

Remarks of Chairman Jeb Hensarling to the Economic Club of New York
As Prepared for Delivery
June 7, 2016

We remain stuck in the slowest and weakest economic recovery in our history. Last quarter's pathetic GDP growth of less than 1 percent merely punctuates the point. The economy isn't working for tens of millions of working Americans who cannot get ahead and fear for the future of their families. Their paychecks remain stagnant; their savings have declined.

Why is this happening? One of the principal reasons is the Dodd-Frank Act, a grave mistake Washington foisted upon the American people nearly 6 years ago. Simply put, Dodd-Frank has failed. It's time for a new legislative paradigm in banking and capital markets. It's time to offer all Americans opportunities to raise their standards of living and achieve financial independence.

In a phrase, we need economic growth for all and bank bailouts for none. This is the foundation of the Republican plan I will unveil today.

Why has Dodd-Frank failed? Because Dodd-Frank rests upon faulty principle, faulty premise and faulty policy.

Those on the Left who gave us Dodd-Frank believe in the principle that human nature is self-destructive and that people (except themselves, of course) are fundamentally ignorant. Therefore, when it comes to markets they believe private businesses are essentially predatory in nature and people are hapless victims.

Consequently, their solution to the financial crisis was to impose yet even more stifling government regulations, restrict economic liberty and give Washington the power to direct financial institutions.

But as Alexander Hamilton said in Federalist 76, human nature is not "universal venality." "There is a portion of virtue and honor among mankind," he wrote. We should not "either flatter...its virtues or exaggerat[e]...its vices."

If human nature is all-good, we need *no* government. If human nature is all-bad, we need *unlimited* government.

The only government suited to a *realist* vision of human nature is based upon the principle of *limited* government: the neutral rule of law under a Constitution of consent. It is the principle that allows the people to labor, invest, invent, save, trade, co-operate, and compete; to endure the risks of failure, and keep the rewards of success.

Dodd-Frank's false premise is that an alchemy of Wall Street greed, outsized private risk and massive Washington de-regulation almost blew up the world economy. According to their narrative, this necessitated massive taxpayer bailouts and a functional occupation of our capital markets by federal regulators.

But financial regulation did not decrease in the decade leading up to the crisis – it markedly *increased*. In fact, regulatory restrictions on financial services grew every year between 1999 and 2008. Financial services was, and remains, one of the heaviest regulated industries in the economy.

It wasn't de-regulation that caused the financial crisis; it was dumb regulation.

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And certainly there were no dumber regulations than those that forced Fannie Mae and Freddie Mac to make bad loans through mandatory “Affordable Housing Goals.” More than 70 percent of subprime and Alt-A mortgages that led to the crisis were backed by Fannie and Freddie, the FHA and other taxpayer-backed programs.

For those who believe Washington to be a better arbiter of acceptable financial risk than the market, they should take careful note of this. Additionally, I invite them to review the books of the National Flood Insurance Program, the Pension Benefit Guaranty Corporation, and the Federal Housing Administration. And let’s not forget the Medicare and Social Security Trust Funds.

Turning to greed, it is an article of faith on the Left that Wall Street greed caused the crisis. My question is when hasn’t there been an element of greed on Wall Street?

There has certainly always been greed in Washington; the greed of Washington elites for more power and control over our economy, our lives, and our liberty. Dodd-Frank is the absolute epitome of Washington greed – and it is this greed we should fear the most.

When they voted for it, supporters of Dodd-Frank told us it would “promote financial stability,” “end too big to fail,” and “lift the economy.” None of this has come to pass.

Today the big banks are bigger and the small banks are fewer. In other words, even more banking assets are now concentrated in the so-called “Too Big to Fail” firms. Pray tell, how does this promote financial stability?

Dodd-Frank codified into law Too Big to Fail and taxpayer-funded bailouts. This is bad policy and worse economics. It erodes market discipline and risks even further bailouts. It becomes a self-fulfilling prophecy, helping make firms bigger and riskier than they otherwise would be.

According to the Richmond Federal Reserve, the implicit and explicit federal guarantees of financial sector liabilities have increased to a whopping 60 percent of total liabilities post-Dodd-Frank. When private investors, depositors, and counterparties expect a bailout, their incentives to monitor risk clearly wane.

Additionally, Dodd-Frank’s Volcker Rule and provisions of Basel have led to dramatic bond market illiquidity and volatility. Many believe this could well be the source of the next financial panic. When it comes to systemic risk, regulatory micromanagement is no substitute for market discipline.

Next, instead of lifting our economy as Dodd-Frank’s supporters claimed it would, it has made us less prosperous. Bank small business lending has dropped since Dodd-Frank was passed – stifling entrepreneurship and causing economic growth to suffer.

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Consumers have been hurt as well, from the loss of free checking, to higher interest rates on their credit cards, to a surge in fees. And the Federal Reserve reports that – when fully phased in – one-third of black and Hispanic mortgage borrowers will be hurt by Dodd-Frank’s Qualified Mortgage rule based solely on its rigid debt-to-income ratio. Ladies and gentlemen, only Washington would dare call this “consumer protection.”

But perhaps more ominously than making us either less prosperous or less stable, Dodd-Frank has also made us less free. Dodd-Frank moves us away from the equal protection offered by the impartial rule of law towards the unequal and victimizing rule of political bureaucrats.

It represents a breathtaking, unconstitutional outsourcing of legislative powers to the executive branch, with the Orwellian-named Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC) the two prime beneficiaries.

The CFPB may arguably be the single most powerful and least accountable Federal agency in the history of our nation. The CFPB Director – one man – has the unbridled and unprecedented power to unilaterally declare virtually any mortgage, credit card or bank account “unfair” or “abusive” at which point Americans can’t have it – even if they need it, want it, understand it and can afford it.

Equally offensive is the Financial Stability Oversight Council. This amalgamation of many of the same Washington regulators who failed to do their jobs in the run-up to the last financial crisis is now charged by Dodd-Frank to manage our economy away from the next.

Much criticism has centered on FSOC’s lack of transparency. But more troubling is its vast powers under a vague mandate. Dodd-Frank gives FSOC the ability to designate companies as Too Big to Fail if it “determines that material financial distress” at the company “could pose a threat to the financial stability of the United States.” But nowhere in Dodd-Frank, or anywhere else in the U.S. Code for that matter, are these terms defined. So by defining these vague terms in any fashion that pleases them, this “super-group” of regulators can exert ultimate functional control over almost any large financial firm in our economy, and do so with utter disregard for due process. This is not the rule of law; it is the rule of rulers, and it’s an anathema to a free and democratic society.

I am reminded of what James Madison wrote in Federalist 47: “The combination of all power legislative, executive, and judiciary in the same hands...may justly be pronounced the very definition of tyranny.” Dodd-Frank empowers financial regulators to be tyrants and forces investors – perhaps for the first time in our history – to seriously calculate political risks within our own economy.

I fear Dodd-Frank’s ultimate purpose is to eventually render effective control of our capital markets to the state; to turn large money-center banks into functional utilities, so that the state can allocate credit within our

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economy to politically favored classes. In other words, to take over the commanding heights of our economy. This must not be allowed to stand.

Ladies and gentlemen, it is time for a new paradigm in banking, capital markets and financial opportunity. It's time to enact the Financial CHOICE Act. Our Republican Financial CHOICE Act, which stands for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs, rests upon the following principles:

- (1) Economic growth for all must be revitalized through competitive, transparent and innovative capital markets;
- (2) Every American, regardless of their circumstances, must have the opportunity to achieve financial independence;
- (3) Consumers must not only be vigorously protected from fraud and deception, but from the loss of economic liberty as well;
- (4) Taxpayer bailouts of financial institutions must end and no company can remain too big to fail.
- (5) Systemic risk must be managed through market discipline with profit and loss;
- (6) Simplicity must replace complexity because complexity can be gamed by the well-connected and abused by the Washington powerful; and
- (7) Finally, both Wall Street and Washington must be held accountable.

Our Republican plan rests on the belief that bank capital is the most basic element in making a financial system healthy, resilient and reliable for economic growth.

This capital approach is endorsed by former Fed Chairman Alan Greenspan, who recently stated: "Lawmakers and regulators, given elevated capital buffers, need to be far less concerned about the quality of the banks' loans and securities portfolios since any losses would be absorbed by shareholders, not taxpayers. This would enable the Dodd-Frank Act...to be shelved, ending its potential to distort the markets – a potential seen in the recent decline in market liquidity and flexibility."

Recent statements from former Fed Governor Robert Heller, FDIC Vice Chairman Tom Hoenig, and a number of prominent economists show that there is a growing consensus surrounding the idea of a tradeoff between heightened capital levels and a substantially lower regulatory burden.

Undoubtedly, a strongly capitalized banking sector can help avoid the recurrence of a financial crisis of the magnitude we saw in 2008.

Since that crisis, U.S. banks have raised hundreds of billions in new capital and regulators have required institutions to maintain higher capital buffers – not under any new authority but under regulatory authority they possessed before the crisis. I for one believe this generally to be a good thing.

But capital standards that were already complex have become even more complex and controlling with the

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latest iteration of the Basel capital accords. I do not believe this to be a good thing.

The Republicans' better approach will relieve financial institutions from regulations that create more burden than benefit in exchange for meeting higher, yet simple, capital requirements. Our reform plan allows banks to opt-in to an alternative regime that replaces growth-strangling regulation with reliable accountability. It stops investors from betting with taxpayer money. Think of it as a market-based, equity financed Dodd-Frank off-ramp.

To avail themselves of this exchange, many larger banks will have to raise significant additional equity capital. Most community banks will have to raise little to no additional capital. Regardless, the option remains with the bank. For banks willing to put their investors in front of hardworking taxpayers in the event of a failure, the Republican plan will free banks to help more Americans finance their individual American dreams. Let me briefly explain how it will work.

Under our plan, banks that maintain a simple leverage ratio of at least 10 percent and, at the time of the election, have a composite CAMELS rating of 1 or 2 may elect to be functionally exempt from the post-Dodd-Frank supervisory regime, the Basel III capital and liquidity standards, and a number of other regulatory burdens that pre-date Dodd-Frank.

Any bank that chooses to maintain a 10 percent leverage ratio in order to qualify for regulatory relief under our plan will be significantly better capitalized than Dodd-Frank or any U.S. or global regulator currently requires them to be. Under the Basel accords, banks must maintain at least a three percent leverage ratio, and U.S. prudential regulators require six percent for those considered globally systemically important.

Collectively, we estimate that those U.S. banks currently identified by regulators as G-SIBs will need to raise several hundred billion dollars in new equity to qualify for regulatory relief in our plan, assuming their asset size remains constant. The leverage ratio we are using is essentially the same as the "Supplementary Leverage Ratio" that the U.S. prudential regulators implemented post-Dodd-Frank.

We chose to use the Supplementary Leverage Ratio because it is a more stringent measure of capital adequacy than the Basel risk-based capital regime traditionally favored by global banking regulators and more stringent than using the GAAP leverage ratio.

Risk-weighting is simply not as effective. First, it is far too complex, requiring millions of calculations to measure capital adequacy. Second, it confers a competitive advantage on those large financial institutions that have the resources to navigate its mind-numbing complexity. Third, regulators have managed to get the risk weights tragically wrong, for example, treating toxic mortgage-backed securities and Greek sovereign debt as essentially risk-free. One myopic globally imposed view of risk is itself risky. Finally, risk-weighting places regulators in the position of micro-managing financial institutions, which politicizes credit allocation. Witness

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the World Bank recently advertising its zero risk rating under the Basel Accords for their “green bonds.”

A survey of capital levels at 115 large global banks by McKinsey and Company found that during the last financial crisis, no bank that had at least 10 percent of tangible common equity to risk-weighted assets at the end of 2007 failed or required substantial government assistance. Under our approach, banks would need to meet a far more stringent 10 percent leverage ratio.

Some may ask: If large banks have to raise billions of dollars in new capital to satisfy your 10 percent leverage ratio, won't banks be forced to scale back their lending?

Again, the Republican plan does not “force” any bank to raise a dime of new capital. Rather, it allows banks to opt into a regime that replaces Dodd-Frank’s suffocating regulatory complexity and control with market discipline. So banks will opt into the Republican plan’s new regime only if it makes them more competitive — in other words, if it lets them better serve customers at lower cost.

Furthermore, equity capital can be put to work no differently than debt or deposits. It is not money put under a mattress.

While a 10 percent leverage ratio may seem high by current standards, history suggests it is far from abnormal. Prior to the founding of the Federal Reserve and the creation of federal deposit insurance (i.e., before banks benefited from a federal safety net), the U.S. banking industry’s ratio of tangible equity to assets ranged between 13 and 16 percent, regardless of bank size.

FDIC Vice Chairman Tom Hoenig has cited evidence that “going into the crisis of 2008, banks holding an average 12 percent capital saw more modest declines in loans and a quicker recovery. In contrast, banks with capital below 8 percent, including the largest banks, experienced more dramatic declines in lending.”

Given the devastation caused to economic growth by the last financial crisis, the role of bank capital in reducing the frequency and magnitude of such systemic events should not be understated.

One of the accelerants of the financial crisis was bank runs fueled by fears that banks were too highly leveraged to withstand periods of extreme market stress. Stanford economist Edward Lazear points out this source of market instability is mitigated by a better capitalized banking sector: “Bank investment funded by equity avoids the danger of a run,” he said. “If the value of a bank’s assets falls, so too does the value of its liabilities. There is no advantage in getting to the bank before others do.”

Now allow me to elaborate on the regulatory relief for a qualifying bank under our plan:

- The bank would be deemed “well capitalized” for prompt corrective action purposes;
- It would no longer be subject to Basel Committee capital or liquidity requirements as implemented by the U.S. banking regulators; and

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- It would be able to make capital distributions freely; and would additionally be able to consummate transactions without being subject to the regulatory challenge of increasing risk to the stability of our banking or financial system, or on grounds related to capital or liquidity standards of concentrations of deposits or assets.

In addition, the Republican plan would provide that no Federal rule establishing “heightened prudential standards” of the type provided for in Dodd-Frank would apply to qualifying banking organizations, including the living will requirement which a recent Government Accountability Office study found has been administered without transparency or due process.

In short, a strongly capitalized qualifying bank will be enabled to remove government bureaucrats from its boardroom and lend and invest freely.

Another key part of our reform plan is to end too big to fail once and for all. The answer is simple: bankruptcy, not bailouts. Recently the House passed the bipartisan Financial Institution Bankruptcy Act, which creates a new subchapter of the Bankruptcy Code tailored to specifically address the failure of a large, complex financial institution. This is part of our Financial CHOICE Act.

Three sound reasons justify the Republican preference for bankruptcy over bailouts.

First, the bankruptcy process is administered through the judicial system, by impartial bankruptcy judges charged to guarantee due process in public proceedings.

This is in stark contrast to Dodd-Frank’s “Orderly Liquidation Authority,” whereby government bureaucrats can exercise vast discretion to favor some creditors and impose losses on others.

Second, the bankruptcy process provides certainty for stakeholders to understand how the firm will be treated based on centuries of well-settled legal precedent. The lack of certainty created the dangerous ad hoc policies of 2008, which helped precipitate the financial crisis.

Third, and most important, bankruptcy does not depend on taxpayer-provided funds to bail out, liquidate, or reorganize a failing institution.

Some large firms will likely become smaller, because the credit they now obtain will be priced according to their inherent risk of failure without implicit government guarantees backing firms that are Too Big to Fail. As a result, failure — when it does happen — will be more contained.

The Financial CHOICE Act takes other needed steps to end bailouts. For example, we prohibit the use of Treasury’s Exchange Stabilization Fund to bail out a financial firm or its creditors, and impose significant, new

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and real constraints on the Federal Reserve's emergency lending authority.

Specifically, we impose on the Fed Bagehot's famous dictum: lend freely, but only to solvent institutions, only against sound collateral, and only at interest rates high enough to dissuade those who are not genuinely in need.

As you've heard on the presidential campaign trail, some say the only way to truly solve the too big to fail problem is to "break up the banks." But our goal should not be to downsize *or* super-size banks but to "right-size" them under market dynamics.

To promote economic growth, we will need both Citibank with an "i" located a few blocks from here and City Bank with a "y" located in Forney, Texas in my district. Both types of banks have a vital role to play in revitalizing economic growth.

To ultimately end taxpayer-funded bailouts, we must also end Washington's ability to designate any institution as "systemically important (SIFI)." It becomes a self-fulfilling prophecy. Our Republican reform plan repeals FSOC's authority to designate so-called SIFIs going forward and retroactively repeals FSOC's previous SIFI designations.

Accountability is at the heart of our Republican reform plan. If we are to successfully protect consumers and grow our economy, we must demand greater accountability from both Washington and Wall Street.

The Financial CHOICE Act makes sure every financial regulation passes a rigorous cost-benefit test, so we'll know a proposed rule's impact on economic growth *before* it takes effect.

We will put all the financial regulatory agencies on budget. The bare minimum level of accountability to "We the People" is to have their elected representatives in Congress control the power of the purse, as inscribed in our Constitution.

It should be carefully noted, though, that our reform plan protects the Federal Reserve's independence in conducting monetary policy by leaving that function off-budget. The Fed's prudential regulatory and financial supervision activities, however, will now be subject to the normal and transparent congressional appropriations process.

Our plan also holds Washington accountable by converting financial regulatory agencies presently headed by single directors – the CFPB, the Office of Comptroller of the Currency, and the Federal Housing Finance Agency – into bipartisan commissions. A bipartisan structure will compel these agencies to consider multiple viewpoints and perspectives in their rule-makings and protect them from partisanship.

A critically important fourth plank of our Washington accountability plan is the REINS Act, which has already

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passed the House and requires all major financial regulations to first be approved by Congress before they can take effect. This will effectively return Article 1 lawmaking back to Congress. This reform alone can dramatically improve our economy's growth potential.

Next, we repeal the Chevron doctrine requiring the judiciary to give deference to financial regulatory agencies' interpretation of the law. The doctrine is unfair and an affront to due process and justice.

But just as unaccountable bureaucrats in Washington can harm our economy and consumers, so can illegal activity by bad actors at financial institutions. That is why we must ensure consumers and investors are protected, treated fairly and have access to competitive, transparent and innovative markets that are vigorously policed for fraud and deception.

Therefore the Financial CHOICE Act will impose the toughest penalties in history for financial fraud, self-dealing and deception.

We will double the cap for the most serious securities law violations and will allow for triple monetary fines when penalties are tied to illegal profits. We will give the SEC new authority to impose sanctions more closely linked to investor losses – and increase punishments even more for repeat offenders. We will increase the maximum criminal fines for both individuals and firms that engage in insider trading.

Our plan toughens penalties—not out of some ideological or poll-driven war against Wall Street, but simply to better protect consumers and strengthen their markets. This is key to economic growth.

But as fines and penalties increase, so must due process rights. Too many citizens have been “shook down” or abused by their government. Thus we will provide an immediate right of removal to federal court for respondents in administrative proceedings.

We will ensure that disciplinary proceedings are public, that all fines imposed by regulatory agencies are sent to the Treasury for deficit reduction, that regulatory entities created by Congress are subject to full congressional oversight, and that other due process rights are strengthened.

After holding Washington and Wall Street accountable, our reform plan next focuses on re-igniting America's entrepreneurial spirit by increasing capital formation and financing options so more Americans can create, build and innovate. We start by repealing the misguided and unneeded Volcker Rule.

From its inception, the Volcker Rule has been a solution in search of a problem. Of the roughly 450 financial institutions that failed during or as a result of the crisis, not a single one failed because of proprietary trading. In fact, financial institutions which varied their revenue stream were better able to weather the storm, continue lending, and support jobs.

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Nearly six years later, it is apparent not only that the Volcker Rule was unnecessary, but also that it has made capital markets less liquid and more fragile, and undermined financial stability.

Other pro-growth measures include the exemption of all asset classes save residential mortgages from mandatory risk retention; the expansion of the Sarbanes-Oxley 404(b) auditing exemption for smaller public companies, and the elimination of Dodd-Frank's politically-driven, unnecessary disclosures such as extractive resources and pay ratios.

The Financial CHOICE Act updates the rules to allow small businesses to better compensate their employees with ownership in the business; provides a voluntary exemption from duplicative and expensive data reporting requirements; and modernizes the Business Development Company regulatory regime so BDCs can invest more in small and middle market companies.

Our plan gives the SEC the authority to register venture exchanges so JOBS Act companies can list on an exchange that is tailored to the needs of smaller issuers; provides broker-dealers with the legal certainty to issue research on exchange traded funds; increases the pool of accredited investors; and ensures that startups have the confidence to meet with angel investors without running afoul of the securities laws.

Other pro-growth reforms in our plan will provide much-needed relief to community financial institutions that are being crushed by Washington's "one-size-fits-all" regulatory approach. We are losing, on average, one community financial institution each day – and they are not dying from natural causes but from the sheer weight, volume, complexity and expense of Washington's rules.

So our plan requires financial regulators to tailor regulations so they fit a bank or credit union's business model and risk profile. This allows America's small, hometown banks and credit unions to focus their time and resources on serving their customers rather than the dictates of Washington bureaucrats.

Our plan provides for the timely release of exam reports, creates a mechanism for institutions to appeal exam findings without fear of bureaucratic retaliation, and creates an extended 18-month exam cycle for certain credit unions. We permit small institutions to more easily finance acquisitions and allow well-capitalized community institutions to file short-form call reports in the first and third quarters of each year.

Our plan also provides critically needed mortgage relief with reforms that let community banks back into the mortgage business and ensure qualified borrowers can purchase a home while preserving prudent underwriting standards. Changes include an ability-to-repay safe harbor for loans held on portfolio, ensuring the availability of mortgage credit for manufactured homes, fixing the way points and fees are calculated, and exempting small servicers from escrow requirements.

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These are the fundamental provisions and a few details of our Republican economic growth plan for capital markets, banking and financial opportunity. Once we release the legislative text, I'm hopeful you will take time to learn more about it, because it deserves your support.

In conclusion, our circumstance is unprecedented in our history. Seven years after the Great Recession ended...and so few meaningful jobs, so little growth. The American people deserve something better than they're getting now. They deserve an economy that's more prosperous...a future that's more secure...a nation that's more free.

This nation's fiscal, monetary and regulatory policies all need fundamental reforms because all are dragging down job- and business-creation. Without robust capital markets, economies cannot innovate rapidly or grow sufficiently to create new businesses and jobs.

The nexus of finance and innovation is central to economic growth. If these major engines of growth are missing, then government policies are having negative causal effects on growth.

After most other recessions, the engines of growth returned, fueled by capital flows from U.S. banks and financial institutions. The difference this time is clear: it's the inefficiencies thrown by Dodd-Frank into the capital flow fuel line. This is why ending and replacing the mistake of Dodd-Frank is the necessary start if we ever hope to restore real economic growth in America.

You cannot have capitalism without capital. Capitalism, or free enterprise, is the greatest, most effective economic system to raise prosperity for everyone from the bottom to the top, to create jobs, to give consumers more choices, and generate innovative technological improvements for a better life.

More importantly than anything else, free enterprise – resting on the rule of law – provides the moral basis of a fair and just distribution of goods and services, ordered to the good and the happiness of every human being.

We don't need to envision new principles to restore economic growth, we need only to take back the Founders' vision and take up a new policy direction for the financial sector of the 21st century. Thank you.