Insight

Top 9 Wins for Consumers in the CHOICE Act

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This week the House will vote on the Financial CHOICE Act – CHOICE, standing for "Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs." It's landmark legislation that's been years in the making, first taking on the form of CHOICE 1.0 last year, and finally receiving approval as CHOICE 2.0 this year. Coming in at nearly 600 pages, there is a lot to digest.

What's in this for the average American? The overarching goal of this administration and this congress is to improve economic conditions, and the best way to improve economic conditions is to do so from the ground up. CHOICE does just that by cutting burdensome compliance costs, increasing options for both consumers and businesses, and fostering and environment of innovation and capital creation. This list is by no means complete, but here are a few of the ways that CHOICE will improve economic conditions from the ground up.

1. **Providing an "off-ramp" from Dodd-Frank and Basel III capital and liquidity requirements for banks that choose to maintain higher levels of capital.**

Perhaps the most notable provision of the CHOICE Act, is the choice that it provides to financial institutions. Instead of the top-down, industrial era centralized regulation of banks from Dodd-Frank, CHOICE would allow banks to choose to maintain a high level of capital and qualify for an exit. Choosing the latter would provide an exit from (in the words of the Committee) "any federal law, rule, or regulation that provides limitations on mergers, consolidations, or acquisitions of assets or control, to the extent the limitations relate to capital or liquidity standards or concentrations of deposits or assets" as well as "any federal law, rule, or regulation that permits a banking agency to consider risk to the stability of the United States banking or financial system added to various federal banking laws by Section 604 of the Dodd-Frank Act, when reviewing an application to consummate a transaction or commence an activity."

Instead of dated regulations (and regulators) prescribing how much capital a financial institution should hold, CHOICE allows banks to decide what should be on their balance sheets according to their individual business models and financial strategies and projections. It's in a bank's best interest to be strongly capitalized and able to withstand financial shocks, and CHOICE rewards those banks by removing the shackles of additionally, burdensome regulatory standards.

2. **Removing backward-looking operational risk capital requirements to free up billions of dollars of currently-trapped capital.**

One of the smallest provisions of CHOICE is also one of the most consequential. In Section 152, CHOICE eliminates the backward-looking concept of operational risk. Specifically, it mandates that the agencies that oversee banks "may not establish an operational risk capital requirement for banking organizations, unless such requirement is based on the risks posed by a banking organization's current activities and businesses; is appropriately sensitive to the risks posed by such current activities and businesses; is determined under a forward-looking assessment of potential losses that may arise out of a banking organization's current activities and businesses, which is not solely based on a banking organization's historical losses; and permits adjustments based on qualifying operational risk mitigants."

Operational risk is the concept that regulators use to measure the possibility that a bank's own actions could lead to losses, as opposed to outside influences from negative economic or market forces. Like other capital requirements, operational risk capital is the increased amount of capital that regulators require banks to hold to cover any such operational losses. The notional of operational risk and capital held to protect against such did not exist prior to 2008. Only with the advent of poor subprime underwiring, problems with securitization, and – especially – the need to settle lawsuits and government penalties has it been implemented and taken on any importance. But from the perspective of 2017, it suffers two flaws. First, it is generally calculated based on banks' past actions, not on the future outlook. It is not filling the role of providing a cushion against the unforeseen future. Second, it feeds the regulators conceit that there is actually a way to identify individual types of risks and calculate the appropriate capital charge for each. And as with other capital requirements, operational risk capital results in banks having less capital available to lend out, invest, or return to shareholders.

Moving from backward to forward looking assessments of risk is sensible and will create a safer, sounder financial system. It would also free up much needed capital for a small business lending market that still has not fully recovered from the crisis. Some analysts estimate that this change in CHOICE could free up over $200 billion in capital at just the four largest U.S. banks – a number that could stretch far higher across the entire banking sector.

3. **Modernizing the regulatory structure to encourage innovation and promote capital formation.**

When the SEC was created, Congress gave it three missions: 1) protect investors, 2) maintain fair, orderly and efficient markets, and 3) facilitate capital formation. After the financial crisis, the authors of Dodd-Frank gave the SEC several new responsibilities which were neither related to its missions nor which aided capital markets, innovators, or investors. In fact, former SEC Commissioner Gallagher has been on record saying that Dodd-Frank mandates prevented the SEC from engaging in its statutory regulatory mission. CHOICE will repeal many of the Dodd-Frank provisions that have been forcing the SEC to use its resources on activities outside of its mission.

Specifically, the CHOICE Act will incorporate a number of previously Committee- or House- passed capital formation bills that promote access to capital for small businesses and startup companies as well as expanding parts of the Jumpstart Our Business Startups Act that ease the process for companies going public, remove barriers to entry for venture exchanges which would give small businesses greater access to capital, and rework the regulatory framework for business development companies to increase their ability to finance small and startup companies, among other jobs-creating and capital-forming provisions.

4. **Restructuring the CFPB, its leadership, and submitting it to the Congressional appropriations process.**

The Consumer Financial Protection Bureau (CFPB) has become one of the most well known and most controversial creations of Dodd-Frank. Since its inception, instead of protecting consumers it has burdened consumers with nearly 17 million hours of paperwork requirements and almost $3 billion in regulatory costs. That doesn't account for the billions in civil penalties that the CFPB has levied on businesses, many of which resulted from unsubstantiated accusations that were agreed upon under the sole direction of the Bureau's director, without the oversight of a panel or even the oversight of the congressional appropriations process. Instead, the CFPB relies on a set, annual draw from the Fed – funds ultimately traceable back to the average

American.

The CHOICE Act will dramatically change these consumer burdens from the agency meant to protect them. First, it will change the structure from an independent, unaccountable director, to a director that serves at the will of the president and is subject to removal. CHOICE will further subject the CFPB (which will be renamed the Consumer Law Enforcement Agency or CLEA) to the congressional appropriations process – so if it is not living up to congressional expectations, it will not continue to receive hundreds of millions of taxpayer dollars. Finally, CHOICE will reform the mission of the CFPB. Instead of allowing it to go rogue and create costly new regulations, CLEA will only be tasked with enforcing those laws and regulations that are already on the books from the several other financial regulatory agencies. All things combined, CHOICE will make the CFPB a workable, efficient entity that will no longer burden, but that will actually protect, consumers.

5. **Repealing DOL's fiduciary rule and directing the SEC to study the effects of a similar rule before proposing such.**

Although Dodd-Frank directed the SEC to study the need for establishing a new fiduciary standard of care for brokers and advisers, the Department of Labor (DOL) took it upon themselves to write the fiduciary rule, separate from and conflicting with Dodd-Frank's requirements. The rule is scheduled to go into effect June 9 (although DOL has stated they won't enforce the rule until January 1, 2018). AAF research has found that if the fiduciary rule is implemented in full as it is written, the effects will be extremely costly. For example, retirement savers will see their costs increased by 73 to 196 percent as a result of a mass shift toward fee-based accounts; firms providing investment advice will see an average of $21.5 million in initial compliance costs and $5.1 million in annual maintenance costs; and up to 7 million current IRAs would fail to qualify for an advisory account due to the balance being too low for the adviser to maintain. In fact, the fiduciary rule, even before being fully implemented, has already cost firms over $100 million and has resulted in fewer options for savers.

The CHOICE Act, understanding the importance of a fiduciary standard but realizing the problems with the current rule from DOL will completely repeal DOL's fiduciary rule and will require the SEC to conduct a study resulting in a report to the Senate Banking Committee that finds whether: (1) retail customers are being harmed because broker-dealers are held to a different standard of conduct from that of investment advisers; (2) alternative remedies will reduce any confusion and harm to retail investors due to the different standard of conduct; (3) adoption of a uniform fiduciary standard would adversely impact the commissions of broker-dealers or the availability of certain financial products and transaction; and (4) the adoption of a uniform fiduciary standard would adversely impact retail investors' access to personalized and cost-effective investment advice or recommendations about securities. The SEC's chief economist would also be required to support any conclusions in the report with his own economic analysis. Lastly, CHOICE would require DOL to amend its fiduciary rule to that of the SEC. Such changes to the fiduciary rule would not only benefit investors, but would expand the ability of advisers and broker-dealers to advise clients, and help keep open many of those advisory shops and small businesses that would have been forced to close under the current rule as written.

6. **Repealing FSOC's SIFI designation authority and requiring FSOC to be more accountable and transparent.**

AAF has written extensively about the Financial Stability Oversight Council (FSOC), how it is flawed at its core as an entity; how its decision making processes are arbitrary and capricious; how its designations levy huge cost burdens on companies (without performing a cost-benefit analysis beforehand) and harm their international competitiveness; and how it is perhaps the most powerful and least transparent regulatory body. FSOC's process has prioritized designation and regulation of institutions, often arbitrarily, over the identification of activities that pose actual systemic threats and has done so in a fundamentally flawed manner – namely FSOC has designated companies inconsistently and with little to no transparency to the companies or to taxpayers during the process. Doing so puts those companies and their customers at risk of serious financial consequence.

Specifically, FSOC's regulatory designation imposes direct costs and risks on the designated institutions. The magnitude of the costs is uncertain, given that the specific rules and capital requirements have yet to be determined, but it cannot be presumed to be negligible. More worrisome is the fact that FSOC's two-tiered system will alter competition in the insurance sector. Other things being equal, the increased costs of enhanced supervision by FSOC will reduce companies' ability to compete effectively, shifting business and risk to non-designated companies not subject to enhanced supervision and, in effect destabilizing rather than stabilizing the market.

CHOICE would repeal FSOC's authority to designate non-bank financial companies as Systemically Important Financial Institutions (SIFIs) and would repeal any previous SIFI designations that were made. It would also require FSOC to be more transparent and consistent as it transitions to serving as an inter-agency forum for (1) monitoring market developments; (2) facilitating information sharing and regulatory coordination; (3) bringing the primary federal regulators together to identify and mitigate risks to financial stability; and (4) report those risks to Congress with ameliorative policy recommendations. Keeping FSOC intact as the forum, or Council, that it was originally intended to be but removing its burdensome ability to designate is a win for taxpayers, businesses, and their customers.

7. **Applying the Regulations from the Executive in Need of Scrutiny (REINS) Act to all Financial Agencies.**

The REINS Act would allow Congress to approve or disapprove of "major" regulations (anything producing $100 million or more in economic impacts) before they go into effect. AAF research found that, if adopted, REINS could save more than $27 billion in annual regulatory costs and 11.5 million annual paperwork burden hours. The CHOICE Act would apply such a requirement on any major regulations coming out of any financial agency, including the CFPB (or, CLEA), SEC, CFTC, FDIC, FTC, NCUA, OCC, and others. Considering that financial agencies have levied $55.7 billion in regulatory costs and 110 million in paperwork burden hours just over the last 12 years, applying the REINS Act to those agencies and their regulations would life an enormous burden off of the regulated entities, putting much needed capital back into the market.

8. **Abolishing the Office of Financial Research.**

Much like the Volcker Rule (below), the creation of the Office of Financial Research (OFR) was a solution in search of a problem. And, like the CFPB, it also sets its own budget and receives funding every year without going through the congressional appropriations process. In fact, its funding comes from "assessments" on FSOC-designated nonbank financial companies as discussed above. In short, it represents a lot of problems all wrapped into one. Also problematic is the fact that OFR consolidates, instead of diversifying, the federal government's research and viewpoints on threats to and risk in the financial system. By not leaving the assessment and recommendations surrounding perceived financial threats to the individual agencies subject to their individual authorities and expertise (e.g. the 300+ PhD economists at the Federal Reserve), Dodd-Frank added another layer of complexity and confusion to the financial regulatory system.

CHOICE eliminates OFR in its entirety, which, by getting rid of another redundant bureaucracy, will improve the system's ability to identify and combat risk by diversifying risk management tactics and opinions and returning financial regulation to streamlined operations.

9. **Repealing the Volcker Rule.**

Like OFR, the Volcker Rule was a solution in search of a problem. Proprietary trading was not the cause of the financial crisis, and Volcker did little more than amount to another needless regulatory burden on the financial sector. As Volcker forced banks to shed their market-making operations, consumers lost their ability to trade quickly and at a steady price. And since, Dodd-Frank also levied higher capital requirements, banks haven't been taking up any excess space holding inventories of assets awaiting a buyer. For example, in 2007, JPMorgan carried $2.7 trillion in corporate bonds. By the end of 2015, that number was down to $1.7 trillion and falling. That lack of liquidity hurts consumers directly as their options for financial products and services become limited, and indirectly, as less liquid U.S. banks lose their competitiveness abroad – Europe and much of the rest of the world are not restricted by bans on proprietary trading, etc. It should also come as no surprise that as the Volcker rule prohibits proprietary trading, those activities get driven into less regulated or even unregulated areas of the financial system, which debatably undermines the entire purpose of the rule. Not to mention the fact that decreased liquidity from Volcker translates to increased costs of capital for businesses.

Repealing the Volcker Rule through the CHOICE Act will return banks to their market making function, increasing liquidity and allowing markets to have more of a cushion to deal with any negative shocks. Its repeal will further reprieve small and community banks from the burdens of having to report on the Volcker Rule's requirements (even though the small and community banks do not proprietarily trade). At last, CHOICE's repeal of Volcker is the solution to its own problems.

Consumers aren't the only ones that will benefit from reforms in the CHOICE Act. Last month the Congressional Budget Office (CBO) scored the bill and found that, if enacted, the legislation would reduce the federal deficit by $24.1 billion over 10 years and reduce direct spending by $30.1 billion, most of which results from the elimination of OLF and the restructuring of the CFPB. Considering that Dodd-Frank has been called the Obamacare for financial services, the CHOICE Act should be considered a repeal and replacement of it, and an effective one at that. The House should pass CHOICE this week, and the Senate should work toward a companion bill of its own to ensure that Americans don't continue to be burdened by Dodd-Franks onerous regulations.