

# Banking *and* Finance



**FREE to PROSPER**  
*A Pro-Growth Agenda for  
the 115th Congress*



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# Banking and Finance

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Access to capital is fundamental to the operation of a free society. It allows for the foundation, expansion, and smooth running of the private enterprises that make up the market 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 the financial 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 most 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. A multitude of other 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, 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. Instead, it doubled down on the bank regulatory regime that failed to prevent the financial crisis. In fact, Dodd-Frank regulates such extraneous issues as debit card interchange fees and accounting for conflict minerals that had nothing to do with the crisis.

Dodd-Frank was intended to address the problem of “too big to fail.” It has failed to do so. The big banks are even more dominant than before the crisis, and the vastly increased regulatory burden imposed on smaller banks has led many of them to merge to create bigger banks that are able to withstand the increased regulatory costs. Some have even closed. Wall Street was targeted, but Main Street was hit.

Worse, banking regulators have abused their authority to crack down on legal businesses that regulators find distasteful.

This overregulation has made banks wary of lending to people without perfect credit or to small businesses and startups. These groups have turned to alternative sources of funds, but they are finding those attacked by regulators as well.

Even worse yet, Dodd-Frank created an unconstitutional and overly powerful regulator, the Consumer Financial Protection Bureau (CFPB), which lacks proper checks and balances.

Congress must rein in these regulators and pass laws that will 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 would:

- ◆ Assist in capital formation by allowing banks to swap less stringent regulation for holding more capital;
- ◆ Reduce the regulatory burden and make regulators accountable by reforming the Federal Reserve, the CFPB, and other regulators, while allowing meaningful relief from regulation for smaller institutions; and
- ◆ 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” under Dodd-Frank.

Further reforms will be needed, including legislation to allow financial technology firms, known as FinTech, to pursue innovation in financial services without having to deal with the regulatory burdens of banks. An amended Fix Crowdfunding Act and other pieces of legislation described in detail in this section could help achieve those objectives.

## BRING ACCOUNTABILITY TO THE UNACCOUNTABLE CONSUMER FINANCIAL PROTECTION BUREAU

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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, the CFPB has far more power than the CPSC, as it was deliberately constructed to operate free from the traditional checks and balances of an independent agency. As a result, it is not accountable to Congress, the President, the courts, or the people in general.

Congress exercises no “power of the purse” over the CFPB, because the agency’s budget—administered essentially by one person—comes from the Federal Reserve, amounting to approximately \$400 million that Congress cannot touch or regulate. The president cannot carry out his or her constitutional obligation to “take care that the laws be faithfully executed” because the president cannot remove the CFPB director except under limited circumstances. Dodd-Frank imposes a “for cause” standard for removal of the CFPB head. While this is normal for most independent agencies, the CFPB is unprecedented because it is headed by a single director, rather than by the multimember commissions that generally run independent agencies. Moreover, it draws its budget from the Federal Reserve, thus eliminating congressional oversight, and is subject to reduced judicial oversight because Dodd-Frank requires the courts to give extra deference to its legal interpretations. However, on October 11 a federal circuit court held that the CFPB’s for-cause removal standard is unconstitutional because it makes the director unaccountable to the President.

### **Congress should:**

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- ◆ Pass the Financial CHOICE Act or at least the section of the Act that deals with the CFPB.
- ◆ Pass motions expressing its sense that the CFPB is unconstitutional in its current form, regardless of whether the court ruling that that made the CFPB director removable at will by the President is upheld.
- ◆ Pass Congressional Review Act resolutions of disapproval of the arbitration and short-term lending rules early in the new session.

The Financial CHOICE Act contains provisions that would restructure the CFPB as a traditional independent agency. It would change its mandate to provide for both consumer protection and competitive markets, to establish it as a five-member commission, and to appoint an independent inspector general.

Examples of the CFPB's abuse of power include its rules to limit the use of mandatory arbitration clauses in financial contracts and to severely restrict the terms of short-term and small-dollar loans. Those rules will increase the costs of financial contracts and loans, leading to less availability of credit to individuals who need it.

Experts: John Berlau, Iain Murray

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## OPPOSE REGULATORY OVERREACH IN FINANCIAL SERVICES

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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 rates of closure and merger have doubled since the Act was passed. Only two new banks have been authorized during the past six years. The result is a lack of choice for consumers and a loss of the personal connection between banker and customer that should have been strengthened after the financial crisis.

Financial technology (FinTech) firms have helped fill that void, but they are limited in the credit choices they can offer consumers. Unlike banks, which can be federally chartered, nonbank FinTech lenders must incorporate in their home states. As a result, FinTech lenders cannot lend to customers in other states at the same interest rates that they lend to their in-state customers if the borrower's state caps the interest at a lower amount. That restriction limits consumer choices, including the choice to get a loan at an interest rate lower than that of a federally chartered bank.

Moreover, 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 refused to hear *Madden v. Midland Funding*, in which the Second Circuit Court of Appeals reversed a century of “valid when made” precedent, when the Circuit Court decided that a New York State usury cap was applied to a loan that a debt collector had bought from North Carolina-based Bank of America. That ruling created massive uncertainty in the lending market that could devastate FinTech innovations, such as peer-to-peer lending.

Banking regulators have also felt empowered to go beyond their strict remit. Under a Department of Justice–led initiative called Operation Choke Point, regulators have threatened to crack down on banks that provide financial services to legal businesses that regulators simply do not like, including payday lenders, gun dealers, fireworks stores, and adult entertainment. Many of those businesses have found themselves without access to payment or banking services, despite their not having committed any crime.

### **Congress should:**

- ◆ Pass the Protecting Consumers' Access to Credit Act, sponsored by Rep. Patrick McHenry (R-N.C.) in the previous Congress, to explicitly make the "valid when made" doctrine the law of the land.
- ◆ Pass the Consumer Credit Access, Innovation, and Modernization Act, previously cosponsored by Reps. Blaine Luetkemeyer (R-Mo.) and Gregory Meeks (D-N.Y.), to create a system of optional federal charters for nonbank finance companies that would give them the same right as banks to export interest rates to out-of-state consumers.
- ◆ Pass the Financial Institutions Consumer Protection Act, sponsored in the previous Congress by Rep. Blaine Luetkemeyer (R-Mo.) and Sens. Ted Cruz (R-Tex.) and Mike Lee (R-Utah), to curb the abuses of existing law that allowed Operation Choke Point. Specifically, it would stop regulators from (a) terminating bank accounts without reason and (b) threatening banks with subpoenas.
- ◆ Repeal the Durbin Amendment, which imposes caps on interchange fees for payment cards that have led to fewer financial service offerings for bank customers.

Finally, the Dodd-Frank Act gave the Federal Reserve the power to impose a price cap on interchange fees, which are part of the fees banks charge merchants when a customer uses the bank's debit card to purchase something from them. Interchange fees had nothing to do with the financial crisis, but the cap was included in the Act at the last minute in "the Durbin Amendment," named after its sponsor, Illinois Senator Dick Durbin. The rationale was that merchants would pass along the cost savings to customers. But research has shown that those cost savings never materialized; instead, banks passed along the loss of revenue to all customers in the form of higher fees. As a result, the Federal Reserve's price controls have led to 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

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## ALLOW FINANCIAL SERVICE PROVIDERS TO OFFER CONSUMERS INNOVATIVE NEW SERVICES THROUGH THE GROWTH OF FINTECH AND CROWDFUNDING

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The advent of “sharing economy” platforms like 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, new financial service providers face a number of antiquated rules that keep their innovations from growing or even getting off the ground.

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

The Jumpstart Our Business Startups (JOBS) Act attempted to change that situation, and it has had much success in allowing entrepreneurs more freedom to solicit and advertise to “accredited investors”—those with \$1 million in assets or earnings of \$200,000 a year. The growth of portals that match entrepreneurs with those wealthy investors, such as CircleUp and Israel-based OurCrowd, has exploded.

But unfortunately, after much delay, the JOBS Act provisions recently implemented by the Securities and Exchange Commission (SEC) to allow equity crowdfunding from ordinary investors fell woefully short of their stated goal. Although the rules exempt small public companies from some onerous mandates of the Sarbanes-Oxley and Dodd-Frank financial regulation laws, they contain their own thicket of new red tape. And 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.

Peer-to-peer lending has expanded credit options for consumers and small businesses. But it is also 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, ordinary investors make almost no peer-to-peer loans to small businesses.

### **Congress should:**

- ◆ Build on the JOBS 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. These provisions were contained in the original Fix Crowdfunding Act, sponsored by Rep. Patrick McHenry (R-N.C.) in 2016. Unfortunately, they were dropped in order for the bill to get strong bipartisan support in the House.
- ◆ Allow special-purpose acquisition companies, in which lead investors negotiate on behalf of others, to use crowdfunding for ordinary investors. It is a preferred investing method among angel investors and venture capitalists and would likely benefit ordinary investors as well. This provision stayed in the Fix Crowdfunding Act that was overwhelmingly approved by the House in 2016.
- ◆ Expand the “accredited investor” definition beyond the wealth threshold to include those who have proved their sophistication in other ways, such as passing exams for financial advisers and brokers. This action would be accomplished by the Fair Investment Opportunities for Professional Experts Act that passed the House with a strong bipartisan vote in 2016.
- ◆ Strip the SEC’s 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 cybercurrency from overregulation.
- ◆ Repeal the Durbin Amendment. Short of that, make sure it applies only to physical debit cards and not to electronic methods of payment.
- ◆ Repeal the Department of Labor’s “fiduciary rule,” which limits choices and raises costs for retirement saving in Individual Retirement Accounts and 401(k) plans.

The SEC is one of several regulatory agencies vying—or being pushed—to regulate Bitcoin, a new form of cybercurrency that offers substantial benefits, from currency hedging to faster payments. Such new payment technologies may also be stifled by Dodd-Frank’s Durbin Amendment, which controls the fees that debit card issuers can charge retailers from 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, some consumers and providers will always value personalized service. Whether to use automated or personal service should be a choice rather than a mandate. Unfortunately, the Department of Labor’s “fiduciary rule”—which mandates that financial professionals serve savers’ “best interests” as the DOL paternalistically defines those interests—will impose so many costly mandates on brokers and insurance agents who help with retirement savings that they may no longer be able to work with middle-income and low-income savers. Those savers will be stuck with untested “robo-advice” because of this flawed regulation.

Experts: John Berlau, Iain Murray

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## ADDRESS TOO-BIG-TO-FAIL

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The Dodd-Frank “financial reform” law, rammed through Congress in 2010, was supposed to protect taxpayers against the prospect of future bailouts by ending the phenomenon of “too big to fail.” Yet many of its provisions enshrine too-big-to-fail and potential bailouts.

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

The Financial Stability Oversight Council (FSOC), a secretive bureaucracy created by Dodd-Frank, designates firms as SIFIs through an arbitrary process. Some firms embrace their SIFI designation, whereas others fight it because of the added regulation it entails. MetLife has successfully challenged its SIFI designation in federal court, but the FSOC is appealing.

In spite of these actions, the government-sponsored enterprises (GSEs) 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 since 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.

Under the Third Amendment to the GSEs’ senior preferred state purchase agreements, implemented by the Obama administration in 2012, the government confiscates any profit the GSEs make—even after they have paid the government back. That action leaves the GSEs with no capital reserves, making them vulnerable to even the slightest hiccup in the economy. 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. 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 home buyers.

### **Congress should:**

- ◆ End the Financial Stability Oversight Council's exemption from the Freedom of Information Act and mandate that its meetings be open to the public.
- ◆ Repeal the FSOC's power to designate firms as too-big-to-fail SIFIs under Dodd-Frank. The Financial Choice Act would accomplish that objective. Short of that, grant both designated firms and their competitors express avenues to challenge a SIFI designation in court.
- ◆ Phase out Fannie and Freddie, and do not replace them. That phaseout can be done through the method laid out in the Protect American Homeowners and Taxpayers (PATH) Act, in which the GSEs sell off parts of their portfolios every year until they are completely liquidated. It 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.
- ◆ Until Fannie and Freddie are phased out, end the Third Amendment profit sweep and ensure that they maintain adequate capital. The Housing Finance Restructuring Act of 2016, introduced in the House by Rep. Mick Mulvaney (R-S.C.) in the last Congress, 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.
- ◆ 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.

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 as 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.

Also, innovative new entrants should be allowed to bring new competition into the financial services industry. Since the passage of Dodd-Frank in 2010, federal regula-

tors have allowed only two new banks to open for business. And well-managed non-financial 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 these restrictions to entry. For example, in Great Britain the retail giant Tesco runs one of the country's largest banks. 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

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