2

Banking and Finance

Access to capital is fundamental to the operation of a free society. It allows for the foundation, 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 to the benefit of their employees and customers. When too many restrictions are placed on such a system, the economy slows both in its general flows and in innovation.

In the modern global economy, provision of 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 and crowdfunding prominent among them. At the individual household level, a variety of finance companies offer small-dollar loans that are often essential for keeping the lights on.

The smooth running of this system was disrupted by the financial crisis. A variety of government interventions, such as the Community Reinvestment Act and the actions of Fannie Mae and Freddie Mac, led lenders to overextend themselves by extending credit to a variety of sources that were unlikely to pay it back. Political convenience replaced sound economic judgment as a determinant of capital provision. When the banks that had extended the most problematic credit began to fail, government's reaction was to prop them up with taxpayer bailouts, thereby socializing their losses and breaking the incentive structure for avoiding such problems.

The Dodd-Frank Act of 2010 was meant to help solve the financial crisis, but in fact it did nothing to change the situation and made the problem worse. The establishment of the Financial Stability Oversight Council created a whole new class of designated "too big to fail" firms that are essentially controlled by financial regulators. Mortgage lending was further concentrated in Fannie and Freddie. A whole host of new regulations stifled credit provision by smaller banks. The Durbin Amendment's cap on credit card interchange fees may have forced a million people out of the banking system entirely by increasing other bank fees. The creation of the Consumer Financial Protection Board threatens the very existence of the small-dollar loan industry, as does a

Department of Justice initiative called Operation Choke Point. Finally, Securities and Exchange Commission (SEC) regulations threaten the development of crowdfunding as an alternative.

The result is a system where accessing capital is overly difficult for those otherwise qualified to receive it, while government is attempting to take over the provision of household credit—and in the case of mortgages has already done so.

The Competitive Enterprise Institute has proposed necessary reforms on those issues since before the financial crisis. The reform package we suggest would go some way toward correcting the problems introduced by Dodd-Frank as well as those that caused the financial crisis.

NEW APPROACH TO TOO BIG TO FAIL

When President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, he claimed the law would end bailouts for good. But nearly five years after its enactment, the problem of "too big to fail" has only gotten worse, as the five largest banks now hold 45 percent of Americans' financial assets, up from 30 percent 10 years ago, according to the Mercatus Center at George Mason University. Since the enactment of Dodd-Frank, 10 percent of small banks have either been acquired or closed. Innovations in consumer and business finance and payments systems are bubbling to the surface, but in many cases they remain stuck in regulatory limbo. That leaves consumers and small entrepreneurs with limited choices in saving, investing, and credit.

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.
- Short of repealing the FSOC's designation of large banks as "systemically important financial institutions" (SIFI), give entities so designated more avenues to challenge the designation in court.
- Bar federal banking regulatory agencies from applying Basel III and other bank-centric rules to nonbanks, such as insurers.
- Repeal Dodd-Frank's Durbin Amendment, which sets price controls for what retailers pay banks and credit unions to process debit cards.
- Put the burden of proof on regulators at the Federal Deposit Insurance Corporation (FDIC), Federal Reserve, and Office of the Comptroller of the Currency when processing applications for new bank charters. Require bureaucrats to give specific reasons why such a charter would harm the safety and soundness of the financial system before denying a charter application for a new bank. Make a denial of a charter application challengeable in court.

Far from ending bailouts of big financial institutions, Dodd-Frank has enshrined them into law through the creation of the Financial Stability Oversight Council. Set up under Dodd-Frank, the FSOC has the power to designate a "systemically important financial institution." Dodd-Frank exempts this agency from open-meeting laws and the Freedom of Information Act, and the FSOC's secrecy rivals that of defense and intelligence agencies.

A SIFI designation means that a firm cannot be allowed to fail through normal bankruptcy or receivership, and gives the government the authority to make creditors of the financial institution whole. Large banks and financial firms with a SIFI designation have a competitive advantage over their smaller counterparts, as market participants are more likely to extend credit to SIFIs, given that government guarantee.

The SIFI designation has other market-distorting effects. Because the bailout of one SIFI is paid for by the others, the FSOC has an incentive to find healthy, stable companies to designate as a SIFI to pay the cost of bailing out a SIFI that engages in riskier activities. And when nonbank financial companies are designated as SIFIs, they may face bank-like capital rules, such as the much-criticized international Basel III standards (rules created by the Bank of International Settlements in Basel, Switzerland, that favor government securities over corporate bonds, and that are of questionable value for banks as well), which nearly all experts agree are inappropriate for insurance companies or asset managers, if they are even appropriate for banks.

That is why MetLife strenuously objected to being designated a SIFI in September 2014. It is also why in 2014 the House and Senate unanimously passed and President Obama signed into law the Insurance Capital Standards Clarification Act, which modifies Dodd-Frank to make it clear that the government need not force SIFIs or insurance companies with banking affiliates to adhere to bank-centric capital rules.

At the same time, innovations in consumer and business finance and payments systems are bubbling to the surface, but in many cases they remain stuck in regulatory limbo. Well-managed companies like Walmart and Apple can dip their toes into financial waters but cannot get bank charters because of a de facto FDIC ban on new charters for "industrial lending companies" affiliated with nonbank firms. In fact, the federal government has slowed to a halt approval of new bank charters in general. Fewer than 30 charters for new banks were approved from 2009 to 2012.

Big banks are effectively sheltered from competition from both smaller rivals and larger firms that cannot form banking units. That factor exacerbates the problem of too-big-to-fail by limiting alternatives when a giant bank falters. To permanently end bailouts, Congress needs to end subsidies and simultaneously open up avenues for competitors to the big banks.

Experts: John Berlau, Iain Murray, Todd Zywicki

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BANKING REGULATORY REFORM

As of the second quarter of 2014, the regulated banking sector—comprising over 5,700 banks—held assets of over $15 trillion, including deposits totaling more than $10 trillion, and had $8 trillion worth of loans outstanding, according to Federal Deposit Insurance Corporation (FDIC) data. Although that picture might appear healthy at first glance, it conceals several problems. The number of people without a bank account in the United States rose by about 1 million between 2009 and 2013, owing to increased bank fees. An as-yet-unquantifiable number of businesses have had their bank accounts canceled as a result of Operation Choke Point, an aggressive Justice Department–led campaign to choke off financing for politically disfavored businesses. Individual immigrants are finding it more difficult to make money transfers, known as remittances, to their families abroad. Those problems need to be addressed to ensure renewed growth in the banking sector and the smooth running of a reliable financial system.

Congress should:

- Repeal the Durbin Amendment, Subtitle G, Section 1075, of the Wall Street Reform and Consumer Protection Act, better known as the Dodd-Frank Act.
- Amend Section 335 of Dodd-Frank to reduce the current standard maximum deposit insurance amount to $100,000.
- Repeal Section 1073 of Dodd-Frank to alleviate burdensome restrictions on remittance transfers to foreign countries.

Durbin Amendment. Interchange fees are the fees merchants pay to banks when a consumer uses a credit or debit card to pay for an item. The Durbin Amendment to the Dodd-Frank Act imposed price controls on transaction fees for debit cards for which the user's bank has assets of over $10 billion, affecting 64 percent of all debit card transactions issued in the United States. Those price controls reduced the average fee per transaction from about $0.50 to $0.24, which has resulted in a decrease in bank revenue of about $8 billion, with a similar increase to merchant revenue. The amendment was justified on the grounds that retailers would pass on the savings to consumers, but that has not in fact transpired. Instead, all the costs of the fee increase have been passed on to *bank* customers. In a June 2014 study, George Mason University law professor Todd Zywicki, International Center for Law and Economics Executive Director Geoffrey J. Manne, and Reason Foundation Vice President Julian Morris found the bank actions had the following effects:

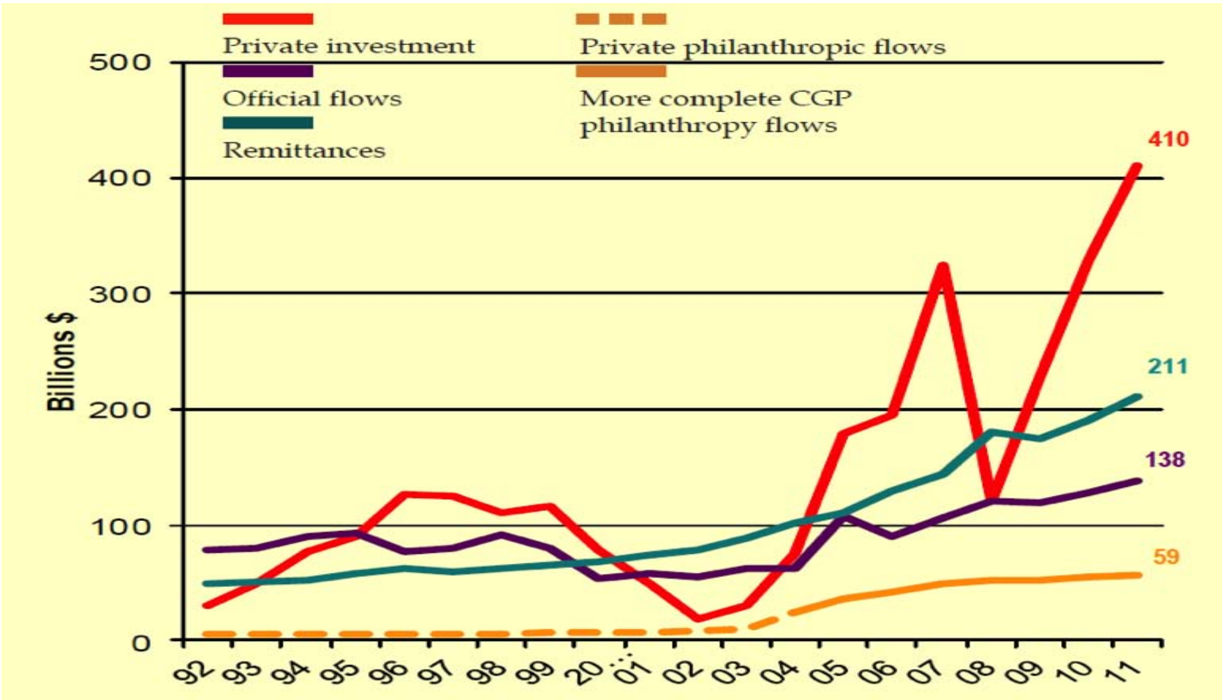
- Banks began to offer fewer free checking accounts. "The total number of banks offering free current accounts fell by 50% between 2009 and 2013," they note. "In comparison, fee-free banking actually increased at banks not subject to the Durbin Amendment."
- The minimum monthly balance requirement for free current accounts tripled between 2009 and 2012, increasing from about $250 to over $750.
- Average monthly fees on nonfree current accounts also doubled between 2009 and 2013, from about $6 to more than $12.
- Fee increases and loss of access to free checking led to an addition 1 million Americans, mainly among low-income households, joining the nation's unbanked population.
- Because of the increased fees, consumers have changed their behavior in relation to the banking products they use, increasing use of credit and prepaid cards, while decreasing use of debit cards. Credit and prepaid cards are not subject to the Durbin fee caps.

In addition, David Evans, Howard Chang, and Steven Joyce of the University of Chicago's Coase-Sandor Institute for Law and Economics found that the net decrease in consumer welfare as a result of the Durbin Amendment was between $22 billion and $25 billion annually, which equates to a loss of $200 per household.

The potential harm caused by interchange fee regulation has been known for some time. In a paper from 2002, Jean Tirole, who won the 2014 Nobel Prize for Economics, warned that regulators could not know the appropriate level of any cap. To increase consumer welfare, to reduce the number of the unbanked population, and to promote lower banking fees, Congress should repeal the Durbin Amendment in its entirety.

Deposit Insurance Reform. Deposit insurance was introduced in the United States in response to a series of Great Depression-era

Figure 2.1 Official, Private Investment, Philanthropic, and Remittance Flows from Donor Countries to Developing Countries, 1991–2011 (Billions of $)



Source: Carol Adelman, Jeremiah Norris, and Kacie Marano, "The Index of Global Philanthropy and Remittances 2013," Hudson Institute, 2013.

banking crises. The Banking Act of 1933 created the Federal Deposit Insurance Corporation to restore confidence in the banking system by providing that a certain amount of every bank customer's deposits would be guaranteed by the insurance system. In 1950, the amount insured was $10,000, which translates to about $80,000 today. The amount was raised through a series of steps to $100,000 in 1980, despite reservations by the FDIC itself.

During the financial crisis, the collapse of Washington Mutual and other banks raised concern among policy makers that ordinary consumers with banking assets, such as certificates of deposit, valued over $100,000 could lose out in the event of a string of bank collapses. The amount insured by the FDIC was therefore temporarily raised to $250,000 before the Dodd-Frank Act permanently increased it to that level.

Deposit insurance at such levels introduces a significant degree of moral hazard into the banking system. That means that bankers, knowing their customers' deposits are not at risk because they are backstopped by the FDIC, are more likely to engage in risky behavior with those deposits. They are also less likely to object to government rules that increase risk, such as the Community Reinvestment Act.

Moreover, the increased limits appear to have changed the FDIC's behavior. It has issued to banks guidance aimed at reducing its exposure to risky behavior by banks. One example was a 2011 FDIC guidance document aimed at increasing monitoring of relationships with third-party payment processors dealing with "high-risk" industries. That guidance was used by the Department of Justice to help initiate Operation Choke Point, whereby the department used its subpoena power to investigate such relationships. In many cases, banks responded to the increased level of scrutiny by terminating the banking relationship with the processor or industry in question—regardless of the bank's history with its customers. As a result, legal businesses have been left without access to banking services.

To reduce moral hazard in the banking industry, to reduce the incentives on the FDIC to impose unduly heavy-handed regulation, and to return deposit insurance to levels at which it was originally intended to protect working people's accounts, Congress should amend the Dodd-Frank Act to reduce deposit insurance to the previous level of $100,000 per account.

Remittances. Some of the world's poorest people depend on money they receive from relatives working in developed countries. In fact, that money dwarfs the world's official foreign aid budget, and the gap is increasing. In 2011, total private flows of aid totaled $680 billion—almost five times the official figure of $138 billion, according to the Hudson Institute. However, an argument that the industry facilitating those transfers is exploitative has gained currency and was enshrined in the Dodd-Frank Act, even though remittances had nothing to do with the financial crisis.

As a result, the Consumer Financial Protection Bureau, an agency set up by Dodd-Frank, has issued a rule (Remittance Transfer Rule—Subpart B of Regulation E) that imposes certain constraints on international money transfers. Its most important provision is the right to cancel a money transfer within 30 minutes of its being initiated. Proposals to reduce fees charged by remittance firms have also been advanced internationally by the World Bank in partnership with the G-8 and G-20.

Critics claim that high transfer fees are the result of an alleged market failure that calls for greater regulation. Yet markets in remittances are frequently overregulated. Many African governments have exclusive deals with money transfer companies, which operate as national monopolies, free from competitive discipline. And there are other regulatory pitfalls that drive up prices. A Western Union spokesperson told the *Guardian*:

> Our pricing varies between countries depending on a number of factors, such as consumer protection costs, local remittance taxes, market distribution, regulatory structure, volume, currency volatility and other market efficiencies. These factors can impact the fees and foreign exchange rates offered by corridor and service type.

All that suggests the remittance market needs less regulation. Proper competition, lower taxes, less restrictive "consumer protection" measures (which quickly become outdated), and less red tape in general would all likely increase the flow of funds between individuals.

Moreover, the 30-minute cancellation window would technically ban remittances using Bitcoin, whose transactions are irreversible. Yet Bitcoin is increasingly the vehicle of choice for remittances as its transaction costs are essentially zero.

Therefore, Congress should repeal or amend the section of Dodd-Frank dealing with remittance transfers to allow for Bitcoin transactions and a more flexible and competitive remittance market.

Experts: Durbin Amendment: John Berlau, Iain Murray, Todd Zywicki

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ACCESS TO CAPITAL FOR SMALL AND MID-SIZED FIRMS (JOBS ACT II)

When Congress passed and President Obama signed the Jumpstart Our Business Startups (JOBS) Act of 2012, it marked a bipartisan recognition that securities laws—some dating from before most Americans had a telephone in their home—were holding back capital raising in the age of the mobile app. "A lot has changed in 80 years, and it's time our laws did as well," the president said upon signing the bill. "Because of this bill, startups and small business will now have access to a big, new pool of potential investors—namely, the American people." But although some regulatory barriers have been eased, the SEC has yet to finalize the crucial "crowdfunding" provisions of the JOBS Act to help the smallest startups partner with ordinary investors. As a result, opportunities for economic mobility are being lost.

Congress should:

- Permanently exempt publicly traded companies with a market value of less than $700 million from the most onerous provisions of Sarbanes-Oxley, Dodd-Frank, and other securities laws. Rep. Michael Fitzpatrick's (R-Ill.) Fostering Innovation Act (H.R. 2629), which passed the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises in 2014, would exempt companies meeting that threshold from the "internal control" auditing mandates of Sarbanes-Oxley.
- Lower the threshold for "accredited investors"—investors from whom entrepreneurs can raise capital while facing much less red tape than a public company—from its current floor of $1 million in net worth to $500,000. Further, as proposed by prominent crowdfunding attorney and blogger Mark Roderick, ordinary investors should be allowed to invest in a nonpublic firm if 25 percent of the initial capital is raised from accredited investors. That provision should satisfy many of the investor protection concerns by allowing wealthy accredited investors to give a "seal of approval" by putting their own money at stake.
- Revise the JOBS Act's "crowdfunding" provisions to allow entrepreneurs to increase the amount they can raise from investors from $1 million to $10 million. Repeal the onerous liability provision in the JOBS Act's crowdfunding section, which could potentially unleash a flood of lawsuits, not just for fraud but for vaguely defined "omissions of material fact." Repeal the mandate that crowdfunding portals must be registered broker-dealers. Those measures are contained in both Rep. Patrick McHenry's (R-N.C.) Startup Capital Modernization Act (H.R. 4565), which passed the House Financial Services Committee in 2014, and his Equity Crowdfunding Improvement Act of 2014 (H.R. 4564).

Although the JOBS Act modestly loosened the reins on entrepreneurs and investors, markets and innovation have taken a gallop in progress. According to Renaissance Capital, 2013 had 222 initial public offerings (IPOs), the most in the United States since 2000. Ever since the burdensome Sarbanes-Oxley Act was signed by President George W. Bush in 2002, there has been a dearth of IPOs on U.S. exchanges. Title I of the JOBS Act allows "emerging growth companies"—those with less than $750 million in market value and $1 billion in annual revenues—a five-year exemption from the costly "internal control" audits of Sarbanes-Oxley, as well as some provisions of Dodd-Frank. There is more than a casual connection between that regulatory relief and the sudden IPO boom, as evidenced by the fact that 80 percent of IPOs are "emerging growth companies" using the JOBS Act exemptions.

New opportunities to raise funds from millionaire "accredited investors" have also sprouted after Title II of the JOBS Act repealed the 80-year-old ban on advertising for investors by nonpublic companies. New Internet portals, such as AngelList and OurCrowd, have sprung up to allow entrepreneurs to communicate with the general public about investment opportunities, so long as they verify that only "accredited investors" are the ones who sign up.

However, the crowdfunding provisions of Title III were greatly watered down at the last minute before the JOBS Act passed the Senate. And because even those weakened provisions have yet to be implemented by the SEC, ordinary investors and small entrepreneurs are still losing out on many of the opportunities crowdfunding can provide. Congress should eliminate barriers to ease crowdfunding's move from a model based on donations to one based on wealth building and profit sharing.

Experts: John Berlau, Iain Murray

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GSE REFORM

Following the financial crisis of 2008, a consensus formed among lawmakers that government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac played a significant, if not the major, role in the mortgage meltdown. There also emerged a consensus that the GSEs needed to be curbed, if not phased out. Yet six years after the crisis, Fannie and Freddie are bigger than ever, and unsubsidized private capital still constitutes a minuscule share of the mortgage market. Nine out of 10 home mortgages are securitized or insured by federal government housing entities, putting taxpayers at risk and limiting choice and competition for homeowners.

Congress should:

- Pass legislation implementing a wind-down of Fannie and Freddie along the lines of the Protecting American Taxpayers and Homeowners Act, which passed the House Financial Services Committee in 2013. The GSEs would sell off part of their portfolios every year until they are completely liquidated.
- In the legislation, include a provision to ensure that GSE shareholders are fairly compensated in such a wind-down. Create a commission to determine fair market value of shares and to resolve claims. The legislation should not interfere with pending or future shareholder lawsuits, but set up the commission as an alternative mechanism that shareholders can use to settle claims.
- Repeal the "qualified mortgage" and "qualified residential mortgage" provisions of Dodd-Frank.

In the first few years after the housing crisis, the Obama administration called for, in the words of Treasury official Michael Stegman, "shrinking the government's footprint in housing finance." Yet because of government backing and crippling regulations facing competitors, Fannie and Freddie are once again making money hand over fist, and the government's role in the mortgage market continues to expand. Should anything go wrong, taxpayers will be left on the hook for an even bigger bailout.

Private capital has been scared off by Dodd-Frank's stringent underwriting rules, such as the regulations for "qualified mortgages" and "qualified residential mortgages" (two separate interlinking provisions of the law), from which loans bought by Fannie and Freddie are largely exempt. It has also been frightened by arbitrary actions against Fannie and Freddie shareholders. In 2012, the Obama administration implemented the "Third Amendment" in governing Fannie and Freddie, which allows the Treasury Department to take 100 percent of all the GSEs' profits in perpetuity, even after the GSEs paid back taxpayers for the cost of the 2008 government bailout.

Experts: John Berlau, Iain Murray, Fred Smith

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OPERATION CHOKE POINT

Operation Choke Point is a Department of Justice-led initiative based on guidance from the Federal Deposit Insurance Corporation aimed at "choking off" the financial oxygen to certain industries designated as "high risk" for fraud. It is an example of executive overreach, as it abuses existing powers for purposes never intended by Congress. As a result, it has turned into both an extensive fishing expedition that has caused many legal businesses to lose banking services and a vehicle for bypassing the legislative process to shut down politically disfavored industries.

Congress should:

- Amend the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) to prevent its abuse by politically motivated prosecutors.
- Reform the Bank Secrecy Act to provide less room for regulatory overreach.
- Remove all funding for Operation Choke Point.
- Amend Dodd-Frank to provide specific guidance on what constitutes, and does not constitute, fraud in payday lending to prevent regulatory abuse.

Operation Choke Point is ostensibly a joint effort by various regulatory entities—the Department of Justice, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation most prominent among them—to reduce the chances of Americans falling victim to fraud in a variety of "high-risk" industries, predominantly payday lending. It uses existing regulatory powers to provide heightened supervision of banks that do business with the third-party payment processors that provide payment services to those industries. CEI's *Issue Analysis* "Operation Choke Point: What It Is and Why It Matters" provides detailed background on how Operation Choke Point began and what it has turned into.

However, that seemingly laudable aim conceals a worrying reality. There is nothing illegal about most of those industries (at least not yet). However, because they have been designated high risk, banks are cutting off dealings with many processors and companies preemptively, before Choke Point's heightened supervision comes into play. As a result, many companies and individuals that have done nothing wrong have been frozen out of banking services. Without the links to banks, their financial lifeblood is choked off indeed.

Policy makers should weigh Operation Choke Point's few successes in stopping genuine fraudsters against that significant chilling effect, of which the primary victims are the customers of legal businesses that become unable to access financial services. In some cases, that chilling effect will push customers of the now-unobtainable service toward illegal providers, with subsequent risks to their health, liberty, or both.

The Department of Justice's main tool for its overzealous investigation has been subpoenas issued under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989—a statute that was not designed to prosecute consumer fraud, but rather fraud against banks. As a result, it allows for much greater damage awards than other more appropriate statutes for investigation and penalties, such as the Federal Deposit Insurance Act and the Federal Trade Commission Act. That higher level of potential damages for which banks might be found liable is a likely reason for banks to sever ties with potential "high-risk" customers. Congress should amend FIRREA to clarify that it is not intended for use in cases of consumer fraud.

The Department of Justice and its allies have used the Bank Secrecy Act's reporting provisions to compel banks to provide information on their customer activities that go well beyond anything authorized by normal legislative or regulatory authority. The Bank Secrecy Act should ideally be repealed, or at the very least amended, to place strict bounds on what regulators may require of banks—preferably requiring evidence of wrongdoing in order to be allowed to begin a criminal investigation.

Operation Choke Point began with executive branch agencies acting on their own, without authorization from Congress. Therefore, Congress should use the power of the purse to curtail this rogue operation. The House of Representatives has already passed a motion defunding the operation, and that should be a priority in the new Congress.

One of Operation Choke Point's primary targets has been the payday loan industry, even though the Dodd-Frank Act specifically exempted the industry from such regulatory constraints as interest rate caps. Nevertheless, financial regulators have taken such high annual percentage rate (APR) equivalents as de facto indicators of fraud, an approach that is completely inappropriate for payday loans, which are extremely short-term by definition. Therefore, Congress should amend Dodd-Frank to state in its instructions to regulators that high APR equivalents are not themselves indicators of fraud and should not be construed as such. Similar provisions should also apply to such indicators as high "recharge" rates (payments refused by the customer's bank), to which the payday loan industry is particularly susceptible.

Experts: Iain Murray, John Berlau

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