

# RESTORING THE RULE OF LAW IN FINANCIAL REGULATION

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The financial crisis of 2007–08 ushered in the most sweeping changes in financial regulations since the Great Depression. Unlike the reforms wrought in 1932–35, which remained in place for decades, much of the post–2008 legislation is already a likely target for repeal or at least significant modification.

Critics point to many shortcomings. Some focus on the costs of regulation, arguing that regulatory reform has benefited large Wall Street banks by codifying their status—as “too big to fail”—and by creating new regulatory costs that big banks can bear more easily than competitors. Small banks face a morass of new rules and compliance burdens. Lux and Greene (2015) find that the “increasingly complex and uncoordinated regulatory system has created an uneven regulatory playing field that is accelerating consolidation for the wrong reasons,” producing a declining market share for community banks. These various costs are being passed on to bank customers. Many Americans are finding it increasingly difficult to access banking services on favorable terms. For example, the share of banks offering free checking accounts fell from 75 percent prior to Dodd-Frank to 37 percent in 2015. Monthly service fees charged by banks have grown 111 percent over the same time, while the

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number of “unbanked” Americans has grown. Credit card interest rates are 2 percent higher, and the number of credit card accounts has fallen by 15 percent. A Goldman Sachs Global Markets Institute (2015) study on the consequences of financial regulation for small businesses also found major costs: “The tax from increased bank regulation falls disproportionately on the smaller businesses that have few alternative sources of finance. We see this in the muted recovery in bank lending to small businesses: outstanding commercial and industrial (C&I) loans for less than \$1 million are still well below the peak 2008 level and are only 10 percent above the trough seen in 2012.”

Other critics have focused on the current or prospective failings of regulation to achieve its desired prudential objectives. The continued reliance by capital regulation on book values of tangible net worth as a measure of loss absorbing capacity is one obvious weakness. That approach is not likely to work better in the future to prevent too-big-to-fail banks from failing because it does not reliably track the true economic value of bank equity. Risk measurement under the Basel approach employed in the United States and many other countries notoriously creates opportunities for circumvention through the understatement of risk. New bank liquidity requirements are extremely complex, easy to circumvent, and lacking in any fundamental grounding in economic theory. Title II of Dodd-Frank is viewed by many academic critics as unworkable and unlikely to produce orderly resolution of nonbank institutions or large bank holding companies<sup>1</sup>

In this article, I focus on another, even more fundamental, problem. Increasingly, our regulatory structure has been adopting processes that are inconsistent with adherence to the rule of law.<sup>2</sup> These process concerns are rarely voiced by academics, but that is a strange omission. Appropriate regulatory process is fundamental to the ability of regulation to succeed because process defines the incentives of regulators, which are crucial to ensure that regulators act diligently in pursuit of bona fide objectives. Relying on regulatory

<sup>1</sup>See Calomiris (2017a) for a detailed review of each of these issues and proposals for regulatory standards that would be more likely to succeed.

<sup>2</sup>There are many definitions of “rule of law.” I use the term to refer to the predictable and nondiscriminatory enforcement of laws and regulations.

processes that avoid transparency, accountability, and predictability increases regulatory risk and is likely to lead to poor execution of regulatory responsibilities, as well as create unnecessary regulatory costs and opportunities for politicized mischief. This is not merely a theoretical concern. As I will show, because recent regulation has increased regulators' discretionary authority, and has reduced the predictability and transparency of regulatory standards, it has reduced the accountability of regulators. This has already resulted in abuses that not only deform our democracy but also impose unwarranted costs on the financial system and distract from legitimate problems that should be the focus of prudential and consumer protection regulation.

## The Demise of the Rule of Law in Financial Regulation

### *CFPB Structure, Process, and Policies*

Barney Frank has said that he regards the creation of the Consumer Financial Protection Bureau (CFPB) as the greatest achievement of the Dodd-Frank Act.<sup>3</sup> But the CFPB has been a lightning rod for controversy, both about its policies and with respect to its structure and process. With respect to its structure and process, the CFPB was given a unique position within the government. Its budget is determined without the possibility of congressional limitation (its expenses are assessed against the Federal Reserve System, prior to the Fed rebating its surplus to the Treasury), its mandate is extremely broad, and unlike similar regulatory authorities (such as the Securities and Exchange Commission [SEC]), it is run by an individual director rather than a bipartisan panel. In October 2016, a three judge panel of the U.S. Court of Appeals for the District of Columbia found not only that the CFPB was incorrect in its interpretation of a law that it used to justify the imposition of a \$109 million penalty, but also that the CFPB “violated bedrock due process principles” and that its structure was unconstitutional because Congress gave the CFPB “more unilateral authority than any other officer in any of the three branches of the

<sup>3</sup>See “Dodd-Frank Five Years Later: Barney Frank’s Greatest Victory, Regret,” November 6, 2015, available at <http://mitsloan.mit.edu/newsroom/articles/dodd-frank-five-years-later-barney-franks-greatest-victory-regret>.

U.S. government, other than the president” and that consequently the CFPB “possesses enormous power over American business, American consumers and the overall U.S. economy” (U.S. Circuit Court for the District of Columbia 2016). The full appellate court overturned that ruling in January 2018, but the conflict over the CFPB’s structure continues.

With respect to its policies, the CFPB has been aggressive in promoting unprecedented interpretations of consumer protection regulation. Perhaps its most controversial decision was the use of “disparate impact” theory to gauge discrimination against minorities. According to this theory, if one group of people (identified on the basis of racial or ethnic identity) receives different average *outcomes* (different approval/denial rates or different terms for lending), even in the absence of any evidence of differences in *treatment* by a lender on the basis of race or ethnicity, then that disparate impact constitutes evidence of illegal discrimination. Furthermore, the CFPB’s (2014) information about race and ethnicity was derived not from actual knowledge of individuals’ race and ethnicity, but rather from “a Bayesian Improved Surname Geocoding (BISG) proxy method, which combines geography- and surname-based information into a single proxy probability for race and ethnicity.” In other words, discrimination was punished based on forecasted probabilistic racial or ethnic identities, not actual ones.

The report of a congressional investigation into CFPB’s practices by the U.S. House Committee on Financial Services (2015) found that the CFPB had knowingly failed to control for influences other than discrimination that cause differences in outcomes, and that its actions were inconsistent with congressional intent in creating the CFPB, with the law (which specifically exempted certain automobile financing from CFPB authority), and with Supreme Court definitions of what constitutes discrimination. Racial and ethnic forecasting was also unreliable. The Executive Summary of the report is a scathing indictment of CFPB practices:

Since at least February 2012, the Bureau of Consumer Financial Protection (Bureau), and in particular its Office of Fair Lending and Equal Opportunity, has engaged in an aggressive effort to enforce the Equal Credit Opportunity Act (ECOA) against vehicle finance companies using a controversial theory of liability known as disparate impact. In doing so, it has attempted to implement a “global solution” that enlists

these companies in an effort to alter the compensation of automobile dealers, over which the Bureau has no legal authority. As internal documents obtained by the Financial Services Committee and accompanying this report reveal, the Bureau's ECOA enforcement actions have been misguided and deceptive. The Bureau ignores, for instance, the lack of congressional intent to provide for disparate impact liability under ECOA, just as it ignores the fact that indirect auto finance companies are not always subject to ECOA and have a strong business justification defense. In addition, memoranda reveal that senior Bureau officials understood and advised Director Richard Cordray on the weakness of their legal theory, including: (1) that the practice the Bureau publicly maintained caused discrimination—allowing auto dealers to charge retail interest rates to customers—may not even be recognized as actionable by the Supreme Court; (2) that it knew that the controversial statistical method the Bureau employed to measure racial disparities is less accurate than other available methods and prone to significant error, including that for every 100 African-American applicants in a data set for which race was known, the Bureau's proxy method could only identify roughly 19 of them as African-Americans; and (3) that the Bureau knew that factors other than discrimination were causing the racial disparities it observed, but refused to control for such factors in its statistical analysis. Notwithstanding the weakness of its case, the Bureau pursued its radical enforcement strategy using “unfair, abusive, and deceptive” tactics of its own, including by making an example of a company over which it had significant political leverage and concealing other aspects of its efforts from public scrutiny. The purpose of this report is to provide the public with a better understanding of the Bureau's activities.

Thus, the CFPB appears to have created and enforced a new theory of discrimination, one that was inconsistent with economic evidence about the causes of disparate impact, and one that lawmakers characterize as contrary to statutory language and Supreme Court opinions about what constituted illegal discrimination. Clearly, there is a connection between the unconstitutional structure and process that created the CFPB, which insulated its imperious director from any budgetary or administrative discipline, and its abuse of power. The broad lesson—which applies to the regulatory reliance

on guidance in general—is that financial regulatory power is easily politicized and abused when it is not required to adhere to statutory authority, or at least to a formal rule making process.

### *Operation Choke Point*

Imagine that you are operating a business and you get a call from your banker explaining that she can no longer provide services to you. Your accounts at the bank must be closed immediately, despite the fact that your business is thriving and you have done nothing unlawful. When you call another banker to try to open an account, he turns you down, too. The bankers all tell you the same story: bank regulators have told them that they should not serve you, and they must obey or will face significant regulatory penalties. Welcome to the Obama Administration's main post-Dodd-Frank contribution to financial regulation, known as "Operation Choke Point."

Alongside a litigation initiative that began in the Justice Department, in 2011, the Federal Deposit Insurance Corporation (FDIC) and other bank regulators warned banks of heightened risks from doing business with certain merchants. Purveyors of "pornography" or "racist materials" may enjoy First Amendment rights, but not the right to a bank account. Gun and ammunition dealers were targeted despite their Second Amendment rights. Firms selling tobacco or lottery tickets were *persona non grata*, too. Payday lenders also were targeted on the basis of the presumption that they prey on the poor. A total of 30 undesirable merchant categories were deemed to be "high-risk" activities. In 2012, the FDIC explained that having the wrong kinds of "risky" clients can produce "unsatisfactory Community Reinvestment Act ratings, compliance rating downgrades, restitution to consumers, and the pursuit of civil money penalties." Other regulatory guidelines pointed to difficulties banks with high "reputation risk" could have consummating acquisitions (Calomiris 2017b).

A report by the House Committee on Oversight and Government Reform (2014) unearthed internal FDIC emails voicing intent to "take action against banks that facilitate payday lending" and "find a way to stop our banks from facilitating payday lending," which highlighted the FDIC's use of Memoranda of Understanding with banks and Consent Orders to implement its campaign against payday lending. The report concluded that "senior policymakers in FDIC headquarters oppose payday lending on personal grounds," and that FDIC's campaign against payday lenders reflected "emotional

intensity” and “personal moral judgments” rather than legitimate safety and soundness concerns, and was “entirely outside of FDIC’s mandate.”

The Inspector General of the FDIC (2015) issued a report substantiating those judgments. It found that FDIC staff had been working with the Department of Justice to identify banks’ relationships with payday lenders, which (contrary to the FDIC’s financial interests and duties) served to make litigation risk from the Justice Department greater for banks with payday lending relationships. Operation Choke Point is not grounded in bank regulators’ expertise or mission, just their willingness to harass bank clients whose activities they dislike.

Some observers may agree with Mr. Obama’s list of disfavored industries. But now that Mr. Trump has taken office, will they agree with his list? Do we want our regulatory system to be a tool for attacking those our president dislikes? If not, it’s worth asking why the political abuse of regulation has become easier than in the past, and what can be done to stop it.

There was never legislation defining the 30 industries as undesirable, nor did regulators establish rules to set clear standards for what constituted undesirable behavior by a bank’s client, or announce penalties for banks serving undesirables. Such legislation or formal rule making likely would have been defeated owing to the checks and balances inherent in congressional debate or formal rule making under the Administrative Procedures Act. Instead, regulators relied on guidance—which requires no rule making, solicits no comments, entails no hearings, avoids defining violations, specifies no procedures for ascertaining violations, and defines no penalties that will be applied for failure to heed the guidance.

Communications between regulators and banks are private; banks often aren’t permitted to share them with outsiders. Regulators avoid public statements explicitly requiring banks to terminate undesirables, but privately threaten banks with an array of instruments of torture that would have made Galileo faint, using secrecy to avoid accountability.

As DeMuth (2014), Epstein (2014), Hamburger (2014), and Baude (2016) have documented, and as financial regulatory practice illustrates, there has been a dramatic increase in reliance on guidance in recent years. Financial regulators can find it particularly useful to rely on vaguely worded guidance and the veil of secrecy to maximize

discretionary power, although doing so imposes unpredictable and discriminatory costs on banks and their customers.

The regulators' campaign against payday lenders produced a wave of bank relationship terminations, with dire consequences for the industry since 2013. That not only victimized payday lenders, it also imposed significant costs on consumers by reducing competition. A large, and very one-sided, academic literature convincingly shows that payday lenders serve customers' interests and perform competitively (see Calomiris 2017b: Appendix A). Their presence reduces borrowing costs for customers. If the prejudiced views of bureaucrats about payday lending had been held up to scrutiny during public hearings, their jaundiced portrayals of the industry would have been disproven. But using guidance avoids having to defend one's prejudices in public. Once the government and its regulators decided to strip the industry of its ability to transact with banks, the view that payday lenders were "risky" became self-fulfilling.

Payday lenders are now suing bank regulators for the harm they have suffered (a lawsuit in which I have filed a report on Plaintiffs' behalf—Calomiris 2017b). In that lawsuit there is more at stake than the fate of payday lenders or their customers. Regulators' reliance on vague guidance and discretionary judgments about ill-defined violations under a veil of secrecy constitute a major departure from the rule of law, with far-ranging adverse consequences for our economy, our political institutions and our society.

Operation Choke Point has been discontinued. In an August 16, 2017, letter by Assistant Attorney General Stephen Boyd to Senators Tillis and Crapo, Secretary Boyd writes:

We share your view that law abiding businesses should not be targeted simply for operating in an industry that a particular administration might disfavor. Enforcement decisions should always be made based on the facts and the applicable law.

. . . The [2013] FDIC guidance included a footnote listing certain "elevated-risk" merchants, including short-term lenders and firearms dealers. The FDIC subsequently rescinded its list . . . The Department of Justice (Department) strongly agrees with this withdrawal. All of the Department's

bank investigations conducted as part of Operation Chokepoint are now over, the initiative is no longer in effect, and it will not be undertaken again.

. . . We reiterate that the Department will not discourage the provision of financial services to lawful industries, including businesses engaged in short-term lending and firearms-related activities [Boyd 2017].

Despite that assurance, another administration might very well decide to encourage similar regulatory abuses of power in the future. Congress should prevent that from being possible. Or, if the Department of Justice believes that such actions were already illegal, perhaps it will consider criminal legal action against its own former officials responsible for this disgrace.

### *Financial Stability Oversight Council*

Dodd-Frank created a new macroprudential mandate for the newly established Financial Stability Oversight Council (FSOC) and Office of Financial Research (OFR). The OFR is supposed to identify potential systemic risks, using its unprecedented access to the proprietary data of financial regulators and financial institutions, and inform the FSOC of risks. The FSOC, chaired by the Secretary of the Treasury, has a statutory duty to facilitate information sharing and regulatory coordination by the various financial regulators. It is charged to respond to systemic risks by recommending appropriate strengthening in regulatory standards, and designating, as appropriate, certain financial market utilities and nonbank financial institutions (or other firms) as systemically important (and therefore subject to new regulations). It is also empowered to break up any firms in the United States that it deems to be a “grave threat” to systemic stability.

Critics of FSOC (and OFR) have pointed to two primary problems in its structure and operation: procedural shortcomings and politicization. The two problems are closely related. With respect to procedural shortcomings, at least one SEC commissioner—Michael Piwowar—has complained publicly about being shut out of FSOC deliberations. Piwowar (2014) notes many concerns about FSOC, which he labels, among other things, the “Unaccountable Capital Markets Death Panel.” Piwowar has

identified an important problem. Not only is FSOC unaccountable, it also is composed of the heads of the various financial regulatory agencies, all of whom are appointed by the same political party. The diversity that is either required by statute, or is a function of staggered appointments over time, for the SEC, the Commodity Futures Trading Commission (CFTC), the Federal Reserve Board (FRB), the FDIC, and others does not apply to the FSOC's deliberations, which also remain largely secret.

Even worse, the FSOC has not established standards to guide its designations of firms as systemically risky or "grave threats." Creating the power to regulate anyone in the U.S. economy, and to shut down any business operating in the U.S. economy, is worrying enough, but when that authority can be exercised by members of one political party, acting in secret without any specified standards to guide them, it must be considered outside the realm of actions that should occur in a democracy governed by the rule of law.

On December 18, 2014, Metlife was notified by FSOC that it had been designated a nonbank systemically important financial institution (SIFI), which implied new regulatory burdens and risks. Metlife challenged the FSOC's decision in federal court and on March 30, 2016, U.S. District Court Judge Rosemary Collyer ruled in Metlife's favor and rescinded its SIFI designation. The Judge's opinion is interesting because it pointed to the shortcomings of FSOC's procedures as central to the case. In doing so, the Judge's opinion opened a broader debate about the abuse of guidance by regulators.

Judge Collyer's opinion was, therefore, especially noteworthy as one of the first attempts by a federal court to disallow the unlimited use of regulatory discretion in the administration of regulatory guidance. The judge did not disallow guidance, *per se*, but she rejected unlimited and inconsistent discretion in its use as a regulatory tool, "[h]aving found fundamental violations of established administrative law":

During the designation process, two of FSOC's definitions were ignored or, at least, abandoned. Although an agency can change its statutory interpretation when it explains why, FSOC insists that it changed nothing. But clearly it did so. FSOC reversed itself on whether MetLife's vulnerability to financial distress would be considered and on what it means to threaten the financial stability of the United States. FSOC

also focused exclusively on the presumed benefits of its designation and ignored the attendant costs, which is itself unreasonable under the teachings of *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699 (2015). While MetLife advances many other arguments against its designation, FSOC's unacknowledged departure from its guidance and express refusal to consider cost require the Court to rescind the Final Determination.<sup>4</sup>

In addition to the potential for abusive actions, there is also reason to be concerned about FSOC inaction. Strangely, FSOC and OFR have been largely silent about the mounting systemic risks in U.S. real estate, which many observers believe may be substantially overpriced. Indeed, it is not an exaggeration to say that FSOC seems to be uninterested in the only obvious and legitimate systemic risk facing the U.S. economy today.

The unprecedented pandemic of financial system collapses over the last four decades around the world is largely a story of real estate booms and busts (Jordà et al. 2015; Calomiris 2018). Real estate is central to systemic risk in many countries because of four facts. First, exposures to real estate risk inherently are highly correlated with each other and with the business cycle, which means that downturns in real estate markets can have large and sudden implications for massive amounts of loans and securities backed by real estate.

Second, real estate assets are unique and generally cannot be liquidated quickly at their full long-term value, which can imply large losses to holders who are forced to sell real estate quickly. Those losses can further exacerbate financial losses and magnify systemic risk.

Third, over the past 40 years worldwide, and especially in the United States, real estate is increasingly funded by government-protected and government-regulated entities. That protection encourages the politicization of real estate funding (given the strong short-term political incentives to subsidize mortgage risk).

Fourth, throughout the world, a large amount of commercial and/or residential real estate investment is being funded increasingly

<sup>4</sup>Opinion of Rosemary M. Collyer, U.S. District Judge, United States District Court for the District of Columbia, *MetLife v. FSOC*, March 30, 2016, available at [www.metlife.com/assets/cao/sifiupdate/MetLife\\_v\\_FSOC—Unsealed\\_Opinion.pdf](http://www.metlife.com/assets/cao/sifiupdate/MetLife_v_FSOC—Unsealed_Opinion.pdf).

within banks, which rely primarily on short-term debt for their funding. As we witnessed during the Subprime Crisis in the United States, real estate losses produced substantial liquidity risk (beginning in August 2007 in the asset-backed commercial paper market, and continuing through September 2008 in the repo and interbank deposits markets), which deepened the losses during the crisis and magnified the general contraction in credit that ensued. But this is not just a problem of large banks. The loan portfolios of small banks in the United States are also highly exposed to residential and commercial real estate risk, which over the past two decades averaged about three-quarters of total lending by small banks.

Many observers see large banks as the only source of systemic risk in the economy, but that mistaken view forgets that the United States has been the most financially unstable developed economy in the world for more than a century, despite the fact that large banks are a recent development in the United States (Calomiris and Haber 2014: chaps. 6–7). The 1980s banking crises were all about real estate losses incurred by small banks—not just in housing, but also in commercial real estate, especially in the southwest and the northeast, and in agricultural real estate throughout the country.

It is not hard to see why FSOC has been silent about the excessive exposure to real estate in the banking system, the increased risk taking by the GSEs and the FHA, the failure to reform the GSEs, and the increasing riskiness of mortgages over the past three years. Any discussion about these important systemic risks would be politically inconvenient.

For example, no one expected Jacob Lew, the Treasury secretary in the same administration that appointed Mel Watt to head the Federal Housing Finance Agency (FHFA), to criticize Mr. Watt's decisions to increase mortgage risk after his appointment as head of FHFA. Immediately upon assuming authority, Mr. Watt reduced the down payment limit on GSE-eligible mortgages from 5 percent to 3 percent. The GSEs remain in conservatorship, and the combination of the watering down of the “Qualified Mortgage” (QM) and “Qualified Residential Mortgage” (QRM) rules and exemptions (Gordon and Rosenthal 2016), alongside these lax FHFA standards, and the government's funding of the GSEs and the FHA and VA, continue to ensure that government subsidization of housing finance risk—the central problem highlighted by the 2007–08 crisis—will continue.

The continuation of the government's push for risky housing finance has resulted in a continuing escalation of mortgage risk.<sup>5</sup> For first-time buyers, combined loan-to-value ratios have risen from 90.7 percent in February 2013 to 91.9 percent in January 2017, and the average debt service-to-income ratios rose over that period from an average of 36.4 percent to 37.7 percent. As of the end of January 2017, 28 percent of first-time buyers had debt service-to-income ratios in excess of the QM limit of 43 percent, which is four percentage points higher than it was two years earlier. Fannie Mae, Freddie Mac, FHA, and VA hold riskier mortgage portfolios than banks, and they account for about 96 percent of purchased mortgage volume.

Given the political push for providing financing subsidies in the form of government-sponsored encouragement of systemic mortgage risk, the FSOC prefers to focus its attention on "interconnect- edness" when discussing systemic risk, rather than recognize the central importance of real estate finance in producing systemic shocks (Scott 2016, Calomiris 2018).

Nor does the FSOC care to focus on the potential for small banks' funding of commercial and residential real estate to create systemic risk. Small banks are politically popular in Congress (which rightly worries that regulatory burdens are putting many of them out of business). Builders and realtors also are popular with both political parties (Calomiris and Haber 2014: chaps. 7–8; Gordon and Rosenthal 2016) and no one is going to point toward small banks' outsized exposures to real estate, or any other exposures to real estate, as a problem. When I did so in congressional testimony (Calomiris 2015), I was attacked from both sides of the aisle for failing to appreciate the importance of the "American dream." Of course, mortgage subsidies have little effect on housing affordability (currently at a long-term low in the United States) because they not only expand credit but also prop up home prices, but honesty about housing markets has always been in short supply in Washington.

When I talk to OFR economists about the need to focus attention on real estate risks, it often seems that people start looking at their shoes. I have found the economists at the OFR to be skilled and diligent, and I find much of the OFR's research output quite useful,

<sup>5</sup>The facts noted in this paragraph are taken from Pinto and Peter's (2017) Power Point presentation.

but they have a blindspot when it comes to the risk-creating policies of the Administration.

### *Stress Tests*

As part of the resolution of the financial crisis, U.S. banks were stress tested by the Federal Reserve in 2009 (the Supervisory Capital Assessment Program). Beginning in 2011, stress tests became a regular feature of the regulatory apparatus and, beginning in 2014, stress tests were required as part of Dodd-Frank for all banks with more than \$10 billion in assets.

In concert with reformed capital ratios, stress tests could be an effective means of encouraging bankers to think ahead—leading them to consider risks that could cause sudden losses of value, and prodding them to increase capital buffers and improve their risk management practices. As they are currently structured, however, stress tests violate basic principles of the rule of law that all regulations should adhere to. Banks that fail stress tests are punished for falling short of standards that are never stated (either in advance or after the fact). This makes stress tests a source of uncertainty rather than a helpful guide against unanticipated risks.

Fed officials have justified the lack of transparency and accountability in stress testing because of the need to ensure that banks do not game the test, but that is not a reasonable argument. Changing economic circumstances imply that every year the scenarios that are relevant for stress testing should change, and therefore scenario modeling should not be highly predictable on the basis of past years' tests. Ex post disclosure of the tests, combined with learning over time, changes in scenarios that track changing market circumstances, the use of multiple scenarios designed by multiple teams of experts, and rotation of the people designing scenarios should provide more than adequate unpredictability about the specifics of any test to prevent gaming of the test by bankers. Keeping the details of the methodology of stress testing a permanent secret has very undesirable features: it makes it impossible for market participants to learn what regulators regard as appropriate modeling techniques and assumptions, thereby insulating the regulators from any accountability for poor test design.

Regulators not only impose unstated quantitative standards for meeting stressed scenarios, but they also retain the option of simply deciding that banks fail on the basis of a qualitative judgment

unrelated even to their own secret model's criteria. It is hard to believe that the current structure of stress tests could occur in a country like the United States, which prizes the rule of law, the protection of property rights, and adherence to due process.

## Process Reform

How can we reform financial regulatory process to restore adherence to the rule of law? Some solutions are simple and obvious: Operation Choke Point is a sad episode in our nation's history and its revival should be prevented by legislation. But, as the above examples show, there is a more general problem illustrated by Operation Choke Point, one that arises because of the increasing reliance on guidance, which allows regulators to avoid accountability for their actions.

I favor requiring regulators to rely on formal rule making rather than guidance, so that regulation can be based on clearly defined standards, debated in public, and enforced transparently. Over a short period of time, I propose that existing guidance should be phased out entirely and replaced by formal rules. This will be a massive undertaking, and I do not recommend it lightly. But it is crucial for restoring the rule of law to our financial system. Eliminating the reliance on guidance also will reduce regulatory risk substantially, with favorable consequences for both growth and stability.

In addition to this overarching reform, below I propose specific reforms that address the specific problems outlined above in the FSOC, the CFPB, and stress testing.

### *FSOC Reform*

FSOC should be made as politically independent as possible, especially because it (and the OFR that advises it) should retain necessary access to privileged data. FSOC's mission should be identifying problems related to systemic risk, especially potential shortcomings in the enforcement of regulatory standards.

Barth, Caprio and Levine's (2012) proposal for a "Sentinel" is a potential model. In their formulation, this body would be administered independently but have access to privileged data, including information about the actions of regulators and supervisors. To accomplish that mission, the FSOC would have to be removed from the Treasury and established on other, independent footings. It may still make sense to have the FSOC meet with regulators (such as Fed governors, SEC

commissioners, and FDIC officials) but to be able to oversee the actions of those parties effectively it must be separate from them.

The designation of SIFI status, like other regulatory designations, should follow from clear rules, not opaque discretionary judgments that invite the abuse of power. For example, in addition to size thresholds (which measure an institution's systemic importance), the degree of a nonbank institution's reliance on short-term debt, and the degree to which it uses short-term debt to fund illiquid investments, such as commercial real estate loans, could be taken into account explicitly (and quantitatively) when formulating a rule for what constitutes systemic importance.

### *CFPB Reform*

The CFPB could play a constructive role in monitoring compliance with consumer protection laws, such as disclosure requirements, mortgage brokerage standards, fair lending requirements, and anti-discrimination statutes. It should focus on monitoring and enforcing compliance of the laws that exist (e.g., by using testers to root out discriminatory treatment of consumers), advise Congress on the creation of new laws, and engage in formal rule making that is consistent with specific powers delegated to it by Congress. These functions are analogous in the banking sphere to some of the activities of the SEC, and it seems natural for the CFPB to adopt a similar bipartisan commission structure, which will help to insulate it from counterproductive political pressures. In keeping with this new structure, the CFPB's activities should no longer be funded by special access to Federal Reserve surplus.

### *Reforming Fed Stress Tests*

Two important sets of reforms are needed to address the current deficiencies in the process governing stress tests. First, the criteria for stress tests must be clarified, and the stress tester (the Fed) must be made accountable for its approach to measuring compliance. The Fed does not need to predisclose the specific models it will use, but it does need to explain, and demonstrate that it is adhering to, a reasonable and transparent process to build the models that will be used to measure compliance. And it must disclose the models it employs with a lag, to ensure accountability for the quality of its testing standards.

One practice that would improve accountability and reduce the ability of banks to game the test would be for the Fed to invite

independent teams to assist it in building models (perhaps using multiple models rather than one). The Fed could rotate its model-building personnel and alter its scenarios in light of changing economic circumstances, which would ensure that its models conform to best practice while also remaining somewhat unpredictable. Each year, the Fed could disclose the models that were used previously, which would ensure accountability by permitting detailed criticisms by academic and industry observers.

Improved regulatory accountability likely would produce improvements in stress testing. Currently, there is great room for improvement. Stress tests should focus realistically on the true loss of economic value under various forward looking scenarios, based on defensible cash flow forecasts, not just tangible asset loss projections or forecasts of broad financial accounting measures. To accomplish that objective, bank cash flows must be analyzed properly. Managerial accounts of revenues and expenses should be separated by line of business, and cash flow projections for each line of business under each scenario should be justified by reference to observable historical patterns. For example, under a scenario of severe housing finance decline, mortgage servicing income is likely to be more affected than asset management fees. To be able to realistically capture the effects of macroeconomic scenarios on bank condition the data used in stress testing must be improved dramatically.

## Conclusion

Some readers will regard the proposed reforms presented here as quixotic. I recognize that politics, not just principled thinking, will guide regulatory reform. Nevertheless, in spite of the partisan acrimony that rages in Washington, there may be cause for some optimism when it comes to process reform. President Trump has called for an overhaul of financial regulation, and congressional Republicans have enunciated principles of reform that echo many of the process concerns discussed above. Furthermore, there is evidence that Democrats are also becoming increasingly concerned about principles of due process now that they no longer control the administration of regulation. Despite the partisan battles that have defined financial regulation throughout its history, it seems that now might be an ideal time for both parties to find common ground supporting a policy platform that depoliticizes financial regulation and strengthens the rule of law.

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