THIRD WAY

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A Policymaker's Guide to the Financial CHOICE Act

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Policymakers have a *choice*—do you preserve Dodd-Frank, the most important financial reform law in 75 years, or do you subject the nation to more risk? The House Republican Financial CHOICE Act, H.R. 10, repeals the most important Dodd-Frank reforms, defangs the Consumer Financial Protection Bureau, and significantly diminishes the independence of the Federal Reserve and other banking industry regulators. With H.R. 10, the choice is clear—Congress must say ***no*** to the Financial CHOICE Act.

Dodd-Frank is a pro-growth, pro-market, pro-investor law that is essential to prevent another financial crisis like we experienced in 2008. In the recession that followed that crisis, over nine million jobs disappeared and at least 11 million people lost their homes. Furthermore, $13 trillion in wealth evaporated, including $2.7 trillion in retirement savings. Nearly every American household was affected in some way by the government's failure to prepare for an economic catastrophe of this magnitude. This is why we have the Dodd-Frank law today.

The Financial CHOICE Act, however, would completely dismantle the Dodd-Frank law and its pro-growth, pro-market, pro-investor protections. This memo summarizes the Dodd-Frank provisions most vulnerable to being abolished by the Financial CHOICE Act and why these regulations are essential to keeping our economy safe from a future crisis.

Key Points

- **Dodd-Frank is a pro-growth, pro-market, and pro-investor law.**
  - ***Pro-growth***: It protects our banking system from melting down.
  - ***Pro-market***: It focuses on risk that could be spread through our interconnected financial institutions.
  - ***Pro-investor***: American families who participate in markets as retail investors are protected from harm.
  - The Financial CHOICE Act would undo the progress that Dodd-Frank has made to make the financial sector safer while still preserving its ability to innovate and allocate capital. (Testimony, 4/28/17)

- **Dodd-Frank is a balanced law that makes banks safer.**
  - When banks are safer, we reduce the probability that a crisis will happen. That gives the economy more room to run and grow. (Testimony, 4/28/17)

- **There is a tangible economic benefit to making the financial sector stable.**
  - Dodd-Frank regulations generate valuable benefits to GDP because they make future financial crises less likely to occur—and less costly when they do occur. (Report, 1/11/17)

  - According to a cost-benefit analysis of capital and liquidity requirements performed by Third Way, Dodd-Frank contributes $351 billion to U.S. GDP over 10 years. (Testimony, 4/28/17)

- **The United States has had 85 straight months of private-sector job growth.**
  - Former Chairman Barney Frank: "The argument that the legislation and the subsequent regulation somehow retarded our economy is very hard to make, given that our economy is doing better than anybody in the world. ... the only time we have seen better progress in reducing unemployment was during the '90s, in the Clinton administration." (Transcript, 7/21/15)

- **No one wants a bank bailout to happen ever again.**
  - To end bailouts, three things need to happen: 1) banks must be stronger financially, 2) regulators must be able to test banks' crisis preparedness on a regular basis, and 3) the legal system must have a way to handle banks whose failure could cause a bigger catastrophe. (Memo, 4/25/17)

  - Dodd-Frank achieves each of these goals through increased equity, improved liquidity, annual stress tests, and Orderly Liquidation Authority. The CHOICE Act would make a huge mistake weakening these tools when the evidence is clear that they work. (Memo, 4/25/17)

- **Re-litigating Dodd-Frank is a danger our economy simply cannot afford.**
    - Former Chairman Barney Frank: "If you're going to re-litigate every policy decision that's ever made when the majority changes, you'll have a very unstable situation." (Transcript, 7/21/15)

Capital and Liquidity Requirements

- **Erasing bank capital rules would cost our economy $351 billion.**
    - Risk-weighted capital requirements and the liquidity coverage ratio contribute 1.62% to GDP, according to a cost-benefit analysis by Third Way. While these rules are recommended by an international agreement, they would not be implemented without Dodd-Frank. (Memo, 2/6/17)

- **Risk-weighted capital requirements prevent banks from becoming insolvent.**
    - Riskier assets like mortgage loans, corporate loans, and commercial real estate loans have a higher probability of default than Treasury bonds, and therefore have higher risk weights. (Memo, 2/10/14)
    - At the end of 2016, U.S. banks had 41% more risk-based capital than they did at the end of 2009. (Memo, 4/25/17)

- **The liquidity coverage ratio makes banks more prepared to weather a crisis.**
  - Requiring banks to hold more liquid assets strengthens their ability to raise cash rapidly and survive times of market stress. (Report, 11/18/14)
  - The liquidity coverage ratio ensures that large banks can fund their cash flow needs with internal assets for at least 30 days. That way, a bank will not suddenly find itself unable to meet upcoming expenses, as happened in several bank failures during the crisis. (Report, 11/6/15)
  - The liquidity coverage ratio does not apply to banks with less than $50 billion in assets. (Report, 11/6/15)
  - Improving bank liquidity, like increasing bank equity, does come with tradeoffs. Banks have to scale back lending to a certain degree in order to meet these requirements. But the benefit is that the economy is stronger. The longer that the financial sector can go without a bank run or a liquidity crisis, the more the economy can grow. (Memo, 4/25/17)

- **The simple leverage ratio in the CHOICE Act is not good enough to protect the world's largest economy.**
  - Under the CHOICE Act's regime, the leverage ratio is the only thing standing between some regulation and no regulation. No one should be comfortable with just one number determining whether banks can opt-out of the entire framework for financial safety regulation. (Testimony, 4/28/17)

Consumer Financial Protection Bureau

- **Dodd-Frank created the only federal agency 100% focused on protecting consumers in the financial marketplace.**
    - Prior to Dodd-Frank, an ineffective patchwork of consumer protections existed for mortgages and other consumer financial products. Consumer protection law enforcement was in the hands of multiple regulators. To enhance and simplify consumer protection, Dodd-Frank consolidates enforcement into a single point of authority wholly focused on protecting consumers—the Consumer Financial Protection Bureau. (Report, 11/18/14)
    - Since the Consumer Bureau was created, it has benefited 27 million Americans. Most notably, it has transformed the mortgage industry with "Know Before You Owe" rules that benefit borrowers, lenders, and investors alike. (Memo, 2/6/17)

- **The CHOICE Act severely curtails the Consumer Bureau's ability to fulfill its consumer protection mission.**

Financial Market Utility SIFI Designation

- **Dodd-Frank allows Financial Market Utilities to access emergency loans from the Federal Reserve System in the event of a crisis.**
  - Eight Financial Market Utilities (FMUs) are currently designated as Systemically Important Financial Institutions (SIFIs). (Report, 11/6/15)

  - FMUs, also known as central counterparties or clearinghouses, mitigate counterparty risk—the risk that one side or the other cannot hold up its end of a trade. Instead of the seller and buyer directly swapping with each other, an FMU provides payments from accounts in the counterparties' names, and it provides securities from a central repository. (Report, 11/6/15)

  - FMUs stand in the middle of trillions of dollars of counterparty exposures, so it is critical that they have enough liquidity to clear all of the transactions they handle. To receive eligibility for emergency Fed loans, FMUs are required to hold enough internal funds to cover the potential default of their two biggest customers. (Report, 11/6/15)

- **The CHOICE Act repeals SIFI designation for Financial Market Utilities**, which puts the financial markets at risk of freezing up in a crisis.

Financial Stability Oversight Council

- **Dodd-Frank created a forum for regulators to exchange information about risks in the financial system.**
  - Before Dodd-Frank, banking regulation was siloed. Dangerous risks built up in our financial system in the run-up to the financial crisis, but they went largely unnoticed—in part because of our fractured regulatory system. (Report, 11/18/14)

  - Dodd-Frank created the Financial Stability Oversight Council (FSOC), a single watchdog whose sole purpose it to look out for risks throughout the financial system. FSOC brings regulators together so they can discuss issues in their jurisdiction, look for interconnections that can cause systemic harm, and take action before it's too late. (Report, 11/18/14)

  - The Office of Financial Research (OFR) assists FSOC by providing the data and analysis regulators need to identify potential risks. (Report, 11/18/14)

- **The CHOICE Act restricts the FSOC's ability to take pre-emptive action to avert a future financial crisis.** Furthermore, the CHOICE Act abolishes the Office of Financial Research.

Orderly Liquidation Authority

- **Orderly Liquidation Authority ended "too big to fail."**
  - During the financial crisis, unprecedented ad hoc emergency measures had to be taken to prevent an unravelling of the economy. (Report, 11/18/14)

  - Orderly Liquidation Authority (OLA) is a back-up in case there are spillover risks that regular bankruptcy cannot contain. (Memo, 4/25/17)

  - OLA ensures that the losses of a failing financial institution are borne by the private sector, so that taxpayers are never on the hook. (Memo, 2/6/17)

- **The CHOICE Act would completely repeal Title II of the Dodd-Frank Act, which enacted Orderly Liquidation Authority.**

Qualified Mortgage Rule

- **Dodd-Frank created a new, clear standard that increases the quality of individual mortgage loans.**
  - The housing bubble was inflated by poorly underwritten loans, risky consumer decisions, and outright mortgage fraud. Now, lenders must verify a potential homebuyer's employment and income in order to ensure they can actually afford their mortgage. (Report, 11/18/14)

  - To be considered a qualified mortgage (QM), the borrower may not have a debt-to-income ratio greater than 43%. In addition, risky interest-only loans, negative amortization loans, and loans with balloon payments are not considered QM. (Report, 11/18/14)

  - A lender that makes a QM loan is protected from a future lawsuit filed by a borrower who claims that they were sold a loan they couldn't afford. Similarly, borrowers who receive QM loans are assured they haven't been sold an overly risky, unaffordable mortgage. (Report, 11/18/14)

- **The CHOICE Act would permit any loan to be considered a Qualified Mortgage if it is held on the lender's portfolio**, regardless of its compliance with the debt-to-income rule and other consumer safeguards.

Stress Tests

- **Thanks to stress tests, our largest banks are now fireproof.**
  - Dodd-Frank created stress tests—an annual crisis simulation for large, interconnected banks. In 2014, five large banks failed. In 2016, only one did. (Memo, 2/6/17)
  - Banks with at least $10 billion in assets must perform an annual internal test; that's about 100 of the more than 6,000 institutions in the U.S. banking system. (Memo, 4/25/17)
  - Systemically important banks have to do two internal tests and two tests run by the Fed every year. (Memo, 4/25/17)

- **The CHOICE Act weakens the stress test exercise** by making the penalty on paying out dividends optional for banks that meet its low standard for exemption from the rules, the 10% leverage ratio. (Testimony, 4/28/17)

Volcker Rule

- **Dodd-Frank returns banks to their core functions of lending, raising capital, and serving clients through the Volcker Rule.**
  - Banks have insured deposits from millions of Americans, as well as access to public safety nets—such as FDIC deposit insurance and Federal Reserve loans. These measures are in place to ensure that banks can provide essential services that support the economy—not to provide a backstop for banks to gamble with their own funds. (Report, 11/18/14)

  - Before Dodd-Frank, banks were allowed to make short-term speculative bets for their own profit. The Volcker rule prevents banks with insured deposits and access to the safety net from making speculative bets, including banning them from having their own internal hedge funds or private equity funds. They also have to sharply curtail any investments they make in these types of institutions. (Report, 11/18/14)

  - While there is evidence that liquidity has become more fragile, it may also be due to factors like monetary policy, investor behavior, and technological changes. (Report, 1/11/17)

- **The CHOICE Act repeals the Volcker Rule.**

  - Getting banks to lend more on Main Street is a worthy goal; a free pass for risky stock trading is entirely unrelated. (Memo, 2/6/17)