The Heritage Foundation

BACKGROUNDER

No. 3152 | AUGUST 31, 2016

Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction

Norbert J. Michel, PhD

Abstract

House Financial Services Committee Chairman Jeb Hensarling (R–TX) has released a discussion draft of a major regulatory reform bill called the Financial CHOICE Act. The core component of this proposed reform is a regulatory off-ramp, a provision that provides regulatory relief to banks that choose to hold higher equity capital. Any serious financial regulation reform should consider this approach because there is little justification for heavily regulating firms that absorb their own financial risks. The Financial CHOICE Act also replaces large parts of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act that increased the risk of future financial crises and bailouts. Overall, the Financial CHOICE Act takes an overwhelmingly positive approach toward reforming financial market regulations. This Heritage Foundation Backgrounder*, focusing only on the money and banking sections of the Financial CHOICE Act, highlights the best features of the discussion draft and offers suggestions for improvements.*

Key Points

- The Financial CHOICE Act offers major financial regulatory reforms. The legislation would replace large parts of the harmful 2010 Dodd–Frank Act, and provide regulatory relief for banks that choose to hold higher equity capital.
- The act's capital election provision is a regulatory off-ramp that exempts banks from onerous regulations if they meet a higher capital ratio. There is little justification for heavily regulating firms that absorb their own financial risks—and higher capitalized banks do exactly that, lowering the likelihood of taxpayer bailouts.
- The CHOICE Act replaces Dodd–Frank's orderly liquidation authority with an improved bankruptcy process for large financial firms.
- The CHOICE Act makes many major improvements to the Federal Reserve's emergency lending authority and to the Fed's regular operating procedures, essentially by adopting the text of the 2015 Fed Oversight Reform and Modernization Act.
- The Financial CHOICE Act is a major step in the right direction for the U.S. economy.

House Financial Services Committee Chairman Jeb Hensarling (R–TX) has released a discussion draft of a major regulatory reform bill called the Financial CHOICE Act.[1] This legislation would replace large parts of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act. Key sections of the bill would reduce the risk of future financial crises and bailouts, and would allow investors and consumers to prosper by freeing them from centralized regulation and micromanagement.

The cornerstone of this proposed reform is a regulatory off-ramp, a provision that provides regulatory relief to banks *if* they choose to hold higher equity capital than they are currently

This paper, in its entirety, can be found at **http://report.heritage.org/bg3152**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

required to hold. Put differently, banks that choose to improve their ability to absorb losses earn regulatory relief. This approach makes sense because there is little reason to heavily regulate banks that can absorb their own financial risks. Overall, the Financial CHOICE Act represents an overwhelmingly positive approach to regulatory reform that would move the nation's financial markets in the right direction. This *Backgrounder*, concentrating *only* on the money and banking sections of the Financial CHOICE Act, reviews the best features of the discussion draft and offers suggestions for improvements.[2]

Title I: Regulatory Relief for Strongly Capitalized, Well-Managed Banking Organizations

Title I can be viewed as the centerpiece of the CHOICE Act because it spells out the "capital election" provision of the bill (in Sections 101, 102, and 105). The capital election is optional, and it creates what has been referred to as a regulatory off-ramp for banks. The provision rewards banks by exempting them from onerous regulations if they choose to meet a higher capital ratio, thus credibly reducing their probability of failure and any consequent taxpayer bailouts. This approach makes sense because there is little justification for heavily regulating firms that absorb their own financial risks. Section 102 spells out several regulations that banks which choose to meet the capital election requirements would be exempt from following.

This list of federal rules and regulations includes those that address capital and liquidity standards, capital distributions to shareholders, and mergers and acquisitions. In particular, it exempts qualified banks from these rules that are imposed in the name of mitigating "risk to the stability of the United States banking or financial system," an ill-defined metric in Dodd–Frank that gives overly broad power to federal regulators. These exemptions would effectively exempt qualified banks from all Basel III capital and liquidity rules, a huge improvement considering how poorly previous iterations of the Basel rules have performed.[3]

Suggested Title I Improvements. Title I of the Financial CHOICE Act represents a major regulatory improvement because it helps restore market discipline while reducing banks' regulatory burdens. It provides a *voluntary* mechanism by which banks can receive regulatory relief for choosing to fund their operations with more equity. The following recommendations would help expand these benefits even further:

- **Eliminate stress tests.** The bill would still allow federal banking regulators to conduct stress tests for banks that qualify for the capital election, but the benefit of these exercises is highly dubious.[4] Banks that absorb the costs of their own financial risks have every incentive to plan for contingencies, and there is no reason to think that regulators can accurately model the impact of all contingencies in the first place. For example, when Regions Financial Corporation advised investors that it would likely realize $3.4 billion in combined 2009–2010 losses, Federal Reserve Governor Daniel Tarullo's team of regulators forced Regions to raise enough capital to withstand $9 billion in losses. Regions showed a combined loss for these two years of just over $2 billion.[5]

1. The acronym CHOICE stands for "Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs." The discussion draft is available at House of Representatives Financial Services Committee, "Discussion Draft," 111th Congress, 2nd Session, June 23, 2016, http://financialservices.house.gov/uploadedfiles/choice_act-_discussion_draft.pdf (accessed July 19, 2016).
2. Separate Heritage Foundation *Backgrounders* detailing securities markets provisions and consumer financial regulations in the Financial CHOICE Act are forthcoming.
3. Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounder* No. 2905, April 23, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2905.pdf.
4. Section 665 of the Financial CHOICE Act (discussed below) would improve the transparency of these stress tests, a much-needed improvement over the current framework.
5. Jon Hilsenrath, "Battle Inside Fed Rages Over Bank Regulation," *The Wall Street Journal*, March 8, 2010, http://www.wsj.com/articles/SB10001424052748704754604575095321531680234 (accessed July 20, 2016). The combined figures are taken from Regions annual reports. Additional annual reports for Regions show that the company lost an additional $429 million in 2011, and then earned a profit each year from 2012 to 2016, for a total four-year *profit* of more than $4 billion.

- **Expand the list of exemptions.** The bill could be improved by providing even more regulatory relief for qualifying firms. For instance, qualified banks could be exempt from regulations associated with any, or all, of the following: the Truth in Lending Act (TILA);[6] the Real Estate Settlement Procedures Act (RESPA);[7] the Home Mortgage Disclosure Act (HMDA);[8] the Equal Credit Opportunity Act (ECOA);[9] the Fair Housing Act (FHA);[10] and the Community Reinvestment Act (CRA).[11]

- **Create a new federal banking charter.** To provide even greater regulatory relief to financial firms that put more private capital at risk, a new federal banking charter could be created. The charter could, for instance, exempt any financial firm organized as a partnership from all of the above-mentioned regulations, as well as Sections 16 and 21 of the Glass–Steagall Act.[12] The charter could include an explicit prohibition of any federal assistance from the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, or any other federal (or state) program or law that transfers taxpayer funds or provides financial guarantees.

- **Use a higher, simpler leverage ratio.** Provided they receive a CAMELS rating of either 1 or 2 from their regulator,[13] banks that have an average leverage ratio of at least 10 percent qualify for regulatory relief under the capital election. There are many ways to calculate a bank's leverage ratio, and the formula in the discussion draft is the ratio of tangible equity to leverage exposure, where "leverage exposure" is defined as it is for the Basel III supplementary leverage ratio (SLR).[14] Using the SLR in this manner is problematic for several reasons.

  First, qualifying banks would be exempt from the Basel III capital rules only if they *already comply with* one of the Basel III capital rules. Second, the SLR is a complex risk-weight-based approach that has little to do with how most banks operate in the first place. It assigns 21 weights to the various types of over-the-counter (OTC) derivative contracts, with the lowest weights assigned to interest-rate derivatives. These interest-rate derivatives make up almost 80 percent of the OTC derivatives market and they are heavily concentrated among four large banks.[15] Thus, using the SLR in this manner would impose yet another layer of complex regulation on

6. 15 U.S. Code 1601 et seq. TILA is implemented by Regulation Z (12 CFR 1026).
7. 12 U.S. Code 2601 et seq. The Department of Housing and Urban Development (HUD) originally implemented RESPA by Regulation X. Under Dodd–Frank, the Consumer Financial Protection Bureau (CFPB) restated HUD's implementing regulation at 12 CFR Part 1024 (76 Fed. Reg. 78978). See Consumer Financial Protection Bureau, "Integrated Mortgage Disclosure Rule Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z)," *Federal Register*, Final Rule, Vol. 78, No. 251 (December 31, 2013), https://www.gpo.gov/fdsys/pkg/FR-2013-12-31/pdf/2013-28210.pdf (accessed July 20, 2016).
8. The HMDA is implemented by Regulation C, and Dodd–Frank transferred HMDA rulemaking authority from the Federal Reserve Board to the CFPB.
9. The ECOA is implemented by the CFPB's Regulation B. (See 12 CFR, part 1002.)
10. The FHA is Title VIII of the Civil Rights Act of 1968, as amended (42 U.S. Code 3601, et seq.). For additional information on the FHA and the ECOA, see John Walter, "The Fair Lending Laws and Their Enforcement," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 81 (1995), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.7566&rep=rep1&type=pdf (accessed July 20, 2016).
11. See 12 U.S. Code 2901; the CRA is implemented by Regulations 12 CFR parts 25, 195, 228, and 345.
12. The 1999 Gramm–Leach–Bliley Act repealed only two sections of the Glass–Steagall Act, Sections 20 and 32. However, Section 16, as encoded in 12 U.S. Code 24 (Seventh), and Section 21, as encoded in 12 U.S. Code 378, remain intact.
13. Banking regulators use the CAMELS rating system to produce a composite rating of individual banks' overall condition and performance. The letters of the acronym represent the following six characteristics: (1) capital adequacy, (2) asset quality, (3) management administration, (4) earnings, (5) liquidity, and (6) sensitivity to market risk. See news release, "Uniform Financial Institutions Rating System," Federal Reserve Board of Governors, December 24, 1996, http://www.federalreserve.gov/BoardDocs/press/general/1996/19961224/default.htm (accessed July 20, 2016).
14. See Section 105(4), Section 105(5), and Section 105(9). The supplementary leverage ratio is defined in Title 12, CFR 3.10(c)(4)(ii).
15. Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities," First Quarter 2016, p. 3, http://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq116.pdf (accessed August 2, 2016). The Office of the Comptroller of the Currency reports, "During the first quarter of 2016, four large commercial banks represented 91.0 percent of the total banking industry notional amounts and 81.5 percent of industry NCCE [net current credit exposure]." The four banks are J.P. Morgan Chase, Bank of America, Citibank, and Goldman Sachs.

most of the banking industry because of the way a handful of very large financial institutions operate.

Furthermore, the SLR is not as transparent as other measures that are reported based on standards set according to generally accepted accounting principles (GAAP), and the required Basel III components for replicating the SLR are currently not included in the Federal Financial Institutions Examination Council (FFIEC) call reports. Finally, using the SLR in this manner gives an international committee undue influence on U.S. law and undermines the authority of the Financial Accounting Standards Board (FASB), the organization responsible for issuing GAAP. One possible benefit of using the SLR is that it (arguably) does a better job than GAAP of accounting for payment risk due to derivative exposure. However, the SLR's leverage exposure can be approximated using GAAP-based derivative exposures already reported in the FFIEC call report data.[16]

Using this type of alternative would be far more transparent, less complex, and would not usurp the FASB. For the eight global systemically important banks (G-SIBs), using 2015 data, this alternative method yields a leverage ratio that is (on average) approximately 2 percentage points lower than the Basel III ratio. (See Table 1.) Instead of relying on the SLR for the denominator of the qualifying leverage ratio, the alternative measure presented in the third column of Table 1 uses call report items to approximate derivative exposure and total off-balance-sheet exposure. These estimates are then added to the firm's total assets to serve as the denominator of the alternative qualifying leverage ratio. The estimates for derivatives exposure and total off-balance-sheet exposure are calculated as follows:

- ***Off-balance-sheet exposure:*** the sum of all *unused commitments,* all *other* off-balance-sheet liabilities (excluding derivatives), and all categories of *letters of credit*.

- ***Derivatives exposure:*** the sum of total *net current credit exposure* for OTC derivatives, and 7 percent of total *notional* derivative exposure.

The 7 percent figure is the median of the 21 weights (conversion factors) used in the Basel III rules to estimate potential future exposure (PFE).[17] Thus, the alternative ratio presented on Table 1 applies the same weight to *all* derivative contracts to arrive at PFE instead of relying on the Basel weighting system. Table 1 shows that this GAAP-based alternative more closely approximates some firms' Basel III ratio than others; the largest differences are for those firms with the largest notional derivatives exposures.[18] Given that the capital election is optional, the added simplicity and transparency of such an alternative measure, as well as its standard reliance on GAAP rules, outweigh using the SLR measure for the denominator.

Title II: Ending "Too Big to Fail" and Bank Bailouts

Title II of the Financial CHOICE Act takes a major step toward undoing Title I of Dodd–Frank, one of the most controversial titles of the 2010 law. A main problem with Title I of Dodd–Frank is that it created the Financial Stability Oversight Council (FSOC), a sort of super-regulator tasked with singling out firms for especially stringent regulation. These firms, commonly referred to as systemically important financial institutions (SIFIs), are those which regulators believe would damage the broader economy if allowed to file bankruptcy. In other words, Title I of Dodd–Frank charges the FSOC with

16. Another alternative is to use the International Financial Reporting Standards (IFRS) leverage ratio, a measure that can also be viewed as an approximation of the Basel III SLR. However, using the IFRS would undermine the FASB in the same manner as using the SLR. And, while publicly traded banks do report the IFRS ratio in their financial statements, the figures required to replicate the IFRS ratio are not in the FFIEC call report data.

17. Basel III estimates derivative exposure as the sum of current credit exposure and PFE.

18. The four firms with the largest notional derivatives exposures (from highest to lowest) are J.P. Morgan Chase (71.2 percent in interest-rate contracts), Citibank (73.2 percent in interest-rate contracts), Goldman Sachs (94.3 percent in interest-rate contracts), and Bank of America (71.9 percent in interest-rate contracts). For the percentages, see Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities," Table 3. As mentioned above, these four banks account for more than 90 percent of the industry's notional derivative exposure. Interest-rate derivatives make up more than 80 percent of the OTC derivatives market, and interest-rate derivatives receive the lowest conversion factors in the Basel III scheme.

TABLE 1

Comparative Leverage Ratios of Eight U.S. Global Systemically Important Banks

Bank Name	IFRS	Self-Reported Basel III	Alternative IFRS–Basel III
Goldman Sachs	5.00%	5.90%	0.68%
Morgan Stanley	4.22%	5.80%	4.46%
State Street	5.52%	5.80%	5.48%
Bank of NY Mellon	4.31%	4.90%	4.98%
Citibank	6.57%	7.08%	2.40%
Wells Fargo	8.20%	7.70%	5.48%
Bank of America	5.78%	6.40%	4.58%
JPMorgan Chase	5.93%	6.50%	3.04%
Average	**5.69%**	**6.26%**	**3.89%**

IFRS—International Financial Reporting Standards
NOTES: The alternative IFRS-Basel III leverage ratio is calculated as "total bank equity capital" (end of Q4 2015) divided by total assets. Total assets include an approximation of off-balance-sheet and net derivative exposures. Net derivative exposure is estimated by summing the categories of "Net Current Credit Exposure" for OTC derivatives, and adding 7 percent of notional derivative exposure (as an estimate of the Basel III potential future exposure). Off-balance-sheet exposure is estimated by summing all unused commitment items as well as all other off-balance-sheet liabilities (excluding derivatives), and all categories of letters of credit.
SOURCES: Federal Deposit Insurance Corporation, "Capitalization Ratios for Global Systemically Important Banks (GSIBs)," December 2015, https://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q15.pdf (accessed July 21, 2016), and author's calculations based on data from figures reported in the FFIEC Call Report Data.

BG 3152 heritage.org

identifying those firms regulators deem too big to fail. While the CHOICE Act does not fully repeal Title I of Dodd–Frank, it comes very close.

Rather than eliminate the FSOC completely, the CHOICE Act strips it of its authority to designate nonbank financial firms for stringent regulations (Section 113 of Dodd–Frank), as well as its authority to recommend more stringent regulations for individual financial *activities*.[19] The CHOICE Act also retroactively repeals any previously made FSOC designations for nonbank financial companies. Additionally, the CHOICE Act repeals Section 115 of Dodd–Frank, which authorizes the FSOC to make recommendations for more stringent regulations to the Federal Reserve Board of Governors for both nonbank financial firms and large bank holding companies.

The CHOICE Act also forces the FSOC to go through the regular congressional appropriations process, and eliminates the Office of Financial Research, an autonomous agency created (by Title I, Subtitle B, of Dodd–Frank) within the U.S. Treasury. Furthermore, the CHOICE Act repeals Title VIII of Dodd–Frank, a section of the law that gives the FSOC similar (overly broad) special-designation authority for specialized companies known as finan-

19. Dodd–Frank authorizes the FSOC to designate certain activities for special regulation and/or limit/prohibit firms from offering financial services/products in several sections. The CHOICE Act repeals this authority by repealing Sections 115, 120, and 121 of Dodd–Frank, but it does not repeal Section 112 (though it amends Section 112). Section 112(a)(2)(K) confers a duty on the FSOC to (in accordance with Dodd–Frank) "make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets."

cial market utilities.[20] Combined, these changes transform the FSOC into an institution capable of doing much less damage to the economy by essentially converting the FSOC to a regulatory council for sharing information.

Separately, Title II of the CHOICE Act repeals Dodd–Frank's orderly liquidation authority (OLA) and amends the bankruptcy code so that large financial firms can credibly use the bankruptcy process. Dodd–Frank's controversial OLA was the 2010 law's alternative to bankruptcy for large financial firms, and it was based on the faulty premise that large financial institutions cannot fail in a judicial bankruptcy proceeding without causing a financial crisis. The OLA gives these large financial companies access to subsidized funding and creates incentives for management to overleverage and expand their high-risk investments.[21] The CHOICE Act implements an improved bankruptcy process for large financial firms by adopting the text of H.R. 2947, the Financial Institution Bankruptcy Act of 2016.[22]

Title II of the CHOICE Act further guards against bailouts and too-big-to-fail problems by eliminating several harmful government-guarantee programs. Specifically, the CHOICE Act eliminates several so-called emergency liquidity and stabilization guarantee programs implemented by Sections 1104, 1105, and 1106 of Dodd–Frank. Just as important, the CHOICE Act repeals the FDIC's authority to issue emergency loan guarantees, an authority the FDIC used to guarantee nearly $350 billion in private debt in the wake of the 2008 crisis.[23] Overall, Title II makes meaningfully positive changes to the U.S. financial regulatory framework.

Suggested Title II Improvements. Title II of the Financial CHOICE Act takes several major steps to reduce the likelihood of bailouts. It stops the FSOC from identifying firms that regulators deem too big to fail, it removes most of the FSOC's overly broad regulatory authority, and it eliminates Dodd–Frank's controversial OLA. In other words, the CHOICE Act undoes much of what Dodd–Frank did to enshrine too big to fail. The following recommendations would help reduce the likelihood of bailouts even further:

- **Explicitly convert the FSOC to a sharing council.** The bill would strip most of the regulatory authority from the FSOC, largely converting it to a regulatory council for sharing information. A safer approach—which would better ensure that the FSOC can only share information rather than impose regulations—would be to explicitly amend the council's authority so that its *only* responsibility is to provide a mechanism for financial regulators to formally share information.

- **Amend the treatment of repurchase agreements and derivatives in bankruptcy.** In a typical bankruptcy, an automatic stay is implemented that serves as a financial timeout. Basically, a bankrupt firm's creditors have to wait until the bankruptcy judge declares that the new, or newly reorganized, company can start making payments. A major exception is that virtually all repurchase agreements (repos) and derivatives contracts are exempt from the automatic stay. Derivatives and repos have long enjoyed this special treatment in bankruptcy, as well as special exemptions (safe harbors) from other core provisions of bankruptcy, including limitations on preferential and fraudulent transfers.[24] Not surprisingly, these safe harbors have contributed to the widespread use of these instruments among financial firms, and likely contributed to system-wide liquidity

20. Norbert J. Michel, "Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII," in Norbert J. Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans* (Washington, DC: The Heritage Foundation, 2016), http://www.heritage.org/research/reports/2016/04/the-case-against-dodd-frank.
21. Paul Kupiec, "Title II: Is Orderly Liquidation Authority Necessary to Fix 'Too Big to Fail'?" in Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*.
22. The Financial Institution Bankruptcy Act of 2016 passed the U.S. House by voice vote on April 12, 2016.
23. Norbert J. Michel, "Title XI Does Not End Federal Reserve Bailouts," in Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*.
24. Edward Morrison and Joerg Riegel, "Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges," Columbia Law School Center for Law and Economic Studies, *Working Paper* No. 291, January 25, 2006, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878328 (accessed July 20, 2016).

and solvency problems during the 2008 crisis.[25] The Financial Institution Bankruptcy Act of 2016 (included in Title II of the Financial CHOICE Act) addresses this concern mainly by subjecting derivatives and repos to an automatic 48-hour stay. This change is welcome, but the complete elimination of the exemption and all safe harbors that derivatives and repos enjoy would be optimal.

Title VII: Fed Oversight Reform and Modernization (and Title VI Section 665)

Title VII of the Financial CHOICE Act would implement several major reforms to the Federal Reserve. To achieve these reforms, the CHOICE Act essentially adopts the text of H.R. 3189, the Fed Oversight Reform and Modernization (FORM) Act of 2015.[26] Thus, a main benefit of the CHOICE Act is that it would help to improve economic outcomes by forcing the Fed to conduct monetary policy in a more transparent manner. The FORM Act has been mischaracterized as forcing the Fed to conduct policy using the Taylor Rule,[27] but the bill simply does not do so. Instead, the FORM Act forces the Fed to rationalize whatever model it chooses to make its policy decisions against the Taylor Rule. Such a change would represent a major improvement in transparency compared to the ad hoc policymaking that the Fed now conducts purely at its own discretion.[28]

The CHOICE Act also improves the overall representation of the Federal Reserve District Banks on the Federal Open Market Committee. First, the bill would amend the Federal Reserve Act so that six, rather than five, Fed District presidents would sit on the committee, thus narrowing the majority position that the Fed Board of Governors currently holds on the committee. Additionally, the bill would end the New York Fed's *permanent* seat on the committee and allow, instead, all district presidents to rotate on an equal footing.[29] The CHOICE Act would also subject staff members to more transparency and ethics standards similar to those that apply to Securities and Exchange Commission employees, and would require the board to disclose all staff salaries in excess of the annual rate of basic pay for GS-15 employees on the General Schedule pay scale.

Section 707 of the CHOICE Act places restrictions on the Federal Reserve's authority to conduct so-called emergency lending under Section 13(3) of the Federal Reserve Act.[30] Though it would be better to eliminate this authority altogether—emergency loans are not necessary for providing market-wide liquidity—the bill aims to make it more difficult for the Fed to conduct bailout-style loans to insolvent firms. The restrictions in the CHOICE Act include the following: (1) requiring at least nine Fed District Bank presidents to authorize emergency loans (currently, only the affirmative vote of five members of the Board of Governors is required); (2) barring debt recipients from using equity as collateral; (3) requiring the Fed Board of Governors to promulgate a rule describing acceptable collateral; (4) making emergency loans contingent on the board and all federal banking regulators overseeing a borrower to first certify that the borrower is solvent; and (5) requiring the board to charge borrowers a minimum interest rate that cannot be below a market rate.

The CHOICE Act makes two additional key transparency improvements to the way the Federal Reserve operates. Section 709 removes remaining restrictions that prevent the Government Accountability Office from fully auditing the Fed's operations. In particular, the bill removes restrictions on auditing the Fed's monetary policy decisions as well as its dealings with foreign central banks and gov-

25. David Skeel and Thomas Jackson, "Transaction Consistency and the New Finance in Bankruptcy," *Columbia Law Review*, Vol. 112 (2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1773631 (accessed July 20, 2016), and David Skeel, "Bankruptcy Boundary Games," *Brooklyn Journal of Corporate, Financial & Commercial Law*, Vol. 4 (2009), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1274&context=faculty_scholarship (accessed July 20, 2016).

26. H.R. 3189 passed the U.S. House of Representatives on November 19, 2015, by a vote of 241 to 185.

27. Named after Stanford economist John B. Taylor, the Taylor Rule is an equation often used to benchmark a central bank's interest-rate-targeting policy. See John B. Taylor, "Discretion Versus Policy Rules in Practice," Carnegie-Rochester Conference Series on Public Policy, Vol. 39, 1993, pp. 195–214, http://web.stanford.edu/~johntayl/Papers/Discretion.PDF (accessed August 12, 2016).

28. Norbert J. Michel, "Why Congress Should Institute Rules-Based Monetary Policy," Heritage Foundation *Backgrounder* No. 2991, February 11, 2015, http://www.heritage.org/research/reports/2015/02/why-congress-should-institute-rules-based-monetary-policy.

29. These changes would amend Section 12A(a) of the Federal Reserve Act, 12 U.S. Code 263(a).

30. 12 U.S. Code 343(3).

ernments.[31] Also, Section 711 requires the Federal Open Market Committee to record all of its meetings and to release full transcripts to the public. There is no legitimate economic reason for any government agency, including the Federal Reserve, to object to either of these types of reforms.

Another provision of the bill, Section 665 (in Title VI), would greatly improve congressional oversight of the Fed by placing its prudential regulatory and financial supervision activities under the regular congressional budget process. Finally, the CHOICE Act would allow a major study of the nation's monetary policy. Section 710 (Title VII) establishes a formal monetary commission by incorporating text similar to the Centennial Monetary Commission Act of 2013 (H.R. 1176). The idea is to "establish a commission to examine the United States monetary policy, evaluate alternative monetary regimes, and recommend a course for monetary policy going forward." This type of commission would provide the appropriate venue for both critics and supporters to discuss the Fed's operations and its proper role.[32]

Suggested Federal Reserve Reform Improvements. Title VII of the Financial CHOICE Act implements several major reforms to Congress's oversight of the Federal Reserve and the manner in which the central bank conducts monetary policy and emergency lending. Additionally, Title VI, Section 665, of the CHOICE Act subjects the Fed's regulatory activities to congressional appropriations. The following recommendations would help reform and modernize the Federal Reserve's operations even more:

- **End the Fed's role as a regulator.** Removing regulatory functions from the Federal Reserve is long past due.[33] Prior to the 2008 crisis, a special task force under the direction of former Treasury Secretary Henry Paulson recommended that most of the Fed's regulatory authority be dramatically reduced or transferred to other agencies.[34] Stripping the Fed of regulatory authority would have been entirely consistent with the international trend during the last few decades of the 20th century, whereby roughly a dozen developed countries took regulatory authority away from their central banks.[35] Ironically, in an earlier draft of what became the Dodd–Frank Act, Senator Chris Dodd (D–CT) included legislative text that would have transferred the Federal Reserve's regulatory authority to a single financial regulator called the Financial Institutions Regulatory Administration (FIRA).[36]

  Policymakers should not leave the Fed—with its history of regulatory capture and credit allocation to failing firms (and their creditors)—in charge of regulating financial markets and providing emergency lending, while simultaneously being responsible for conducting the nation's monetary policy. Beyond the basic temptation to provide so-called emergency funds to failing firms it regulates, the Fed also faces the incentive to use monetary policy actions to counter any regulatory failings. This combination further reduces the ability of markets to discipline poorly managed firms, injects even more politics into central banking, and jeopardizes the long-term

31. Section 709 repeals the four sets of restrictions in 31 U.S. Code 714(b).
32. Norbert J. Michel, "The Centennial Monetary Commission Act of 2013: A Second Look at the Fed and the 2008 Financial Crisis," Heritage Foundation *Backgrounder* No. 2926, July 1, 2014, http://www.heritage.org/research/reports/2014/07/the-centennial-monetary-commission-act-of-2013-a-second-look-at-the-fed-and-the-2008-financial-crisis.
33. Norbert J. Michel, "Improving Financial Institution Supervision: Ending the Federal Reserve's Regulatory Role," testimony before the Financial Institutions and Consumer Protection Subcommittee, Committee on Banking, Housing and Urban Affairs, U.S. Senate, November 21, 2014, http://www.heritage.org/research/testimony/2014/12/step-one-for-improving-financial-institution-supervision-ending-the-federal-reserves-regulatory-role (accessed July 21, 2016).
34. U.S. Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure," March 2008, http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&sqi=2&ved=0CB4QFjAA&url=http%3A%2F%2Fwww.treasury.gov%2Fpress-center%2Fpress-releases%2Fdocuments%2FBlueprint.pdf&ei=ViBqVKyrCMKqNs3ggvgM&usg=AFQjCNEfnzAADfbXaKq4WkvwsXO2A9I_pQ&bvm=bv.79142246,d.eXY (accessed November 18, 2014).
35. Charles Calomiris, "Alan Greenspan's Legacy: An Early Look; The Regulatory Record of the Greenspan Fed," American Economic Association Papers and Proceedings, Vol. 96 (2006), pp. 170–173, https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/4435/Greenspan_Fed.pdf (accessed November 18, 2014).
36. Section 322(e) of the Restoring American Financial Stability Act of 2009 would have accomplished the transfer.

price stability goal of monetary policy. A central bank simply does not need to function as a regulator in order to conduct monetary policy.[37]

- **Fully repeal the Fed's authority to make emergency loans.** Throughout its history, the Fed's emergency lending and discount-window loan policies have jeopardized its operational independence and put taxpayers at risk. Congress should restrict the Fed to providing system-wide liquidity on an ongoing basis. A central bank does not need emergency lending authority to conduct monetary policy.[38]

- **Replace the Fed's primary dealer system with a market-wide liquidity system.** The Fed conducts open-market operations—buying and selling Treasury securities to implement monetary policy—with a limited number of financial firms known as primary dealers. The current primary dealer framework was created in the 1960s when a centralized open-market system in New York offered clearer advantages. Markets have changed dramatically since the 1960s, and allowing all banks to participate in open-market operations would provide a more liquid interbank lending market. The Fed successfully used the Term Auction Facility to inject liquidity into the market during the 2008 crisis, and this program could be modified to replace the current primary dealer system.[39]

Title IX: Repeal of the Volcker Rule and Other Provisions

The main provision in Title IX of the Financial CHOICE Act repeals Section 619 of Dodd–Frank, otherwise known as the Volcker Rule. The Volcker Rule was supposed to protect taxpayers by prohibiting banks from engaging in what is known as proprietary trading—that is, making risky investments solely for their own profit. Although it sounds logical to stop banks from making "risky bets" with federally insured deposits, this idea ignores the basic fact that banks make risky investments with federally insured deposits every time they make a loan. There is really no reason to think that the Volcker Rule would have prevented—or even softened—the 2008 crisis or any previous financial crisis. The practical difficulties associated with implementing the rule caused regulators to spend years working on what ended up being an enormously complex and largely pointless rule.[40]

Title IX also repeals several other sections from Title VI of Dodd–Frank, addressing items such as studies on credit cards and on banks' investment activities, and also an amendment to the Securities Act of 1933 regarding conflicts of interest for certain securitizations.[41] There are likely other sections from Title VI of Dodd–Frank worth repealing, but it is hard to improve on Title IX of the CHOICE Act given that it repeals the Volcker Rule. Furthermore, several provisions in Title VI of Dodd–Frank would be obviated for firms that hold higher capital.[42]

Conclusion

House Financial Services Committee Chairman Hensarling's discussion draft of the Financial CHOICE Act includes many ideas that would reduce the risk of future financial crises and bailouts. Implementing these ideas would allow Americans to prosper by reducing overbearing government regulations. The centerpiece of the CHOICE Act, a regulatory off-ramp, is a feature that should be included in any major financial regulatory reform bill. This

37. Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," *Federal Reserve Bank of Richmond Working Paper* No. 88-1 (May/June 1988), https://www.richmondfed.org/publications/research/working_papers/1988/wp_88-1.cfm (accessed November 18, 2014).

38. Michel, "Title XI Does Not End Federal Reserve Bailouts."

39. George Selgin, "L Street: Bagehotian Prescriptions for a 21st Century Money Market," *The Cato Journal*, Vol. 32, No. 2 (Spring/Summer 2012), http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2012/7/v32n2-8.pdf (accessed July 21, 2016).

40. Norbert J. Michel, "The Volcker Rule: Three Years and Nearly 1,000 Pages Later," The Daily Signal, December 12, 2013, http://dailysignal.com/2013/12/12/volcker-rule-three-years-nearly-1000-pages-later/.

41. The CHOICE Act repeals Sections 603, 618, 619, 620, and 621 of Dodd–Frank.

42. Sections 606 and 607, for example, amend bank-holding-company capital rules. These provisions would be unnecessary for banks electing to hold higher capital. See Steph Miller, "No Need for Title VI with Simpler, Higher Capital," in Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*.

off-ramp provides regulatory relief to banks that choose to hold higher equity capital, thus improving their ability to absorb losses while reducing the likelihood of taxpayer bailouts.

There is little reason to heavily regulate banks that can absorb their own financial risks, and reducing the likelihood of taxpayer bailouts gives investors and customers the necessary incentives to monitor—and to discipline—firms' behavior. Thus, the CHOICE Act replaces government regulation with market regulation for firms that absorb their own risks. The CHOICE Act also restructures (or repeals) several harmful sections of the 2010 Dodd–Frank Act that make future financial crises and bailouts more likely, and makes several major improvements to the Federal Reserve. There is no doubt that adopting the ideas in the CHOICE Act would be an overwhelmingly positive step for U.S. financial markets and the broader U.S. economy.

*—**Norbert J. Michel, PhD,** is a Research Fellow in Financial Regulations in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*