FINANCIAL REGULATION

Congress should

- repeal the Dodd-Frank Act;
- short of repeal, make major modifications to Titles I, II, VIII, and X of Dodd-Frank, which cover the Financial Stability Oversight Council, orderly liquidation authority, financial services as a public utility, and the Consumer Financial Protection Bureau;
- wind down Fannie Mae and Freddie Mac without establishing a new guarantee for mortgage risk;
- reform the Federal Housing Administration;
- roll back recent expansions in federal deposit insurance;
- repeal the Community Reinvestment Act of 1977; and
- eliminate the Exchange Stabilization Fund.

From its earliest days, the American system of banking regulation has been characterized by state and federal authorities that bestow market power on banks through restrictions on the entry of competing firms into the market and through limitations on acquisitions and diversification. These entry and structural barriers have created profit opportunities for existing market players and resulted in a more fragile banking system. Examples of such restrictions include limitations on the geographical and product diversity of bank portfolios.

The relative fragility of the U.S. banking sector, a direct result of the restrictions, led to the creation of government safety nets, such as the Federal Reserve and the Federal Deposit Insurance Corporation. Countries that have avoided these types of restrictions on geographical and product diversity, such as Australia and Canada, have exhibited greater stability; they adopted government safety nets for their banking systems much later, if at all. Moreover, entry barriers have created economic rents or excess profits (a point that politicians have not ignored). A significant portion of modern banking regulation involves the redistribution of those excess profits, though, of course, the amount is difficult to measure. We are quickly reaching—and may have already passed—

the point at which the redistribution of rents and the costs of other regulations outweigh the benefits that banks receive from both the safety net and entry barriers.

Any credible attempt to reform our system of banking regulation must address all these factors. A free, competitive, and healthy banking system is one with few barriers to entry, no government safety net, and no redistribution of wealth or income. As long as government safety nets are extensive, the resulting moral hazard will necessitate prudential regulation. Since prudential regulation is inferior to market discipline, an extensive bank safety net almost certainly will lead to a financial crisis.

Dodd-Frank

The Dodd-Frank Act expands the government safety net and continues to use the banking system as an avenue to redistribute wealth. Dodd-Frank will likely increase both the frequency and severity of financial crises by further reducing market discipline and increasing the political control of our financial system. The best solution would be to repeal the entire Dodd-Frank Act. Short of that, policymakers should focus on Titles I, II, VIII, and X.

Title I—Financial Stability Oversight Council

The Financial Stability Oversight Council is tasked with labeling companies, including nonbank financial companies, as "systemically important"—that is, "too big to fail." That role gives regulators significant supervisory power over all large financial institutions and creates an implied government backstop for firms so labeled. To end the perception of "too big to fail," we must end the use of such labeling by government.

Title II—Orderly Liquidation Authority

Orderly liquidation authority (OLA) empowers the federal government, via the Federal Deposit Insurance Corporation (FDIC), to take over and "resolve" failing nonbank financial companies and bank holding companies. That authority creates confusion and uncertainty in a crisis and codifies the potential for the regulators to discriminate between different classes of creditors or rescue creditors. The use of OLA is at the discretion of the Treasury secretary, which means it is unlikely to be used, particularly if the Treasury can rely on other sources of funding to keep failing institutions afloat. All the necessary tools to implement the resolution of a large systemic bank or other financial company can be achieved with some modifications to the U.S. Bankruptcy Code, such as creating a new Chapter 14 in the code.

Title VIII—Payment, Clearing, and Settlement Supervision

Title VIII creates a new regulatory framework for certain payment, clearing, and settlement companies. This new regime is similar to the special regulatory framework that Title I creates for systemically important financial institutions. Title VIII broadens the concept of what constitutes a public utility to include companies in the financial industry (now) legally referred to as "financial market utilities," a term that conveys a special status for one segment of financial markets. Title VIII ultimately restricts competition among financial firms, increases consumer prices, concentrates financial risk, and invites taxpayer bailouts.

Title X—Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) promises to do for nonbank financial companies what the federal government has done for banks: subject them to political pressure to follow noneconomic lending standards. The CFPB also attempts to do to other forms of finance what the federal government has done to the mortgage market, namely, turn them into a source of systemic risk. Although structural changes—such as putting the agency under a five-member commission—would be modest improvements, they fall short of correcting the worst flaws of the CFPB. Thus, full repeal is needed along with repeal of the various "protection" statutes mentioned earlier. Short of abolishing the CFPB, Congress should place the CFPB within the congressional appropriations process; change its governance structure to a board rather than a director; direct the CFPB to define "abusive" with a notice-and-comment rulemaking process; require cost-benefit analysis for all CFPB rules; have a chief economist report directly to CFPB leadership; remove CFPB involvement with the FDIC; and require the CFPB to include safety and soundness considerations in its rulemakings.

Mortgage Finance

Given their prominent role in the financial crisis, the federally backed mortgage companies Fannie Mae and Freddie Mac should be wound down over a brief number of years. That end can be accomplished by using the receivership mechanism in the Housing and Economic Recovery Act of 2008 (HERA). Because HERA does not abolish their charters, Congress should sunset those charters while also setting a path to reduce loan limits, increase down payments, and raise guarantee fees for Fannie Mae and Freddie Mac. The remainder of our financial system has sufficient capacity to absorb the activities of Fannie Mae and Freddie Mac and to do so in a manner with significantly less leverage.

Essentially, Fannie Mae and Freddie Mac are avenues for banks to transfer mortgage credit risk from themselves to the taxpayers. Such a transfer increases the amount of credit risk in the system, so those guarantees should be ended and not replaced. If policymakers believe the companies have some economic value, their charters could be converted to bank holding companies, subjecting them to the same competitive and regulatory environment as commercial banks.

Federal mortgage subsidies—predominantly in the form of Federal Housing Administration (FHA) guarantees, have long led the mortgage market in the direction of riskier underwriting standards. The FHA has paved the way for both very low down-payment and low borrower-credit lending. A significant portion of FHA loans would not be made by any lender under the current terms without a government guarantee. That means those loans should not be made because they leave the taxpayer and the financial system at considerable risk. Although the long-term goal should be the elimination of the FHA, Congress in the interim should immediately require borrowers to make a 5 percent cash down payment; require the FHA to allow only reasonable debt-to-income ratios of no more than 30 percent; restrict loans to borrowers with a credit history no worse than a 600 FICO equivalent; and require in-person prepurchase counseling for FHA borrowers with FICO equivalents of between 600 and 680. Eligibility should also be limited to borrowers whose incomes do not exceed 115 percent of the state median income.

Federal Deposit Insurance

Discussions of moral hazard during the financial crisis generally focused on the incentives of management and equity holders, yet far more moral hazard results from a reduction in monitoring by creditors. The most important creditor class for a commercial bank is depositors, who provide about 81 percent of funding for the total banking system (the rest coming from equity and borrowed funds). Substantial academic literature demonstrates that depositors are capable of monitoring banks and that government-provided deposit insurance reduces that monitoring and results in greater risk taking by banks.

The public interest would be best served if Congress were to reduce federal deposit insurance coverage to the pre–savings and loan crisis limit of $40,000. To further the goal of reducing systemic risk, Congress should also limit the total deposit insurance coverage of any one bank to 5 percent of total insured deposits.

As of September 30, 2021, the FDIC backs $9.6 trillion in deposits. That amount represents about 54 percent of outstanding U.S. domestic deposits. It also represents a more than 50 percent increase in insured deposits since 2015. Part of the increase was due to the Federal Deposit Insurance Reform Act of

2005, which raised the limit for deposit insurance for retirement accounts to $250,000. Congress should repeal those provisions of the 2005 act. Within the Troubled Asset Relief Program (TARP), Congress also raised the deposit insurance cap to $250,000 until January 1, 2010. Dodd-Frank made the coverage expansion contained in TARP permanent.

Dodd-Frank's Section 335 extends the 2005 retirement coverage limit of $250,000 to all accounts. According to the Federal Reserve's Survey of Consumer Finance, as of 2019, the median U.S. household held just $5,300 in a transaction account (checking, savings, money market, call accounts, and prepaid debit cards). For the fewer than 10 percent that held certificates of deposit, the median holding was just $25,000. A cap of $40,000 (the pre–savings and loan crisis limit) would more than adequately cover the vast majority of U.S. households, while also greatly improving market discipline on U.S. banks. Even with significantly reduced deposit insurance coverage, middle- and low-income families could still be completely protected.

The argument behind expanding deposit insurance is that it reduces panics or bank runs. That may well be true in the short run, yet it comes at the cost of a tremendous reduction in market discipline. A World Bank study across more than 150 countries found that, all else being equal, those countries with more-generous deposit insurance schemes suffered more frequent banking crises. Similar results hold for the United States, as various academic studies have found that U.S. uninsured deposits provide substantial monitoring of bank health. The related decline in market discipline that results from deposit insurance has been documented across time and differing regulatory structures. Few relationships in economics have been found in so many different settings as the link between expanded deposit insurance and bank instability.

Community Reinvestment Act of 1977

A variety of statutes are intended to encourage banks either to make loans they would not otherwise make or to make loans available on terms they would not have made otherwise. Many of these statutes add considerable uncertainty to the lending process by giving borrowers an avenue to escape their obligations (or litigate) in the event of nonmaterial violations of these federal laws. The result is often to force lenders toward average cost pricing, such that better quality borrowers cross-subsidize poor-credit borrowers. These statutes are sometimes "justified" on the basis of the safety net benefits that banks receive from the government. Congress should roll back that safety net and repeal the Community Reinvestment Act (CRA).

The CRA was passed to nudge banks into making loans to less creditworthy borrowers within their service areas. The law was enacted at a time when local

banks restricted the supply of loans because of their local market power. Initially designed as a "process-oriented" measure, in the 1990s the CRA began to resemble a quota system for lending. The CRA now represents a transfer from banks and higher-credit borrowers to lower-credit borrowers. Economist Jeffrey Gunther also found evidence that increased CRA activity comes at the expense of bank safety and soundness. Accordingly, the transfers inherent in the CRA may well end up coming from the taxpayer. The act should be eliminated.

Exchange Stabilization Fund

Housed within the Treasury Department, the Exchange Stabilization Fund (ESF) was created to manage the gold-dollar parity, an activity that was abandoned decades ago. At this point, the ESF largely serves as a $500 billion slush fund for the Treasury. In the absence of outright elimination of the fund (the preferred option), significant limitations should be placed on Treasury's power to use it. For example, the ESF should be used only to provide temporary, fully collateralized liquidity to solvent institutions. Treasury should not be entitled to use the fund to obtain equity stakes in, provide guarantees for, or otherwise assist insolvent institutions. Congress would also serve the public interest by prohibiting the use of the ESF to provide direct assistance to financial institutions; that is, the ESF could better target its intended purpose: exchange rate stability.

Conclusion

America continues a relatively slow, weak recovery from the financial crisis. The legislative response to the crisis, most particularly the Dodd-Frank Act, has largely ignored the drivers of the crisis, leaving our financial system and economy as vulnerable as ever. To add insult to injury, financial regulatory reform postcrisis has greatly extended both explicit and implicit government guarantees of financial market risk taking, making future crises all the more likely. Our financial regulatory system is in dire need of wholesale reform. The proposals offered here are a starting point for such efforts. Additional reforms to impose market discipline and to reduce political interference with our financial system are also needed if we are to achieve both robust economic growth and financial stability.

Suggested Readings

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