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Financial Services and Monetary Policy

Summary and Key Talking Points

Policy Proposals

1. Repeal the Dodd-Frank Act.
2. Eliminate federal credit subsidies, guarantees, and insurance.
3. Eliminate Fannie Mae and Freddie Mac and shrink the role of the Federal Housing Administration.
4. Reform the U.S. Securities and Exchange Commission.
5. Reduce regulatory impediments to capital formation.

Quick Facts

1. Due to Dodd–Frank, regulators added more than 16,000 pages of financial regulations in six years.
2. Americans currently shoulder approximately $20 trillion in debt exposure from loans, loan guarantees, and subsidized insurance provided by roughly 150 federal programs.
3. Deregulation did not cause the 2008 financial crisis; poorly designed government policies did. Between 1999 and 2008, the government implemented more than 800 separate rules and regulations.

Power Phrases

Debunking a False Narrative

- Contrary to popular belief, the financial regulations existing prior to Dodd–Frank contributed significantly to the 2008 crash.

Centralized Solutions Have Not Worked

- Monetary policy from the Federal Reserve has been increasingly relied on to fix an expansive list of economic problems.
- However, the evidence shows that the Fed has not been as effective as expected in stabilizing the economy.
- Meanwhile, the long-term purchasing power of the dollar has dramatically declined under the Federal Reserve's watch.

Reform and Restrain

- It is time to reform and consolidate financial regulations while reexamining the Federal Reserve's track record and its role in our economy.

The Issue

The dominant narrative regarding the cause of the 2008 financial crisis is that deregulation in the 1990s was responsible, but that story is dead wrong. In fact, even if Congress were to repeal the entire Dodd–Frank Act, which it should, a highly flawed regulatory structure would still remain. There has never been a substantial reduction in the scale or scope of financial regulations in the U.S., especially not in the 1990s, and the pre-Dodd–Frank system contributed mightily to the 2008 crash. For nearly all of U.S. history, financial regulations—not simply banking regulations—have increasingly focused on risk management conducted by regulatory agencies rather than on disclosure and fraud prevention. Simultaneously, monetary policy has been increasingly relied upon to fix an expansive list of economics problems, well beyond the scope of the original stated purpose of creating a central bank (to provide an elastic currency), and well beyond what can reasonably be expected of monetary policy.

Preventing problems at financial firms from turning into system-wide banking crises has been a main justification for this approach, but it has failed miserably. The U.S. has had 15 banking crises since 1837, one of the highest totals among developed countries. Of the severe economic contractions that occurred in six developed nations between 1870 and 1933, *banking* crises occurred only in the U.S., and the U.S. is one of only three developed countries to have had two or more banking crises between 1970 and 2010. Furthermore, the evidence shows that the Federal Reserve has not been as effective as was once thought in accomplishing its stabilization goals. The long-term purchasing power of the dollar has dramatically declined under the Federal Reserve's watch, and the benign deflation that arises from improved productivity has all but disappeared in the U.S.

In addition to these shortcomings, the U.S. regulatory and monetary framework, for at least a century, has protected incumbent firms from new competition—the very market force that drives innovation, reduces prices, and prevents excessive risk-taking. As a result, entrepreneurs have suffered from fewer opportunities, and consumers have suffered from fewer choices, higher prices, and less knowledge regarding financial risks. Thus, the U.S.'s approach to regulating and stabilizing financial markets has made it more difficult to create and maintain jobs and businesses that benefit Americans.

Recommendations

Repeal the Dodd–Frank Act. The Dodd–Frank Act became law during the Obama presidency when Nancy Pelosi (D–CA) led the House of Representatives and Harry Reid (D–NV) presided over a near filibuster-proof Senate majority. It was a partisan bill that garnered no Republican votes in the House and just three in the Senate. Dodd–Frank was largely a progressive wish list of policies that failed to address, much less fix, what caused the 2008 financial crisis. The more than 800-page boondoggle expanded the failed regulatory approach that helped create the 2008 crisis in the first place, and increased the federal government's involvement in planning for, protecting, and propping up the financial system, thus enshrining "too-big-to-fail" policy into law. Repealing Dodd–Frank would be a good first step—but only a first step—toward protecting taxpayers and allowing private firms to easily provide the financial services that consumers need. In June 2017, the House passed the Financial CHOICE Act, a comprehensive financial regulatory reform bill that would have replaced the core of Dodd–Frank. Key provisions in the Financial CHOICE Act would have helped to restore market discipline and reduce regulatory burdens, thus moving the nation's financial markets in the right direction. The Senate, however, passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155), a tremendously watered-down (compared to the CHOICE Act) bill that failed to repeal a single title of Dodd–Frank. (The bill did not even include those reforms that passed the House with strong bipartisan support.)

Rather than negotiate a compromise between the two approaches, the Senate forced the House to accept the Senate's bill, and the President signed S. 2155 into law. The bill left all of Dodd–Frank in place, but provided special exemptions to various Dodd–Frank requirements for (mainly) smaller banks. While those banks were surely happy to have any regulatory relief, even the new exemptions came with the type of regulations that the CHOICE Act would have eliminated.

Provide an off-ramp style federal financial charter. Although banks are more heavily regulated than other financial firms, virtually all financial companies are subject to extensive restrictions on their activities, capital, and asset composition. Simultaneously, U.S. taxpayers have been forced to absorb more of these institutions' financial losses in the name of ensuring stability. The result has been a massive substitution of government regulation for market competition, which culminated in the 2008 financial crisis. Fixing this framework requires rolling back both government regulation and taxpayer backing of financial losses, making it possible for private citizens to build a stronger financial system that efficiently directs capital to its most valued uses. Creating a new federal charter for financial institutions that relieves the regulatory burden for those who absorb more of their own financial risks and forgo government assistance would help achieve these goals.

Eliminate federal credit subsidies, guarantees, and insurance. Americans collectively shoulder approximately $20 trillion in debt exposure from loans, loan guarantees, and subsidized insurance provided by roughly 150 federal programs. This scheme erodes the nation's entrepreneurial spirit, increases financial risk, and fosters cronyism and corruption. The programs and subsidies have given rise to powerful constituencies of beneficiaries because any losses are dispersed among millions of taxpayers. The government's credit portfolio consists of direct loans and loan guarantees for housing, agriculture, energy, education, transportation, infrastructure, exporting, small businesses, and other purposes; federal insurance programs cover bank and credit union deposits, pensions, flood damage, declines in crop prices, and acts of terrorism. Capital for mortgage lending by banks (and non-banks) is provided by government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac, while federally-backed deposit insurance creates distortions and risks. Congress should immediately reduce federal deposit insurance coverage and ensure that coverage is provided on a per individual basis. Congress should also phase out government-backed deposit insurance along with all other credit subsidies, guarantees, and insurance.

Eliminate Fannie Mae and Freddie Mac, and shrink the role of the Federal Housing Administration (FHA). Fannie Mae and Freddie Mac, the government-sponsored mortgage giants, should be shut down for good. Both enterprises remain wards of the federal government, and they distort the market by issuing mortgage-backed securities with subsidized government guarantees. If such guarantees are necessary, the private sector can issue them and price them appropriately. Congress should take steps to liquidate Fannie and Freddie's mortgage portfolios, as well as the companies themselves, and to ensure that they are not simply replaced by a new government-sponsored agency. Federal policies implemented through these government-sponsored enterprises have made housing more expensive and increased Americans' risky debt. To begin winding them down, the GSEs should be prohibited from purchasing mortgages for homes that are not owner-occupied homes or for "cash out" refinances. Congress should also ensure that the GSEs only purchase smaller loans and charge higher fees, and that bank capital requirements no longer favor the GSEs' mortgage-backed securities. For decades, the Federal Housing Administration (FHA) has competed with the GSEs for the riskiest mortgage loans, and the scope of the FHA's mortgage insurance program must be addressed at the same time the GSEs are eliminated. Otherwise, all the risky loans financed by the GSEs will simply be insured by the FHA. The solution is simple: Restrict the FHA to insuring only a fraction of each mortgage (instead of 100 percent coverage), and do so for creditworthy low-income, first-time home buyers only.

Reform and consolidate financial regulators. Financial regulators' budgets should be entirely composed of money appropriated by Congress. A commission governing structure for all financial regulators should be considered. Congress should also consolidate related powers in one regulator; remove authorities from agencies ill-equipped to use them; and revamp processes to ensure appropriate accountability for, and public input in, rule-making. Ideally, Congress would merge existing agencies and create only one federal banking regulator and one capital markets regulator. In the process, Congress should remove the Federal Reserve entirely from regulation and supervision. Congress should also eliminate the (Dodd–Frank created) Consumer Financial

Protection Bureau (CFPB). Most of the Bureau's authority could easily be handled by the Federal Trade Commission (FTC), an agency whose mission is to protect consumers. These policy reforms would produce more effective financial regulation by making financial market participants, including regulators, more directly accountable for their actions.

Restrain the Federal Reserve with rules-based monetary policy and emergency lending restrictions. Congress can greatly improve monetary policy by replacing the Federal Reserve's current legislative mandate to promote stable prices and maximum employment. In its place, Congress should give the Federal Reserve a mandate with the single goal of achieving monetary neutrality (supplying only the amount of money the economy needs to keep moving, no more and no less) by stabilizing overall spending in the economy. Maintaining a reasonable growth path for total spending—often referred to as nominal gross domestic product (NGDP) targeting—is the best way for the Federal Reserve to maintain monetary neutrality. Among other benefits, this new framework would allow the price level (overall prices) to decline as productivity improves, thus making it easier for people to enjoy the benefits of more goods for sale at lower prices. Congress should also limit the Federal Reserve so that it can only provide system-wide liquidity on an ongoing basis, rather than allocating credit to specific firms on an ad hoc basis. Emergency lending authority is unnecessary for conducting monetary policy, and Congress should replace the Federal Reserve's existing primary dealer system with a single standing facility to meet extraordinary as well as ordinary liquidity needs. This change would make Fed lending to insolvent institutions—even during a crisis—unnecessary.

Reduce regulatory impediments to capital formation. Congress should remove regulatory impediments that limit entrepreneurs' access to the capital necessary to launch and grow new businesses. Congress should preserve the existing thresholds for private offerings and expand the ability of sophisticated investors to invest in private offerings (usually Regulation D offerings). Current law allows large public companies to raise capital without having to deal with 50 different expensive and time-consuming state registration and qualification requirements (known as blue sky laws). Congress should allow smaller public companies and other smaller companies with extensive federal disclosure requirements to also be free of this burden. Congress should replace the 14-plus categories of securities-issuing firms (as described by the existing rules) with three disclosure regimes: public, quasi-public, and private. Just as important, Congress should replace the current complex and arbitrary federal disclosure system with a reasonable, coherent, and scaled disclosure system that imposes increasing requirements as companies grow and have more shareholders with more capital at risk. Congress, or the Securities and Exchange Commission (SEC), should clarify that entrepreneurs may use finders and private placement brokers to assist them in raising capital. Finally, it is time to create a micro-offering exemption allowing very small private companies to raise capital without having to comply with complex SEC rules.

Design an efficient securities-fraud deterrence regime. For capital markets to function well, investors need accurate information about securities. If investors do not trust firms' disclosures, they will discount what they are willing to pay for securities. This increases the cost of capital and makes it more difficult, even for honest firms, to cost-effectively raise capital. Deterring fraud in the capital markets should be a government priority, but the current U.S. approach to securities-fraud deterrence falls far short of the ideal. Congress and the SEC should implement a system that: (1) places more emphasis on culpable individual and manager liability, (2) reduces the reliance on corporate criminal penalties borne by shareholders, and (3) limits private enforcement to traditional common law remedies or other compensatory remedies possessing similar safeguards against over-deterrence.

Reform the SEC. The U.S. Securities and Exchange Commission is the most important regulator of U.S. capital markets. Although its budget has increased by 82 percent over 10 years, its effectiveness remains in doubt. Resources have flowed into unnecessary management, "support," and ancillary functions, while core functions have been neglected. Its organizational structure is unwieldy. The Commission needs to be better managed—it does not need (as has been proposed) more managers. The number of direct reports to the Chairman needs to be reduced. Its information technology programs appear to be poorly managed and are unnecessarily costly. The SEC bases its decisions on inadequate data. It does much less than most agencies to provide data to Commissioners, other policymakers, and the public. Its enforcement efforts directed at fraud and other malfeasance by managers of large financial institutions are inadequate. The Commission does little to remove unnecessary regulatory impediments to entrepreneurial capital formation. Reforms are necessary so that the SEC can better support well-functioning capital markets.

Reform FINRA. FINRA is the primary regulator of broker-dealers and their employees. It is neither a true self-regulatory organization nor a government agency. It is largely unaccountable to the industry and to the public. Due process, transparency, and regulatory-review protections normally associated with regulators are not present, and its arbitration process is flawed. Reforms are necessary. FINRA itself, the SEC, and Congress should reform FINRA to improve its rule-making and arbitration process.

Do not impose beneficial ownership reporting requirements. Congress is seriously considering imposing a beneficial ownership reporting regime on American businesses and other entities, including charities and churches. The most recent legislation, the Corporate Transparency Act (CTA) and the ILLICIT Cash Act, would create a large compliance burden on businesses with 20 or fewer employees (the only non-exempt category) and would create as many as one million inadvertent felons. Under the CTA, religious organizations, charities, and other exempt entities and their employees would be subject to fines and imprisonment unless they file the proper certification of exemption with the Financial Crimes Enforcement Network. The rules are easily and lawfully avoided by the sophisticated—and would do virtually nothing to achieve their stated aim of protecting society from terrorism or other forms of illicit finance. Furthermore, the vast majority of the information that the proposed reporting regime would obtain is already provided to the Internal Revenue Service (IRS). Allowing the IRS to share this information with the Treasury Department's Financial Crimes Enforcement Network would better meet the needs of law enforcement by providing more comprehensive information and better enforcement than would the proposed reporting regime.

Facts and Figures

FACT: Deregulation did not cause the 2008 financial crisis.

- In the time period between the supposed deregulation in 1999 and the Lehman Brothers' failure in 2008, financial regulators issued 7,100 pages of regulations.
- These regulations implemented more than 800 separate rules.

FACT: Extensive regulation is supposed to prevent problems at financial firms from turning into system-wide banking crises, but the approach has failed.

- The U.S. has had 14 major banking crises in the past 180 years, one of the worst track records in the developed world.
- The U.S. is one of only three developed countries with two or more banking crises between 1970 and 2010.

FACT: Dodd–Frank doubled down on the failed approach of the past.

- From the enactment of Dodd–Frank in 2010 to July 2016, regulators added more than 16,000 pages of financial regulations to the Federal Register.
- Dodd–Frank required regulators to implement approximately 400 separate rules.

FACT: The regulatory relief bill signed into law in 2017 merely provides special exemptions to certain Dodd–Frank regulations.

- This bill—S. 2155—did not repeal one single title of the Dodd–Frank Act.

FACT: Poorly designed government policies led to the 2008 financial crisis.

- Special bankruptcy safe harbors induced firms to rely more heavily on derivatives and repurchase agreements (repos) than they would have in the absence of the special protections. Data show that the portion of total investment bank assets financed by repos doubled between 2000 and 2007. The market would not have supported such high increases in leverage without the special protections.

FACT: The Federal Reserve's track record deserves a closer look.

- Research with updated data shows that the pre–Federal Reserve era economy was about half as volatile as previously thought in terms of both unemployment and overall output.
- Overall, inflation volatility has barely declined relative to the pre-Fed era, but average inflation has gone from approximately 0 percent to more than 3 percent.

Additional Resources

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