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How Dodd-Frank Harms Main Street

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The financial crisis of 2007-2008 was a shock to the American economy. The federal regulatory response of 2009-2010 was equally shocking to the financial system.

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The reforms enshrined in the *Wall Street Reform and Consumer Protection Act* — popularly known as Dodd-Frank after its main sponsors, then-Sen. Christopher Dodd (D- Conn.) and then-Rep. Barney Frank (D-Mass.) — were intended to protect Main Street and consumers from financial predation by Wall Street. Instead, the law has reduced access to credit for small businesses and has resulted in fewer choices for consumers, while doing little to punish the main culprits in the financial crisis.

New Regulatory Agencies

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: prevent bank failures from endangering the economy and create a new federal financial regulator.[2] Officials sold the Dodd-Frank Act to the American people as promoting financial soundness and stability by reining in Wall Street and the big banks. Instead, much of Dodd-Frank is a broad enabling act granting power to executive-agency bureaucrats to write specific regulations outside the checks-and-balances oversight governing the rest of the federal government.

The Consumer Financial Protection Bureau (CPFB). Dodd-Frank led to the creation of a new financial regulatory agency, the Consumer Financial Protection Bureau (CPFB). Congress exercises no "power of the purse" over the CFPB. The agency's budget comes from the Federal Reserve, and amounts to approximately $600 million that Congress cannot touch or regulate.[3] 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 CPFB also operates outside the normal regulatory channels, authoring and enforcing unwieldly reforms. A recent target involved prepaid debit cards. The CFPB took it upon itself to regulate these increasingly popular payment methods through an 800-page regulation addressing how the cards may be issued and handled.[4] Issuers now have to provide long-form and short-form information sheets to recipients, depending on the circumstances, each describing a variety of fees that might be incurred in the process of everyday use. Dodd-Frank also empowered CFPB to impose similar cumbersome regulations on other diverse financial products, such as auto loans, debt collection, electronic payments, mortgages, overdrafts, payday lending and overseas remittances. The Board is planning or has already issued rules in all of these areas.

Dodd-Frank's massive and burdensome impact on the financial industry can also be seen in the law's first two titles. At face value, the creation of these

agencies would seem to be an improvement on the "Too Big to Fail" phenomenon that led to the crisis and bailouts. These titles have worked much different in practice, though.

The Financial Stability Oversight Council (FSOC). Title I of Dodd-Frank created the Financial Stability Oversight Council (FSOC), a regulatory agency with the power to designate firms as Systemically Important Financial Institutions (SIFIs). SIFIs are identified as those firms with over $50 billion in assets that could endanger the entire financial system if they were to get in trouble.

SIFI status represents a reward to big banks. Before the 2008 crisis, big banks — generally those with over $100 billion in assets — benefited from investors' and depositors' confidence that the government would bail them out because of their size. Thus, they represented a lower risk to investors, which meant these banks could raise capital much more cheaply than their competitors. SIFI designation has entrenched this advantage. Banks with more than $100 billion in assets, like the Bank of New York Mellon, continue to enjoy increased consumer confidence resulting in greater business.

The Orderly Liquidation Authority (OLA). Title II creates an Orderly Liquidation Authority (OLA), the organization responsible for supposedly winding down a failed SIFI without the need for a taxpayer bailout. The OLA gives the Treasury Secretary the power to liquidate any financial company, so long as the Federal Deposit Insurance Corporation (FDIC) and the Fed are in agreement, and enables the FSOC to suspend bankruptcy laws. This puts investors and shareholders in jeopardy based on the whim of bureaucrats.

Proponents of Dodd-Frank argue that the OLA offers a way to liquidate insolvent banks in an orderly fashion. FDIC Chairman Martin Gruenberg has even recommended a solution that would create a "bridge" company. The government would place the existing company in receivership and transfer 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.[5] This system would replace the transparency of the regular bankruptcy process with a shadowy regime that empowers regulators and interested stakeholders, including other SIFIs, to operate with little government oversight. Moreover, liquidation is only one of a range of options for dealing with an SIFI in trouble, and is likely a last resort.

How Dodd-Frank Harms Consumers

The Treasury will not cover the costs of the OLA operation, leaving the rest of us to pay for this process.

Raising the Cost of Insurance. To understand how we pay for OLA, it is important to note that the FSOC's SIFI designation authority is not restricted to big banks, but encompasses any large financial institution, including large insurance companies. American International Group (AIG), General Electric (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 have a very low potential for a systemic risk to the financial system.

Why then is the FSOC designating insurers 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, receives fees levied on SIFIs. Insurers have large amounts of low-risk assets that make an attractive pool of money. 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 $3 billion to $8 billion a year, with the bulk affecting retirees, who will see their incomes drop.[6]

The regulations imposed by the SIFI designation also create perverse incentives for insurers, signaling that the FDIC will not allow the institution to fail. That could increase insurance firms' willingness to take on risk, thus making them less stable — and making their SIFI designation a self-fulfilling prophecy.

Reducing the Number of Banks. Small and community banks are suffering the most from Dodd-Frank. [See the figure.] 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."[7]

Small banks facing these new pressures have three options: Increase their compliance departments and pass the costs on to their customers, merge with other banks to be able to afford a large compliance department, or close altogether.[8] Two thousand community banks and credit unions have closed or merged since 2010. A recent Harvard University study found that the rate of decline in community banks, as a proportion of the U.S. banking system, has doubled since 2010. What the study found "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."[9]

Raising Consumer Fees. Surviving Main Street banks 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.[10] Thanks to the CFPB's qualified mortgage rule, community bankers can no longer base loan decisions on what they know about the applicant, but instead have to qualify applicants based on a host of consumer "protections." 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," said James Hamby, president and CEO of Vision Bank in Ada, Oklahoma, to 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."[11]

Other restrictions introduced by Dodd-Frank have compounded the problem. The Durbin Amendment capped "swipe fees" charged to merchants for use of debit card payment networks, which have significantly increased the cost of providing debit cards to customers. While the amendment exempted credit cards and small banks, SIFI-designated banks — including Bank of America, J.P. Morgan Chase and Wells-Fargo — issue a huge share of payment cards in the United States.

Merchants, particularly large retailers, lobbied for this change for years, bridling 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 a $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. Meanwhile, banks made up for reduced profits by raising customer fees, resulting in a net present cost to the economy of around $25 billion.[12]

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 falling by half after the passage of the Durbin Amendment. The average minimum monthly holding requirement for no-fee banking tripled from $250 to $750. Average monthly fees doubled.[13]

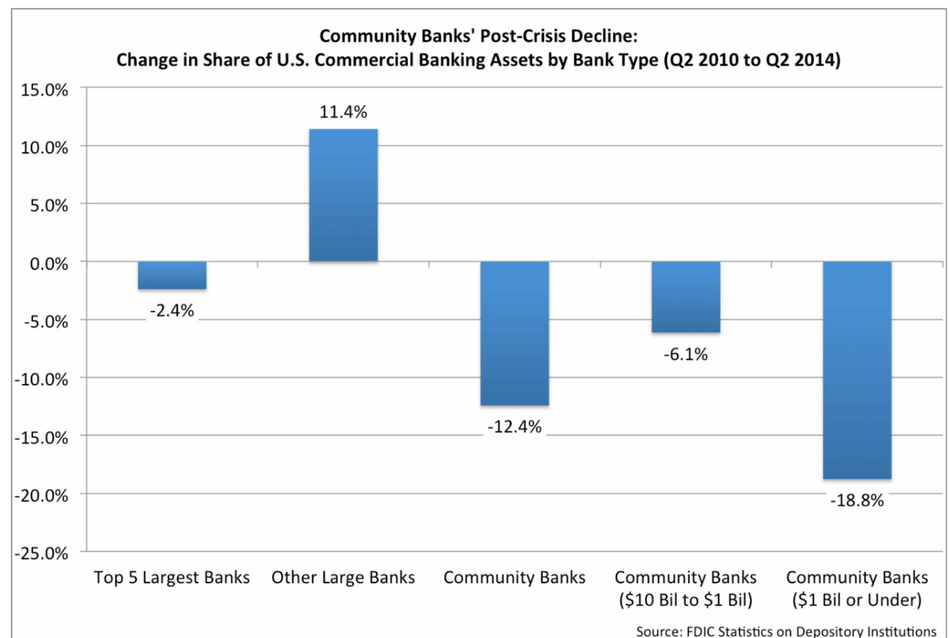
These fee increases made the banking system too expensive for about a million people, largely from the poorest sectors of society. They have since turned to alternative financial services, including prepaid debit cards (subject to the 800-page rule mentioned above), payday lenders and check cashing shops.[14]

A Constitutionally Dubious Regulatory Agency

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.

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.

Meanwhile, the CFPB has issued a study condemning mandatory arbitration clauses that enable financial firms to extend credit to consumers who would otherwise pose too great a risk. Relying on a discredited study by the Center for Responsible Lending that alleged racial discrimination in automobile financing, the CFPB has also asserted the power to regulate nonbank lenders.[15]



Source: Lux and Greene, 2015.

The Bureau is also preparing a rule regulating payday lenders — with little evidence they cause real harm worthy of regulation. 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.[16] 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."[17] The CFPB has ignored this study and others like it and issued its own studies justifying its rulemaking.[18]

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. The rules have forced many out of the banking system altogether, only to face alternatives, such as prepaid debit cards and payday loans, that are 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. 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.

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Notes

1. Adapted with permission from Iain Murray, "How Dodd-Frank Harms Main Street," Competitive Enterprise Institute, July 20, 2015. Available at https://cei.org/sites/default/files/Iain%20Murray%20-%20How%20Dodd%20Frank%20Harms%20Main%20Street.pdf.
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