Banking *and* Finance

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A Pro-Growth Agenda for the 116th Congress

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Banking and Finance

Access to capital is fundamental to the operation of a free society. It allows for the formation, expansion, and smooth running of the enterprises that make up the private economy. It also provides room for the experimentation that allows innovation in product and service delivery. A well-functioning financial system helps match investors with enterprises for mutual benefit and for the benefit of their employees and customers. Placing too many restrictions on the financial system hinders both the efficient allocation of capital and innovation that can benefit consumers.

In the modern global economy, access to capital generally occurs through the banking system as credit, through loans or credit cards. Once enterprises have reached a certain size, they can access capital markets, such as stock markets and debt offerings. Thanks to technological innovation, recent years have seen an explosion of alternative means of gaining capital—peer-to-peer lending, cryptocurrency, and crowdfunding most prominent among them. At the household level, a variety of companies offer small-dollar loans that often help individual consumers pay the bills and keep the lights on in times of financial need.

The smooth running of this system was disrupted by the financial crisis, now more than a decade old. A variety of government interventions, such as the Community Reinvestment Act and the actions of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, led lenders to overextend themselves by extending credit to a variety of borrowers who were unlikely to pay back the debt. Political convenience replaced sound economic judgment in capital provision decisions. A multitude of factors added to the problem, including:

- The moral hazard of deposit insurance;
- Zoning restrictions that fueled unsustainable housing price rises;
- Loose monetary policy;
- Problems with bank modeling of risk; and
- International regulation (such as the Basel accords on the risk weighting of capital assets) that inaccurately weighted the risk faced by debt holders.

When the banks that had extended the most problematic credit began to fail, the federal government's reaction was to prop them up with taxpayer bailouts, thereby socializing their losses and undermining the incentives for avoiding such problems.

The Dodd-Frank Act of 2010 was meant to help prevent a similar financial crisis, but it did nothing to change the situation and made the problem that led to the crisis worse. In fact, it doubled down on the bank regulatory regime that failed to prevent the financial crisis. Worse, Dodd-Frank imposed costly regulations addressing extraneous issues that had nothing to do with the crisis, such as debit card interchange fees, arbitration agreements in credit card contracts, and accounting for conflict minerals.

Dodd-Frank was intended to address the problem of too-big-to-fail; it has failed to do so. Dodd-Frank took aim at Wall Street, but it hit Main Street the hardest. The big banks are more dominant than they were before the crisis. The vastly increased regulatory burden imposed on smaller banks has led many of them to merge to become bigger, in order to be able to withstand the increased regulatory costs. Some have closed. Worse, banking regulators have abused their authority by cracking down on legal businesses that regulators find distasteful.

Such overregulation has made banks wary of lending to people without perfect credit or to small businesses and startups. Those parties have turned to a burgeoning industry of alternative funds but are finding those attacked by regulators as well. Even worse, Dodd-Frank created an unconstitutional, overly powerful regulator, the Consumer Financial Protection Bureau, which lacks proper oversight by elected officials.

Although the 115th Congress successfully passed an important financial reform bill—the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155)—most of the Dodd-Frank regulatory framework remains intact.

Lawmakers need to do more to allow for the emergence of a competitive, safe, and sound financial system. Congress must further rein in these regulators and pass laws to rectify the mistakes of Dodd-Frank. The Financial CHOICE Act—for Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs—will go a long way toward righting the wrongs inflicted by Dodd-Frank.

The Financial CHOICE Act, which passed the House in 2017, would:

- Assist in capital formation by allowing banks to swap less stringent regulation for holding more capital.
- Reduce the regulatory burden by repealing several provisions of Dodd-Frank, such as the mandate for publicly traded companies to disclose whether their products contain "conflict minerals" from certain areas of the Congo, as well as the economically destructive Volcker Rule, which bars banks from engaging in broadly defined "proprietary trading."
- Make regulators accountable by reforming the Federal Reserve, the CFPB, and other regulators by subjecting them to Government Accountability Office audits.
- Provide a better solution to the too-big-to-fail problem by allowing for a new chapter in the bankruptcy code to replace the counterproductive "orderly liquidation authority" established under Dodd-Frank to seize and bail out financial firms.

Further reforms will be needed, including legislation to allow financial technology (FinTech) firms to pursue innovation in financial services without having to deal with the regulatory burdens faced by banks. The Jumpstart Our Business Startups (JOBS) Act, Investor Confidence Act (which passed the House in 2018), and other pieces of legislation described in detail in this section could enable those reforms.

BRING ACCOUNTABILITY TO THE UNACCOUNTABLE CONSUMER FINANCIAL PROTECTION BUREAU

The Dodd-Frank Act of 2010 created the Consumer Financial Protection Bureau ostensibly to protect consumers from "faulty" financial products, much like the Consumer Product Safety Commission (CPSC) purportedly protects consumers from faulty household products. However, Dodd-Frank gave the CFPB far more power than the CPSC has ever had. In fact, Dodd-Frank deliberately set up the CFPB to operate free from the oversight faced by independent agencies. As a result, it is not accountable to Congress, the president, the courts, or voters.

Congress should:

- Pass sections of the Financial CHOICE Act that deal with the Consumer Finance Protection Bureau or the Financial Product Safety Commission Act.
- Pass motions expressing its sense that the CFPB is unconstitutional in its current form.

Congress exercises no power of the purse over the CFPB because the agency's budget—administered essentially by one person, its director—comes from the Federal Reserve. That amounts to approximately $600 million that Congress cannot touch or regulate. The president cannot carry out his constitutional obligation to "take care that the laws be faithfully executed" because he cannot remove the CFPB director except under limited circumstances. Dodd-Frank, going beyond the "for cause" standard for removal from most independent agencies, says that the president may remove the director only "for inefficiency, neglect of duty, or malfeasance in office." Judicial review of the CFPB's actions is limited, because Dodd-Frank requires the courts to give extra deference to the CFPB's legal interpretations.

The only meaningful checks on the CFPB's actions have come from congressional disapproval of its regulations. The 115th Congress, for example, successfully used the Congressional Review Act to block rules that govern arbitration agreements in financial contracts and fair lending laws in auto lending.

Despite Congress' efforts, the bureau has promulgated other harmful rules, such as the regulation of short-term, small-dollar loans—a move that threatens to deprive some of the most vulnerable American consumers of desperately needed credit.

The Financial CHOICE Act contains provisions that would restructure the CFPB as an executive agency. It would change the CFPB's mandate to provide for both consumer protection and competitive markets, make the director removable by the president, and require rigorous cost–benefit analysis of all its promulgated regulations. It requires the bureau to conduct comprehensive cost–benefit analyses before adopting regulations and affords Congress the opportunity to approve significant agency-issued regulations before they take effect. Alternatively, the bipartisan Financial Product Safety Commission Act also restructures the bureau as a typical independent agency, with a five-person bipartisan commission.

Experts: John Berlau, Iain Murray, Daniel Press

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OPPOSE REGULATORY OVERREACH IN FINANCIAL SERVICES

Since the passage of the Dodd-Frank Act in 2010, banking regulators have gone into overdrive. Community and regional banks have been so badly affected that their rate of closure and merger has doubled since the Act's passage. Only a dozen new banks nationwide have been authorized during the past decade. The result is a lack of choice for consumers and a loss of the personal connection between banker and customer.

Congress should:

- Pass the Protecting Consumers' Access to Credit Act (H.R. 3299, S. 1642, 115th Congress), which would explicitly make the "valid when made" doctrine the law of the land.
- Pass the Modernizing Credit Opportunities Act (H.R. 4439, 115th Congress), which would codify the FinTech–bank partnership model into law.
- Pass the Financial Services Innovation Act, to create a "regulatory sandbox" to allow new innovative firms a period of relaxed regulation.
- Repeal the Durbin Amendment to Dodd-Frank.

Fortunately, Congress has begun to move. The 115th Congress passed and President Trump signed the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155), which lowered the regulatory burden for hundreds of community and regional banks across the country. But this is only a start. The vast majority of Dodd-Frank's regulatory structure remains, strengthening the biggest banks and hampering small and newly formed firms, such as financial technology companies.

FinTech firms that are unable to navigate the regulatory maze of gaining a federal charter must incorporate in their home states. As a result, they suffer from a patchwork of inconsistent regulations. They cannot lend to customers in other states at the same interest rates as their in-state customers if the borrower's state caps the interest at a lower amount. This means that a FinTech lender looking to operate nationwide would have to become licensed and regulated in all 50 states. That severely limits consumer choices, including the choice to get a loan at an interest rate lower than that of a federally chartered bank.

In addition, the centuries-old "valid when made" doctrine—under which loans considered valid in the state they were made could not be considered usurious when sold to an out-of-state party—is under attack. The Supreme Court recently declined to hear *Madden vs. Midland*, in which the Second Circuit Court of Appeals reversed a century of "valid when made" precedent. The Second Circuit ruling created massive uncertainty in the lending market that could devastate FinTech innovations such as peer-to-peer lending. In 2015, when the case was decided, the number of loans made to less creditworthy borrowers in the Second Circuit declined by 52 percent from the previous year, whereas it increased by 124 percent outside the Second Circuit during the same time period. Congressional legislation codifying "valid when made" as law could boost borrowers' and investors' opportunities everywhere.

Finally, the Dodd-Frank Act gave the Federal Reserve the power to impose a price cap on interchange fees, which banks charge merchants when a customer uses the bank's debit card to make a purchase. Interchange fees had nothing to do with the financial crisis, but the cap was included in the Act at the last minute in a provision known as the Durbin Amendment, after its sponsor, Sen. Dick Durbin (D-Ill.). The rationale was that merchants would pass along the cost savings to customers, but research shows that those cost savings never materialized, while banks passed along the loss of revenue to all customers in the form of higher fees. The result of the Federal Reserve's price controls has been a reduction in the number of free checking accounts available, an end to debit card rewards programs, and higher costs at the margin of bank service availability that may have pushed up to 1 million people out of the banking system altogether.

Experts: Iain Murray, John Berlau, Daniel Press

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ALLOW CONSUMERS GREATER ACCESS TO INNOVATIVE NEW FINANCIAL SERVICES THROUGH THE GROWTH OF FINTECH, CROWDFUNDING, BLOCKCHAIN, AND CRYPTOCURRENCY

The rise of sharing economy platforms such as Uber and Airbnb has vastly improved transportation and lodging options for consumers. Financial services are starting to undergo a similar revolution. But just as Uber and Airbnb had to fight outdated taxi and hotel regulations to gain a foothold, so do new financial service providers face a number of antiquated rules that keep their innovations from growing or even getting off the ground.

Congress should:

- Build on the Jumpstart our Business Startups Act by expanding the amount that can be raised through equity crowdfunding from $1 million to $5 million and the contribution level from ordinary investors from $1,000 to $5,000. Those provisions were in the original Fix Crowdfunding Act in 2016. Unfortunately, they were dropped for the bill to get bipartisan support in the House.
- Allow special-purpose acquisition companies, in which lead investors negotiate on behalf others, to utilize crowdfunding for ordinary investors. This is a preferred investing method among angel investors and venture capitalists and would likely bring benefits to ordinary investors as well. This provision was part of the JOBS and Investor Confidence Act, which the House passed overwhelmingly in 2018.
- Expand the "accredited investor" definition beyond the wealth threshold to include those who have proven their sophistication in other ways, such as by passing exams for financial advisers and brokers. This would be accomplished by the Fair Investment Opportunities for Professional Experts Act, which passed the House with strong bipartisan votes in 2016 and 2017 and was included as part of the JOBS and Investor Confidence Act in 2018.
- Strip the Securities and Exchange Commission of the power to regulate peer-to-peer loans as securities. This action has bipartisan support and passed a Democratic-controlled House as a provision of Dodd-Frank in 2010, but it was cut from the Senate version of the bill.
- Protect cryptocurrency from overregulation, particularly from the SEC. Pass legislation to make clear that neither cryptocurrency nor offerings of it are "securities" and should not be regulated by the SEC. Ensure that government

has the tools to punish crypto-fraud through traditional anti-fraud agencies such as the Federal Trade Commission, but otherwise preserve the culture of "permissionless innovation" that has allowed for the dynamic growth of the Internet and other technologies to proceed largely unimpeded.

- Repeal the Durbin Amendment. Short of that, make sure it applies only to physical debit cards and not all electronic methods of payment.

Crowdfunding—which allows filmmakers, artists, and entrepreneurs to raise funds online from millions of fans on sites such as Kickstarter and Indiegogo—is becoming the next frontier in investing around the world. Entrepreneurs are using portals to find investors, without need for middlemen such as brokers and stock exchanges. But in the United States, even individuals raising small amounts have been barred from equity crowdfunding from investors.

The JOBS Act attempted to change this. It has had some success in allowing entrepreneurs more freedom to solicit and advertise to accredited investors—those who meet the Securities and Exchange Commission's threshold of $1 million in assets or $200,000 a year in earnings. The growth of portals that match entrepreneurs with such wealthy investors, portals such as CircleUp and Israel-based OurCrowd, has exploded.

Unfortunately, after much delay, the JOBS Act provisions recently implemented by the SEC to allow equity crowdfunding from ordinary investors fell woefully short of their stated goal. Although the rules exempt small public companies from some of the more onerous mandates of the Sarbanes-Oxley and Dodd-Frank financial regulation laws, they contain their own thicket of new red tape. The limits on the amount that can be raised this way are so low that they do not justify the compliance costs for many small firms.

Increasingly, crowdfunding has come to rely on offerings of new cryptocurrency—sometimes called "initial coin offering"—to fund new business ventures. In reward-based crowdfunding, funders receive products such as t-shirts or a sample of the item produced. In equity-based crowdfunding, by contrast, the funders are investors who receive a share in the business or a note with a promised rate of return.

Even though digital coins may grow in value more than do t-shirts, which often are the rewards for crowdfunding offerings for movies and recordings, those offerings fall into the rewards-based crowdfunding category, as they do not offer funders either a share of the company or a promised return on investment. Yet the SEC, without congressional authority, is increasingly claiming jurisdiction by labeling digital currency products as "securities." Such overreach from the SEC, and the threat of overregulation from other agencies, could chill innovation in this sector and related development in improving blockchain-distributed ledger technology that holds promise in everything from health care to land titling. Cryptocurrency creators could suddenly become subject to the thickets of red tape that face public companies, such as the mandates of Sarbanes-Oxley and Dodd-Frank. Securities registration rules could also prove highly impractical for blockchain technology if, for instance, now-anonymous individuals who maintain the blockchain have to register as investors or securities issuers.

Peer-to-peer lending has expanded credit options for consumers and small businesses, but its growth has been limited by the SEC's interpretation of 1930s-era securities laws. The SEC treats peer-to-peer loans as securities that must be subject to much of the same red tape as a stock or bond offering. As a result, two large companies, Prosper and Lending Club, have a virtual duopoly on peer-to-peer lending for consumers. And, unlike in other countries, there is almost no peer-to-peer lending by ordinary investors to small businesses.

The SEC is one of several regulatory agencies vying—or being pushed—to regulate Bitcoin, Ethereum, and dozens of new cryptocurrencies, which offer benefits from currency hedging to faster payments. Such new payment technologies may also be stifled by Dodd-Frank's Durbin Amendment, which puts price controls on what debit card issuers can charge the retailers for whom they process payments. According to George Mason University law professor Todd Zywicki and other researchers, the Durbin Amendment may have already caused as many as 1 million consumers to lose access to banking services, as the price controls shifted debit card costs from the nation's biggest retailers to its poorest consumers. If regulators treat new payment methods such as Apple Pay as electronic "debit cards," innovation benefiting consumers and retailers will be stifled.

Even with the advent of financial technology, or FinTech, some consumers and providers will always value personalized service. Whether to use automated or personal service should be a choice, not a mandate. The Department of Labor's fiduciary rule mandated that financial professionals serve savers' "best interests"—as defined by DOL. That rule threatened to impose so many costly mandates on brokers and insurance agents that it would have made it cost-prohibitive for them to work with middle- and low-income savers, who would have been be stuck with untested "robo-advice" as a result of this flawed regulation. Fortunately, in 2018, the Fifth Circuit Court of Appeals threw out the DOL rule as "arbitrary and capricious," and the Trump administration declined to appeal. Congress should make sure that the Department of Labor and other agencies, such as the SEC, do not promulgate new rules that similarly raise costs and reduce choices for middle-class investors.

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ADDRESS TOO-BIG-TO-FAIL

The 2010 Dodd-Frank "financial reform" law was intended to protect taxpayers against the prospect of future bailouts by ending the phenomenon of too-big-to-fail financial institutions. Yet many of its provisions enshrine too-big-to-fail and the potential bailouts for such large financial institutions.

Congress should:

- End the Financial Stability Oversight Council's (FSOC) exemption from the Freedom of Information Act, and mandate that it open its meetings to the public.
- Repeal the FSOC's power to declare firms as too-big-to-fail SIFIs under Dodd-Frank. The Financial Choice Act would accomplish this. Short of that, grant designated firms and their competitors expedited avenues to challenge a SIFI designation in court.
- Phase out Fannie Mae and Freddie Mac and replace them with nothing.
- Until Fannie and Freddie are phased out, end the Third Amendment profit sweep and ensure that Fannie and Freddie maintain adequate capital.
- Phase out federal deposit insurance. Short of that, bring down the maximum insured per deposit from $250,000 to $100,000, the limit that existed for two decades before the financial crisis.
- Shift the burden of proof to bank regulatory agencies when processing applications for new bank entrants. Require those agencies to give specific reasons why a new bank would harm the safety and soundness of the financial system before rejecting its application. Make denial of an application challengeable in court.

It is always harmful for the government to pick winners and losers by designating certain firms for additional protection or regulation, yet Dodd-Frank empowers the government to do precisely that. Most prominently, the federal government can designate certain financial firms as systemically important financial institutions (SIFIs), which cannot be allowed to fail through the normal bankruptcy or receivership process. The creditors of the SIFIs also enjoy a competitive advantage in obtaining credit, in that the federal government has the authority to make them whole.

The Financial Stability Oversight Council, a secretive bureaucracy created by Dodd-Frank, designates firms as SIFIs through an arbitrary process that lacks rules for so designating the firms and that is closed to the public. Some firms embrace the designation of a SIFI, whereas others fight it because of the added regulation it entails. MetLife has successfully challenged its SIFI designation in federal court, and AIG was de-designated as a SIFI in late 2017.

In spite of all this, the government-sponsored enterprises Fannie Mae and Freddie Mac—arguably the most "systemically important" financial entities, given their role in fomenting the financial crisis—are allowed to operate with virtually no capital buffer. The government's "conservatorship" of Fannie and Freddie—which began in 2008, when it bailed out the GSEs in exchange for a 79.9 percent ownership stake in each of them—has increased the hazard they pose to taxpayers.

Fannie and Freddie should be phased out and replaced with nothing. There should be no government-sponsored enterprise for mortgages any more than there should be for other types of credit, such as car loans. This phaseout can be done through the method laid out in the Protect American Homeowners and Taxpayers (PATH) Act, which passed the House Financial Services Committee in 2013. Under the PATH Act, the GSEs sell off parts of their portfolios every year until they are completely liquidated. The phaseout can also be done by breaking up the GSEs and ending their line of credit with the U.S. Treasury. Any plan must uphold the rule of law by granting shareholders fair compensation for the value of their shares.

Under the Third Amendment, implemented by the Obama administration in 2012, the government confiscates any profit the GSEs make—even after they have paid the government back. That leaves the GSEs with no capital reserves, which makes them vulnerable to even the slightest hiccup in the economy. Although the Third Amendment "sweep" is an unjust taking from Fannie and Freddie's private shareholders and is currently being challenged in several lawsuits as unconstitutional, it is still ongoing. As long as this arbitrary confiscation is allowed to stand, a great amount of private capital will be scared off from the mortgage market, leaving government-backed mortgages as the only alternative for prospective homebuyers.

Both shareholders and taxpayers suffer from the Third Amendment's raid of all the GSEs' profits for the U.S. Treasury. Shareholders see their assets taken without government compensation, and the taking of that capital leaves the GSEs less financially stable and more prone to a potential bailout. The Housing Finance

Restructuring Act of 2016 is an important step in this direction. It requires that any profits made by the GSEs be used for rebuilding capital levels to help prevent future taxpayer bailouts.

To really end too-big-to-fail, Congress must minimize the damage to the financial system from any one bank's failing by limiting deposit insurance and allowing more competition. Deposit insurance creates moral hazard because banks know they will be bailed out if they take too many risks. Meanwhile, depositors lack incentives to monitor how much risk their banks are exposed to. The private sector can create more responsive mechanisms of insurance.

Innovative new entrants should be allowed to compete in the financial services industry. Since passage of Dodd-Frank in 2010, federal regulators have allowed only a dozen new banks to open for business. Well-managed nonfinancial firms, such as Walmart and Berkshire Hathaway, have been rebuffed in their attempts to open affiliated banks to serve consumers. Virtually no other developed country has such restrictions to entry. For example, the retail giant Tesco runs one of the largest banks in the United Kingdom. Keeping banking as an "old boys' club" with few new entrants makes the financial system less competitive and less safe.

Experts: John Berlau, Iain Murray, and Daniel Press

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