The Presidency, Congressional Republicans, and the Future of Financial Reform

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The Presidency, Congressional Republicans, and the Future of Financial Reform

Summary
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Disciplines
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As the curtain falls on the Obama presidency, historians have already begun to put the past Administration into a broader context.

While only the Affordable Care Act will be identified by the former President’s name—even Obama has embraced the Obamacare moniker—the Wall Street Reform and Consumer Protection Act of 2010, or Dodd-Frank, will figure prominently in any assessment of Obama’s legacy.

As with its older sibling, how Dodd-Frank is assessed will be a partial function of how much of it survives. Since before its enactment in July 2010, Republicans have been circling wagons to amend it, gut it, or repeal it. Now that the party has assumed control of both houses of Congress and the White House, some skeptics are ready to forecast the dismantling of Dodd-Frank. For support, they point to the Financial CHOICE Act, a piece of legislation introduced by Republicans in September 2016.

Not so fast. While the CHOICE Act would certainly amount to a wholesale repudiation and near complete repeal of Dodd-Frank’s key provisions, a difficult political dynamic is underway that the election of Donald Trump complicates, rather than facilitates. At play is both an ideological difference in how the government should approach financial reform, but also institutional differences that have more to do with presidential politics than partisan ideology.

**SUMMARY**

- When it comes to financial regulation, many have assumed that the Trump Administration will now work in concert with a Republican-controlled Congress to repeal Dodd-Frank in full—a move anticipated in the CHOICE Act, a piece of legislation introduced by Republicans in September 2016. But there are reasons to believe that this will not be straightforward.

- Republicans fashioned the CHOICE Act in anticipation of a Hillary Clinton presidency, with the goal of limiting the executive’s discretion in response to financial risk. In light of Donald Trump’s unexpected rise to the Presidency, it is possible that some Republicans may start reevaluating the benefits of limiting executive authority. And recent comments by President Trump’s pick for Treasury Secretary, Steven Mnuchin, suggest that the Administration favors keeping some aspects of Dodd-Frank.

- This issue brief examines the tension between the Republican ideological commitment to curbing executive power and the opportunity Republicans now have for Trump to dominate the direction of financial regulatory reform. The discussion will focus on three key policy outcomes that Republicans have sought during the last six years: reforming the Federal Reserve, overhauling the Consumer Financial Protection Bureau, and changing the way in which the nation’s largest financial institutions are designated and regulated.
In this Issue Brief, I will discuss those two sometimes conflicting motivations behind Republican reform of the financial sector and focus especially on three key policy outcomes that Republicans have sought during the last six years: reforming the Federal Reserve, overhauling the Consumer Financial Protection Bureau, and changing the way the largest financial institutions are regulated. The issues described here are much broader than the CHOICE Act, though that proposed legislation provides a useful jumping off point for discussion. The real questions are about who controls power within the party system: those with ideological commitments to specific policy outcomes, or those who seek to increase the institutional power of the President. Prior to last November, Republicans calls for financial reform had been predicated on a Hillary Clinton presidency. Now that that has not come to pass, and Republicans control both the executive and legislative branches, this Issue Brief reviews a new set of questions that have arisen as to how the ruling party will pursue its agenda with respect to financial regulation.

THE POLITICAL DYNAMICS OF FINANCIAL REFORM

It is inaccurate to refer to “Dodd-Frank” as a single law. It is, in fact, sixteen different statutes rolled into one. But when Dodd-Frank’s critics point to an overarching zeitgeist, it is essentially technocratic: the Act puts enormous power in the hands of regulators—whether at the Federal Reserve or FDIC, or new agencies like the Consumer Financial Protection Bureau and the Financial Stability Oversight Council—to prevent, manage, and resolve abuses of the financial system that can result in crisis.

The Republican model for reform is very different. Rather than delegating to regulators this power, the Republican model would place more control in the hands of market participants themselves and, failing that, judges. The defenders of the Republican plan for financial reform would emphasize a light governmental touch and the rule of law. Let market participants allocate risk as makes most sense to their business model and let them fail when they cannot. That failure will be resolved by law-following bankruptcy judges after the fact, not fine-tuning central bankers well before.

The CHOICE Act reflects those twin pillars. The surprise election of Donald Trump suggests to many, including the CHOICE Act’s sponsors in Congress, that this Republican approach to governance and regulation will finally get its due. But there is a problem with this assumption. The CHOICE Act is a staging ground not only for ideological conflict between technocratic Democrats and market-oriented Republicans, but also for an institutional conflict between the executive and Congress. The bill was introduced with the presumption that Hillary Clinton would win the presidential election. Much of the language aimed at limiting the powers of the executive can be read through that prism. But what does the direction of financial reform under an ostensibly unified Republican federal government look like? And what happens if the new Republican President disapproves of some of his party’s established views on the 2010 law?

These are the questions for those who would predict a wholesale abandonment of Dodd-Frank. While we cannot be sure of the final shape of a financial reform under a government united by the Republican Party, we can be certain that the policy and institutional preferences of the

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7 From the opening lines of a speech delivered by Ben Bernanke on November 14, 2007: “Montagu Norman, the Governor of the Bank of England from 1921 to 1944, reputedly took as his personal motto, “Never explain, never excuse.” Norman’s aphorism exemplified how he and many of his contemporaries viewed the making of mon-
Republican President will change that ethos. For example, President Trump's nominee for Treasury Secretary, Steve Mnuchin, has already walked back the idea of doing away with Dodd-Frank in its entirety. During his Senate confirmation hearing, Mnuchin said that the new administration favors the Volcker Rule, which prevents commercial banks from using depository assets for making investments not on behalf of a client. As Mnuchin stated, “The concept of proprietary trading does not belong in banks with FDIC insurance.”

This declaration should surprise some of Obama’s and Dodd-Frank’s longest-standing Republican critics: repeal of the Volcker Rule has long been a goal of those critics.

Whatever the ultimate direction that these legislative and executive debates take, three major points will be central to any discussion of financial reform. These three areas of potential reform are: the Federal Reserve’s operations, particularly as they pertain to how the Fed conducts monetary policy; the role of the Consumer Financial Protection Bureau; and the process of designating and regulating large financial institutions as “systemically important” and thus subject to additional regulatory constraints. The remainder of this Issue Brief highlights and addresses the critical aspects of each of these three areas, with the acknowledgment that other important issues remain outstanding, such as the complexities of the Volcker Rule and the massive growth of the shadow banking system.

REMODELING THE ROLE OF THE FED

Politicians, activists, academics, and central banks have discussed many ways to alter the status quo of the Fed’s independent monetary policy authority and financial industry supervision over the past few years. In response to the Fed’s outsized role in combating the ill effects of the financial crisis, there has been a call for greater transparency and accountability of the Bank’s activities. While the Fed has been subject to a variety of critiques for the way it has handled the response to financial crises and bank supervision generally, the main focus—and certainly the place where the Fed is likely to fight back the hardest—is in the specific ways that it conducts monetary policy.

Republicans have long criticized the Fed for using discretion in conducting monetary policy, rather than following a rigid, programmatic rule. Legislative proposals, including within the CHOICE Act but also predating it, would insert much more congressional engagement with monetary policy through more transparent rulemaking. House Republicans have called for the Fed’s monetary policy committee, the Federal Open Market Committee (FOMC), to explain all of their policy rate decisions in terms of a standardized rule and to do so, specifically to Congress, within days of each FOMC meeting. Critics of this proposal have wrongly asserted that this rule necessarily must be the Taylor Rule, named for the simple arithmetic function first devised by Stanford economist John Taylor to describe how the Fed conducted monetary policy from 1987-1992. The original proposals do indeed mandate that conformity, but the current legislative plan would require the Fed to choose its own rule and explain why it deviates from the Taylor Rule, if in fact it does.

The Fed has argued—persuasively, in my view—against this proposal. Guiding monetary policymaking by a coherent and consistent rule is not necessarily disadvantageous. The Fed has embraced this method for decision-making, as the recent disclosures in the 2011 FOMC transcripts

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2. The current proposal does not abolish the FSOC outright, but rather repurposes the entity as an inter-agency forum on financial stability with a mission that is largely relegated to market monitoring and information sharing. In that sense, it mirrors the pre-Dodd-Frank Presidential Working Group on Financial Markets, created by Ronald Reagan in 1988.
suggest. And the idea that the Fed should not be a fortress of technical solitude is a sound one. We are a long way off from the central banking ethos that dominated the 19th and 20th centuries to “never explain, never excuse,” in the words of one prominent central banker.

Indeed, the Fed is today one of the most transparent of all governmental institutions. It holds regular press conferences; its key leaders give speeches and congressional testimony. Its minutes are released after three weeks, and full transcripts released on a five-year lag. Mandating monetary policymaking by rule will enhance transparency in some ways, but it won’t add transparency where none exists.

Perhaps more importantly, transparency isn’t always an unmitigated good. When macroeconomic conditions change, the Fed presently has the flexibility to adjust course, regardless of any guiding rule, without worrying about triggering searing congressional scrutiny at precisely the time of monetary experimentation. A fixed rule, especially one reportable to and subject to the oversight by Congress, could prevent the Fed from being able to quickly pivot in response to new information. The alternative is monetary policymaking by legislative committee, which is an institutional arrangement that independent central banks are precisely designed to correct.

A second perennial proposal is a U.S. Government Accountability Office (GAO) annual audit of the Fed’s day-to-day monetary policy operations. Auditing the Fed enjoys a storied, bipartisan history, but it is important to distinguish an accounting audit from a political one. Today, the Federal Reserve undergoes a thorough accounting audit each year, conducted by a leading accounting firm with topline results disclosed to the public. It is also audited by the GAO in other ways, and has an independent Inspector General that conducts audits and investigations of various activities. Congress has also mandated one-time audits of specific activities, as it did in Dodd-Frank in auditing the Fed’s emergency lending program.

That leaves the question: what is left for the GAO to audit? The answer is the Fed’s internal monetary policy deliberations, especially where those decisions are controversial. It is again understandable that members of Congress want to have a tighter grip on the way the Fed conducts itself: the Fed is, after all, a creature of Congress. But a GAO audit would only increase the level of organizational complexity within the Fed, already one of the most complex institutions of government. It would also be an easy bludgeon for members of Congress to litigate their preferred approach to monetary politics. Again, insulating the Fed from the day-to-day of partisan politics is precisely the point of independent central banking. That insulation isn’t a complete removal—the Fed is still deeply embedded within the political system. But a GAO audit of monetary policy would remove almost all of that insulation altogether.

A third, newer proposal, subjects all financial regulatory agencies to the annual appropriations process. The Consumer Financial Protection Bureau’s non-appropriated status has long been a source of contention, as discussed below, but the Federal Reserve has funded itself beyond appropriations since its founding in 1913. The current proposal would exclude the Fed’s monetary policy operations and focus solely on its regulatory and financial supervisory activities. In principle, there is justification for this proposal, given how important the appropriations process is to congressional oversight of the administrative state and how much financial regulators have existed outside of that process (in addition to the CFPB and the Fed, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and some other financial regulators are also not subject to the appropriations process).

The proposal’s defining weakness, though, is that appropriations oversight is a blunt tool not easily separated among functions. If it is true that the Fed should have budgetary independence for the conduct of monetary policy, then subjecting it to the appropriations process for regulatory matters will only invite congressional meddling into anything the Fed does that is of political interest to members of Congress. In practice, there may be no meaningful way to separate supervisory and regulatory activity from monetary policymaking.

**OVERHAULING THE CFPB**

The Consumer Financial Protection Bureau began its life as a policy proposal by then-Professor Elizabeth Warren, published in Democracy magazine in 2007. Interestingly, the “Financial Product Safety Commission” that Warren first proposed (or the Consumer Financial Protection Agency originally proposed in
the Frank version of the statute that became Dodd–Frank) looks very little like the final Consumer Financial Protection Bureau created by the final statute. The differences are at the heart of what makes the CFPB so controversial today. These differences have little to do with functions and everything to do with structure. Functionally, the CFPB today is very much in line with what Warren, now a Democratic Senator from Massachusetts, proposed—the CFPB seeks to protect consumers from financial fraud and educate them about financial products like mortgages, credit cards, and student loans. But structurally, the decision to render the new governmental agency a sub-bureau of the Federal Reserve headed by a single individual was not a Democratic idea, but a Republican one. Senator Bob Corker (R-TN) was a key figure in negotiating the Senate version of the bill and changing the structural features of the CFPB not to insulate it from political oversight, but to quiet conservative fears about more and more bureaucracy interfering with market activity. The model for the CFPB was the Fed, not the SEC.

Republican enthusiasm for that different structure didn’t even last through the legislative session that created it. The latest proposals would effectively abolish the CFPB and replace it with a regulatory commission called the “Consumer Financial Opportunity Commission,” given the dual mandate to enforce consumer financial protection laws (though with significantly limited tools for doing so) while enhancing “financial opportunity” for individuals and businesses, including banks. It would also be subject to the congressional appropriations process (it is currently funded through the Fed), be required to conduct cost-benefit analyses for all its regulations, and lose much of its enforcement authority. For example, it would have to consider the safety and soundness of financial institutions when promulgating new rules.10 States and tribes would be allowed to request unconditional waivers from CFPB regulations governing short-term, small-dollar credit (i.e., payday loans). And the Commission also would no longer have the authority to ban products or services it deems abusive.

The curious redesign of the CFPB prompts the question: why not just abolish the agency altogether? The answer probably has more to do with the optics of that kind of abolition rather than policy preference. Given that House Republicans fear the backlash for being seen on the wrong side of consumers, abolishing the Bureau is not politically feasible, leaving an overhaul of its organizational structure and elimination of much of its functional authority as the only way to accomplish those same ends.

The debate the Republicans seek to have is a worthy one. Should the CFPB look more like the SEC, less like the Fed? Should the United States have a CFPB at all? Certainly its budgetary autonomy protects it from congressional oversight in a way that most agencies don’t enjoy. (See Figure 1 for how the CFPB’s budget per employee compares to the Fed and SEC.) But that debate should be clear on its terms. Restructuring the CFPB as an ambiguously charged independent commission would produce precisely the kind of bureaucratic muddle that.

Senate Republicans sought to avoid by making the CFPB an independent bureau of the Fed in the first place. If the Republicans want to eliminate the Bureau on the charge that it has overstepped its bounds and that consumer financial protection regulations hurt consumers more than they protect them, then that merits debate. Deregulation through reregulation is an inefficient, opaque, and confusing mechanism for accomplishing the same goal.

Journalists have tried, in vain, to get a commitment from the Trump Administration on the CFPB’s future. Of all the various aspects of financial reform, the identity and future of the CFPB will probably be the most contested fight of the upcoming debate.

RETHINKING SIFI DESIGNATION AND REGULATION

The third debate, already underway and likely to continue, relates to the way the federal government regulates the nation’s largest banks. The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) to designate bank and non-bank financial companies as SIFIs and thus subject to greater regulatory burdens meant to prevent their failure. This is the first order of business for Dodd-Frank, appropriately located in the Act’s Title I. The CHOICE Act, and likely any future incarnation, would repeal most of this authority.11

Under the proposed legislation, the FSOC’s authority to break up large financial institutions upon the recommendation of the Federal Reserve would disappear. The Council’s
research support arm – the Office of Financial Research – would be eliminated. Additionally, the FSOC would no longer be able to designate non-banks as SIFIs, and all of its previous designations of non-bank financial companies (e.g., AIG, Prudential, and MetLife) would be invalidated. This includes clearinghouses for derivatives – one of the very few aspects that both Republicans and Democrats lauded in the 2010 law. And even those large banks that Republicans agree could threaten the stability of the financial system could make a few changes to their capital structures and avoid most of the regulatory framework that Dodd-Frank created.

If Republicans have shown discomfort with Title I, they have wholesale disregard for Title II. Title II recognizes that the regulatory efforts to prevent the largest banks from failure will not always work and provides a second, regulator-focused process whereby the largest banks are resolved through an “orderly liquidation” rather than either a messy bailout or a catastrophic bankruptcy. Reflecting a strong Republican consensus, the CHOICE Act eliminates all of Title II and replaces it with an addition to the U.S. Bankruptcy Code. When critics have said they hope to repeal the Dodd-Frank Act, they are sometimes speaking of precisely this proposal.

Some of the ablest experts on Dodd-Frank view Title II as creating an institutional framework that will effectively guarantee further 2008-style government interventions in market processes. But it is not at all obvious that so-called Article I judges are a superior approach. Bankruptcy judges are not experts in banking, and may be too inclined to treat bank debt as they would any other corporate reorganization. There may be benefits to letting Dodd-Frank test its mettle before handing over all liquidation authority to courts.

**CONCLUSION**

The Republican vision of financial regulatory relief over the last six years has been focused on limiting the executive’s discretion in response to financial risk. Purists will continue to lobby for these limits regardless of who holds the office of President, viewing ample executive discretion as the core problem to be corrected. Political strategists, however, who awoke in a Republican-controlled Washington, DC, may start reevaluating their priorities. Now that a Republican is President, the great unknown for the future of financial reform is whether an insulated CFPB with a Trump appointee at its helm is the surest way to effectuate Republican policy goals, or whether a Trump-dominated Fed is superior to a rule-bound central bank more likely to interfere with Republican fiscal priorities, or a regulatory apparatus dominated by sympathetic personnel is indeed preferable to a system with less of that kind of partisan control. And, of course, much of the outcome on these policies will be driven by Trump himself. The White House is divided between those, like the Secretary of the Treasury-designate, who are old hands on Wall Street and those who reflect more of a populist suspicion of that very authority. It is on three key issues – the Fed’s role as a central bank and financial regulator insulated from Congressional oversight and the appropriations process; the CFPB’s governance structure and broad authority; and the designation and regulation of SIFIs – that the most important piece of financial legislation in decades, the Dodd-Frank Act, will be affirmed, amended, or rejected. Each path has enormous ramifications for the health and stability of the U.S. financial system.
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