excellent idea. I have some questions about whether the FDIC or the Comptroller of the Currency is going to be able to implement it, but we ought to get them to try to implement it.

These are agencies, especially the FDIC, which have never been able to come up with a truly risk-based insurance system, even though Congress has asked for it. You are asking them to make even more kinds of distinctions. Maybe if you push them, they will do it, but it is a great idea.

Mr. TIPTON. I appreciate that.

I would just like you to comment, maybe, as well—we continue to see and we have heard the comments that only 60 percent of Dodd-Frank has currently been implemented, and 40 percent is yet to come.

I think the chairman has probably adequately labeled this as a kind of mission creep, or stealth regulatory actions that are moving forward. Not knowing, as Senator Gramm had spoken to as well—creating that uncertainty in the marketplace, are we really actually helping to cripple the American economy in this recovery that is impacting our ability to be able to prosper?

Mr. WALLISON. Sure. There are two things that are operating here.

One is uncertainty. And at the very beginning when Dodd-Frank came down, uncertainty was the principal problem. But as the regulations started to come out, there were actual real costs that were imposed on institutions, keeping them from making financing available to the real economy, to the business economy, and reducing growth. It's as simple as that.

Mr. TIPTON. And is there a problem—and, Senator Gramm, you may want to speak to this as well—having unaccountability? The Federal Government wants to be able to have all financial institutions have accountability. I think that we have the empathy, certainly, with that.

But now we have a lot of institutions that are being established which are accountable to whom?

Mr. GRAMM. They are not accountable to anybody. In fact, the intention of the Consumer Financial Protection Bureau was to put it in the Fed so it had enshrined funding, and to deny the Fed any oversight ability over it whatsoever. They are the most isolated and protected government agency that I am aware of that has ever been created. If there has ever been a law that violated the separation of powers, that is it.

But that is not all of it. That is true in all of these other areas where regulators have in essence become little kings. They decide what the law says, and when it says it, and it creates tremendous uncertainty.

And when people are uncertain, they don't act. That is basically what is happening here.

And your point about the recovery or argument about the recovery—when is the last time you heard a candidate campaigning on "Happy days are here again?" Ronald Reagan did in 1984, "Morning in America." I don't hear anybody doing it today.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Williams.

Mr. WILLIAMS. Thank you, Chairman Hensarling.

And thanks to all the witnesses today, and to my good friend and our good friend from Texas, Senator Gramm. Thank you for being here.

I am a small business owner. I have been a small business owner for 44 years—a car dealer. And I can tell you, Main Street America is hurting.

I go back to $1 gasoline, I go back to 20 percent interest, I go back to 1988, go back to 9/11, and I have never seen the inability to get a quick recovery like I have with the inability to come back from this Obama economy. Small business is hurting.

And when you look at that, 400 new regulations, billions of dollars in crushing compliance costs, massive consolidation for smaller community financial institutions, and I could go on and on about the real effects of the disastrous laws we have talked about today.

In addition, we have an economy that, as we have talked about also, has created 12 million fewer jobs in the last 6½ years, the lowest labor participation rate in nearly 4 decades, and a national debt that stands over $18 trillion. Main Street America, again, I repeat, is not back.

Senator Gramm also mentioned the lack of new banks being created in the wake of the financial crisis. It has been long documented that in my home State of Texas, banks large and small are struggling just as much as anywhere in the country and we have the best economy in the country.

So my first question would be to you, Senator. You note in your testimony that Dodd-Frank was enacted 5 years ago. Only two new banks have been chartered in the United States. Later in your testimony you state that Dodd-Frank has undermined a vital condition required to put money in America back to work: legal and regulatory certainty.

Would I be correct in assuming that you would view these two phenomena—the almost total absence of new bank charters since Dodd-Frank became law, and the climate of legal and regulatory uncertainty created by Dodd-Frank—as closely related?

Mr. GRAMM. I don't think there is any doubt about the fact that we have a financial system now that is very much bogged down with uncertainty and overregulation. It is not uncommon for a small bank in a small town that is not part of any chain, that makes virtually no bad loans, that had nothing to do with the subprime crisis—it is not unusual for them to be audited five different times in a year.

So you figure they spend 2 weeks getting ready for the audit, and then they spend 2 weeks responding to the audit. And so all of a sudden you have 10 weeks—did I multiply that correctly? No. You have 20 weeks that are taken away from the job that they are supposed to do.

And they have a CRA audit, they have all of these audits, and it seems to me that first of all, they ought to be audited by one audit and it ought to go for everything. We are making life hard for these people and they are making life hard for America by not making the loans we need to grow the economy. And it is just that simple. This is not a complicated problem.

Mr. WILLIAMS. And in the end, small business hurts. And I don't know how you would start a business today, with Dodd-Frank, with CFPB, with taxes. I don't know how you would get a loan. I don't know how a young person would get a loan to start a business.

So what about those considering chartering a new bank and the considerable efforts necessary to raise capital? To do so, isn't the regulatory apparatus constructed by Dodd-Frank a huge impediment?

Mr. GRAMM. I probably should not say this because I can't verify that it is true, but somebody sent me a memo this morning that the second bank which has been chartered under Dodd-Frank has opened this week. I think the name of it is the Bird in the Hand Bank. It is worth two in the bush.

And supposedly they have 10 employees, and they show up to open their business and they have 10 government bureaucrats who show up to tell them how to do their business.

Now look—it makes for a nice joke, but the plain truth is when a bank charter has no value, it tells you something is going on. We have vast parts of the American community, many minority communities, that are grossly underserved financially, that are underbanked, that don't have bank accounts. And we need more banks to open, but banks are not going—people are not going to invest capital if they can't earn profits and if they don't have certainty.

Chairman HENSARLING. The time of the gentleman has expired.

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

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

And thank you, gentlemen, for being here. I appreciate it.

Now, all of us who have run or owned small businesses or family budgets know that we can't spend more money than we take in for long periods of time and borrow to make up the difference and survive. As a business owner myself, and as a former State treasurer up in Maine, I have also learned that high levels of public debt can be very damaging to an economy and job creation for a couple of reasons that we all know: It discourages business investment when the government can't get its fiscal house in order; and also the debt service payments—the interest payments on that rising debt chokes off the government's ability to fund roads and bridge repair, educate our kids, protect our environment, or defend our country.

Now, here in Washington—I am a freshman; I have been here for 7 months—I have learned that the folks here have been doing this for a very, very long period of time, and it has accelerated over the past 6½ years. So now, we have this $18 trillion national debt.

The interest payments—1 year on that debt is about $230 billion. That is almost twice what we spend in a year on veterans' benefits. And the CBO projects that in 10 years the interest on that debt will be $26 billion or thereabouts. We will exceed what we spend to defend our country.

We have folks who come before us, like Treasury Secretary Lew, say, "Well, that is no big deal because it only represents 3 percent of GDP." Now, on the second day I was here, the House of Representatives passed H.R. 1, which requires the Federal Government to balance its books by way of a constitutional amendment requiring such.

So I would like to ask you, Dr. Gramm, what do you think of H.R. 1, about requiring a discipline here in Washington to balance our books and to start paying off our debt, and what advice would you give to the Senate?

Mr. GRAMM. First of all, let me say that what I worry about in the debt—of course, the debt held by the public has doubled in the last 7 years—is that we are paying $230 billion a year to service that debt when interest rates are practically zero. Some day in God's good time, we are going to have ordinary interest rates.

And when you go back and look at what ordinary interest rates have been in the post-war period, they have been about 5 percent on a 5-year Treasury note. If we were paying that interest cost today, the cost of servicing the debt would skyrocket and we would be spending as much money servicing the debt as we spend on Social Security.

So the problem with debt is that it is forever if you don't pay it off.

Mr. POLIQUIN. I assume, therefore—

Mr. GRAMM. So I think it is a very real problem and I think that we are going to end up in the not-too-distant future paying the price of this debt, and it is going to crowd out spending, and it is going to deny people services, and people are going to be unhappy about it.

Mr. POLIQUIN. Do you believe, therefore, Dr. Gramm, that it is a good idea for Washington to have an institutional discipline coded in our Constitution to balance the books every year?

Mr. GRAMM. If I could make one change in American government, I would want to require a balanced budget—

Mr. POLIQUIN. Thank you—

Mr. GRAMM. —the reason being then you have to choose. We could have—look, the two parties—people have different values and they put a different weight on different things, but if we really had to choose and we didn't have a choice except to pay our way, we would have a lot of bipartisanship because we would end up compromising and we would have democracy at its best. Now we don't have to choose.

Mr. POLIQUIN. Thank you, sir.

Mr. Miller, do you think that a balanced budget amendment to our Constitution is a good idea?

Mr. MILLER. I think Congress should do its job. The chairman, in his introduction of me, mentioned that I was the chairman of the Oversight Subcommittee for the Science Committee. We had a great many hearings designed to get at—

Mr. POLIQUIN. Do you think—

Mr. MILLER. Excuse me—designed to get at programs that were badly run and were spending too much money, and reducing 2 percent across-the-board is lazy, slovenly work on the part of Congress.

Mr. POLIQUIN. Do you think Washington, sir—

Mr. MILLER. Figure out—

Mr. POLIQUIN. Sir, do you—

Mr. MILLER. —what the government is spending money on. I know that is hard work, but it is really your job.

Mr. POLIQUIN. I am assuming, sir, that you do not think an institutional discipline to balance the budget in our Constitution is a good idea. Is that correct, sir?

Mr. MILLER. Why don't you do your job? Why don't you figure out what the government does—spends—

Chairman HENSARLING. The time of the gentleman has expired.

Mr. POLIQUIN. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentlelady from Utah, Mrs. Love.

Mrs. LOVE. Thank you very much.

I just want you to know first of all, Senator Gramm, I have listened to your testimony and I have had to smile because I think that you have articulated so well the problems that we have had with Dodd-Frank.

I don't think anyone in this body is saying that we didn't have to address a financial crisis, but sometimes too much medicine is really bad also, and can actually hurt.

The one portion that I want to point out to you that I really appreciate was when you talked about people of value and rewarding people of value. And I want you to know, these are the people who took all the risks; these are the people who have been able to come in and been able to fix companies and do several things.

And although we know that there are always some bad players, I believe we need to do everything we can to make sure we give people as many opportunities as possible.

My parents—my father came here with very little money, just $10 in his pocket. And I want you to know that those are the people who actually gave him a chance.

Those people gave him three jobs, sometimes all at once, to make sure that they made ends meet, to the point where my dad was actually able to be a manager without having the education that he needed. He gathered the experience that he needed to become a manager and put three kids through school. And that is the American Dream.

So I thank you very much for bringing that up.

I would like to actually focus on the Volcker Rule and its impact. In your testimony you said that despite years of delay and hundreds of pages of new rules, no one knows what the Volcker Rule actually requires.

Mr. GRAMM. Not even Mr. Volcker.

Mrs. LOVE. As a matter of fact, as articulated by Paul Volcker himself, it was to stop large banks with large trading and derivative operations from gambling with taxpayer-backed deposits.

Given the enormous regulatory burdens being carried by small community banks, and the much-discussed impacts on credit availability, shouldn't banks with less than $10 billion in total assets, in your opinion, be explicitly exempt from the Volcker Rule?

Mr. GRAMM. Let me tell you what happened as observed it: Paul Volcker was the Chairman of the President's Economic Recovery Advisory Committee. They had never had a meeting.

Months, years were going by. Mr. Volcker was becoming unhappy. He started telling people he was unhappy.

And then he had this idea about proprietary trading and banks. Nobody was for it. The Democrats in Congress weren't for it.

But suddenly it became the be-all proposal even though nobody knew what it meant. And so now we have a proposal such that, despite years of study, and thousands of pages of regulations, nobody knows what it means.

And so what is happening is as we are really starting to implement it, at some point somebody is going to figure out what they think it means and then banks are going to have to comply with it. And I think it is going to have a very negative effect in terms of the ability of people to manage their capital.

And every time you limit a bank's ability to be efficient in using its capital, you are hurting the bank and you are hurting the bank's customers. And that is what I think is going to happen.

Mrs. LOVE. Okay. Do you have—I'm sorry—

Mr. GRAMM. I am not sure I have answered your question.

Mrs. LOVE. It is just that I am thinking about the Volcker Rule and the $10 billion in total assets, and also the implement that they have on the ILCs, the issues that the—that they have to deal with with the affiliates of the ILC.

I am looking at this Volcker Rule and I am looking at the unintended consequences and wondering what needs to be done so that we can provide some regulatory relief to the small banking agencies and also to the small bankers—sorry—and also to our ILCs, who are—pretty much can't do business with other companies because of the affiliates language in there.

Mr. GRAMM. Let me just quickly respond. I think a nice proposal would be to have the regulators write what they think is required by it, have it submitted to Congress, and if Congress didn't approve it, then that part of the law would be repealed.

Mrs. LOVE. Great idea.

I want to finish with this note: We are not talking about banks here, really. We are not even really talking about big banks—large banks, ILC.

We are talking about the American people and their ability to be able to get some credit so that they can achieve their dreams, and what we are doing to actually help that or stop that. And let's make sure that we are on the side of the American people.

Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair wishes to advise Members that the Chair intends to recognize two more Members and then we will adjourn. Currently, that will be Mr. Hill and Mr. Emmer.

The gentleman from Arkansas, Mr. Hill, is now recognized.

Mr. HILL. Thank you, Mr. Chairman.

It is certainly good to see you, Senator Gramm.

And my old friend, Peter Wallison, glad to have you back.

And, Congressman Miller, thank you for coming back to the committee.

I want to tell you that for certainly the past 17 years as an entrepreneur, prior to coming to Congress in January, I was one of those banks that Senator Gramm was referring to when he described the multi-examination cycle. And in the State securities department, the State insurance department, the Federal Reserve Bank of St.

Louis, the State banking department of Arkansas, the FDIC, the FINRA, the SEC Fort Worth, and I am not sure if I have left anybody out, I never had one of those agencies ever shirk their consumer protection obligation under Federal or State law, ever.

And from that point of view, I think one of the main titles of Dodd-Frank is the single most redundant—you say independent and unaccountable—agency ever created, and that is the CFPB. And I stand in awe that Congress would do that to itself. And I didn't—I left out the State's attorney general and the FTC in that process.

Peter Wallison, on the subject you laid out for the committee that in 2008, 50 percent of the mortgage market at that time at the peak was subprime, and that 78 percent of those were guaranteed by FHA or Fannie and Freddie, and yet Dodd-Frank completely ignores reforms in the mortgage market.

My experience as a banker during that crisis was that people were trying to sell us secondary-market instruments, privately issued, purely for CRA credit, and the spread on those securities were no greater than mortgages that we originated in our own portfolio.

So we had no risk spread premium for them allegedly being a subprime credit or CRA-type credit. I found that sort of amazing, as a banker at the time, and one reason why we just—there was no spread, there was no benefit to it. We didn't need the CRA credit, so we passed on it.

But it struck me that they wouldn't have existed if Fannie and Freddie had not reduced their own underwriting standards. And 20 years ago they were the gold standard of underwriting standards. They were the clearinghouse. Could you reflect more on that deterioration in the Federal Government's leadership in declining underwriting standards?

Mr. WALLISON. Yes. Up until 1992, Fannie and Freddie would only accept prime mortgages. In fact, they were known for that.

And a prime mortgage had a good credit rating for the borrower; it had a downpayment of 10 to 20 percent; it had a debt-to-income ratio of no more than 38 percent. That was the prime mortgage and that kept mortgage defaults in the United States somewhere below 1 percent on a regular basis.

But in 1992, the affordable housing goals were imposed on Fannie Mae and Freddie Mac and then raised over time from 30 percent to 56 percent. And during that period they had to reduce their underwriting standards in order to meet those goals.

So by 1995, Congressman, they were accepting mortgages with 3 percent downpayment. And by 2000, they were accepting mortgages with no downpayment at all.

That was all to meet the government quota.

Mr. HILL. You know what—

Mr. WALLISON. That is why we had so many mortgages in our financial system that were poor quality in 2008.

Mr. HILL. What frustrates me from a public policy point of view is that Congress was so eager in the Clinton and early Bush Administrations to boost home ownership rates at this huge cost to society and to the economy, and skewing capital markets. And yet, that increase was so modest it was almost microscopic. I think today the news came out that it has fallen back to 63.3 percent or something like that, I think it was announced this morning.

But it never really—all that effort didn't produce the lasting economic benefits of sort of the pot of gold at the end of the rainbow. What do you think, looking on—studying—and Senator Gramm as well—what do you think sustainable home ownership rates are in our economy?

Mr. WALLISON. Let me just add something before Senator Gramm just briefly, and that is home ownership rates were 64 percent for 30 years between 1965 and 1995, so it looks like that is the natural rate of home ownership in this country.

Mr. HILL. Yes. Okay.

Senator Gramm?

Mr. GRAMM. Yes. Look, I think the way to promote home ownership is to promote jobs. If people have jobs, if they have a solid future, if they are confident in their future, they will be able to buy a home and they will be able to pay for it.

We are trying to create home ownership without people having to do the things you do that make it possible for you to own a home. So I think a jobs program is the best housing program, the best education program, the best nutrition program.

Mr. HILL. Thank you, Senator.

I yield back.

Mr. GRAMM. We need to get back to that.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Minnesota, Mr. Emmer.

Mr. EMMER. Thank you, Mr. Chairman.

And thanks to the panel, for a couple of extra minutes.

Mr. Wallison, I wanted to ask you a question, because many of our colleagues believe that deregulation played a large role in the economic collapse in 2008. I find the argument somewhat disingenuous since apparently the number of banking regulations in Title 12 of the Code of Federal Regulations actually increased by approximately 20 percent between 1997 and 2008.

In fact, in the 2 decades preceding the financial crisis of 2008, Congress gave Federal regulators broad new powers over banks, mortgage lenders, and other financial services firms through the Federal Deposit Insurance Corporation Improvement Act of 1991, the Home Ownership and Equity Protection Act of 1994, the 2001 Bank Secrecy Act amendments made by the USA PATRIOT Act, the Sarbanes-Oxley Act of 2002, and the Fair and Accurate Credit Transactions Act of 2003.

The question with that is, did deregulation of the financial industry play a large role in the economic collapse of 2008?

Mr. WALLISON. First of all, it didn't occur, so it couldn't have had any role in 2008. There was no deregulation before 2008. In fact, there was none throughout our economy except in finance.

In the financial area, there was no deregulation from the New Deal up until 2008. Every other area of the economy did very well with deregulation. We had a lot of growth, a lot of improvement in products and innovation, reduction in cost, and so forth, all because of deregulation.

But not in finance, which has been controlled by the government very carefully, and I am here—speaking here almost entirely of the banking system, which has been increasingly regulated all this time. And the Acts you refer to, FDICIA and FIRREA, were perfect examples of that.

Now, when people try to blame the financial crisis on deregulation, they point to Senator Gramm's Act, Gramm-Leach-Bliley, in the elimination of one part of the Glass-Steagall Act. That had no effect whatsoever on the financial crisis, which, as we know, was the result of mortgage meltdown, the housing system in this country coming apart because of a reduction in underwriting standards, which was induced, as I have said, by government activity.

So there was no deregulation and there is no reason to blame deregulation for the financial crisis.

Mr. EMMER. Senator Gramm, you were waving at me?

Mr. GRAMM. Let me just say, people assume that because I am the "Gramm" of Gramm-Leach-Bliley that somehow this is me. This is what I thought in 1999. Ninety members of the Senate voted for it. It was supported by President Clinton and every financial regulator in America, and it was the best judgment I had at that point. But if I thought that it was a mistake, I would say so.

I don't see any evidence that it was a mistake. If allowing banks and security companies to—insurance companies to affiliate through a financial services holding company where bank capital couldn't be put into those other areas—if that were a problem in causing the financial crisis the financial crisis would have start in—started in Europe where they never separated the things to begin with.

Mr. EMMER. Senator?

Mr. GRAMM. And I would add to your list one other thing.

Mr. EMMER. What is that?

Mr. GRAMM. When the Congressional Research Service did its outline of Gramm-Leach-Bliley it never used the word "deregulation" or "deregulates." The truth was it allowed the affiliation but it kept the same regulators regulating the same thing.

There isn't any evidence to substantiate the claim that there was this massive deregulation between 1980 and the financial crisis. It just won't hold water.

Mr. EMMER. Thank you.

I see that my time is quickly expiring so, Mr. Chairman, I will yield back.

Chairman HENSARLING. The time of the gentleman has expired. There are no other Members in the queue.

I would like to thank our witnesses for their testimony today.

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.

This hearing stands adjourned.

[Whereupon, at 1:09 p.m., the hearing was adjourned.]

APPENDIX

July 28, 2015

Written Testimony of Senator Phil Gramm Before the U.S. House of Representatives Committee on Financial Services

Washington, D.C.

July 28, 2015

It is a great honor and pleasure to be asked to testify today. I am especially honored to sit at the witness table with Peter Wallison and Congressman Brad Miller. Peter Wallison has been the strongest and clearest voice on the subprime crisis and has contributed more to our understanding of that problem than anyone.

Many of you know I have a long and deep relationship with your Chairman. Long ago and far away I taught him Money and Banking at Texas A&M, and as any old teacher would, I take great pride in the job he has done and the man he has become.

By any measure we are today experiencing the weakest recovery of a post-war era. Had this recovery simply matched the strength of the average of the other ten recoveries since World War II, 14.4 million more Americans would be working today and the average income of every man, woman and child in the country would be $6,042 higher. The incomes of the poor, middle income workers, women and minorities have fallen even during the recovery, an unprecedented event. All this economic carnage has occurred despite a doubling of the Federal debt and an expansion of the Federal Reserve Bank balance sheet and the monetary base at rates never before witnessed.

Five years after the enactment of Dodd-Frank, the causes and effects of the failed recovery can be seen throughout the banking system. Monetary easing by the Fed has inflated bank reserves but has barely increased lending. Today banks hold an extraordinary $29 of reserves for every dollar they are required to hold. In the first quarter of 2015 banks actually deposited more money in the Fed ($65.1 billion) than they lent ($52.5 billion).

According to the FDIC, 1,341 commercial banks have disappeared since 2010, one each day in the first quarter of 2015. Remarkably, only two new banks have been chartered in the last five years. By comparison, in the quarter century prior to the financial crisis roughly 2,500 new banks were chartered. Even in the depths of the Great Depression of the 1930s, on average 19 banks a year were chartered.

As regulatory burden has exploded under Dodd Frank, community banks have hired 50% more compliance officers while overall industry employment has expanded by only 5% and is still below the pre-crisis level. Industrial, consumer and mortgage finance has continued to flee the banking system, as increasing regulatory burden has led almost half the banks to cut offerings of financial products and services. New financial services technology has continued to blossom, but it has been almost exclusively developed and implemented outside the banking system. As a result, massive amounts of resources and talent in banks have been sidetracked rather than being employed to make loans and grow the economy.

Much of our slow growth is not just a product of mounting regulatory burden but of legislative and executive actions that have empowered regulators to set rules rather than implement rules set by Congress. Dodd-Frank has undermined a vital condition required to put money and America back to work -- legal and regulatory certainty.

To be fair to the Dodd-Frank Act, Congress has been more descriptive than proscriptive in banking laws for some time, and a certain amount of regulatory flexibility is necessary. But, in the Securities Exchange Act of 1934 and most subsequent banking law before Dodd-Frank, the powers granted to regulators by Congress were fairly limited and generally exercised through bipartisan commissions, where major decisions were debated and voted on in the clear light of day. Precedents and formal rules were knowable by the regulated. Also, regulators generally had to be responsive to Congress, which controlled their appropriations and possessed super majority confirmation powers. These checks and balances, while imperfect, did promote general consistency and predictability in federal regulatory policy.

The Dodd-Frank Act delegated far more discretionary power to financial regulators than had ever been granted before and undermined the checks and balances that had historically marked the process. For example, the Consumer Financial Protection Bureau (CFPB) was structured with no bipartisan commission and automatic funding, which virtually eliminated any real ability for elected officials to check its policies. In the process, consistency and predictability were replaced by uncertainty and fear.

U.S. regulators are now imposing restrictions on financial institutions that were never contemplated by Congress and pushing international regulations on insurance companies and money market funds that Congress never authorized.

The Financial Stability Oversight Council (FSOC) was specifically empowered to override precedents and bipartisanship. Since FSOC meets in private and is made up exclusively of the sitting President's appointed allies, bipartisan input and sunshine -- the historic checks on regulatory abuse -- have been lost. In addition, since what constitutes a systemically important institution was never defined by Dodd-Frank, it has become whatever FSOC says it is. The systemically important designation of FSOC is now a sword hanging over the head of every major financial institution. Banks that have been designated have regulators embedded in their executive offices to monitor and advise, eerily reminiscent of the old political officers who were placed in every Soviet factory and military unit.

Despite years of delay and hundreds of pages of new rules, no one knows what the Volcker Rule requires—not even Paul Volcker.

Over the years the Federal Trade Commission and the courts had defined "unfair and deceptive", but when Dodd-Frank added "abusive" without defining it, financial institutions can now engage in activities that are not unfair or deceptive by long standing precedent and still be judged by the CFPB as being "abusive".

Then there is the "living will", a plan not of how banks will be run but how they would be liquidated if they failed. The Fed and the FDIC have almost total discretion in deciding whether the plan is acceptable and therefore whether to institute a variety of penalties, including the divestiture of assets. No other industry in the nation makes or publishes such plans, or expends management energy and board time on how to shut down their business. Their energy is rightly focused on how to build their business and the economy.

What does the stress test test? Not only does no one know, but the regulators see that as a virtue. The Fed's Vice Chairman has stated that giving banks a clear road map for compliance might make it "easier to game the test". But isn't the fact that compliance is easier when you know what the law says the whole point of the rule of law?

To limit abuse by its rulers, ancient Rome started the then-revolutionary practice of writing down the law and permitting citizens to go and read it. Under the Dodd-Frank Act, and numerous other actions taken during this Administration, regulatory authority is so broad and so vague that the conditions of Roman law are no longer met in America. The rules are now whatever regulators say they are. This is the rule of government, not the rule of law.

Most criticism of Dodd-Frank focuses on the massive increase in regulatory burden it has imposed, but the most costly and dangerous effect of Dodd-Frank, ObamaCare and virtually every other legislative and regulatory action of this Administration is the uncertainty and arbitrary power it has created by the destruction of the rule of law. These policies are shackling economic growth but more importantly, they are imperiling our freedom.

Testimony of Brad Miller
House Committee on Financial Services
Hearing entitled "The Dodd-Frank Act Five Years Later: Are We More Prosperous?"
July 28, 2015

Good morning Chairman Hensarling, Ranking Member Waters and Members of the Committee. I'm Brad Miller. I served for an eventful decade as a member of this Committee.

I introduced legislation early in 2004 to prohibit predatory subprime mortgage lending. I endured the explanation by the industry and by their many allies on this Committee that I probably meant well, but subprime mortgages were the triumph of the innovation that comes from unfettered capitalism. From the industry, their allies on this Committee, and conservative commentators, not a discouraging word was heard about subprime mortgages. Dreary rules like those I proposed, they said, were relics from a distant time when the financial industry did not perfectly understand and manage risk, and would deny low-income and minority borrowers the dream of home ownership.

I have not heard that argument since September of 2008, when the Bush Administration came to Congress and said that if we did not act immediately, the world's financial system would collapse and what followed would make the Great Depression seem like a hiccup. But within days I heard another argument from the same people that I had never heard before. Liberals bullied innocent banks into giving foolish mortgages to low-income and minority borrowers. It was government, they said, that caused the crisis.

That argument has been demolished repeatedly by peer-reviewed, scholarly studies, but I did not believe that argument the first time I heard it because of my own experience and what I know of the law of evidence. When a witness's testimony is self-serving, the witness made "prior inconsistent statements" that were also self-serving at the time, and the witness cannot explain the inconsistency, you can decide not to believe a word the witness said.

Since then I may have disbelieved some things industry lobbyists said that were actually true. There's a reason that parents for centuries have told their children the story of "The Little Boy Who Called Wolf. "

The Dodd-Frank Act is the response to the worst financial crisis and the worst economic downturn since the Great Depression. The Act includes a version of the home mortgage rules that I first introduced in 2004, and home mortgages are the nation's largest asset class. The Act created the Consumer Financial Protection Bureau to protect against other abusive practices, and to examine skeptically industry arguments that new lending practices that appear predatory to the uninitiated are really marvels of innovation. The Act requires banks to have more capital, and gives regulators more authority to require large financial institutions to show that they won't bring the entire financial system down if they get in trouble and to make changes if they can't. Trading in derivatives is more transparent than it was before, although that is an unacceptably low bar.

Dodd-Frank was a compromise and reformers did not get all we wanted, but it was probably all that was possible at the time, given the industry's continued enormous clout in Washington, even while the industry stood in complete disrepute among the American people. We are better off, and more prosperous, than we would be without it.

But we have a financial system that still needs reform. The industry is too crooked, too large and takes too much of the economy at the expense of people trying to make an honest living. Instead of a smooth flow of money from savers to people who can put money to productive use, far too much money coagulates on Wall Street.

First, there has been no end to scandals: Pervasive misrepresentation of the mortgages that backed mortgage-backed securities, illegal foreclosures, manipulation of LIBOR and the other BORs, manipulation of electricity and other markets, manipulation of Treasury auctions, money laundering for drug cartels and genocidal regimes, rigging foreign exchange markets, and on and on.

According to a recent survey, almost half of financial industry professionals said they thought their competitors cheated, and 22 percent said they observed or had firsthand knowledge of misconduct at the workplace. Other findings suggest that many more probably saw the same conduct and had no problem with it.

According to a 2012 poll, 68 percent of Americans ***disagreed*** with the statement "In general, people on Wall Street are as honest and moral as other people."

William Dudley, head of the New York Fed and a Goldman Sachs alum, said last year that repeated scandals were not the work of a few bad apples but were the product of the culture of Wall Street, which is a threat to financial stability.

And some, to quote the Republican frontrunner, I assume are good people.

Second, the financial sector has more than doubled in size as a percentage of the economy since 1980. Largely because of the mergers during the crisis, which resembled a drunken couple holding each other up on the dance floor, on top of the deregulation of the nineties, including Gramm-Leach-Bliley, the biggest banks are even bigger. Some on this Committee have pointed to that consolidation as evidence that Dodd-Frank made the financial system less stable, but have not supported any legislation to break up the biggest banks. I introduced legislation that Sherrod Brown introduced in the Senate to break up the six biggest banks into at least 30 banks by capping the overall size. I do not recall any support for that proposal among the critics of Dodd-Frank. Others propose a modern requirement that investment banks be separated from commercial banks, but again, with little support from critics of Dodd-Frank.

Instead, Congress repealed the provision of Dodd-Frank that required that the riskiest swaps be traded in a separately capitalized, "bankruptcy remote" subsidiary to protect taxpayer insured deposits and our economy's payment system.

Most of the debate about the size of the financial system has been about what happens when things go wrong, like London Whale trades. What happens when things go right is just as big a problem. When things go right, there is harm that often goes undetected, like a patient with a parasite who does not understand why he is always tired.

The Whale trades were in JPMorgan's "synthetic credit portfolio." Real credit is vital to the economy. Synthetic credit is a derivative that is a bet on whether a borrower defaults on a debt to someone else. The contribution to the economy of synthetic credit appears to approximately the same as the nutritional value of plastic fruit.

The financial reforms enacted by Congress in the New Deal showed urgency and imagination, and the economy grew by eight percent a year for the first four years of the Roosevelt Administration before the recession of 1937 and 1938. That will be hard to replicate. But the reforms ended frequent financial crises and created a steadily growing economy that lasted for well more than a generation and created widely shared prosperity. The prosperity extended to Americans who had been left out before. In 1930, per capita income in the South was 55 percent the national average. In 1960, it was 78 percent.

Yes, I want to avoid another financial crisis, but I also want an economy that grows and creates more prosperity for more Americans. To accomplish that, we still have work to do.

American Enterprise Institute for Public Policy Research

Statement before the House Financial Services Committee

The Dodd Frank Act Five Years Later: Are We More Prosperous?

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

July 28, 2015

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

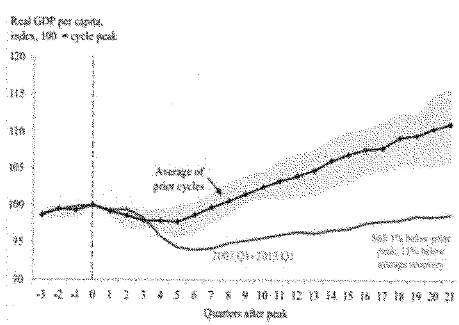
Chairman Jeb Hensarling, Ranking Member Waters and members of the Committee:

I am grateful for the opportunity to testify before this committee on the question: "The Dodd-Frank Act Five Years Later: Are We More Prosperous?" My name is Peter Wallison. I am the Arthur F. Burns Fellow in Financial Market Studies at the American Enterprise Institute. My testimony is my own and does not necessarily represent the views of AEI.

I am particularly delighted to be seated here with Phil Gramm, not only the teacher of the chairman of this committee but to my mind the greatest political economist ever to sit in the US Senate. He is sorely missed by everyone who recognizes the need today for pro-growth economic and financial policies. To be sure, there are great advocates for these policies in Congress today, but the knowledge and clarity of expression of Senator Gramm was and is unique. Although I like to have the opportunity to speak once in a while when I testify before congressional committees, I would happily cede all of my time to Phil Gramm. In that way, not only will the members of this committee be educated, but so will I.

Dodd-Frank became a law on July 21, 2010, and this testimony will use that date as the reference point for determining the economic effects of the act. On whether we are more prosperous since July 21, 2010, it is important to understand that the question of prosperity or economic growth is relative. There has certainly been economic growth since July 21, 2010. In that sense, we are more prosperous, but as Senator Gramm said in his written testimony: "Had this recovery simply matched the strength of the average of the other ten recoveries since World War II, 14.4 million more Americans would be working today and the average income of every man, woman and child in the country would be $6,042 higher."

Below is a chart, prepared by the Federal Reserve Bank of Dallas that encapsulates the point that Senator Gramm is making.



NOTE: The gray area indicates the range of major recessions since 1960, excluding the short 1980 recession. 3
SOURCES: Bureau of Economic Analysis; Census Bureau; authors' calculations.

As the chart shows, through the first quarter of 2013, there had been some economic growth, but far less than in a normal recovery. Since then, as we know, things have not improved substantially. A recent op-ed in the *Wall Street Journal* by Glenn Hubbard (former chair of the Council of Economic Advisers under George W. Bush) and Kevin Warsh (a former Governor of the Federal Reserve) in effect updates this chart: "Economic growth in real terms is averaging a meager 2.2% annual rate in the 23 quarters since the recession's trough in June 2009. The consensus forecast of about 1% growth for the first half of this year offers little solace."[1]

What's the problem?

I believe that all the new regulation added by the Dodd-Frank Act in 2010 is the primary reason for the slow growth this country has experienced since 2010. Later in this testimony, I will show that the new regulations imposed on banks—particularly small banks—has created a bifurcated economy. Large firms in the real economy, which can access the capital markets for financing, have been growing roughly in line with previous recoveries, but smaller firms that rely on banks for financing are growing far more slowly. Since most of the growth in the US economy, and especially in employment, comes from small firms, the economy is underperforming and will continue to underperform until the treatment of banks under Dodd-Frank Act is substantially modified or repealed.

A Cost-Benefit Analysis of Dodd-Frank's Additional Regulations on Banks

The relevant question about the efficacy of any new regulation such as the Dodd-Frank Act is always one of balancing costs and benefits. Regulation inevitably imposes costs, and placing additional costs on any business will virtually always reduce the system's productivity and growth by diverting expenditures to regulatory compliance instead of greater production. In banking and finance, which rely heavily on human capital, it may be easier to measure at least one element of cost—the effect on hiring practices. If, in order to comply with a regulation, a bank has to hire a compliance officer rather than a loan officer, the bank will inevitably be less productive—it will make fewer loans for the same amount of revenue.

Looking simply at employment practices instead of other effects of regulation is a very simple idea, and it doesn't fully reflect all the costs of additional regulation. As Greg Ip recently wrote in the *Wall Street Journal*, "[N]o one knows the true costs or benefits of the blizzard of laws, rules and penalties imposed since the financial crisis...Unlike the rules governing pollution and automobile safety, the costs and benefits of big new financial rules are seldom rigorously quantified... The costs of financial regulation go beyond what banks and their shareholders must pay for more compliance personnel. By making credit more expensive and restricting supply, new regulation can ding growth, especially at times like the recent past when the Fed can't compensate by lowering interest rates, which are already near zero."[2]

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[1] Glenn Hubbard and Kevin Warsh, "How the U.S. Can Return to 4% Growth," *Wall Street Journal*, June 23, 2015.

[2] Greg Ip, "Missing in Financial Rules Debate: Hard Numbers," *The Wall Street Journal*, May 13, 2015.

Nevertheless, although we can't put a number on all the costs of more regulation, at least for the banking industry we can say that hiring practices shaped by additional regulation may be one way to measure some of the costs of the new regulation that came with the Dodd-Frank Act. I will assume in the discussion that follows that all the new regulations that have been imposed on banks have required them to add compliance officers instead of loan officers, and that this was one major cost of the Dodd-Frank Act. It added costs, but reduced the amount of lending. The next question is measuring the benefit.

Giving Congress its due, in enacting Dodd-Frank Congress was trying to achieve financial stability in the future through stricter regulation of the financial system. In doing so, I believe Congress misdiagnosed the financial crisis as the result of lax regulation of the private financial sector. In effect, it treated the symptoms rather than the disease. The symptoms were the weakness of private financial institutions as unprecedented numbers of mortgages defaulted in 2007 and 2008, but the disease was the government's housing policies, which—between 1992 and 2008—caused a drastic deterioration in residential mortgage underwriting standards. A single fact demonstrates the government's role in weakening the financial system: in 2008 more than half of all mortgages in the US—31 million loans—were subprime or otherwise weak and risky. And of these 31 million mortgages, 76 percent were on the books of government agencies. This shows, without question, that the government created the demand for these low quality mortgages.[3]

For purposes of this testimony, however, whether Congress was right or wrong in its diagnosis of the financial crisis is immaterial. Even if Congress was correct in its assessment of the causes of the crisis, we can evaluate whether the balance it struck between costs and benefits in the regulation of banks was correct. Here we can be reasonably sure that we know what benefit Congress was seeking. Because of its diagnosis of the crisis, Congress was seeking to create future stability in the financial system by imposing greater regulation on private sector financial firms, particularly banks. So the question is whether the stability Congress was hoping to achieve through additional regulation in Dodd-Frank outweighs the costs.

Before beginning this analysis, it is important to note that we cannot weigh all the costs of Dodd-Frank. We don't have the capacity to do that at this point. When Jamie Dimon, the chair of JPMorgan Chase, asked Ben Bernanke in 2011 whether "anyone bothered to study the cumulative effect of all these things," Bernanke replied, "I can't pretend that anybody really has. You know, it's just too complicated. We don't really have the quantitative tools to do that."[4]

Nevertheless, the fact that we can't quantify all the costs of Dodd-Frank does not mean that we can't assess at least one of them, and that is the cost of hiring compliance officers instead of loan officers. Compliance officers are necessary to meet the regulatory demands of the government; loan officers are necessary to increase lending or to sustain it at previous levels. To the extent that banks have to hire compliance officers instead of loan officers, they are inevitably reducing the amount of lending they will do.

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[3] For additional details, see Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again*, Encounter Books, 2015.

[4] Deal Book, "What Dimon Told Bernanke," *New York Times*, June 8, 2011.

A good place to assess the cost-benefit question underlying Dodd-Frank is the act's requirement that all bank holding companies with $50 billion in assets or more be considered systemically important financial institutions (SIFIs) and subjected to "stringent" regulation by the Fed. Among many other requirements, these banking organizations must also prepare living wills—detailing how they would be broken up if they fail—and participate in annual Fed-designed stress tests. These and other requirements add substantial additional costs to whatever "stringent" regulation entails. These substantial additional costs, even if only in the form of more compliance officers than loan officers, will mean that these banks will supply less credit to the real economy. If banks did not have to hire any compliance officers, all their new hires—if any—would be loan officers, which would generate more loans and hence more revenue and more economic growth for the real economy.

Do the benefits that Congress sought in imposing substantial new regulation on banking organizations with assets of $50 billion or more outweigh the costs? The benefit is added stability. With "stringent" regulation, stress tests and living wills, it is fair to assume that these banks will be less likely to fail in the future, and if they fail their failure will not be as disorderly as failures in the 2008 financial crisis. The cost is that these banking organizations will, through their subsidiary banks, be making less credit available to the real economy because they have been required to hire more compliance officers instead of loan officers.

The Federal Reserve's Flow of Funds accounts tells us that as of the end of the first quarter of 2015 the total financial assets in the US were $86 trillion, and total assets of private depository institutions were $17 trillion. $50 billion is .3% of 17 trillion. So the drafters of the Dodd-Frank Act believed that a banking organization with .3% of the assets of the entire banking business would cause the financial system to become unstable if it failed. A bank with $200 billion in assets would have 1.2% of total bank assets. Even a bank with $500 billion in assets has only a little over 3% of all bank assets. It seems completely implausible that in an economy with $85 trillion in financial assets and a banking system with $17 trillion in assets the failure of a $50 billion banking organization—or even a $200 billion or $500 billion bank—would cause any significant instability. Losses, yes. Instability in the whole financial system, no.

So it seems that Congress struck the wrong cost-benefit balance between economic growth and stability when it decided that any banking organization with assets of $50 billion or more ought to be subjected to costly new regulations in the interest of assuring the future stability of the financial system. This new regulatory burden imposes a high cost in the form of much slower growth—especially, as we will see, for businesses dependent on banks—with very little benefit in the form of additional stability. Senator Gramm described the high cost relative to benefits in the statement from his testimony that I quoted above. In that case, which assumed that Dodd-Frank had not been adopted at all, the cost came in the form of a slower economic recovery since the end of the 2009 recession than the average recoveries of the past.

We don't know how much additional growth we would have had if Dodd-Frank had drawn the SIFI line for banking organizations at the different place—say, at $500 billion or $1 trillion. Although we know that regulation has some cost, there is insufficient data available to draw any connection between a certain amount of new regulatory cost and a certain amount of reduced economic growth. But what we do know in the case of the special regulations imposed on banks with more than $50 billion in assets up to as much as $500 billion is that we have bought more stability than we need at the cost of reduced economic growth.

The same is true for small banks, which have also been required to address many new regulations coming out of Dodd-Frank, especially in mortgage lending, debit and credit card activity and consumer lending. There has actually been some solid academic work on how regulation affects the employment practices and profitability of community banks—those with assets of less than *$50 million*. In 2013, three economists at the Federal Reserve Bank of Minneapolis actually looked at the effect of new regulations on these small institutions. They chose to model only the effects on bank hiring, although many other factors—risk-taking, legal liability, product costs—are affected by additional regulation. "[W]e find," they write, "that the median reduction in profitability for banks with less than $50 million is 14 basis points if they have to increase staff by one half of a person; the reduction is 45 basis points if they increase staffing by two employees. The former increase in staff leads an additional 6 percent of banks this size to become unprofitable, while the latter increase leads an additional 33 percent to become unprofitable."[5]

Although community banks with less than $50 million in assets are of course much smaller and simpler than banks with $50 billion in assets, the point is the same if we are talking about the effect of regulations on hiring practices. If a banking organization larger than $50 billion has to hire additional compliance officers in order to meet its new stringent regulation, living will and stress test requirements, its profitability will also be reduced, a certain number of those banking organizations will then become vulnerable to failure, and all of them will reduce the amount of credit they provide because relatively more of their human capital is engaged in compliance rather than sales.

In March, 2014, for example, JPMorgan Chase, the largest US banking organization, cut back its projections for the coming year, saying that its trading profits and return on equity would be down. It noted that it would also add 3000 new compliance employees, on top of the 7000 it added the year before. But the total number of employees of the banking organization were expected to fall by 5000 in the coming year.[6] Absent the regulatory imperative, the bank might have cut 8000 employees instead of 5000, thus cutting its costs somewhat further, or it might have added 3000 new loan officers instead of compliance officers to increase its revenues. But with the regulatory imperative it faced, even a large banking organization that is experiencing a decline in profitability had to increase its hiring of compliance officials and cut employees from its profit-making activities. What we are seeing, then, is a clear case—even at the level of the largest banking organizations—of compliance costs substituted for the personnel that are normally the sources of revenue and profit.

Are There Other Explanations for the Slow Recovery?

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[5] Ron J. Feldman, Jason Schmidt, Ken Heinecke, "Quantifying the Costs of Additional Regulation on Community Banks," Federal Reserve Bank of Minnesota, May 30, 2013, p2.

[6] Dan Fitzpatrick, "J.P. Morgan Dims Its Light on 2014," *Wall Street Journal*, February 26, 2014.

Defenders of Dodd-Frank sometimes argue that a slow recovery is typical after financial crises, but recent scholarship casts doubt on this explanation. Michael Bordo and Joseph Haubrich studied 27 recession-recovery cycles since 1882 and concluded: "Our analysis of the data shows that steep expansions tend to follow deep contractions, though this depends heavily on when the recovery is measured. In contrast to much conventional wisdom, the stylized fact that deep contractions breed strong recoveries is *particularly true* when there is a financial crisis."[7] [emphasis added]

Bordo and Haubrich find only three exceptions to this pattern; in these cycles, the recoveries did not match the speed of the downturns. The three were the Depression of the 1930s, the 1990 recession that ended in March 1991, and the most recent recession, which ended in June 2009. What do these three exceptions have in common?

In each case, the government's intervention in the financial system was unusual and extensive. During the Depression Era the Hoover and Roosevelt administrations tried many ways to arrest the slide in the economy, all without success. Hoover was an inveterate activist in all things, and Franklin Roosevelt believed in constant experimentation until something worked. Neither of them seemed to have a consistent theory about what brought on the economic downturn or how to address it. Under President Hoover, Congress passed the Smoot-Hawley Tariff Act, and the Emergency Relief and Reconstruction Act, and established the Reconstruction Finance Corporation. Under Roosevelt, the US went off the gold standard, established a deposit insurance system and a federal regulatory system for state-chartered banks; Congress adopted the National Recovery Act, the Emergency Banking Act, Emergency Farm Mortgage Act, the Securities Act, the Securities & Exchange Act and the Farm Credit Act. Other major laws with financial implications were the National Industrial Recovery Act and the Agriculture Adjustment Act (both of which were eventually declared unconstitutional by the Supreme Court). This enormous flurry of activity, however, while popular with the American people, did not produce a recovery until the nation geared up for war at the end of the 1930s.

In addition, the Pecora hearings of the early Roosevelt administration, propagated the idea that banks' securities activities had caused the crisis; this is uncannily similar to the narrative that produced the Dodd-Frank Act, which blamed the financial crisis on insufficient regulation of the financial system and greed and recklessness on Wall Street. The Pecora hearings resulted in the Glass-Stegall Act, which separated securities and banking activities. Whether or not that was harmful can be debated, but the wholesale revision of financial structures it entailed probably constricted credit and market confidence in the years that followed.

The recession in 1990 and early 1991 came after the collapse of the S&L industry in the late 1980s and the failure of almost 1600 banks during the same period. Both were blamed on insufficient regulatory authority or lax enforcement—again like the narrative that supported the

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

Dodd-Frank Act—and produced the Financial Institutions Recovery, Reform and Enforcement Act (FIRREA) in 1989 and the FDIC Improvement Act (FDICIA) in 1991.

These laws increased the regulatory authority of federal bank regulators, and under pressure from Congress and the public they cracked down on depository institutions, causing a credit crunch and what was called a "jobless recovery" in 1991. As one observer put it, the Comptroller of the Currency "had softened regulatory policies on banks early in his tenure, helping fuel excessive real estate lending by banks. By mid-1990 and early 1991, the regulatory attitudes had apparently changed: "Bank examiners became too restrictive, helping to create a near credit crunch."[8] In addition, the first set of Basel risk-based capital rules were adopted in 1988 and were gradually phased in at this time, requiring banks to re-compute their capital positions and in many cases required them to increase their capital.

Thus, there is historical evidence that the slow recovery from the 2008 financial crisis is due in part—maybe primarily—to the fact that the Dodd-Frank Act was adopted shortly after the crisis. Instead of allowing the economy and the financial system to heal naturally, it introduced constraints, costs and uncertainties that have interfered with the natural course of the recovery. Moreover, like the Pecora hearings, Dodd-Frank was based on the idea that the private sector was to blame for the crisis and thus sought to punish the very entities that were necessary to finance a recovery.

The idea that a post-recession series of actions can in fact slow an economic recovery receives added weight from a recent book by James Grant called *The Forgotten Depression*. Grant traces the sharp downturn and the following sharp recovery in 1920 and 1921. The downturn in 1920 was severe. "Just how severe," writes Grant, "is a question yet to be settled...Official data as well as contemporary comment paint a grim picture. Thus, the nation's output in 1920-21 suffered a decline of 23.9 percent in nominal terms, 8.7 percent in inflation-(or deflation)-adjusted terms. From cyclical peak to trough, producer prices fell by 40.8 percent. Maximum unemployment ranged between two million and six million persons...out of a nonagricultural labor force of 31.5 million. At the high end of six million, this would imply a rate of joblessness of 19 percent." [9]

But the government did nothing. President Wilson had suffered a second severe stroke in October 1919, and was partially paralyzed, although this fact was withheld by the White House. What little energy Wilson had through the election year of 1920 was reserved for the fight over the League of Nations. The Republican Harding administration, which followed, did nothing either, says Grant. "The successive administrations of Woodrow Wilson and Warren G. Harding met the downturn by seeming to ignore it—or by implementing policies that an average 21st century economist would judge disastrous. Confronted with plunging prices, incomes and

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[8] Alan Gart, *Regulation, Deregulation, Reregulation: the Future of the Banking, Insurance, and Securities Industries.* New York: John Wiley & Sons. 1994. p 163.

[9] James Grant, *The Forgotten Depression: 1921: The Crash That Cured Itself.* Simon & Schuster, 2014, p4

employment, the government balanced the budget and, through the newly instituted Federal Reserve, raised interest rates...Yet by late 1921, a powerful, job-filled recovery was under way. This is the story of America's last governmentally unmedicated depression."[10] Needless to say, there was no new regulation, and the economy recovered quickly.

This is not to say that a laissez-faire policy is always best,[11] but simply that adding new regulatory activity after a severe recession seems to slow a rapid return of economic growth, and that certainly seems to be borne out by the examples cited above.

It is of course possible that the 2008 financial crisis and the ensuing recession were such shocks to the economic system that they have caused a secular change in the performance of the US economy—a "new normal" of slow growth and declining living standards for the middle class. However, it is far more likely that government policies are responsible for these conditions, and if we look for the policies that could have had the greatest effect on the economy since the financial crisis, there have been only three—the Affordable Care Act, the Fed's historically low interest rates, and the Dodd-Frank Act. Neither the ACA nor low interest rates should have had a repressive effect on new business formation; quite the contrary. Nor should either of them significantly suppress capital investment—again, it's more likely that they've both had stimulative effects. So that leaves Dodd-Frank as the most likely cause of the slow-growth economy we have been experiencing.

Finally, quite apart from the fact that Dodd-Frank has probably slowed the recovery from the financial crisis and the ensuing recession through adding excessive regulatory costs, it is important to note that it has also added regulations that impose major costs but which have little or no relationship with the financial crisis. In a 2014 study, the American Action Forum showed that three requirements in the Dodd-Frank Act, the pay ratio rule, the Conflict Minerals provisions and the Volcker Rule totaled more than $10 billion in costs for financial firms, but none has been shown to be a cause of the crisis.[12] For the reasons outlined earlier, these costs are reducing the availability of credit and slowing economic growth for reasons of social justice or the placation of a special interests, not because they were deemed necessary to address the financial crisis. In the case of the Volcker Rule, as discussed later, it may be the eventual cause of another financial crisis by reducing liquidity in the financial markets. In this case, the eagerness of Congress to impose more restrictions on the financial system than were warranted by its own misdiagnosis of what happened in 2008 may have planted the seeds for a future crisis.

How Dodd-Frank has Slowed Economic Growth

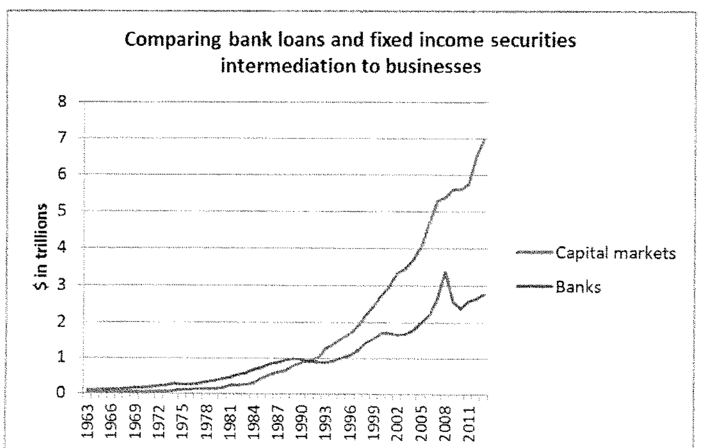
[10] Id., p 1

[11] See, however, Murray Rothbard, *America's Great Depression*, Nash Publishing, 1963, p 167: "If government wishes to alleviate, rather than aggravate, a depression, its only valid course is laissez-faire—to leave the economy alone. Only if there is not interference, direct or threatened, with prices, wage rates, and business liquidation will the necessary adjustment proceed with smooth dispatch. Any propping up of shaky positions postpones liquidation and aggravates unsound conditions."

[12] Andy Winkler, Ben Gitis, Sam Batkins, "Dodd-Frank at 54: More Regulation, More Regulators, and a Sluggish Housing Market," American Action Forum, July 15, 2014. http://americanactionforum.org/research/dodd-frank-at-4-more-regulation-more-regulators-and-a-sluggish-housing-mark.

If excessive regulatory costs have slowed the recovery from the financial crisis, they will continue to slow economic growth until they are reduced or eliminated. In the balance of this testimony, I will focus on the additional regulatory costs imposed on banking organizations, especially small banks, because I think there is a strong case that reducing credit availability from banks is having a particularly adverse effect on small business, which in turn is the principal source of growth and employment in the US economy.

The most important factor in this analysis is the dependence of small and medium sized businesses on bank lending. Larger businesses have access to other sources of credit, primarily through the capital markets. Firms that have registered their securities with the SEC are able to sell bonds, notes and short-term paper in the capital markets—normally a less expensive and easier process than borrowing from a bank. The chart below shows that since the mid-1980s the capital markets have outcompeted the banking industry as a source of credit for business corporations.[13] This popular alternative means of financing, however, is not available to small or medium sized businesses, because they are not generally owned by public shareholders and do not report their financial results to the SEC. Accordingly, they are more dependent on bank financing than larger firms. Greater and more costly regulation of banks, then, would inevitably cause either an increase in the cost of bank credit, a reduction in its availability, or both, to these smaller firms.



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

Source: Fed Flow of Funds

A second factor causing difficulties for small banks in particular is the narrative underlying the Dodd-Frank Act—that the financial crisis was caused by insufficient regulation of banks and other financial firms. Solid academic work by my AEI colleague Paul Kupiec and two others has shown that when the regulators were said to have been lax, that is followed by more intrusive activity by bank examiners, and this reduces the amount of lending. "[S]upervisory restrictions," they report, "have a negative impact on bank loan growth after controlling for the impact of monetary policy, bank capital and liquidity conditions and any voluntary reduction in lending triggered by weak legacy loan portfolio performance or other bank losses."[14] This analysis received confirmation from Fed Governor Duke in testimony to Congress in February 2010, "Some banks may be overly conservative in their small business lending because of concerns that they will be subject to criticism from their examiners...some potentially profitable loans to creditworthy small businesses may have been lost because of these concerns, particularly on the part of small banks."[15]

Finally, the new and more costly regulation imposed by Dodd-Frank appears to have stalled the formation of new banks, which in turn has also affected the availability of credit for the small and medium-sized businesses that are dependent on bank lending. A Federal Reserve Bank of Richmond report in March 2015 notes that "The rate of new-bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010." Trying to assess the reasons for this sharp decline, the report continued, "Banking scholars ...have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started."[16]

The authors suggest other possible causes, but the fact that the decline became so severe in 2010, the year of the enactment of Dodd-Frank, is strong evidence that the new requirements in the act—which have been cited again and again by small banks since 2010—are responsible. In any event, the decline in new banks caused an overall decline of 800 in the total number of small independent banks between 2007 and 2013. This would have had a disproportionate effect on small business and account in part for the failure of the economy to gain any momentum since the enactment of Dodd-Frank.

Another 2015 study ties the decline of community banks even more closely to the Dodd-Frank Act: "[C]ommunity banks' share of U.S. banking assets and lending markets has fallen from over 40 percent in 1994 to around 20 percent today. Interestingly, we find that community banks emerged from the financial crisis with a market share 6 percent lower, but since the second quarter of 2010—around the time of the passage of the Dodd-Frank Act—their share of

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[14] Paul Kupiec, Yan Lee and Claire Rosenfeld, in "Does Bank Supervision Impact Bank Loan Growth?", draft of May 7, 2015, p1.

[15] Quoted in Kupiec, note 16, p3

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

commercial banking assets has declined at a rate almost double that between the second quarter of 2006 and 2010. Particularly troubling is community banks' declining market share in several key lending markets, their decline in small business lending volume and the disproportionate losses being realized by particularly small community banks."[17]

If these factors are indeed adversely affecting banks and thus small business, we should see a difference in growth rates between small business and larger businesses since 2010, when the Dodd-Frank Act was adopted. A recent paper shows exactly that kind of disproportionate effect on small and medium size businesses.

In a Goldman Sachs report published in April 2015, and titled "The Two-Speed Economy," the authors posit that new banking regulations have made bank credit both more expensive and less available. "This affects small firms disproportionately because they largely lack alternative sources of finance, whereas large firms have been able to shift to less-expensive public market financing."[18] But banking regulation was not the only regulation that had an effect on small business: "While banking regulation has played a key role, regulation outside of banking has also raised the fixed costs of doing business." These costs fall most heavily on small firms because larger firms can more easily cope with the fixed costs imposed by regulation.

Using IRS data, the Goldman study finds that large firms—those with $50 million or more in revenue annually, have been growing revenue at a compounded annual rate of 8 percent, while firms with less than $50 million in revenue have been growing revenue at an average of only 2 percent compounded annually. Using Census data, Goldman found that "firms with more than 500 employees grew by roughly 42,000 per month between 2010 and 2012, exceeding the best historical performance over the prior four recoveries. In contrast, jobs at firms with fewer than 500 employees declined by nearly 700 per month over the same timeframe, whereas this figure had grown by roughly 54,000 per month on average over the prior four recoveries."[19]

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

The Goldman paper then turns to the lack of capital investment, and also finds the source of that in financial regulation. "Even as large firms experience a relatively robust recovery, they appear to be investing less than we would expect given their historically high profit margins, and investing with a bias toward shorter term projects; this dynamic may be playing out because large firms are facing less competition from smaller firms. Investments in intellectual property,

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[17] Marshall Lux and Robert Greene, "The State and Fate of Community Banking," *M-R Associate Working Paper Series*, No. 37, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, February 2015, p1

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

[19] Id., p8

for example, are tracking nearly five percentage points below even the low end of the historical experience and more than 20 percentage points below the historical average."[20]

Finally, the Goldman paper expresses concern that this is not necessarily a temporary phenomenon: "Taken together, the reduced competitiveness of small firms and the changing investment decisions of larger ones are reshaping the competitive structure of the US economy in ways that are likely to reverberate well into the future, and in ways that any future evaluation of the aggregate effects of post-crisis regulations should consider."[21]

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

Dodd-Frank, the Volcker Rule and the Danger of another Financial Crisis

Any policy that reduces market liquidity should be worrisome for this country, given the experience of the financial crisis. More than anything else, the crisis was a liquidity crisis, not a solvency crisis. When Lehman Brothers was allowed to fail, liquidity in the market dried up, meaning that firms that wanted to sell securities to raise cash were not able to do so. We don't know what lies before us, and what event or events could cause many investors to seek to liquidate their holdings of fixed income securities, but what is clear is that if the market does not have the liquid resources to buy these securities their prices will drop precipitously. The securities "fire sales" that regulators say they are worried about will become a reality. The irony is that it is the laws and regulations that Congress has put in place through the Dodd-Frank Act that will cause the crisis.

Chief among these is The Volcker Rule, which forbids banks or their affiliates to engage in proprietary trading of debt securities. Although it was justified by the claim that banks were taking risks with insured deposits, this was truly an absurd idea. The riskiest thing that banks do with their insured deposits is make loans. Trading securities in a liquid market is far less risky than giving a borrower a substantial amount of money in the hope of eventual repayment. Before the Volcker rule, banks were active in making markets in debt securities by standing ready to buy or sell these securities . It is very difficult to tell the difference between making a market—that is, buying and selling for your own account—and proprietary trading. As a result, banks have begun to reduce their market-making activities, leaving the market for all securities with far less liquidity than it had before the Volcker rule was adopted. Some large banks have simply disbanded their bond-trading groups.

This has substantially reduced the amount of capital and liquidity available to the debt markets. The lack of liquidity has almost certainly increased the buy-sell spreads in the debt markets and the costs of buyers, sellers and investors who trade in fixed income securities. It is now much more difficult to sell a fixed income security and thus much more risky to buy one. As reported on May 20, 2015 in the *Wall Street Journal*,

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[20] Id., p3
[21] Ibid.

> Talk to almost any banker, investor or hedge-fund manager today and one topic is likely to dominate the conversation. It isn't Greece, or the U.S. economy, or China…It is the lack of liquidity in the markets and what this might mean for the world economy—and their businesses. Market veterans say they have never experienced anything like it. Banks have become so reluctant to make markets that it has become hard to execute large trades even in the vast foreign-exchange and government bond markets without moving prices, raising fears investors will take unexpectedly large losses when they try to sell. The U.S. corporate-bond market has almost doubled to $4.5 trillion since the start of the crisis, yet banks today hold just $50 billion of bonds compared with $300 billion precrisis.[22]

As Douglas Elliott of the Brookings Institution has pointed out, there have been several periods of extreme volatility in recent years, for which market liquidity was necessary. Nevertheless, Basel III's capital requirements and Stable Funding Ratio, and the Fed's new Liquidity Coverage Ratio have all increased the cost of funding a portfolio of bonds, all of which—together with the Volcker Rule—reduce the amount of liquidity in the market. This could lead to a serious liquidity crisis if one or more major financial institutions is required to sell assets to meet its cash needs: "Illiquidity in financial markets," says Elliott, "can help trigger or exacerbate a financial crisis by creating actual or paper losses at banks or other financial institutions. If a bank needs to raise cash quickly, perhaps to meet deposit outflows in the event of a loss of confidence in that institution, they will likely need to sell securities, especially if they have an excessive mismatch between the maturities of their assets and liabilities. In illiquid markets, this would require 'fire sales' in which the seller accepts a significantly lower price in order to get cash quickly."[23]

On October 15, 2014, the Treasury market moved 40 basis points, an almost unheard of drop for the world's most liquid market. Investigations are underway, but it is difficult to believe that this move was not related to the fact that banking organizations—the largest players in the fixed income markets—now hold only one-sixth of the amount of bonds they held before the crisis. There are fewer market makers and the fewer market makers have fewer cash resources. This is a prescription for a liquidity disaster similar to the 2008 financial crisis.

The Obama administration has denied that the Volcker Rule could be a major factor—or indeed any factor—in the decline of market liquidity, but in July 2015, Lael Brainard, Fed governor, admitted that regulation could be playing a role.[24] Other experienced market observers have been more definitive. In a Wall Street Journal op-ed piece on June 9, 2015, Stephen Schwartzman, the CEO of Blackstone, noted that "A warning flashed last October in the U.S. Treasury market with huge intraday moves, unrelated to external events. Deutsche Bank has reported that dealer inventories of corporate bonds are down 90% since 2001, despite

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[22] Simon Nixon, "Why Liquidity-Starved Markets Fear the Worst," *The Wall Street Journal*. May 20, 2015

[23] Douglas J. Elliott, "Market Liquidity: A Primer," Brookings, June 25, 2015.

[24] Ian Katz, "Brainerd Says Rules Probably Have a Role in Liquidity Volatility," BloombergBusiness, July 9, 2015, http://www.bloomberg.com/news/articles/2015-07-09/brainard-says-rules-probably-have-a-role-in-liquidity-volatility.

outstanding corporate bonds almost doubling. A liquidity drought can exacerbate, or even trigger, the next financial crisis."[25]

Another article in the Wall Street Journal in May 2015, reported that a board member of the European Central Bank, Benoit Coeure, saw "extreme volatility in global capital markets [as] showing signs of reduced liquidity." The article noted that "The world's largest banks dumped around $1 trillion in assets from government bond-trading businesses between 2010 and the end of last year."[26]

Still a third article, in the *American Banker* in June 2015, quoted Richard Berner, the director of the Office of Financial Research, a Treasury unit, to the effect that "the financial reform law could 'be contributing to more permanent adjustments that could impair market functioning,' including by reducing market liquidity."[27]

The administration's refusal thus far to admit that the Dodd-Frank Act may be responsible for what could be a future financial catastrophe, must be seen as a wholly political effort to defend what they see as one of President Obama's key legacies. With financial markets "flashing danger" it is time to look objectively at this problem before it causes another financial crisis. Thus, the Dodd-Frank Act is not only holding back the growth of the economy by reducing the credit available for small businesses; it is also creating the foundation for another financial crisis in the future.

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[25] Stephen A. Schwartzman, "How the Next Financial Crisis Will Happen," *The Wall Street Journal*, June 9, 2015.

[26] Christopher Whittal, "ECB's Coeure: Volatility Signals Reduce Market Liquidity," *The Wall Street Journal*, May 19, 2015.

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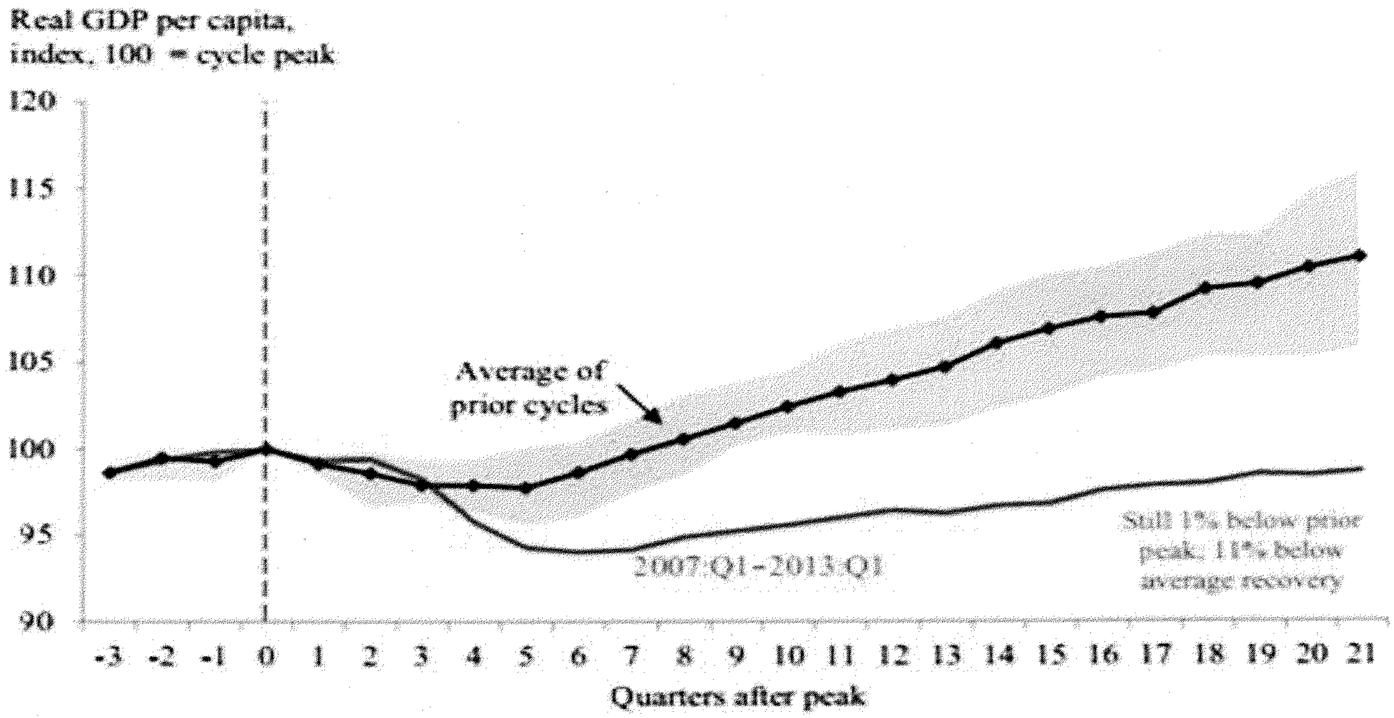
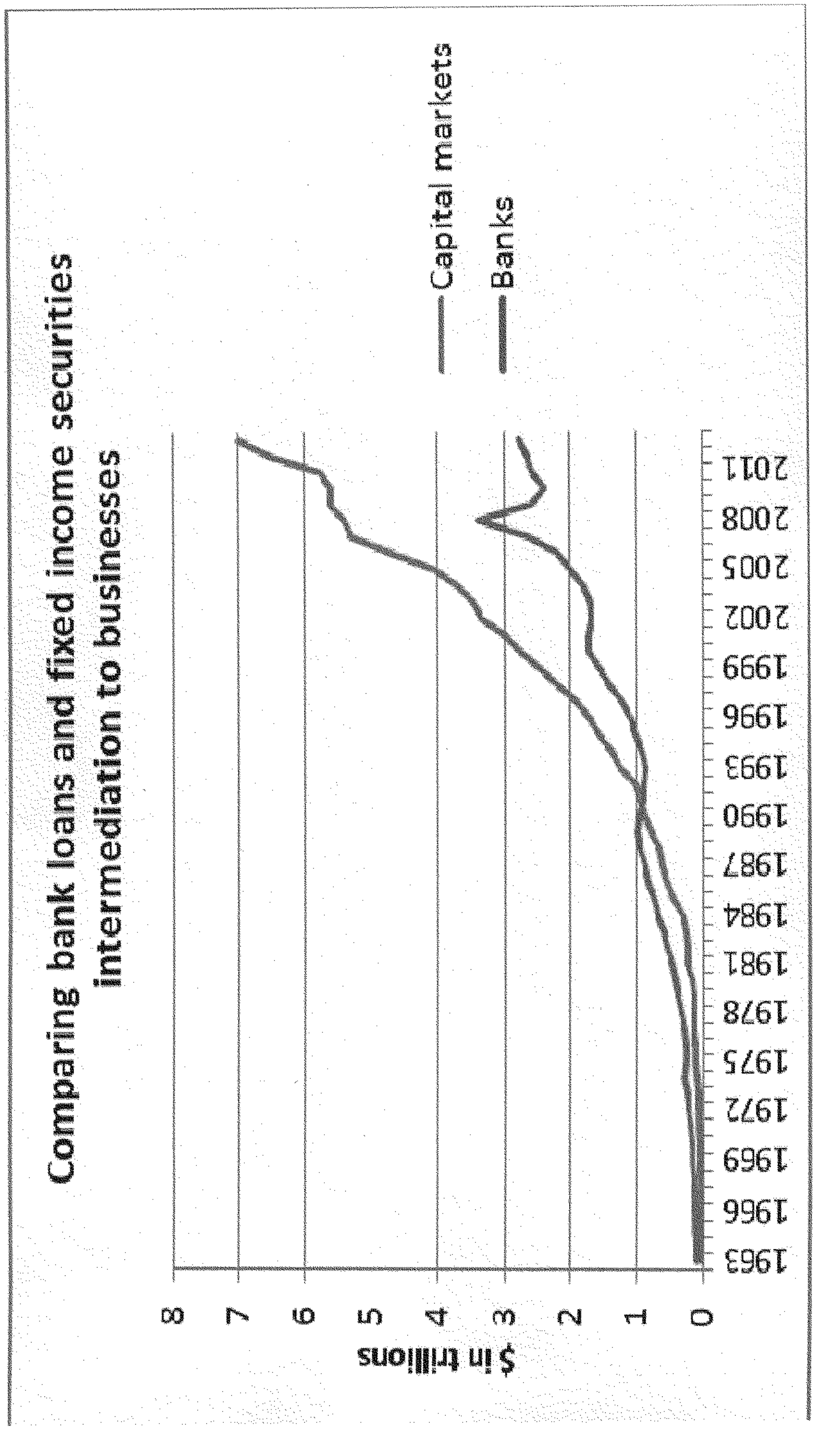


NOTE: The gray area indicates the range of major recessions since 1960, excluding the short 1980 recession. 3
SOURCES: Bureau of Economic Analysis; Census Bureau; authors' calculations.


Comparing bank loans and fixed income securities intermediation to businesses
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QUESTIONS FOR THE RECORD

7/28 Hearing: "The Dodd-Frank Act Five Years Later: Are We More Prosperous?"

Questions to Mr. Peter J. Wallison:

Just prior to the 2012 presidential election, you and Professor Cornelius Hurley of Boston University co-authored an article that appeared in *Forbes* magazine http://www.forbes.com/sites/realspin/2012/08/14/too-big-to-fail-has-become-a-permanent-bailout-program/. In that article, the title of which was, "Too-Big-To-Fail Has Become a Permanent Bailout Program", you said:

> 'Instead of enshrining our TBTF firms, we should be seeking ways to reduce or eliminate their federal subsidies. One way of accomplishing this is to require the TBTFs to identify the portion of their earnings that is attributable to their subsidy.'

The existence of this subsidy has been recognized by nearly every bank regulator.

1. Do you still believe that this subsidy ought to be identified by the TBTF banks?

2. Are you aware of my bill, H.R. 888, also known as the Subsidy Reserve Act of 2015 that would require the six biggest banks to identify their taxpayer subsidies and accrue those subsidies in a reserve pending a right-sizing of the institutions?

3. Do you have a view on that bill?

4. Some, including Sen. Shelby, have argued that the SIFI threshold should be moved up from the current $50 billion test to some higher threshold, say $500 billion. Senator Shelby's bill would require FSOC to determine SIFI status for banks over $50 billion but under $500 billion according to a list of criteria: size, interconnectedness, global activities and substitutability of services. Don't you think, based on your earlier writings, that the receipt of a federal subsidy for being TBTF ought to be added to the list of criteria for determining whether a particular bank is too-big-to-fail or not?" Please explain why or why not.

I have seen this proposal before, although not as a congressional bill. It's an interesting idea, but impractical and probably punitive. We really don't have any good idea about the size, or even how to measure, the TBTF premium, and the bill proposes a formula that is likely to be arbitrary. The Fed will establish the formula, and it will probably be wrong to begin with. Then, after it has been in force for several years, the banks involved will ask that it be reduced. Their competitors will cry foul, saying that whatever the applicant bank is using for the formula is wrong. The Fed will then be afraid to make any changes, fearing congressional criticism. Like the payment of interest on demand accounts, the requirement will then be embedded forever in bank regulation and will continue to punish the banks that are subject to it with unnecessary additions to capital.

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