THE DODD-FRANK ACT FIVE YEARS LATER: ARE WE FREER?

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Thank you chairman Hensarling, ranking member Waters, and members of the committee. It is my pleasure to testify this morning on the question of "The Dodd-Frank Act Five Years Later: Are We Freer?"

Freedom and an effective financial services system go together. Freedom to gain access to capital to start and grow a business, freedom to buy a home and provide for your family's financial security, freedom to choose those whom you entrust with your hard-earned money provide the means for pursuing the American dream.[1]

The recent financial crisis reveals four lessons that highlight the importance of upholding the rule of law during periods of financial crises in order to preserve individual freedom:

- Adherence to the rule of law during the crisis is crucial to allow the economy to restore coordination after a period of eocnomic dislocation.
- Adherence to the rule of law during the crisis is necessary to restrain opportunism by politicians and special interests tempted to use the opportunity presented by the crisis to piggyback satisfaction of their own narrow—and often unrelated—interests.
- Once discretion and political favoritism are unleashed during the crisis, history tells us that the dissipation of the crisis does not bring with it a restoration of the rule of law. Instead there is a sort of "ratchet effect," by which the power seized during the crisis is entrenched in the post-crisis regulatory regime.
- Once discretion and the government's power to pick winners and losers arbitrarily is entrenched, this institutional framework creates moral hazard for policians and

[1] *See* THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (Oxford, 2014).

special interests that creates the conditions for the next crisis, to be met by similar means.

The world of Dodd-Frank exemplifies this progression. The freedom to plan your financial future, buy a home, or open a bank account, is being crushed under an avalanche of costly and arbitrary rules and a regulatory system so complex that only well-lawyered multi-billion dollar banks can survive. On issues ranging from which financial insitutions are considered "Too-Big-To-Fail" to the loan terms of your new car, a handful of unelected Washington bureaucrats are prying into your wallet and bank account to make those decisions for you.

The Impact of Dodd-Frank on Freedom: The Regulatory Burden

In the new world of Dodd-Frank, the success of a financial institution no longer is determined by which banks can serve you best in a competitive market. Instead, it is determined by which institutions can best wind their way through the labyrithian halls of Congress and the Federal Reserve Board.

According to one widely-cited estimate, Dodd-Frank requires 398 new rulemaking by federal agencies[2] and as of July 2014 (when one-quarter of the rulemakings were still left to be completed) Dodd-Frank was estimated to have imposed $21.8 billion and 60.7 million paperwork hours in compliance costs to date[3]. Projecting forward, it is estimated by one economist that over the next 10 years the full compliance costs of Dodd-Frank will result in $895 billion in reduced Gross Domestic Product or $3,346 per working-age person.[4] And these compliance cost estimates do not include all of the costs and burdens of complying with the various guidances, informal actions, and other measures that federal regulators impose on financial institutions and their customers.

But to consider only the economic costs of Dodd-Frank doesn't consider another more intangible cost: Americans are *less free* as a result of Dodd-Frank and what it has spawned. In particular, the financial crisis and the legislation and regulation that has followed in its wake have weakened the rule of law, centralized vast amounts of authority in the hands of unaccountable political bureaucracies, unleashed arbitrary regulatory discretion, and empowered interest groups beyond any time in American history. Moreover, not only did the unleashing of political discretion help to create and worsen the last crisis, by entrenching rather than limiting political discretion, Dodd-Frank and the regulatory norms it embodies, has created moral hazard that is laying the foundation for the next financial crisis.

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[2] Davis Polk, *Dodd-Frank Progress Report*, http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.
Robert Romano, *Dodd-Frank's Regulatory Morass*, PENN PROGRAM ON REGULATION REGBLOG (Nov. 10, 2014), *available in* http://www.regblog.org/2014/11/10/romano-dodd-frank-consequences/.
[3] Andy Winkler, Ben Gitis, and Sam Batkins, *Dodd-Frank at 4: More Regulation, More Regulators, and a Sluggish Housing Market* (July 15, 2014), *available in* http://americanactionforum.org/research/dodd-frank-at-4-more-regulation-more-regulators-and-a-sluggish-housing-mark.
[4] Douglas Holz-Eakin, *The Growth Consequences of Dodd-Frank* (May 6, 2015), *available in* http://americanactionforum.org/research/the-growth-consequences-of-dodd-frank.

Why the Rule of Law Matters During a Financial Crisis

To make a loan, a bank must be able to do two things.[5] It must be able to price the risk of the loan accurately in light of its risk of loss, such as by adjusting the interest rate, downpayment, or other terms of the loan. If the lender cannot price the risk of loss accurately, then the lender must reduce its risk expoosure, either by limiting those to whom it lends (such as refusing to lend to higher-risk borrowers) or by lending less to the same people (such as by reducing available credit lines).

Economic uncertainty interferes with the ability of lenders and borrowers to accurately assess the full risk and cost of making loans and conducting commerical activity. As a result, economists have uniformly found that adherence to the rule of law is an essential condition for economic prosperity, democratic governance, and civil liberties.[6] Moreover, the rule of law serves as a barrier to government corruption and rent-seeking by powerful special interest groups. By ensuring equal and transparent treatment of everyone, the rule of law constrains the discretion to arbitrarily pick winners and losers that provides the engine and incentives for political corruption.[7]

Adherence to the rule of law is especially important during periods of economic dislocation, such as during the financial crisis. Duting such times, billions of decentralized individual decision-makers need to reestablish coordination of their affairs, to make decisions to work, invest, hire, and the like. When other elements of the economic system are in greater flux, adherence to the bedrock predictability of the rule of law takes on special institutional significance.

Instead, the federal government responded erratically and unpredictably during the financial crisis, thereby exacerbating uncertainty and confusion, such as by deciding to bail out Bear Stearns but not Lehman Brothers and attaching different and arbitrary conditions to each subsequent bailout. In so doing, the government's departure from rule of law values worsened the financial crisis and continues to hamper the economy's return to economic stability. As David Skeel has shown, one reason for the catastrophic nature of Lehman Brothers' failure was that the firm—counting on a government bailout—rejected a merger offer as insufficiently generous.[8] Indeed, as several prominent scholars have observed, it likely was not Lehman's failure that spooked the markets, but rather Treasury Secretary Hank Paulson's panicked response to Lehman's failure.[9] As noted by Richard Kovacevich, CEO of Wells Fargo during the financial crisis, prior to TARP and a month after the Lehman bankruptcy, "markets had declined but were still behaving

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[5] *See* Todd J. Zywicki, *Economic Uncertainty, the Courts, and the Rule of Law*, 35 HARV. J. OF L. & PUB. POL'Y 195 (2012).
[6] *See* Todd J. Zywicki, *The Rule of Law, Freedom, and Prosperity*, 10 S. CT. ECON. REV. 1 (2003).
[7] *Id.*
[8] DAVID A. SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2011).
[9] PETER J. WALLISON, BAD HISTORY, WORSE POLICY: HOW A FALSE NARRATIVE ABOUT THE FINANCIAL CRISIS LED TO THE DODD-FRANK ACT (2013); JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTION AND INTERVENTIONS CAUSED, PROLONGED, AND WORSENED THE FINANCIAL CRISIS (2009).

reasonably well, except for those financial institutions that were having liquidity issues."[10] It was only when TARP was announced—and critically, when the government strong-armed *all* big banks into taking bailout money, even those that didn't want it—that "isolated liquidity issues turned into a tsunami impacting all banks and all industries." In short, the TARP *created* the very panic that bailout apologists contend that the TARP supposedly stemmed.[11]

Political Opportunism and the Rule of Law

Adherence to the rule of law is especially important during periods of crisis because that is the time when potential for political opportunism by politicians and interest groups is most dangerous. The actual operation of the government's response to the financial crisis shows the reality of how politicians and special interests use power and political connections unrestrained by the rule of law for their benefit.

Consider the infamous TARP program, which was authorized to provide a temporary bail out for illiquid banks that needed short-term help, but not insolvent banks. The task of distinguishing between illiquid and insolvent banks, however, was not an easy one and required great discretion by those making those decisions. Several economists have subsequently studied how bail out funds were allocated and they have uniformly reached the same conclusion: that bailout funds were directed to banks with "political clout, not those most in need of liquidity."[12] Banks that lobbied the most, contributed the most money to political campaigns, or had former banking regulators or Treasury Department officials on their boards of directors were significantly more likely to receive bailout funds than less-politically connected banks, even where those other banks ostensibly met the TARP's requirements more closely.[13]

Similarly, as I have discussed elsewhere, the entire taxpayer loss in the illegal diversion of TARP funds to General Motors and Chrysler is attributable to preferential treatment provided in those bankruptcy proceedings to the United Auto Workers and various other politically-powerful labor unions that had nothing to do with furthering the financial recovery of those companies.[14] Moreover, the government's intervention in the auto bailouts provided a field day for political opportunism. Politicians used the strings supplied by taxpayers' largesse to influence ordinary business decisions ranging from preventing the closure of particular obsolete manufacturing facilities that happened to be

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[10] Richard J. Kovacevich, *The Financial Crisis: Why the Conventional Wisdom Has It All Wrong*, 34(1) CATO J. 541 (2014).
[11] *See* Todd J. Zywicki, *The Rule of Law During Times of Economic Crisis* (Aug. 26, 2015), *available in* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2651893.
[12] Jim F. Couch, Mark D. Foster, Keith Malone, and David L. Black, *An Analysis of the Financial Services Bailout Vote*, 31 Cato Journal 119 (2011), online at http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2011/1/cj31n1-8.pdf.
[13] For a summary of these studies, *see* Todd J. Zywicki, *Rent-Seeking, Crony Capitalism, and the Crony Constitution*, SUP. CT. ECON. REV. (Forthcoming 2016), *available in* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2651587 (Aug. 26, 2015).
[14] *See* Todd Zywicki, *The Corporatist Legacy of the Auto Bailouts*, LAW & LIBERTY BLOG (Jan. 13, 2014), *available in* http://www.libertylawsite.org/2014/01/13/the-corporatist-legacy-of-the-auto-bailouts/.

located in a particular politician's electoral district; to the identity of suppliers of raw materials; to providing secret financial incentives for Fiat to manufacture "green" cars after the government ordered Chrysler to be given away for free to the Italian automaker.[15] Although American automakers have returned to profitability since they were bailed out, this has been *despite* the government's influence, as low gasoline prices have driven a boom in sales of pickup trucks and other larger vehicles, not the small cars urged by government central planners during the bailout process.[16]

The case study of the auto bailouts also provides a particularly illuminating illustration of why upholding the rule of law matters to both short-term and long-term freedom and prosperity. The primary losers from the government's intervention in the Chrysler bankruptcy case were holders of Chrysler's secured corporate bonds, including the Indiana state teachers and police retirement funds. While secured creditors typically would be paid in full before unsecured creditors, in that case secured creditors received only 29 cents on the dollar while UAW's underfunded health-care VEBA plans received over 40 cents on the dollar.[17]

But the full cost of the government's intervention was not just the direct costs to investors such as Indiana's taxpayers and public employees, there was also an *indirect* cost to the economy from this egregious violation of the rule of law. As I wrote at the time,

> By stepping over the bright line between the rule of law and the arbitrary behavior of men, President Obama may have created a thousand new failing businesses. That is, businesses that might have received financing before but that now will not, since lenders face the potential of future government confiscation. In other words, Mr. Obama may have helped save the jobs of thousands of union workers whose dues, in part, engineered his election. But what about the untold number of job losses in the future caused by trampling the sanctity of contracts today?[18]

Unfortunately my prediction has proven sound: subsequent economic analysis of the long-term effects of plundering Chrysler's secured creditors found that in the wake of the government's action, firms in heavily-unionized industries saw decreased bond prices and increased bond yields, "consistent with the government's intervention in the Chrysler bankruptcy increasing lenders' assessment of the risk of lending to firms with a strong

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[15] Todd Zywicki, *The Auto Bailouts and the Rule of Law*, 7 NATIONAL AFFAIRS (Spring 2011), *available in* http://www.nationalaffairs.com/publications/detail/the-auto-bailout-and-the-rule-of-law.
[16] *See* Zywicki, *Corporatist Legacy*, *supra* note 14.
[17] *See* Zywicki, *supra* note 15. This also ignores the still-unexplained decision of bailout operatives to terminate the pension plans of Delphi's white collar employees as part of that company's bankruptcy case. *See* SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, TREASURY'S ROLE IN THE DECISION FOR GM TO PROVIDE PENSION PAYMENTS TO DELPHI EMPLOYEES (Aug. 15, 2013), *available in* https://www.sigtarp.gov/Audit%20Reports/SIGTARP_Delphi_Report.pdf.
[18] *See* Todd J. Zywicki, *Chrysler and the Rule of Law*, WALL ST. J. (May 13, 2009).

labor presence, leading to a signficiant increase in borrowing costs for those firms."[19] By destabilizing contracts to benefit a powerful special interest, the government created a cloud of political risk over financial markets and the economy.

The End of the Crisis Does Not Bring About the Restoration of the Rule of Law

Still another cost of deviations from the rule of law *during* a financial crisis in the name of claimed "emergency" is that the abatement of the crisis does not bring about a subsequent restoration of the rule of law. Instead, as we have seen, the post-crisis period produces a codification and consolidation of government discretion, making it a long-term element of the economy and society. Although having the superficial appearance of a statute, Dodd-Frank's 2,300 pages of legislation largely enshrines much of the arbitrariness and lawlessness that characterized the government's activities during the crisis. For example, it gives the government virtually unreviewable authority to seize what it deems to be failing financial institutions and to deem certain institutions but not others to be "systematically risky"—although it nowhere defines the criteria that qualify a firm as "systemically risky" and provides limited judicial review of the government's actions.

Three striking examples of the post-crisis regulatory environment illustrate the erosion of the rule of law: the adverse effect of Dodd-Frank on small banks, the execution of Operation Choke Point which limited access to financial services for politically disfavored industries, and the activities of the Consumer Financial Protection Bureau (CFPB).

Disappearing Small Banks

One well-documented effect of Dodd-Frank has been to promote consolidation of the banking industry by driving out smaller community banks that comparatively lack the resources to comply with Dodd-Frank's crushing and ham-fisted regulatory burden. For example, a recent study by scholars at the Kennedy School of Government found that in the period since Dodd-Frank was enacted, the asset bases of smaller banks have shrunk twice as fast as those of large banks, a result that they attribute to the high regulatory costs imposed by Dodd-Frank.[20] In addition, a detailed Mercatus Center study of the impact of Dodd-Frank on smaller banks has found that the law has imposed huge compliance costs on small banks and that they have been less able to bear those costs than large banks.[21]

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[19] Bradley Blaylock, Alexander Edwards, and Jared Stanfield, *The Role of Government in the Labor-Creditor Relationship: Evidence from the Chrysler Bankruptcy*, 50(3) J. OF FINANCIAL AND QUANTITATIVE ANALYSIS 325, 327 (June 2015).

[20] Marshall Lux and Robert Greene, *The State and Fate of Community Banking*, M-RCBG Associate Working Paper No.37 (February 2015) online at http://www.valuewalk.com/wp-content/uploads/2015/02/Final_State_and_Fate_Lux_Greene.pdf.

[21] Hester Pierce, Ian Robinson and Thomas Stratmann, *How Are Small Banks Fairing under Dodd-Frank?*, George Mason University Mercatus Center Working Paper No. 14-05 (February 2014) online at http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank; *see also*

By replacing fair and free marketplace competition for consumer loyalty with competition to best engage in regulatory arbitrage, Dodd-Frank is restricting consumer freedom of choice and innovation. This impact is most noticeable with respect to mortgages. According to the Mercatus Center study, 64 percent of small banks reported that they were making changes to their mortgage offerings because of Dodd-Frank and 15 percent said that they had either exited or were considering exiting residential mortgage markets entirely.[22] Nearly 60 percent of small banks reported that the CFPB or the qualified mortgage rule had a "significant negative impact" on their mortgage operations. Nearly 60 percent said that the CFPB has had a significant negative effect on bank earnings and more than 60 percent said that changes in mortgage regulations had had a significant negative effect on bank earnings.

Moreover, by imposing a one-size-fits-all mechanical underwriting system for mortgages, the Qualified Mortgage rule has deprived community banks of a significant competitive advantage against megabanks: their intimate familiarity with their customers and their ability to engage in relationship lending with their customers. Consumers face a market with fewer choices, less innovation, and less competition than before.

As smaller banks have been disappearing and exiting certain markets, large banks have grown still larger and Dodd-Frank has increased their insulation from competitive pressures. In fact, large banks have admitted as much. For example, JP Morgan Chase CEO Jamie Dimon observed that the aggregate costs of complying with all of the rules, regulations, and capital costs associated with Dodd-Frank has built a "bigger moat" to protect his bank from competition from smaller rivals.[23] Similarly, Goldman Sachs CEO Lloyd Blankfein announced in 2010 that the bank would be "among the biggest beneficiaries" of Dodd-Frank as its regulatory costs and regulatory-created profit opportunities would be particularly advantageous to large banks that could bear those costs more easily than smaller competitors.[24]

Targeting Businesses by Operation Choke Point and the CFPB

In the post-Dodd-Frank era, the vast, ill-defined sway that regulators exercise over banks has enabled them to not only pick winners and losers in the financial system but to also use their clout to force banks to do their bidding outside of the formal regulatory process. Indeed, in some instances government regulators have essentially deputized banks as arms of the federal government, directing banks to attack private parties engaged in legal activities—without evidence of wrongdoing or the public scrutiny that a direct government action would bring. Consider two examples that demonstrate the point:

[22] *Id.*
[23] Rick Rouan, *Dimon says Dodd-Frank puts 'bigger moat' around JPMorgan Chase*, COLUMBUS BUSINESS FIRST (Feb. 5, 2013), *available in* http://www.bizjournals.com/ columbus/blog/2013/02/dimon-says-dodd-frank-puts-bigger.html.
[24] Timothy P. Carney, *Goldman and JPMorgan sit safely behind the walls of Dodd-Frank*, WASHINGTON EXAMINER (Feb. 12, 2015), *available in* http://www.washingtonexaminer .com/goldman-and-jpmorgan-sit-safely-behind-the-walls-of-dodd-frank/article/ 2560179.

Operation Choke Point and the Consumer Financial Protection Bureau's initiative against auto dealers for purported disparate impact in lending rates.[25]

Operation Choke Point

Consider first the shadowy initiative known as Operation Choke Point, which seems to have been spearheaded by the Department of Justice and the Federal Deposit Insurance Corporation (FDIC). Under Operation Choke Point, government regulators targeted myriad legal, but politically unpopular industries, such as firearms dealers, coin dealers, pornography, sellers of "racist materials," home-based charities, and most intensely, payday lending.[26] The FDIC, of course, had no jurisdiction over these industries and absent any demonstrable wrongdoing, the DOJ could not outlaw them either. Yet these limitations did not stop them.

Instead, the FDIC instructed regulated banks to cease providing banking services to these particular industries, with special attention paid to payday lenders, to "choke off the air" needed for these firms and industries to function.[27] Without the ability to clear checks and process electronic payments, payday lenders and other targeted firms simply could not exist and conduct business. Notably, the government's instructions were issued without any evidence that any of the industries on the affected list had done anything illegal, with no due process to the adversely affected firms, and, indeed, with a complete lack of transparency, including a reluctance to even admit except under pressure that the initiative even existed. Equally notable was the selective nature of the government's list of controversial industries that created "reputation risk" for banks, which included industries such as firearms sales but ignored other controversial industries such as abortion clinics. In one particularly colorful example of the lawless nature of the program, a senior official in the Division of Depositor and Consumer Protection instructed that any communications by FDIC Chairman Martin Gruenberg "always mention pornography when discussing payday lenders and other industries, in an effort to convey a 'good picture regarding the unsavory nature of the businesses at issue.'"[28] Aggressive oversight by Congress eventually persuaded FDIC to withdraw its list of

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[25] The following discussion draws from Zywicki, *supra* note 13.

[26] The entire list of targeted industries was promulgated informally by the FDIC in U.S. House, Committee on Oversight and Government Reform, *The Department of Justice's "Operation Chokepoint": Illegally Choking Off Legitimate Businesses?* Staff Report 113th Congress at 11 (May 29, 2014) online at http://oversight.house.gov/wp-content/uploads/2014/05/Staff-Report-Operation-Choke-Point1.pdf.

[27] See, e.g., Letter from M. Anthony Lowe, Director, FDIC Chicago Regional Office to Board of Directors of [Redacted] Bank (Feb. 15, 2013), *available at* http://oversight.house.gov/wp-content/uploads/2014/10/Regional-Director-Letter.pdf (stating that providing banking services to payday lending companies "carries a high degree of risk to the institution, including third-party, reputational, compliance, and legal risk" and that as a result "activities related to payday lending are unacceptable for an insured depository institution").

[28] U.S. House, Committee on Oversight and Government Reform, *Federal Deposit Insurance Corporation's Involvement in "Operation Choke Point,"* Staff Report 113th Congress at 1 (December 8, 2014) online at http://oversight.house.gov/wp-content/uploads/2014/12/Staff-Report-FDIC-and-Operation-Choke-Point-12-8-2014.pdf.

target industries and to formally claim that it was terminating Operation Choke Point,[29] but news reports indicate that it might still be continuing and that its implementation has simply shifted to the CFPB[30].

CFPB and Alleged Discrimination by Auto Dealers

A second example is the effort of the CFPB to enforce fair lending laws on auto dealers for the loans that they issue. Fair lending laws that prohibit discrimination in making loans apply to auto dealers. It is equally clear, however, that Dodd-Frank prohibits the CFPB from exercising jurisdiction over loans made by auto dealers, leaving that responsibility by implication to other federal agencies such as the Federal Trade Commission and DOJ.[31]

Lacking the authority to reach the auto dealers, the CFPB came up with a creative solution—it decided to hold the financial institutions (the indirect lenders) responsible for any alleged discriminatory lending patterns by the auto dealers themselves. Indirect lenders bear this responsibility even though they have no interaction with the borrower, information about the borrower's race, or any reason to believe that the dealers is engaged in discriminatory lending patterns. Moreover, the indirect lenders would be held responsible according to the theory of "disparate impact," making the indirect lenders responsible for any statistical anomalies that seemed to exist, regardless of the lack of any evidence of intentional discrimination.[32]

Both of these examples demonstrate the hazards of the absence of the rule of law in the modern financial regulatory system as the federal government has essentially weaponized America's financial institutions to carry out policies that it couldn't otherwise accomplish. Moreover, much of the policymaking is done in back rooms with no other formal protections or transparency. For example, Operation Choke Point was a secretive government program the very existence of which proved difficult to confirm, much less its details and implementation (it isn't even clear today whether the program continues

[29] See Kent Hoover, *FDIC removes Operation Choke Point's 'hit list,' clarifies guidance to Banks*, The Business Journals (July 29, 2014) online at http://www.bizjournals.com/bizjournals/washingtonbureau/2014/07/fdic-removes-operation-choke-points-hit-list.html.
[30] See Rachel Witkowski, *CFPB Launches Its Own Choke Point-Style Operation*, American Banker (April 8, 2015) online at http://www.americanbanker.com/news/law-regulation/cfpb-launches-its-own-choke-point-style-operation-1073659-1.html.
[31] Dodd-Frank Wall Street Reform and Consumer Protection Act § 1029(a), Pub.L 111-203, H.R. 4173 (2010).
[32] Lacking information on the borrower's race, the CFPB has instead relied on a statistical technique known as Bayesian Improved Surname Geocoding, which has been demonstrated to be statistically invalid in a highly analogous context. *See* Arthur P. Baines and Marsha J. Courchane, *Fair Lending: Implications for the Indirect Auto Finance Market*, American Financial Services Association (November 19, 2014), *available in* http://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf. The absence of any demonstrable victims of discrimination has also created difficulties for the CFPB in deciding to whom do distribute the proceeds of its various legal settlements under this theory. See *Do Two Half Victims Make a Whole Case?*, WALL ST. J. (Apr. 13, 2015), *available in* http://www.wsj.com/articles/do-two-half-victims-make-a-whole-case-1428966741.

and if so, which agency is executing it). The CFPB's attack on indirect auto lenders was issued through a five page "Guidance" document that provided no information about the basis for the CFPB's charge of discrimination or, originally, any methodology for determining liability, no opportunity for public comment or other due process protections, and no assessment of the impact on consumers.[33] In fact, according to a recent report in the *Wall Street Journal*, by narrowing the range over which dealers and consumers can bargain, the overall effect of the CFPB's micro-managing of the auto finance market has resulted in higher interest rates on car loans for consumers.[34] Meanwhile, those entities that are politically disfavored, such as payday lenders and firearms dealers, are crushed with no due process and no opportunity to defend themselves in any transparent regulatory proceeding.

The arbitrary exercise of regulatory authority has real-world consequences for consumers and the economy. For example, the complexity and risk under the Qualified Mortagages rule when combined with the threat of "put back" liability for loans based on trivial technical violations has led several leading mortgage lenders to exit the market for borrowers with lower credit scores.[35] As John Sumpf, the chief executive of Wells Fargo stated, "If you guys want to stick with the programme of 'putting back' any time, any way, whatever, that's fine, we're just not going to make those loans and there's going to be a whole bunch of Americans that are underserved in the mortgage market."[36] Similarly, Federal Reserve Chairwoman Janet Yellen has observed, "Banks, at this point, are reluctant to lend to borrowers with lower FICO scores. They mention in meetings with us consistently their concerns about put-back risk, and I think they are—it is difficult for any homeowner who doesn't have pristine credit these days to get a mortgage."[37]

Government power unconstrained by the rule of law also has direct implications for consumers by cultivating an environment of bureaucratic hubris at the expense of the rest of us. Consider the CFPB's extraordinary data mining program of American families' financial accounts. According to a report by the Government Accountability Office, the CFPB collects information on 10.7 million individual consumer credit reports on a monthly and quarterly basis, more than 500 million credit card accounts on a monthly basis, and 29 million active mortgages and 173 million total mortgages on a monthly

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[33] Consumer Financial Protection Bureau, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act*, CFPB Bulletin 2013-02 (March 21, 2013), *available in* http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf.

[34] *See* Annamaria Andriotis & Gautham Nagesh, *Crackdown on Racial Bias Could Boost Drivers' Costs for Auto Loans*, WALL ST. J. (Aug. 31, 2015), http://www.wsj.com/articles/crackdown-on-racial-bias-could-boost-drivers-costs-for-auto-loans-1441038864. The CFPB ignores other important elements of the inquiry especially that, unlike many other credit transactions, a car loan from an auto dealer is not a stand-alone transaction but is linked to the purchase of a car. For example, auto dealers offer promotional financing deals on particular car models in order to move inventory (rather than cutting the sticker price), which can result in spurious implications of differential pricing overall.

[35] *See* Camilia Hall, *Wells Chief Warns on Mortgage Lending* (Aug. 26, 2014), *available in* http://www.ft.com/intl/cms/s/0/cdfe20f8-2a2d-11e4-a068-00144feabdc0.html#axzz3lZKUva3B.

[36] *Id.*

[37] *Id.*

basis.[38] Moreover, because this data-mining program was not initiated according to any sort of formal notice and comment rulemaking procedure, it is not subject to cost-benefit analysis or any other evaluation as to whether such extensive snooping is necessary to further any legitimate regulatory purpose. In fact, George Mason University economist Thomas Stratmann has estimated that the number of credit card accounts for which the CFPB wants to collect consumer information is some 70,000 times greater than is necessary for the agency to execute its regulatory mission.[39] Indeed, the Bureau itself has refused to permit consumers an opportunity to opt-out of the program, admitting that if consumers were permitted to withdraw consent to the program the government would be unable to obtain the data.[40]

But the costs of CFPB's demand for information do not fall solely on the banks that must provide it. While the CFPB claims that this data is anonymous, every bit of information increases the risk to consumers of identity theft and other misuse of their information. In fact, testifying before this committee last year, CFPB director Richard Cordray admitted that the information the CFPB collects is not 100 percent secure and could be hacked.[41] Moreover, according to a recent article in *Science*, using only three months of anonymous credit card data, the researchers were able to reidentify 90 percent of individuals, with women being more readily reidentifiable than men.[42]

While the unnecessary acquisition and retention of troves of Americans' information is troubling enough in itself, it is especially worrisome in light of repeated rebukes of the CFPB's faulty data security systems.[43] Following massive data security breaches and compromising of personal information by the Internal Revenue Service and Office of Personnel Management, it is inexplicable that the CFPB continues to insist on vacuuming up excessive amounts of consumer data without considering the privacy threat to consumers. Leaving aside the risk of creating a massive trove of financial data for private hackers to target, Americans also have a fundamental interest in not having their purchases tracked by the federal government and an expectation that the government should not demand any more personal financial data than is necessary to advance its legitimate regulatory purposes.

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[38] GOVERNMENT ACCOUNTABILITY OFFICE, CONSUMER FINANCIAL PROTECTION BUREAU: SOME PRIVACY AND SECURITY PROCEDURES FOR DATA COLLECTIONS SHOULD CONTINUE BEING ENHANCED (2014).

[39] *See* Letter of Professor Thomas Stratmann to Congressman Scott Garrett (Jan. 23, 2014), *available in* http://mercatus.org/sites/default/files/StratmannCFPBStatisticMethods.pdf.

[40] *See* Richard Pollock, *Federal Consumer Bureau Data-Mining Hundreds of Millions of Consumer Credit Card Accounts, Mortgages*, WASHINGTON EXAMINER (Jan. 29, 2014), *available in* http://www.washingtonexaminer.com/consumer-bureau-data-mining-hundreds-of-millions-of-consumer-credit-card-accounts-mortgages/article/2543039.

[41] *Id.*

[42] Yves-Alexandre de Montjoye, Laura Radaelli, Vivek Kumar Singh, and Alex "Sandy" Pentland, *Unique in the Shopping Mall: On the Reidentifiability of Credit Card Metadata*, 347 SCIENCE No. 6221 536-39 (Jan. 30, 2015).

[43] *See* Government Accountability Office, *Consumer Financial Protection Bureau: Some Privacy and Security Procedures for Data Collections Should Continue Being Enhanced* (Sept. 2014); Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Office of Inspector General, *Security Control Review of the CFPB's Cloud Computing–Based General Support System*, 2014-IT-C-010 (Washington, D.C.: July 17, 2014).

Moral Hazard and the Rule of Law

The erosion of the rule of law creates a problem for the future: because of the government's demonstrated unwillingness to abide by the rule of law—and the courts' unwillingness to force it to do so in the midst of a financial crisis[44]—the government is unable to credibly commit itself to *not* use its authority to intervene in the economy, to bail out large banks, and to exercise its authority in a political fashion.

Thus, at the same time that smaller banks are being ground under Dodd-Frank's regulatory wheel, there is a general consensus that Dodd-Frank has failed to address the most fundamental regulatory problem highlighted by the financial crisis: financial institutions that are considered "Too-Big-To-Fail" are backed by an implicit government guarantee. Instead of resolving or mitigating that problem, Dodd-Frank has entrenched the TBTF problem. A report by the Government Accountability Office concluded that while Dodd-Frank may have reduced the size of the so-called "TBTF subsidy" for large banks it did not eliminate it, indicating that large banks still retain an implicit government guarantee.[45] A study by the International Monetary Fund concluded that the subsidy to TBTF banks in the United States amounts to some $70 billion per year in lower capital costs and that in turn the existence of an implicit government guarantee promotes the moral hazard problem of greater risk-taking by large banks.[46]

Despite the elaborate procedures concocted in Dodd-Frank for the resolution of financial distress by banks, the fundamental problem is that these procedures simply are not considered credible by market actors. No one seriously believes that a future President and future Congress will feel themselves bound to abide by Dodd-Frank's requirements when it comes to the resolution of distress by financial firms. This disbelief reflects the erosion of the rule of law and, in this sense, the expectation that large banks will be bailed out effectively becomes a self-fulfilling prophecy—just as last time Treasury Secretary Hank Paulson's primary justification for bailing out banks was that the market "expected it."[47]

More generally, in the post-Dodd-Frank world, the combination of vast, unaccountable political power combined with the increased clout of powerful special interests to use the regulatory process has—unsurprisingly—led to an explosion of lobbying activity by financial services firms to avoid the imposition of the crushing burden of heavy and arbitrary government action. In other cases, lobbying reflects rent-seeking activity and

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[44] *See* Zywicki, *supra* note 5.

[45] GOVERNMENT ACCOUNTABILITY OFFICE, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT (July 2014).

[46] International Monetary Fund, *Big Banks Benefit from Government Subsidies*, Global Financial Stability Report (2014) online at http://www.imf.org/external/pubs/ft/survey/so/2014/POL033114A.htm. Other studies reach different conclusions on the continued existence of the TBTF subsidy. For a summary of the literature as well as a caveat on the conclusions that can be drawn, see Todd J. Zywicki, *The Rule of Law During Times of Economic Crisis*, *supra* note 11.

[47] *See* Todd J. Zywicki, *The Next Financial Crisis: What Will the Market 'Expect'?*, LAW & LIBERTY BLOG (May 19, 2013), *available in* http://www.libertylawsite.org/book-review/the-next-financial-crisis-what-will-the-markets-expect/.

efforts by some firms to influence the political and regulatory process to gain a competitive advantage over rivals. In addition, the power of politicians to pick winners and losers arbitrarily has created greater opportunities for rent-extraction by politicians who can threaten to impose new regulations unless bought off by lobbying efforts and campaign contributions.[48]

Little wonder that the financial services industry spends tens of millions of dollars every year on lobbying expenditures to seek special treatment under the law or to protect themselves from arbitrary regulation. In a world where government officials hold the power to hand out billions of dollars of regulatory prizes and punishments with no accountability and no need to justify its actions according to any coherent principle—other than political expediency—powerful special interests are going to try to influence that process to their advantage.[49] The virtue of the rule of law is to restrain the discretionary power of the government to draw these sorts of arbitrary distinctions that permit some interests to benefit politically at the expense of others.[50]

What the Rule of Law Means for the Rest of Us

In this world of lawlessness and arbitrary regulatory authority clout is king. What does that mean for the rest of us? It is not often appreciated, but it is the average American or small business that benefits the most from upholding the rule of law. Big financial firms can survivie—indeed, even thrive—in a world devoid of settled rules and transparent governance. They can afford to hire the lawyers and lobbyists to wend their way through the arcane political and regulatory processes.

But everyone else—small businesses and ordinary families trying to get ahead in life—don't have access to expensive, well-connected lawyers and lobbyists. When we have to pay more for a car loan or can't obtain a credit card, mortgage, or small business loan to make our families' lives better, we can't find a high-priced lobbyist to grease the skids for us. When our government spies on our credit card accounts without our conent and seeks to "choke off" banking services for legal businesses, we are less free. Dodd-Frank has interjected the tentacles of the federal regulatory state into every aspect of our financial system, and as a result we are less free to obtain the means to make our lives better.

Thank you.

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[48] *See* Zywicki, *supra* note 13 (citing example of threats to impose new comprehensive regulations on hedge funds); *see also* Timothy P. Carney, *Schumer's Racket: Lobbyists and Hedge Funds*, WASHINGTON EXAMINER (May 26, 2010), *available in* http://www.washingtonexaminer.com/article/13668.

[49] *See* Gordon Tullock, *The Welfare Costs, of Tariffs, Monopoly, and Theft*, 5(3) WESTERN ECON. J. 224 (June 1967).

[50] *See* Zywicki, *supra* note 11.