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Will (Should) Dodd-Frank Survive?

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Abstract: Despite the fact that it grew out of a financial crisis, the Dodd-Frank Act was not the result of a bipartisan consensus. It received no Republican votes in the House of Representatives and only three Republican votes in the Senate. There are repeated statements by Republicans that they would like to repeal the act if they had the opportunity. One of the reasons for Republican opposition is the fact that the act seemed to be a regulatory overreach not warranted by the circumstances. There was a financial crisis, to be sure, but there were many indications that it was the result of U.S. government housing policies and not a lack of regulation. While repeal seems far-fetched at the moment, if the Republicans hold the House and take control of the Senate in 2012, significant modifications in the act are not out of the question. There are good reasons for substantial modification. The act authorizes a Financial Stability Oversight Council—an organization made up largely of the principal federal financial regulators—to designate certain companies as “systemically important” because their financial distress might cause instability in the U.S. economy. Once this designation is made, these companies are to be regulated and supervised by the Federal Reserve giving that agency enormous power over their capital, liquidity, leverage and activities, and setting up the possibility of a partnership between the Fed and the largest financial institutions in the U.S. In addition, because they have been designated as too big to fail, these companies will have advantages over smaller competitors in obtaining credit, and could drive smaller competitors out of business over time. The act’s restriction on proprietary trading will weaken banking organizations by depriving them of another source of revenue. Finally, the Consumer Financial Protection Bureau has been established in the Fed, but has been made independent of the Fed, the President and Congress, raising questions about its conformity with the normal constitutional scheme.

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA)¹ was signed into law on July 21, 2010, under unusual circumstances and on an unusually partisan basis. It followed, and was a reaction to, the most serious financial crisis since the Panic of 1907 and the Great Depression of the 1930s, and was the work product of the heavily Democratic Congress elected in 2008. Many in that Congress entered office believing that they would have an opportunity—in the words of Barney Frank, the chair of the House Financial Services Committee—to enact a “New New Deal.” In the end, they fell short of anything that ambitious, but in both health care legislation and the DFA, 111th Congress was able—with the active help of the Obama administration—to enact far-reaching legislation. Indeed, one way to look at the Dodd-Frank Act is that it was ObamaCare for the financial industry; like ObamaCare, it left the firms in the affected industry largely intact as private shareholder-owned enterprises but attempted to reduce their autonomy as independent economic actors through stringent regulation.

Despite the fact that it grew out of a financial crisis, the DFA did not receive the bipartisan support that usually follows national crises. It got no Republican votes in the House of Representatives, and only the bare minimum of three Republican votes in the Senate necessary to achieve cloture and take the legislation to a vote. In other words, the Republicans have little or no stake in the DFA, just as they have no stake in ObamaCare. And although few if any Republicans ran for office in 2010 on a platform of repealing the DFA, they exhibit the same antipathy to the DFA as they do with respect to ObamaCare. Since the Republicans will probably retain control of the House in 2012, and seem likely to take the control of the Senate, there is a real possibility that legislation substantially modifying or even repealing the DFA could be adopted in the House before the election of 2012, and in both houses of Congress after 2012. Of

¹ Pub.L. 111-203, H.R. 4173.

course, if President Obama is re-elected in 2012 the likelihood of outright repeal is slim, although major provisions of the law could be modified.

Even now, in their budget cutting efforts, Republicans in the House are denying additional funds to the regulatory agencies that have the heaviest regulatory burdens under the DFA. *Politico* reported on February 18, 2011, “GOP Works to Slow Dodd-Frank to a Halt,”² quoting Senate Banking Committee ranking member, Richard Shelby “A lot of us voted against and opposed Dodd-Frank. Obviously we’d repeal it. So I certainly don’t think we should rush to implement it.” In votes in February 2011, for example, the House cut the Securities and Exchange Commission \$25 million below its 2010 level and about \$200 million below what the President requested for 2011, even though the SEC must propose and adopt at least 70 new regulations under the DFA. An amendment by Barney Frank that would have moved \$131 million from Treasury and other agencies to the SEC was voted down. The cuts at the Commodity Futures Trading Commission, which is required to implement extensive new rules on derivatives, were even more substantial. That agency was cut \$57 million below the 2010 level of \$168 million (and well below the \$308 million the president suggested for 2011). It seems clear that the House, at least, is as eager to defund the regulatory agencies that have to implement Dodd-Frank as it is to defund ObamaCare. If this is a strategy, it is aimed at slowing the implementation of Dodd-Frank to the point where it will not have been fully implemented until after the 2012 elections, leaving it more vulnerable to repeal.

Although the idea of repeal seems far-fetched at this point, especially because of the public’s continuing view that the financial crisis was caused by the Wall Street banks, attitudinal changes with political consequences can change quickly in the electorate. Although today any

² Meredith Shiner, “GOP Tries to Slash Wall Street Law,” *Politico*, February 18, 2011: 1.

effort to repeal many of the restrictions that the DFA imposes on the financial industry—and particularly the banks—would be presented as a Republican effort to help their friends on Wall Street, this may not be immutable. If little progress is made by the administration in reducing unemployment between now and the election of 2012, voters may come to accept the Republican argument that the slow economic recovery is a result of the restrictions imposed by the DFA on the financial industry. This argument will be augmented if it appears that many financial services jobs are moving out of the U.S. because of DFA restrictions.

Other arguments focus on the uncertainties created by the fact that the act sets only broad standards and leaves much of the substantive decision-making to regulators and regulation. In this connection, Alan Greenspan argues in a recently released paper³ that the recovery is particularly slow because uncertainties about regulation and economic growth have reduced the willingness of corporate managements to make long-term fixed investments in plant and equipment. In other recoveries, according to the paper, reluctance to invest for the long term was not apparent at this point. If this idea gains currency among economists, it will support the position of Republicans that the DFA should be substantially cut back or even repealed as a way to restore economic growth.

Finally, there is another wild card in the Republicans' deck. The DFA was based on the assumption that the financial crisis was caused by lack of regulation, poor risk management, predatory lending and Wall Street greed. The act was pushed through Congress almost as emergency legislation necessary to prevent another financial crisis. However, there is a substantial argument that the financial crisis of 2008 was not caused by a lack of regulation or weak risk management, let alone predatory lending, but by the housing policies of the U.S.

³ Alan Greenspan, "Activism," *International Finance*, 2011.

government. These policies fostered the creation of 27 million subprime and other weak loans—half of all mortgages in the U.S.⁴ When the massive 10-year housing bubble began to deflate in 2007, these weak and risky mortgages began to default in unprecedented numbers, causing the collapse of the mortgage-backed securities market and weakening all the major financial institutions around the world that were holding these securities. With investors worried about the condition of all these large firms, the bankruptcy of Lehman Brothers set off a financial panic in which the world’s largest financial institutions hoarded their cash and refused for a time to lend to one another. If this description of the causes of the 2008 financial crisis ever becomes widely accepted, the legitimacy of the DFA would be significantly undercut.

These are the reasons that the DFA, in its current form, may not survive a Republican Congress in 2012. The balance of this paper will discuss why the DFA, as a matter of good policy, *should* not survive.

Regulation to Prevent “Instability”

The DFA is by far the most comprehensive piece of financial regulation ever adopted in the United States. As I will outline in the discussion below, it provides completely unfettered discretionary power to financial regulators, and particularly the Federal Reserve. Although the Fed has been a regulator and supervisor of banks for almost a century, and of bank holding companies (BHCs) for more than 50 years, the DFA is likely to make the Fed the regulator of all the largest nonbank financial firms in the U.S. economy—insurers, securities firms, financial holding companies, finance companies, hedge funds and perhaps others. No agency has ever had this range of authority. Moreover, the DFA requires the Fed to regulate these institutions “more

⁴ See, e.g., Peter J. Wallison, *Dissent from the Majority Report of the Financial Crisis Inquiry Commission*, <http://www.aei.org/paper/100190>.

stringently” than banks or BHCs are currently regulated, but supplies no restraints on the scope of these powers. In effect, as I will describe, the Fed is authorized to do “whatever it takes” to achieve the one thing that is indisputably the singular goal of the DFA: stability in the U.S. financial system. All other goals—economic growth, innovation, efficiency, diversity—are subordinated to the achievement of stability.

In order to achieve this objective, the act creates a Financial Stability Oversight Council (FSOC), made up of all the federal financial regulators and chaired by the secretary of the Treasury. The FSOC is authorized to determine which financial institutions “because of their *material financial distress*... or the nature, scope, size, scale, concentration, interconnectedness, or *mix of [their] activities*... could pose a threat to the financial stability of the United States.”⁵ [emphasis supplied]. Once these firms—called “systemically important financial institutions” (SIFIs)—have been identified by the FSOC, they are turned over for supervision and regulation by the Federal Reserve. It’s easy to see that the standards Congress has laid out in this case—“material financial distress” or a “mix of activities” that might lead to “financial instability”—are highly discretionary, and could mean almost anything. They do not impose any significant restriction on the range of action available to the FSOC.

Both standards for identifying SIFIs—“material financial distress” and “mix of activities”—have far-reaching implications. It is very difficult—indeed, probably impossible—to determine in advance which companies might cause instability in the economy as a result of their material financial distress. Clearly, it would depend on market conditions and particularly the financial condition of other firms at the time. Lehman’s failure, for example, would not have

⁵ *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010), Section 113.

caused a financial panic if all the other major firms in the financial markets at the time were seen as healthy. Nevertheless, Congress required the FSOC to draw the line somewhere, and it is likely that the FSOC will prefer to err on the side of inclusivity rather than exclusivity. It would be embarrassing, after all, to leave out of the SIFI category a firm that later causes financial instability because of its financial distress.

The “mix of business” standard is somewhat easier to understand, but it is far more consequential for all companies, not just those initially identified as SIFIs. In effect, this standard allows the FSOC to require companies of any size to divest activities that the council considers risky or otherwise a potential source of instability, whatever that may mean. This is another extraordinary power—in effect the ability to shape the financial system in any way it wants by prohibiting some kinds of companies from engaging in activities in competition with others. For example, the FSOC might determine that it is a potential source of instability if an insurance holding company owns a retailer, or if a securities firm engages in commercial lending. Rulings of this kind could apply to companies of all sizes, and not just those that have previously been designated as SIFIs. Small companies that do not to divest certain activities could be placed under the supervision of the Fed because of their mix of activities and subjected to the stringent regulation that the DFA requires for SIFIs. Few companies would be willing to make this trade.

The criteria that the FSOC will use to make its determination were recently set out in a notice of proposed rulemaking and largely follow the standards set out in the DFA for determining when a company is a SIFI. These are “size, lack of substitutes for the financial

services and products the company provides, interconnectedness with other financial firms, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny.”⁶

Clearly, vague standards like this mean that the DFA’s standard for making the important decision about whether to regulate a particular nonbank financial firm is so flexible as to be indistinguishable from complete discretion. Although the DFA itself sets a kind of standard for size by requiring that all bank holding companies (BHCs) that have assets of more than \$50 billion are automatically included as SIFIs, the many other criteria the FSOC is to take into account are highly discretionary; the FSOC may add nonbank SIFIs to the list for any number of other reasons listed above, or for reasons it might add in the future. Firms in this group are then subject to regulation and supervision by the Federal Reserve under a “more stringent” standard than that required for ordinary BHCs that are not considered to be threats to financial stability.

Preliminary analyses that have been leaked from the FSOC staff suggest that the standard for identifying SIFIs will be inclusive. For example, an article in Bloomberg on February 17, 2011, based on a confidential preliminary report by the FSOC, noted that, as to insurers, “a big company’s failure could ‘reduce overall investor sentiment...Insurance itself is essential for many day-to-day activities...A sector-wide crisis may have an adverse macroeconomic effect due to its role in the general conduct of economic activity.’”⁷ Reasoning like this—assuming worst-case scenarios—will certainly produce more coverage of insurance companies than their past history would warrant. It is also likely that the Fed, which will bear most of the responsibility for regulation of SIFIs, is likely to be influential in the selection of these

⁶ Financial Stability Oversight Council, Notice of Proposed Rulemaking, “Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies,” 12 CFR Part 1310: 19-20.

⁷ Rebecca Christie and Ian Katz, “Hedge Funds May Pose Systemic Risk in Crisis, U.S. Report Says” *Bloomberg News*, February 17, 2011.

companies, and to prefer more rather than fewer selections. Not only will this give the agency more power, but it will also insulate the Fed from criticism if a financial institution not previously designated as a SIFI and subjected to Fed supervisory authority should become financially distressed and cause instability in the U.S. financial system. Similar approaches listed in the Bloomberg report suggest that private-equity firms and hedge funds could also be systemically important. Finally, since most of these institutions—insurance companies, securities firms, finance companies, and hedge funds—are not regulated for safety and soundness by any agency at the federal level, there is no reason for the FSOC to object on turf grounds to the Fed’s request for greater regulatory reach.

The unprecedented nature of this authority is important to understand. Not only will the Fed, through the FSOC, have the power to determine the scope of its own authority, but that authority is not limited by the rationale for imposing it. Banks, for example, are regulated for safety and soundness because government insurance for their deposits creates moral hazard—that is, depositors do not care what risks banks are taking because their deposits are insured. (It is not really clear why BHCs are regulated—they are not government-backed—but at least one can say that they have an intimate relationship to the insured banks they control.) Extending the same regulation to firms that are not in any way backed by the government, only because their activities or failure or activities *might* be a source of instability, is something entirely new. If government regulation and supervision do not create moral hazard directly—and they probably do—they certainly imply that the government has an interest in the activities of these companies that has never before been legally recognized. We are embarking, therefore, on an entirely new path, not a mere extension of what has gone before.

Although it has not received as much attention as other aspects of the DFA, this may be the most troubling provision of this troubling act. To put it plainly, this provision alone has the potential to change the entire nature of our financial system. Once given supervisory power over a financial institution, the Fed can control its capital, liquidity, leverage, and activities, and with this authority can strongly influence the business decisions these firms will make. The focus for these SIFIs will inevitably change from how they can beat their competition to how they can gain the Fed's approval for any new activity or prevent their competitors from entering a field they already occupy. The full-throated, aggressive competition that we are accustomed to in financial services will become a relic of the past. Our innovative financial industry, which has come to dominate the world, will be tamed—much to the gratification of our trading partners, but not of the American businesses and American consumers who benefited from this competition.

A Government/Financial Sector Partnership

But it gets worse. Can anyone imagine that one of these large financial institutions—securities firms, insurers, hedge funds, finance companies, and others—that will eventually come under the supervision of the Fed will ever be allowed to fail? It has already been determined that their failure will cause instability in the financial system, so we may be sure that every effort will be bent to be sure that they do not fail or suffer financial distress. A great deal of the debate about the act in Congress focused on preventing the Federal Deposit Insurance Corporation (FDIC)—the agency that was given authority to resolve one of these failed institutions if it should fail—from bailing out the managements, shareholders or creditors. Congress went to great lengths to close off all opportunities for the FDIC to bail out SIFIs if they fail. But this effort may have been directed at the wrong agency.

Imagine, for example, a large securities firm in the future that is regulated and supervised by the Fed. The firm has been mismanaged, despite Fed supervision (yes, it does happen, see Wachovia), and it is on its way to failure, an event that would of course be embarrassing for the Fed. The Fed, however, because of the DFA, has the power of life and death over all the major BHCs, insurance holding companies, and other large financial institutions. So the Fed chairman calls the chairman of one of these firms and suggests that it would be a good idea if that firm acquired the failing securities firm: “No, we can’t offer you any funding, of course, we don’t have authority to do that, but there are probably a few other acquisitions you might like to make in the future. . . .”

This is not farfetched. One need only recall how the Fed and Treasury forced Bank of America to eat Merrill Lynch after its due diligence had revealed the losses involved? Or how the New York Federal Reserve Bank—not even the regulator of many of the financial institutions it called together—arranged for the largest New York financial firms to provide life-saving financing for Long Term Capital Management, a hedge fund that the Fed thought might bring down the financial system if it failed. So all the debate about the FDIC’s bailout authority may have failed to consider the Fed’s ability to influence the actions of the firms it will be supervising. The real danger is that the Fed will implement “too big to fail” privately, outside public view, through its new powers under the DFA.

Sadly, this is just one example of the DFA’s deficiencies. Quietly covering up its own messes is one thing, but many other options are available to a financial supervisor that has so much power. Let’s imagine that the largest U.S. banks hold substantial amounts of another country’s debt. If the country fails to meet its obligations, the banks will be seriously weakened, with the possibility of financial instability in the United States. Worse, there could be—at least

this is the fear—an international financial crisis. The Treasury secretary (the chairman of the Oversight Council, incidentally) is quite concerned and calls the Fed chairman, who wants to be cooperative. The solution to the problem, for both the U.S. banks and the international financial system, is to find some buyers for the troubled country's debt. What we need, they agree, are some patient institutional investors with big portfolios, willing to take this country's debt and hold it for a while, bailing out the country and the U.S. banks at the same time—investors, for example, like those insurance holding companies or insurance companies that the Fed supervises. At some time in the future, of course, the insurance companies that had to take on this debt will suffer the consequences, but it can later be blamed on imprudent management. An example of exactly this is the blame cast on Fannie Mae and Freddie Mac for buying weak mortgages, when in fact they did so to comply with the government's affordable-housing requirements.

These examples can be multiplied endlessly. What we are talking about here is a governing system known as corporatism, in this case a partnership between the government and the largest financial institutions in the United States. In this partnership, the big companies are protected against failure but are willing—in fact, eager—to do what the government wants. When we hear the CEOs of large financial firms praising their relationship with the Fed, or the stability that the DFA will bring about, we will know that the partnership idea has taken hold. That is not the financial system we had before the DFA was enacted.

Moral Hazard and Too Big to Fail (TBTF)

Another very troubling consequence of the DFA is a vast increase in moral hazard. Giving the Fed authority to supervise and regulate all large financial institutions in the U.S. economy is only slightly worse than designating those financial institutions for special treatment

because they are likely to cause instability in the financial system if they suffer financial distress. This designation is an open admission that they are, in the common expression, too-big-to-fail (TBTF). Although it is said that large companies are lobbying intensely to avoid the SIFI designation because they fear the tougher regulation they will face from the Fed, this reminds me of the frenzied lobbying by cigarette companies to prevent “Smoking can cause your death” language on cigarette packs. As it turned out, the frightening language did not deter smokers, but it did provide a significant defense against lawsuits by the estates of cancer victims.

In the same way, designation as a SIFI is likely to be a huge competitive advantage for those so named. The reason is simple. Creditors will understand that lending to companies that are considered TBTF will be safer than lending to companies that might actually be allowed to go into bankruptcy. This will give SIFIs major credit-cost advantages over their smaller competitors. With a similar advantage—coming from the market’s belief that they would be rescued by the government in the event of failure (a prediction that of course proved accurate)—Fannie Mae and Freddie Mac were able to drive all competition out of the secondary market for the middle class mortgages they were allowed to buy.

This of course will distort and ultimately suppress competition in the U.S. economy, making it very difficult for smaller companies—even those with better managements—to overtake their larger rivals. It will have a particularly adverse effect on competition in the insurance field. There, companies that can claim they are TBTF—by virtue of a federal designation and special supervision by the Fed—will be able to sell their products more easily to consumers, retail and commercial alike. It will be hard to ignore the fact that an insurance contract with a company that is TBTF is far more likely to pay off in the event of a calamity than a contract with a smaller company that is regulated only at the state level and perhaps at most has

access to a state-based insurance backup system. It might even be possible for the largest insurers to charge a premium for their coverage as a result of designation as a SIFI.

On the other hand, some argue that the added regulatory costs of SIFIs will actually put them at a competitive disadvantage against smaller companies. This seems unlikely, but if true it raises even more serious problems. In that case, heavily regulated SIFIs will gradually be driven out of business against more nimble and lower cost competitors, bringing about the financial instability that the DFA was supposed to prevent. In other words, the only way this system works is if the new regulatory costs exactly balance the credit and capital advantages that SIFIs will gain from their identification as TBTF. That this might happen, of course, is highly implausible.

Stability as the Goal: the Volcker Rule

The structure and substantive elements of the DFA—and indeed all legislation—arise out of a combination of perceptions and ideology. The perceptions that guided the development of the DFA were that deregulation and a lack of regulation were largely responsible for the financial crisis. The underlying ideological notion, which both fed that perception and was driven by it, was that the unregulated market—because of unregulated risk taking—will always create financial crises of this kind. Of course, if we ignore the government’s role in creating the crisis, as outlined above, our search for causes necessarily narrows to the deficiencies of the market.

True, free markets take risks; it is in their nature. Risk taking in turn produces failure, disruption, and losses; it is supposed to, since the failures caused by risk-taking or incompetence take society’s assets out of the hands of bad managers and put them in the hands of good ones.

The economist Joseph Schumpeter taught us long ago that progress occurs through a process he

called “creative destruction.” The new and better supplants the old and inefficient. Innovation involves risk, as does entering new markets, cutting prices, investing for growth, and everything else that has brought material progress in the two centuries since the advent of the Industrial Revolution. As Raghuram G. Rajan observed in his recent book, *Fault Lines*, “We have to recognize that the only truly safe financial system is a system that does not take risks, that does not finance innovation or growth, that does not help draw people out of poverty, and that gives consumers little choice. . . . In the long run, though, that reinforces the incremental and thus the status quo.”⁸

The drafters of the DFA feared risk-taking, innovation, and change, and the act shows it. The best examples are the Volcker rule and the draconian restrictions that the Fed can impose on the SIFIs considered important because they might, under some circumstances, create instability in the U.S. financial system if they fail. Adopted with fear of instability in mind, all of these new restrictions will make it difficult for competition and risk taking to break out among banks, BHCs, and the large nonbank financial firms that will eventually fall under the Fed’s regulatory umbrella.

The Volcker rule prohibits any “banking entity”—which includes a bank, its BHC, and all subsidiaries of the bank and the BHC—from engaging in proprietary trading. Prop trading is the business of trading securities, loans, derivatives, or any other asset for the account of the banking entity itself and not as a service for customers. The fact that the restriction applies to the BHC and all BHC subsidiaries shows the extreme risk-aversion that animated this provision. First, there is no indication that prop trading had anything to do with the financial crisis; in fact,

⁸ Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton, NJ: Princeton University Press, 2010): 19.

it is one of the activities that added significantly to the much-needed revenues and profits of the beleaguered banking system during the past few years. Second, because the BHC and the BHC's subsidiaries do not take deposits and have only very limited access to loans or other financing from the bank itself, a case cannot be made that the depositors' funds or the government's deposit insurance was being used to take substantial risks. Third, there is a very fine line between banks trading instruments that they no longer want to hold, or trading instruments that they use for hedging purposes, and the kind of proprietary trading that the Volcker rule seeks to prevent. Creating a rule that prevents prop trading may make it difficult for banks to engage in trading activities that contribute directly to their safety and soundness.

Finally, even if depositor funds were somehow used for trading purposes that would not mean that they were being used for greater risk-taking than banks and other depository institutions routinely engage in. The irony is that lending—clearly still an approved activity for banks—is riskier than trading. This is because, when a bank lends, it puts its funds largely out of its control; there is no way of knowing how the company or individual borrower will ultimately fare with the use of the bank's loan. However, trading involves buying and holding a portfolio of assets that can be bought and sold. By their nature, these assets are generally liquid, and the bank can easily sell them if it deems the risk of holding them further to be too great. Many traders operate their business so that they are not exposed to changes in the market at the end of each trading day. Of course, there is always the danger of a failure by a counterparty, but that is no different than the failure of a borrower, and generally trades with counterparties are very short-term compared with the long-term risk of a loan.

Although the Volcker rule restrictions do not really reduce bank risk-taking, they are also bad economic and financial policy. By removing banks and banking entities from financial

trading markets, the rule will deprive these markets of much-needed liquidity. Without banks, BHCs, and their affiliates, the vigorous trading that keeps spreads narrow and liquidity high in the U.S. financial markets will significantly decrease. The likelihood is that foreign banks will become the dominant players in the business and world financial markets will move away from the United States.

This also raises a significant question about the future of the banking business. The development of an efficient securities market in the 1960s changed the relationship between banks and their corporate clients. Companies that had registered securities with the SEC found it less expensive and burdensome to meet their credit needs in the securities markets than through bank borrowing. As a result, banks have been concentrating increasingly on trading activities, private banking for high net worth individuals, small-business lending, consumer lending through credit cards, and commercial and residential real estate finance. The largest of these activities is real estate lending, through construction and development loans and commercial and residential mortgages.

This is not a healthy development. As noted in a 2009 *Financial Services Outlook*,⁹ bank lending to real estate in all its forms rose from less than 25 percent of all bank lending in 1965 to more than 55 percent in 2005. Real estate is a risky and highly volatile business, and banks are already too heavily involved in it. By taking away another profitable non-real-estate business from banks, the DFA forces them to concentrate even more heavily on real estate financing. This makes it more likely that the deflation of the next real estate bubble will create another banking crisis.

⁹ Peter J. Wallison, "Losing Ground: Gramm-Leach-Bliley and the Future of Banking," *AEI Financial Services Outlook* (November–December 2009), 4, available at www.aei.org/outlook/100925.

The Volcker rule applies to all banks and BHCs, but the DFA’s restrictions on large BHCs and nonbank financial institutions could extend much further than restrictions on prop trading. In this case, as noted above, the Oversight Council may authorize the Fed—the supervisor of those large financial institutions that have been declared a potential danger to U.S “stability”—to impose “regulations that are more stringent than those applicable to other nonbank financial companies and BHCs that do not present similar risks to the financial stability of the United States.”¹⁰

Efforts to curb bank activities because they are insured by the FDIC have been part of the political debate in Washington since deposit insurance was instituted. Most of the opposition to new or existing bank activities has grown out of competition between industries. The idea that banking and commerce should be separated—that is, nonfinancial firms should not be able to own banks—has been used since the 1930s to prevent banks and BHCs from entering new businesses. For example, the realtors successfully fought the idea that banks or BHCs should be allowed to own real estate brokers. But the DFA is the first example since the passage of the Glass-Steagall Act in which restrictions on bank and BHC activities have been imposed solely because of the fear of risk taking.

Competition Moves to Washington: The War of All Against All

In this sense, the Volcker rule may be the vanguard of further restrictions not only on bank activities but also on the activities of all financial institutions, whether or not they are SIFIs. The FSOC’s authority to classify firms as SIFIs because of their “mix of business”—which is also implied authority for the Fed to restrict the activities of the SIFIs it is supervising—may

¹⁰ DFA, Sec 115(a)(1)(A).

well develop into a set of rules that will attempt to limit what regulators see as risk-taking by financial firms that are expanding their activities onto the traditional turf of other financial institutions. The efforts of the realtors to keep banks or BHCs out of the business of real estate brokerage—efforts that eventually resulted in legislation forbidding the Fed to authorize BHC ownership of real estate brokerage firms—is an example of the kind of cross-industry competition that will in the future be played out at the Fed and in Congress as industries attempt to protect themselves against encroachment by new competitors. Regulation is almost always a conservative influence—regulators frequently fear the risks that new businesses or activities might create for regulated entities—and the DFA has now provided the regulators with a virtually unlimited discretionary power with which they can stifle change in the financial system. That this will also mean the stifling of competition is exactly what large regulated companies like.

This is another sign that the modern proponents of corporatism—a partnership between big government and big financial institutions—won the day in the U.S. Congress, and that what they have done will be hard to undo in the future. Those who see progress in Joseph Schumpeter’s “creative destruction,” in which new and innovative companies displace old ones, will be required to look outside the United States for innovation and change in the financial markets. The likelihood is that many firms that cannot innovate or grow in the newly regulated U.S. markets will go elsewhere, moving out of the United States to jurisdictions where they can operate with more freedom.

Consumer Protection, Protected from Congressional Control

While one of the underlying motives for the DFA was the view that the financial crisis was caused by ineffective or insufficient regulation, another was the notion that the vast number of weak mortgages in the financial system was the result of predatory lending or other deceptive lending practices. Accordingly, in addition to “Wall Street Reform” the DFA also created the Consumer Financial Protection Bureau (CFPB). The CFPB probably has the widest reach into the U.S. economy of any agency in Washington. It extends from the consumer-based activities of the largest banks to the check-cashing stores on Main Street in towns all over the U.S.

There is a carve-out for insurance, but its extent is ambiguous. The act exempts “the business of insurance,” defined as “the writing of insurance or the reinsuring of risks by an insurer, including all acts necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are persons authorized to act on behalf of such persons.”¹¹ This seems clearly to exempt insurers—i.e., those who “write insurance.” However, it may still cover insurance agents, since the exemption in the DFA for insurance extends only to persons “engaged in the business of insurance and subject to regulation by a state insurance regulator.”¹² Unless regulated agents are considered to be engaged in the “writing of insurance”—the way the act defines the business of insurance—they don’t meet both parts of this test.

¹¹ Dodd-Frank, 1002(3).

¹² *Id.*, 1002(22).

The breadth of the CFPB’s jurisdiction is illustrated by the following list of the business activities subject to the agency’s rules, compiled by Davis Polk, a New York–based law firm.¹³

For brevity, I deleted the narrow exceptions that were listed as part of the broad activities outlined below:

- Extending credit and servicing loans, including acquiring, purchasing, selling, brokering, or other extensions of credit;
- Extending or brokering leases of personal or real property that are the functional equivalent of purchase finance arrangements;
- Engaging in deposit-taking activities, transmitting or exchanging funds, or otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer;
- Providing most real estate settlement services, or performing appraisals of real estate or personal property;
- Providing or issuing stored value or payment instruments, or selling such instruments, but only if the seller exercises substantial control over the terms or conditions of the stored value provided to the consumer;
- Providing check cashing, check collection or check guaranty services;
- Providing payments or other financial data processing products or services to a consumer by any technological means;
- Providing financial advisory services to consumers on individual financial matters or relating to proprietary financial products or services, including providing consumer credit counseling or services to assist consumers with debt management, debt settlement services, modifying the terms of a loan or avoiding foreclosure;
- Collecting, analyzing, maintaining, or providing consumer reports or other account information, including information related to consumer credit histories, used or expected to be used in connection with any decision regarding the offering or provision of a consumer financial product or service, subject to exceptions; and

¹³ Davis Polk, “Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010,” 104–105, available at https://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf (accessed August 24, 2010).

- Collecting debt related to any consumer financial product or service.

If we take just one of these services—say, check-cashing—we can begin to understand the potential effect of the agency’s jurisdiction. There are check-cashing stores in virtually every city and town in the United States, and they are not big businesses. They do not generally operate interstate. If they are subject to regulation, it is by a state or perhaps a municipality. Under the DFA, they will be subject to regulation from Washington. We could assume this regulation will be light, maybe a few reports or an occasional visit by an examiner. But the likelihood is that these small companies will be required to comply with certain rules about disclosure, record keeping, personnel qualifications, hours of operation, advertising, signage, and maybe even their rates and products. What will that do to these thousands of small companies? It will force them to raise their prices, certainly, but also to consolidate with larger companies or leave the business. For those who use check-cashing services, this will make life just a little bit more difficult and expensive. Check-cashing services may require regulation, but state or local regulation is likely to be less intrusive and less bureaucratic than regulation from Washington.

But the worst thing about the CFPB is not the costs it will impose on the economy, the innovation it will stifle, or the small businesses it will eliminate. The worst thing about this agency is that it will operate independently, without any control by the Fed, Congress, or the president. The DFA states that even though the CFPB is lodged in the Fed, it is not subject to the control of the Fed. The autonomy language is clear: the Fed may not

(A) intervene in any matter or proceeding before the Director, including examinations or enforcement actions, unless otherwise specifically provided by law; (B) appoint, direct, or remove any officer or employee of the Bureau; or (C) merge or consolidate the Bureau, or any of the functions or responsibilities of the Bureau, with any division or office of the Board of Governors or the Federal reserve banks. . . . No rule or order of the

Bureau shall be subject to approval or review by the Board of Governors. The Board of Governors may not delay or prevent the issuance of any rule or order of the Bureau.¹⁴

The CFPB is also insulated from control by Congress. Under the U.S. Constitution, Congress exerts control over the executive branch of government through its power to appropriate funds. We all learned about this in elementary school as “the power of the purse.” Most regulatory and administrative agencies, including the cabinet departments, must go to Congress each year for appropriations to cover their operations in the following year. In this way, Congress can control executive-branch agencies by reducing funds, denying fund increases, or denying funds for specific purposes. Merely having to go to Congress hat in hand for the following year’s appropriation is an important way for Congress to enforce its own policies—and some humility—on powerful agencies. The CFPB, however, is exempt from this process. Under the DFA, it is allocated up to 12 percent of the Fed’s operating funds, a stipend that amounts to an estimated \$600 million per year. The Fed’s operating funds are not subject to appropriation—part of the special structure intended to keep the central bank independent of the political branches—so the \$600 million that will be made available to the CFPB does not come with any necessary oversight or control, directly or indirectly, by Congress.

In the current session of Congress, the Republicans in the House have sought to control the funds available to the CFPB by directing the Fed not to provide more than \$80 million to the agency. This action is not good policy. It implies more control by Congress over the Fed than is consistent with Fed’s necessary independence. Moreover, assuming that this restriction is eventually enacted, it is questionable whether it can be fully effective as a restraint on the CFPB. Normal appropriations for agencies are done through line items, limiting the amount that an

¹⁴ DFA, Sec 1012(c)(2)–(3).

agency can spend on any particular authorized activity. A limitation on what the Fed can provide to the agency in financing will not allow Congress to affect the agency's priorities.

Finally, the CFPB will be independent of the president, since the director is appointed for a five-year term by the president, with the advice and consent of the Senate, and can only be removed from office for cause.

The CFPB, then, is as independent as the Fed itself, but it has the power to control and regulate the consumer-related operations of companies from the largest banks to the smallest check-cashing stores. Moreover, all this power is concentrated in a single person, the director of the CFPB. Even the Fed, with all its independence, is ultimately governed by a board with a bipartisan membership. The establishment of an agency with this scope of authority, under the direction of a single person removable only for cause, outside the control of Congress or the president, is an unprecedented and—I might say—an irresponsible act, which Congress will eventually come to regret.

Conclusion

The DFA provisions described in this paper are not the only ones that warrant significant modification or repeal. The act contains many other provisions that, in my view, will have a significant adverse effect on economic growth in the future and effect substantial unwarranted changes in the structure of the U.S. financial system. The provisions I have discussed, however, seem to me to be the most troubling from this perspective. If the DFA is the price we had to pay to prevent a recurrence of the 2008 financial crisis, then an argument might be made that the restrictions it imposes were warranted, but inasmuch as the financial crisis was not caused by a lack of regulation there are sound reasons for substantially modifying or repealing the DFA.

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