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Regulatory

The Dodd-Frank Act Five Years  
Later: Are We More Stable?

Todd J. Zywicki

**RISK**

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# The Dodd-Frank Act Five Years Later: Are We More Stable?<sup>1</sup>

**Todd J. Zywicki** – George Mason University Foundation Professor of Law and Executive Director,  
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## **Abstract**

In response to the global financial crisis, in 2010 Congress enacted the Dodd-Frank Financial Reform Act, which was ostensibly designed to “end” the problem of too-big-to-fail banks and otherwise reform and modernize the American financial system. I, and others, have elsewhere considered the impact that Dodd-Frank has had on the financial services industry, banking industry, and consumers. This article focuses on a larger long-term influence of Dodd-Frank and the financial crisis: the impact on the rule of law and freedom. Although Dodd-Frank and the regulations enacted under it could, in theory, be repealed or amended in the future, it will be far more difficult to reverse the impact of Dodd-Frank and the financial crisis on the rule of law, constitutional government and individual freedom and protection from arbitrary government.

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<sup>1</sup> This article is based on testimony presented to the U.S. House of Representatives, Committee on Financial Services (Sept. 17, 2015).

## INTRODUCTION

In response to the global financial crisis of 2008, in 2010 Congress enacted the Dodd-Frank Financial Reform Act, ostensibly to prevent future financial crises, eliminate the problem of too-big-to-fail (TBTF) financial institutions, and increase consumer protections for financial services consumers.

As Dodd-Frank celebrates its fifth birthday, it remains highly controversial and many question whether it has on net been harmful or beneficial to the stability and efficiency of the American financial services sector, the larger economy, and consumers. Less examined, however, is the long-run impact of Dodd-Frank on individual freedom, the rule of law, and constitutional government. In theory, the adverse effects of Dodd-Frank on the economy and financial system can be ameliorated by future legislation to repeal or amend the law. Efforts to reverse the long-run impact on the rule of law and individual freedom, however, will be more difficult. And, in the long run, these impacts may be more important than the direct economic effects of the law.

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.<sup>2</sup>

This article reviews the long-run impact of Dodd-Frank on individual freedom and the rule of law, providing a cautionary tale for the future as well as signals for concrete reforms that Congress and a new President should consider going forward.

## THE IMPACT OF DODD-FRANK ON FREEDOM: THE REGULATORY BURDEN

In the new world of Dodd-Frank, the success of a financial institution is no longer determined by its ability to be among the best providers within a highly competitive market. Instead, it is determined by which institutions can best wind their way through the labyrinthine halls of Congress and the Federal Reserve Board.

According to one widely-cited estimate, Dodd-Frank requires 398 new rulemakings by federal agencies<sup>3</sup> and as of July 2014 (when one-quarter of the rulemakings were still left to be completed) Dodd-Frank was estimated to have imposed U.S.\$21.8 billion and 60.7 million paperwork hours in compliance costs.<sup>4</sup> Projecting forward, it is estimated by one economist that over the next 10 years

the full compliance costs of Dodd-Frank will result in U.S.\$895 billion in reduced GDP or U.S.\$3,346 per working-age person.<sup>5</sup> Furthermore, 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 only consider the economic costs of Dodd-Frank means that another more intangible cost is ignored, namely that 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.

## THE FINANCIAL CRISIS AND THE DECLINE OF THE RULE OF LAW

The recent financial crisis reveals four lessons that highlight the importance of upholding the rule of law during crises in order to preserve individual freedom. First, adherence to the rule of law during the crisis is crucial to allow the economy to restore coordination after a period of economic dislocation. Second, 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. Third, 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

2 See Durkin, T. A., G. Eliehausen, M. E. Staten, and T. J. Zywicki, 2014, *Consumer credit and the American economy*, Oxford University Press

3 Polk, D., 2015, *Dodd-Frank Progress Report*, <http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/>. Romano, R., 2014, *Dodd-Frank's regulatory morass*, Penn Program on Regulation RegBlog, November 10, available in <http://www.regblog.org/2014/11/10/romano-dodd-frank-consequences/>.

4 Winkler, A., B. Gitis, and S. Batkins, 2014, *Dodd-Frank at 4: more regulation, more regulators, and a sluggish housing market*, July 15, available in <http://americanactionforum.org/research/dodd-frank-at-4-more-regulation-more-regulators-and-a-sluggish-housing-mark>.

5 Holz-Eakin, D., 2015, "The growth consequences of Dodd-Frank," *American Action Forum*, May 6, available in <http://americanactionforum.org/research/the-growth-consequences-of-dodd-frank>.

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. Finally, once discretion and the government’s power to pick winners and losers arbitrarily is entrenched, this institutional framework creates moral hazard for politicians and special interests that creates the conditions for the next crisis, which will probably be met by similar means.

The world of Dodd-Frank exemplifies this progression. As a result of Dodd-Frank’s heavy and vague regulatory regime, the law is not just hampering the economy but adversely impacting the ability of Americans to gain access to capital to pursue their dreams in life. Access to capital is the lifeblood of the ability to plan for one’s financial future, buy a home, or open a bank account. Thus, not only is Dodd-Frank having an adverse economic impact, the freedom to pursue one’s dreams in life are being crushed under the thicket 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 institutions are considered TBTF to the loan terms of your new car, a handful of unelected Washington bureaucrats are prying into household and small business finances to make those decisions for you.

### Why the rule of law matters during a financial crisis

To make a loan, a bank must be able to do two things.<sup>6</sup> 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 exposure, 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 commercial 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.<sup>7</sup> 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.<sup>8</sup>

Adherence to the rule of law is especially important during periods of economic dislocation, such as during the financial crisis. During 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.<sup>9</sup> 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.<sup>10</sup> 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 reasonably well, except for those financial institutions that were having liquidity issues.”<sup>11</sup> 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.<sup>12</sup>

### 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

6 See Zywicki, T. J., 2012, “Economic uncertainty, the courts, and the rule of law, 35 *Harvard Journal of Law and Public Policy*, 195

7 See Zywicki, T. J., 2003, “The rule of law, freedom, and prosperity,” 10 *Supreme Court Economic Review*, 1

8 *Id.*

9 Skeel, D. A., 2011, *The new financial deal: understanding the Dodd-Frank Act and its (unintended) consequences*, Wiley

10 Wallison, P. J., 2013, *Bad history, worse policy: how a false narrative about the financial crisis led to the Dodd-Frank Act*, AEI Press; Taylor, J. B., 2009, *Getting off track: how government action and interventions caused, prolonged, and worsened the financial crisis*, Hoover Press.

11 Kovacevich, R. J., 2014, “The financial crisis: why the conventional wisdom has it all wrong,” 34(1) *Cato Journal*

12 Zywicki, T. J., 2015, “The rule of law during times of economic crisis,” August 26, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2651893](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2651893).



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 bailout 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 bailout 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.”<sup>13</sup> 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.<sup>14</sup>

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.<sup>15</sup> 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 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.<sup>16</sup> 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.<sup>17</sup>

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.<sup>18</sup>

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?”<sup>19</sup>

Unfortunately my prediction has been proven correct: 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 labor presence, leading to a significant increase in borrowing costs for those firms.”<sup>20</sup> By destabilizing contracts to benefit a powerful special interest, the government created a cloud of political risk over financial markets and the economy.

13 Couch, J. F., M. D. Foster, K. Malone, and D. L. Black, 2011, “An analysis of the financial services bailout vote,” 31 *Cato Journal* 119, online <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2011/1/cj31n1-8.pdf>.

14 For a summary of these studies, see Zywicki, T. J., 2016, “Rent-seeking, crony capitalism, and the crony constitution,” *Supreme Court Economic Review* (Forthcoming), available in [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2651587](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2651587) (Aug. 26, 2015).

15 See Zywicki, T. J., 2014, “The corporatist legacy of the auto bailouts,” *Law & Liberty Blog*, January 13, available at <http://www.libertylawsite.org/2014/01/13/the-corporatist-legacy-of-the-auto-bailouts/>.

16 Zywicki, T. J., 2011, “The auto bailouts and the rule of law,” 7 *National Affairs*, available at <http://www.nationalaffairs.com/publications/detail/the-auto-bailout-and-the-rule-of-law>.

17 Zywicki, T. J., 2014, “The corporatist legacy of the auto bailouts,” *Law & Liberty Blog*, January 13, available at <http://www.libertylawsite.org/2014/01/13/the-corporatist-legacy-of-the-auto-bailouts/>.

18 See Zywicki, *supra* note 16. 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.sig tarp.gov/Audit%20Reports/SIGTARP\\_Delphi\\_Report.pdf](https://www.sig tarp.gov/Audit%20Reports/SIGTARP_Delphi_Report.pdf).

19 See Zywicki, T. J., 2009, “Chrysler and the rule of law,” *Wall Street Journal*, May 13

20 Blaylock, B., A. Edwards, and J. Stanfield, “The role of government in the labor-creditor relationship: evidence from the Chrysler bankruptcy,” 50(3) *Journal of Financial and Quantitative Analysis* 325, 327

### **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 produced 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.

## **THE IMPACT OF THE DECLINE OF THE RULE OF LAW ON PERSONAL FREEDOM**

Three striking examples of the post-crisis regulatory environment illustrate the erosion of the rule of law in action: 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 after Dodd-Frank’s enactment compared to before, a result that they attribute to the high regulatory costs imposed by Dodd-Frank.<sup>21</sup> 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.<sup>22</sup>

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 home mortgages.

Community banks historically have provided more than half of the residential mortgages in the U.S. 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.<sup>23</sup> 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. One illustration of the value of the traditional relationship-lending model for residential mortgages is that the default rate for residential mortgages made by community banks (with less than U.S.\$1 billion in assets) was 3.47 percent in 2013 compared to a default rate of 10.42 percent for banks with more than U.S.\$1 billion in assets.<sup>24</sup> Thus, this regulatory-induced decline in the market share of small banks is not only hurting consumers, it is making the banking system less stable and less effective. Consumers face a market with fewer choices, less innovation and less competition than before.

The ripple effects of the displacement of smaller banks by large banks are not limited to the direct impact on the banking system but carry over to other markets as well, including agricultural and small business loans. Community banks historically have provided the majority of agricultural and small-business financing in the U.S.<sup>25</sup> As community banks have been driven out of the market by

21 Lux, M., and R. Greene, 2015, “The state and fate of community banking,” M-RCBG Associate Working Paper No.37 (February 2015) online at [http://www.valuwalk.com/wp-content/uploads/2015/02/Final\\_State\\_and\\_Fate\\_Lux\\_Greene.pdf](http://www.valuwalk.com/wp-content/uploads/2015/02/Final_State_and_Fate_Lux_Greene.pdf).

22 Pierce, H., I. Robinson, and T. Stratmann, 2014, “How are small banks faring 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>

23 Id.

24 Peirce, H., 2013, Senior Research Fellow, The Mercatus Center at George Mason University, testimony before the House Committee on Oversight and Government Reform, 113th Congress, 1st session. July 18, [http://smbiz.house.gov/uploadedfiles/12-3-2013\\_peirce\\_burdenssmallbanks\\_testimony\\_112613.pdf](http://smbiz.house.gov/uploadedfiles/12-3-2013_peirce_burdenssmallbanks_testimony_112613.pdf).

25 See Lux and Greene, *supra* note 21, at 1 (noting that community banks provide 77 percent of agricultural and over half of small business loans).

regulatory costs, small business credit has contracted as well, dampening entrepreneurship and economic growth. As noted by one analysis, large firms have performed well since the financial crisis and subsequent recovery, but small firms have suffered low rates of formation, employment growth, and wage growth.<sup>26</sup> Indeed, the number of small firms in the economy actually declined over the period since the crisis, as more small firms disappeared than were created, the first time that this has happened since data became available in the 1970s.<sup>26</sup> A primary explanation for this drop in small business formation and growth is Dodd-Frank and increased financial regulation since the financial crisis, which has fallen especially hard on smaller banks relative to larger banks.<sup>28</sup> Overall, a recent analysis of FDIC (Federal Deposit Insurance Corporation) data found that while bank loans to small businesses had declined by 16% since 2008, loans to large businesses had increased by 37% over that same period.<sup>29</sup> As one commenter described the situation, large banks “have effectively abandoned the small business market.”<sup>30</sup> Another analysis concluded that small business loans are down about 20% since the financial crisis while loans to larger businesses have increased by about 4% over the same period.<sup>31</sup> It appears that some of the unmet demand from the reduction in community bank lending is being served by non-bank lenders that charge higher rates than traditional small business bank loans and which, ironically, are much less-regulated than the traditional banks that they have replaced.<sup>32</sup>

According to Wells Fargo Quarterly survey of small business owners, in the third quarter of 2015, just 33% of small business owners surveyed stated that it would be “very easy” or “easy” to obtain credit if they needed it and 22% said that it would be “somewhat difficult” or “very difficult.”<sup>33</sup> Only 19% said it would be “very easy” to obtain credit when they needed it; even more remarkable, that is the highest level for those saying credit is “very easy” since the recession hit and Dodd-Frank was enacted, as for most of that period the rate has been in the low-teens. By contrast, during the period from the 1Q2004-4Q2007, an average 51% of small business owners said that it was “very easy” or “somewhat easy” to obtain credit if they needed it, and about 12% said it would be difficult. In addition, among those who said that it was easy to obtain credit in the 2004-07 period, 2/3 of those reported it was “very easy” compared to “somewhat easy,” whereas only about half of those who said that it would be easy in the post-Dodd-Frank pool reported that it would be “very easy.”

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.<sup>34</sup> 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.<sup>35</sup>

Moreover, because many of Dodd-Frank’s most expensive rules kick-in once a bank reaches U.S.\$10 billion in assets, that figure acts as a sort of tripwire – either banks try to remain below that threshold, or if they do cross it, then they accelerate their merger activities to try to gain the size and economies of scale necessary to cope with heightened regulatory costs. Thus, the market is becoming increasingly bifurcated between large banks and very small banks, as medium-sized banks grow larger.<sup>36</sup> On the other hand, only one new bank has been formed since the financial crisis and small banks continue to merge or otherwise disappear as a result of their own regulatory costs. This phenomenon of the disappearance of small banks and the lack of creation of new ones led economists from the Dallas Federal Reserve bank to ask whether small banks are “too small to succeed” in light of the huge growth in regulatory cost and complexity imposed in the period since the financial crisis.<sup>37</sup> They too note the important role played by community banks in small business lending and agricultural markets and the adverse effects on small-business formation and growth as a result of this trend toward the disappearance of small banks.

26 Goldman Sachs, 2015, “The two-speed economy,” 2, April

27 Id.

28 Goldman Sachs, 2014, “Who pays for bank regulation,” June

29 Simon, R., 2015, “Big banks cut back on loans to small business,” Wall Street Journal, November 26

30 Id.

31 See Mills, K. G., and B. McCarthy, 2014, “The state of small business lending: credit access during the recovery and how technology may change the game,” Harvard Business School Working Paper 15-004

32 Id.

33 Gallup/Wells Fargo Small Business Survey 24-25, <https://wellsfargoworks.com/File/Index/btDsu4gv9UqK07hpFKVbgw> (Oct. 3, 2015) (responses to Question 11).

34 Rouan, R., 2013, “Dimon says Dodd-Frank puts ‘bigger moat’ around JPMorgan Chase,” Columbus Business First, February 5, available in <http://www.bizjournals.com/columbus/blog/2013/02/dimon-says-dodd-frank-puts-bigger.html>.

35 Carney, T. P., 2015, “Goldman and JPMorgan sit safely behind the walls of Dodd-Frank,” Washington Examiner, February 12, available in <http://www.washingtonexaminer.com/goldman-and-jpmorgan-sit-safely-behind-the-walls-of-dodd-frank/article/2560179>.

36 Picker, L., and M. Monks, 2013, “Small banks feel the urge to merge,” Bloomberg Business, October 3, available at <http://www.bloomberg.com/bw/articles/2013-10-03/dodd-frank-fills-small-banks-with-the-urge-to-merge>.

37 See Ash, P., C. Koch, and T. F. Siems, “Too small to succeed? – Community banks in a new regulatory environment,” Dallas Fed Financial Insights, Vol. 4, Issue 4

### **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: Operation Choke Point and the Consumer Financial Protection Bureau’s initiative against auto dealers for purported disparate impact in lending rates.<sup>38</sup>

#### **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 FDIC. Under Operation Choke Point, government regulators targeted a myriad of legal, but politically unpopular industries, such as firearms dealers, coin dealers, pornography, sellers of “racist materials,” home-based charities, and most intensely, payday lending.<sup>39</sup> 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.<sup>40</sup> 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.’”<sup>41</sup> Aggressive oversight by Congress eventually persuaded FDIC to withdraw its

list of target industries and to formally claim that it was terminating Operation Choke Point,<sup>42</sup> but news reports indicate that it might still be continuing and that its implementation has simply shifted to the CFPB.<sup>43</sup>

Despite these formal actions, there are reports that suggest that Operation Choke Point or some variant thereof, continues to operate within the financial services sector.<sup>44</sup> For example, it has been reported by one bank that the Treasury Department forced it to categorically discontinue providing money transfer services to Somalia. According to Oxfam International, the result of this prohibition on remittances may be the starvation of three million Somalis who depend on remittances from the West.

#### **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.<sup>45</sup>

Lacking the authority to reach the auto dealers, the CFPB came up with a creative solution – it decided to hold the financial institutions

<sup>38</sup> The following discussion draws from Zywicki, supra note 14.

<sup>39</sup> The entire list of targeted industries was promulgated informally by the FDIC in U.S. House, Committee on Oversight and Government Reform, 2014, “The Department of Justice’s “Operation Chokepoint”: illegally choking off legitimate businesses?” Staff Report 113th Congress at 11, May 29, available online at <http://oversight.house.gov/wp-content/uploads/2014/05/Staff-Report-Operation-Choke-Point1.pdf>.

<sup>40</sup> 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”).

<sup>41</sup> U.S. House, Committee on Oversight and Government Reform, 2014, “Federal Deposit Insurance Corporation’s involvement in “Operation Choke Point,” Staff Report 113th Congress at 1, December 8, available at <http://oversight.house.gov/wp-content/uploads/2014/12/Staff-Report-FDIC-and-Operation-Choke-Point-12-8-2014.pdf>.

<sup>42</sup> See Hoover, K., 2014, “FDIC removes Operation Choke Point’s ‘hit list,’ clarifies guidance to banks,” The Business Journals, July 29, available at <http://www.bizjournals.com/bizjournals/washingtonbureau/2014/07/fdic-removes-operation-choke-points-hit-list.html>.

<sup>43</sup> See Witkowski, R., 2015, “CFPB launches its own Choke Point-Style operation,” American Banker, April 8, available at <http://www.americanbanker.com/news/law-regulation/cfpb-launches-its-own-choke-point-style-operation-1073659-1.html>.

<sup>44</sup> See Sant, G., and B. Williams, 2015, “The choking continues after “Choke Point,”” American Banker, October 19

<sup>45</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 1029(a), Pub.L 111-203, H.R. 4173 (2010).



(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 are 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.

A prime illustration of the modern approach to the modern regulatory approach was the CFPB's decision to target Ally Financial for its first high-profile settlement for alleged discrimination in auto dealer markups.<sup>46</sup> According to internal documents examined by the House Financial Services Committee, the CFPB identified Ally as its first target not because Ally had acted in a particularly improper fashion, but because Ally was particularly vulnerable to being strong-armed into a settlement. This was for three reasons. First, as a result of the continued legacy of the auto bailouts, the federal government still held a 73.8% stake in Ally at that time (and still held 63.4% at the time the case was actually settled). Second, Ally had an application pending in front of the Federal Reserve to become a financial holding company, approval of which was necessary to continue its insurance and used-car remarketing operations. Third, the FDIC was conducting a Community Reinvestment Act review of Ally and settlement of the CFPB investigation was a precondition to receive a satisfactory CRA rating, which in turn was necessary for approval of Ally's status change to become a financial holding company. Faced with these obstacles, Ally eventually capitulated and finally paid U.S.\$98 million for restitution and civil penalties.

On the other hand, because the CFPB never identified particular victims of discrimination but relied on statistical aggregates, it had no way of identifying the race of the supposed victims or to identify those to whom restitution should be paid. Instead, the CFPB relied on a statistical technique known as Bayesian Improved Surname Geocoding, which has been demonstrated to be statistically invalid for these purposes.<sup>47</sup> Indeed, according to documents secured by the House of Representatives Financial Services Committee, the CFPB itself was aware of the flaws in the methodology and the CFPB's proposed use, yet nevertheless persevered, using it as a basis to establish liability. The result has been to issue "restitution" checks to many people who have provided no evidence that they were the subject of racial discrimination – including at least one identified beneficiary who is not even a minority.<sup>48</sup>

The 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 is not even clear today whether the program continues 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.<sup>49</sup> 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.<sup>50</sup> 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.

### Other examples of regulatory overreach under Dodd-Frank

The arbitrary exercise of regulatory authority has real-world consequences for consumers and the economy. For example, the complexity and risk under the Qualified Mortgages 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.<sup>51</sup> As John Sumpf, the chief executive of Wells Fargo stated, "If you guys want

46 Report of Republican Staff of the Committee on Financial Services, U.S. House of Representatives, 2015, "Unsafe at any bureaucracy: CFPB junk science and indirect auto lending," November 24

47 See Baines, A. P., and M. J. Courchane, 2014, "Fair lending: implications for the indirect auto finance market," American Financial Services Association, November 19, available at <http://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf>.

48 Wall Street Journal, 2015, "Do two half victims make a whole case?" Opinion, April 13, available at <http://www.wsj.com/articles/do-two-half-victims-make-a-whole-case-1428966741>

49 Consumer Financial Protection Bureau, 2013, "Indirect auto lending and compliance with the Equal Credit Opportunity Act," CFPB Bulletin 2013-02, March 21, available at [http://files.consumerfinance.gov/f/201303\\_cfpb\\_march\\_-\\_Auto-Finance-Bulletin.pdf](http://files.consumerfinance.gov/f/201303_cfpb_march_-_Auto-Finance-Bulletin.pdf).

50 See Andriotis, A., and G. Nagesh, 2015, "Crackdown on racial bias could boost drivers' costs for auto loans," Wall Street Journal, August 31, available at <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.

51 See Hall, C., "Wells chief warns on mortgage lending," August 26, available at <http://www.ft.com/intl/cms/s/0/cdfe20f8-2a2d-11e4-a068-00144feabdc0.html#axzz3IKUva3B>.

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.”<sup>52</sup> 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.”<sup>53</sup>

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 basis.<sup>54</sup> 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 on is some 70,000 times greater than is necessary for the agency to execute its regulatory mission.<sup>55</sup> Indeed, the Bureau itself has refused to permit consumers from opting-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.<sup>56</sup>

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.<sup>57</sup> 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.<sup>58</sup>

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.<sup>59</sup> 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.

## 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<sup>60</sup> – 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 the Act has failed to address the most fundamental regulatory problem highlighted by the financial crisis: financial institutions that are considered TBTF are backed by an implicit government guarantee.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Government Accountability Office, *Consumer Financial Protection Bureau: Some Privacy and Security Procedures for Data Collections should Continue Being Enhanced*, 2014

<sup>55</sup> See Letter of Professor Thomas Stratmann to Congressman Scott Garrett, January 23, 2014, available in <http://mercatus.org/sites/default/files/StratmannCFPBStatisticMethods.pdf>.

<sup>56</sup> See Pollock, R., 2014, “Federal consumer bureau data-mining hundreds of millions of consumer credit card accounts, mortgages,” *Washington Examiner*, January 29, available at <http://www.washingtonexaminer.com/consumer-bureau-data-mining-hundreds-of-millions-of-consumer-credit-card-accounts-mortgages/article/2543039>.

<sup>57</sup> *Id.*

<sup>58</sup> de Montjoye, Y-A., L. Radaelli, V. K. Singh, and A. Pentland, 2015, “Unique in the shopping mall: on the reidentifiability of credit card metadata,” 347 *Science* No. 6221 536-39

<sup>59</sup> See Government Accountability Office, *Consumer Financial Protection Bureau*, 2014, “Some privacy and security procedures for data Collections should continue being enhanced,” September; Board of Governors of the Federal Reserve System, *Consumer Financial Protection Bureau, Office of Inspector General*, 2014, “Security control review of the CFPB’s cloud computing-based general support system,” 2014-IT-C-010, Washington, D.C.: July 17

<sup>60</sup> See Zywicki, *supra* note 6.

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.<sup>61</sup> A study by the International Monetary Fund concluded that the subsidy to TBTF banks in the U.S. amounts to some U.S.\$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.<sup>62</sup>

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 Treasury Secretary Paulson’s primary justification for bailing out banks being that the markets “expected it.”<sup>63</sup>

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 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.<sup>64</sup>

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 their actions according to any coherent principle – other than political expediency – powerful special interests are going to try to influence that process to their advantage.<sup>65</sup> 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.<sup>66</sup>

## **CONCLUSION: DODD-FRANK AND THE DECLINE OF THE RULE OF LAW**

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 survive – 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 – do not have access to expensive, well-connected lawyers and lobbyists. When we have to pay more for a car loan or cannot obtain a credit card, mortgage, or small business loan to make our families’ lives better, we cannot find a high-priced lobbyist to grease the skids for us. When our government spies on our credit card accounts without our consent 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.

61 Government Accountability Office, 2014, “Large bank holding companies: expectations of government support,” July

62 International Monetary Fund, 2014, “Big banks benefit from government subsidies,” Global Financial Stability Report, available 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 Zywicki, *supra* note 12.

63 See Zywicki, T. J., 2013, “The next financial crisis: what will the market ‘expect’?” Law & Liberty Blog, May 19, available at <http://www.libertylawsite.org/book-review/the-next-financial-crisis-what-will-the-markets-expect/>.

64 See Zywicki, *supra* note 14 (citing example of threats to impose new comprehensive regulations on hedge funds); see also Carney, T. P., 2010, “Schumer’s racket: lobbyists and hedge funds,” Washington Examiner, May 26, available at <http://www.washingtonexaminer.com/article/13668>.

65 See Tullock, G., 1967, The Welfare Costs, of Tariffs, Monopoly, and Theft, *Western Economic Journal* 5 :3, 224-232.

66 See Zywicki, *supra* note 12.

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