

July 20, 2015

No. 202

How Dodd-Frank Harms Main Street

Ill-Considered Financial Reform Law Thwarts Americans' Access to Financial System

By Iain Murray*

The financial crisis of 2007-2008 was a drastic shock to the American economy. The regulatory response of 2009-2010 was just as powerful a shock to the financial system. Enshrined in the Wall Street Reform and Consumer Protection Act, popularly known as Dodd-Frank after its main Senate and House sponsors—then-Sen. Christopher Dodd (D-Conn.) and then-Rep. Barney Frank (D-Mass.)—the reforms were intended to protect Main Street and consumers from financial predation by Wall Street. Instead, it has meant reduced access to credit for small businesses and fewer choices for consumers, while doing little to punish the main culprits in the financial crisis.

Dodd-Frank grew out of a 2009 Treasury Department task force proposal, “A New Foundation: Rebuilding Financial Supervision and Regulation,” which had two distinct goals:

- 1) Prevent bank failures from endangering the economy (the task force’s original focus); and
- 2) Set up a new federal regulator, an idea first proposed in 2007 by then-Harvard professor Elizabeth Warren.¹

The latter led to the creation of the Consumer Financial Protection Bureau (CFPB) under Dodd-Frank. Sen. Dodd and Rep. Frank worked closely with the administration to help turn the proposal into law. In December, 2009, Rep. Frank introduced the bill that became the Dodd-Frank Act, which contained most of the original White House proposal.

The bill was an odd contraption from the start. Warren had argued for her agency as a means to protect consumer financial product safety, bringing the benefits of what she termed “a well-functioning market” to financial consumers. In an article in the progressive journal *Democracy*, “Unsafe at Any Rate” (a nod to Ralph Nader’s *Unsafe at Any Speed*), she wrote:

It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street—and the mortgage won’t even carry a disclosure of that fact to the homeowner.²

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But as George Mason University law professor Todd Zywicki points out, Warren's comparison is inapt.

Loans are not toasters...The default and foreclosure crisis was caused by misaligned incentives, anti-deficiency laws, and erratic monetary policy. These causes are all safety and soundness issues and not consumer protection issues. ...

Essentially, safety and soundness relates to banks engaging in risky or responsible lending, while consumer protection deals with fraud, deception, and unfair practices in the marketplace.³

The Dodd-Frank Act was sold to the American people as promoting financial soundness and stability by reining in Wall Street and the big banks, rather than to prevent fraud. When its supporters mentioned fraud, it was in passing. Then-House Speaker Nancy Pelosi said: "No longer again will recklessness on Wall Street cause joblessness on Main Street. No longer will the risky behavior of the few threaten the financial stability of our families, our businesses, and our economy as a whole."⁴

Other items from the wish list of the left were added to the bill as it made its way through Congress. Sen. Richard Durbin (D-Ill.) added an amendment that imposed a cap on the "interchange fees" banks and debit card networks charge to merchants whose customers use the cards.⁵ The House-Senate conference added the "Volcker Rule," named after former Federal Reserve chairman Paul Volcker, to prohibit banks from trading financial instruments with their own money, despite the proposal not even being voted on during the bill's passage.⁶ The final law even included a provision requiring companies to disclose their use of "conflict minerals" that might have originated from the war zone in the Democratic Republic of Congo, in an effort to cut off funding to warlords there.⁷

The bill passed at every stage largely along party line votes, at a time when Democrats controlled both chambers of Congress (the two Republican Senators from Maine voted for the bill). Sen. Dodd even suggested that the lack of bipartisan involvement was a good thing, arguing that to compromise would be a "huge mistake" given the urgency of the problems the bill sought to address.⁸ The final act, signed into law in July 2010, weighed in at 848 pages and over 360,000 words. It is unlikely that many of those who voted for (or against) the bill actually read it.

Federal Power Grab. Much of Dodd-Frank is a broad enabling act granting power to executive agency bureaucrats to write specific regulations. "Laws classically provide people with rules. Dodd-Frank is not directed at people," Yale law professor Jonathan Macey told *The Economist*. "It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies."⁹

This delegation of rulemaking has created great uncertainty for the financial industry. While Dodd-Frank provides an outline, the final rule is usually far more detailed, leaving firms to guess what new restrictions may be put in place. For example, the text of the Volcker Rule in the statute ran to 11 pages. The agencies responsible for the rule produced a draft rule for

comment of almost 300 pages, containing almost 1,500 questions for the industry. The final rule ran to 71 pages, plus over 800 pages of responses to comments and other clarifications, with the process taking over two years.

By 2013, three years after Dodd-Frank's passage, the law firm Davis Polk calculated that over 15 million words of rules required by Dodd-Frank had been written, enough to fill 28 volumes the length of *War and Peace*.¹⁰ At that rate, when Dodd-Frank's required rules are finally complete, over 35,000 pages and over 38 million words will have been added to the financial industry rule book.

To make matters worse, only 58 percent of Dodd-Frank's required rules had been completed almost four years after its passage. Davis Polk tallied up 395 rules the Act mandated the administration to draw up, each with a deadline for finalization. At the end of 2014, only 176—over a third—of 277 deadlines had been met.¹¹

Dodd-Frank does more than just require rules. It also empowers agencies to create new ones as they see fit. For example, the CFPB's recently proposed rule to regulate prepaid debit cards is entirely a creation of the Board.¹² The rule runs to 800 pages of prescriptions as to how the cards, an increasingly popular method of payment, may be issued and handled. There are long and short form information sheets that need to be presented to the recipient depending on the circumstances, each describing a variety of fees that might be incurred if the card is used in certain ways. Dodd-Frank also empowered the CFPB to regulate such diverse financial products as auto loans, debt collection, electronic payments, mortgages, overdrafts, payday lending, and overseas remittances. It is planning or has already issued rules in all of these areas.

Dodd-Frank's impact on the financial industry is clearly massive and burdensome. Some might say, "Good. They deserved it!" But who really bears these burdens? Not so much Wall Street as Main Street. The first two titles of the law are critical to understand why.

Title I created the Financial Stability Oversight Council (FSOC), a regulator with the power to designate a firm with over \$50 billion in assets as a Systemically Important Financial Institution (SIFI) that could endanger the entire financial system if it were to get in trouble.

Title II creates an Orderly Liquidation Authority (OLA), supposedly the means by which a SIFI can be wound down without the need for a taxpayer bailout. At face value, this would seem to be an improvement on the Too Big to Fail (TBTF) phenomenon that led to the crisis and bailouts, but that is not how the law has worked in practice.

SIFI status is clearly valuable, and therefore represents a reward to big banks. Before the crisis, big banks benefited from investors' and depositors' confidence that the government would bail them out because of their size and therefore represented lower risk. Banks with over \$100 billion in assets were normally able to raise capital much more cheaply than their competitors. In practice, SIFI status has entrenched this advantage, and even extended it to more big banks because of the lower formal threshold of \$50 billion. As a result, banks with

more than \$100 billion in assets, like Bank of New York Mellon, have been able to enjoy the advantages of easier money.

Dodd-Frank proponents have argued that the OLA offers a way to liquidate insolvent banks in an orderly fashion. Yet liquidation is only one of a range of options for dealing with a SIFI in trouble, and is likely a last result. Federal Deposit Insurance Corporation (FDIC) Chairman Martin Gruenberg has stated that his preferred solution is to create a “bridge” company, with the government placing the existing company in receivership and transferring its assets to a new company set up by the FDIC, which would presumably include most of the senior staff of the old company as well.¹³ This system replaces the transparency of the regular bankruptcy process with a shadowy regime that empowers regulators and interested stakeholders, including other SIFIs.

“That’s Where the Money Is.” While the costs of this operation will not be paid for by the Treasury, the rest of us will still pay for this process. Here is how.

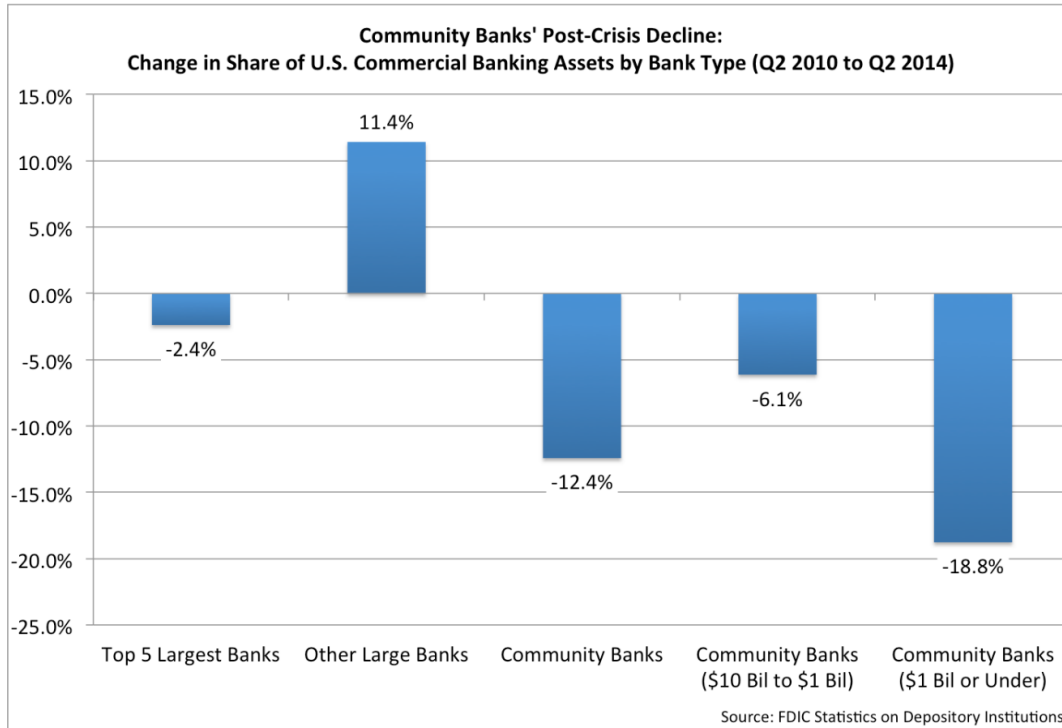
The FSOC’s SIFI designation authority is not restricted to big banks, but encompasses any large financial institution, including large insurance companies. AIG, GE Capital, Prudential, and MetLife have been designated SIFIs (MetLife is challenging its designation in court). Insurers—with the exception of AIG, whose London office had diversified into credit default swaps on subprime loans—had nothing to do with the crisis. In fact, their business model is predicated on accurately assessing payout risk (AIG was an outlier for having deviated from this model). They have proved exceptionally stable over the years, with lifespans far exceeding most banks. They are not particularly interconnected with other financial firms, and are at very low risk of presenting a systemic risk to the financial system.

Why then is the FSOC designating them as SIFIs? As Willie Sutton put it, “because that’s where the money is.” The Orderly Liquidation Fund, established by Dodd-Frank to pay for activities authorized under the OLA and run by the FDIC, is capitalized by fees levied on SIFIs. Insurers have large amounts of low-risk assets that make for an attractive pool of money. So in the event of an orderly liquidation, anyone with an insurance policy will pay for the process. An April 2013 study by the consultancy Oliver Wyman found that the OLA would raise consumers’ aggregate life insurance premiums from \$3 billion to \$8 billion a year, with the bulk affecting retirees, who will see their incomes drop.¹⁴

Unintended Consequences. The regulations imposed by SIFI designation also create perverse incentives for insurers, as it signals that the FDIC will not allow the institution to fail. That could increase insurance firms’ willingness to tolerate risk, thus making them less stable—and making their SIFI designation a self-fulfilling prophecy.

It is, however, small and community banks—Main Street banks—that are suffering the most from Dodd-Frank. Large banks can absorb the costs of burdensome new regulations. They have large compliance departments, and can meet new challenges by making them larger. Smaller banks, however, only have a few compliance staffers. With millions of new words of regulation to deal with, they face a crushing new work load. “Big banks have armies of lobbyists, lawyers, consultants, and compliance staffers, without denting the banks’

profitability,” says Jim Purcell, Chairman and CEO of State National Bank in Big Spring, Texas. “Community banks, by contrast, lack those resources, and every extra dollar of compliance costs is one less dollar to spend on customer service, one more dollar of cost that ultimately must be passed through to customers.”¹⁵



Source: Lux and Greene, 2015

Small banks facing these new pressures have three options:

- 1) Increase their compliance departments and pass the costs on to their customers.
- 2) Close.¹⁶
- 3) Merge with other banks to be able to afford a large compliance department.

Two thousand community banks and credit unions have closed or merged since 2010. A recent Harvard study found that the rate of decline in community banks as a proportion of the U.S. banking system has doubled since 2010, and that “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

Finance Not for the People. Even those Main Street banks that are surviving are facing problems and reducing services. A February 2015 Mercatus Center study found that many such banks have stopped offering home mortgages, home equity lines of credit, overdraft protection, or credit cards.¹⁸ Thanks to the CFPB’s qualified mortgage rule, community bankers can no longer based their loan decisions on what they know about the applicant and instead have to qualify applicants based around a host of consumer “protections” that have caused banks to withdraw from the market altogether. As a result, customers have found

their banking choices severely restricted. “Every dollar spent on regulatory compliance means as many as 10 fewer dollars available for creditworthy borrowers,” James Hamby, president and CEO of Vision Bank in Ada, Oklahoma, told the House Oversight Committee in 2012. “Less credit in turn means businesses can’t grow and create new jobs. As a result, local economies suffer, and the national economy suffers along with them.”¹⁹

Other restrictions introduced by Dodd-Frank have compounded the problem. The Durbin Amendment’s caps on the “swipe fees” charged to merchants for use of debit card payment networks have significantly increased the cost of providing debit cards to customers. While the Durbin Amendment exempted credit cards and small banks, large, SIFI-designated banks—including Bank of America, JP Morgan Chase, and Wells Fargo—issue a huge share of payment cards in the U.S.

Merchants, particularly large retailers, lobbied for this change for years, bristling at the reduced profit they faced when customers chose the convenience of a card compared to cash or check (the Federal Reserve’s check clearing system is free of charge). Their fees were reduced from 44 cents to 24 cents per swipe on average, resulting in \$7.3 billion windfall to merchants. Retail industry groups claim the savings were passed on to consumers. However, David Evans of the University of Chicago Law School and colleagues estimate that only about half of the savings reached consumers, while all of the reduced profits faced by the banks were passed through to their customers in the form of higher fees, resulting in a net present cost to the economy of around \$25 billion.²⁰

The effect on bank customers has been subtle but visible. The number of free checking accounts decreased considerably, with the number of banks offering free checking halving after the passage of the Durbin Amendment (one of the few bright spots for small banks was their ability to increase free checking because of their exemption from the cap). The average minimum monthly holding requirement for no-fee banking tripled from \$250 to \$750. Average monthly fees doubled.²¹

The most pernicious effect of these fee increases is that the banking system became too expensive for about a million people—largely from the poorest sectors of society—who have turned to alternative financial services, including prepaid debit cards (subject to the 800-page rule mentioned above), payday lenders, and check cashing shops.²²

It is not just the poor in America who have suffered from Dodd-Frank. In Africa, Dodd Frank’s conflict minerals provision has badly hurt the economy of eastern Congo, where it has “brought about a de facto embargo on the minerals mined in the region, including tin, tungsten and the tantalum that is essential for making cellphones,” according to freelance reporter David Aronson. As early as 2011, he called the law a “catastrophe” in *The New York Times* because it cut off the region’s sole supply of income that could lift people above subsistence level.²³

The U.S. Court of Appeals for the District of Columbia Circuit struck down large parts of the provision in April 2014 as unconstitutional restrictions on speech and going beyond the remit of the Securities Exchange Commission. Yet, its effects are still being felt. The

Congolese government shut down most of the mines and has begun certifying minerals as “conflict-free,” but as *The Washington Post* reported last December, its progress has been “glacial.”²⁴

Constitutionally Dubious. Dodd-Frank’s conflict minerals provision may not be the last one to be struck down as unconstitutional. The CFPB’s very design raises significant constitutional questions. The American system is based on checks and balances, with power dispersed among the executive, legislature, and courts. Executive agencies, including independent ones, operate with the consent of Congress and the courts, but the CFPB is largely free from these constraints.

Congress exercises no “power of the purse” over the CFPB, because the agency’s budget comes from the Federal Reserve, amounting to approximately \$600 million that Congress cannot touch or regulate.²⁵ The president cannot remove the CFPB director—an executive branch official—except under limited circumstances, such as malfeasance. And judicial review of the CFPB’s actions is limited, because Dodd-Frank requires courts to give extra deference to the CFPB’s legal interpretations.

The roles of the Federal Stability Oversight Council and Orderly Liquidation Authority are equally problematic. The OLA gives the Treasury Secretary the power to liquidate any financial company as long as the FDIC and the Fed are in agreement, and enables the FSOC to suspend bankruptcy laws, as described above. This puts investors and shareholders in jeopardy based on the whim of bureaucrats.

These problems form the basis of a lawsuit challenging the constitutionality of the CFPB and FSOC brought by the Competitive Enterprise Institute, the 60 Plus Association, the State National Bank of Big Spring, and 12 state attorneys general concerned about the safety of their states’ pension investments. (The lawsuit was dismissed for lack of standing in 2013, but it is currently in the appeals process.)

Meanwhile, the CFPB has issued a study condemning mandatory arbitration clauses that enable financial firms to extend credit to consumers that would otherwise pose too great a risk.²⁶ Relying on a discredited study by the Center for Responsible Lending that alleged racial discrimination in automobile financing,²⁷ the CFPB has also asserted the power to regulate nonbank lenders.²⁸

The Bureau is also preparing a rule regulating payday lenders—with little evidence they cause real harm worthy of regulation.²⁹ In fact, the majority of studies about the effects of payday lending show no evidence that they trap borrowers in a harmful cycle of debt.³⁰ Kennesaw State University Statistics Professor Jennifer Priestley cites “a growing body of literature which shows that payday loans may not only fail to harm borrowers, but may actually contribute to an improvement in borrower welfare.”³¹ The CFPB has ignored these studies and issued its own studies justifying its rulemaking.³²

Conclusion. Many of the rules issued under Dodd-Frank have harmed some of the poorest Americans, who have seen their insurance made more expensive, their banking choices

reduced, and their bank fees increased. Many have been forced out of the banking system altogether, only to face the alternatives, such as prepaid debit cards and payday loans, more difficult to access. When legal choices are restricted, people turn to illegal ones. Loans sharks and racketeers could soon make a comeback, thanks to Dodd-Frank's "consumer protection" provisions.

None of this is to deny the good intentions of the bill's authors and the staff of the CFPB, but as C.S. Lewis put it in *God in the Dock*:

Of all tyrannies, a tyranny sincerely exercised for the good of its victims may be the most oppressive. It would be better to live under robber barons than under omnipotent moral busybodies. The robber baron's cruelty may sometimes sleep, his cupidity may at some point be satiated; but those who torment us for our own good will torment us without end for they do so with the approval of their own conscience.³³

In the meantime, the bankers of Wall Street can sleep easy knowing that they can raise capital more cheaply thanks to their SIFI designation, and regulators know that a good, high-paying job awaits them in compliance departments there.

Notes

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