UCONN
LIBRARY

University of Connecticut
OpenCommons@UConn

Connecticut Insurance Law Journal

School of Law

2018

Financial Regulation: The Apotheosis of the Administrative State

The Federalist Society

Follow this and additional works at: https://opencommons.uconn.edu/cilj

Recommended Citation
The Federalist Society, "Financial Regulation: The Apotheosis of the Administrative State" (2018). *Connecticut Insurance Law Journal*. 14.
https://opencommons.uconn.edu/cilj/14

CONNECTICUT INSURANCE LAW JOURNAL

Volume 25, Number 1
Fall 2018

University of Connecticut School of Law
Hartford, Connecticut

FINANCIAL REGULATION: THE APOTHEOSIS OF THE ADMINISTRATIVE STATE

THE FEDERALIST SOCIETY

WAYNE ABERNATHY:

Good afternoon, everyone. Glad to have you here for our session. My name is Wayne Abernathy, I'm executive Vice President for Financial Institutions Policy at The American Bankers Association but here at the Federalist Society I am the chairman of the Financial Services Practice group, who is sponsoring this session today. Financial Regulation: The Apotheosis of the Administrative State. This is a long term for a very important topic, and we very much appreciate you being here to listen from our very experienced, distinguished, and insightful panel.

By the way, if you happen to be interested in the work of the Financial Services Practice group at the Federalist Society, please contact me or one of the officers of the Federalist Society and we can get you involved. Love to have as many people involved as possible.

And now my important duty besides that is to introduce our moderator for today, Judge Carlos Bea. Judge Carlos Bea serves as a judge on the United States Court of Appeals for the Ninth Circuit. He received his bachelor's degree from Stanford University, and his J.D. from Stanford Law School. Judge Bea was born in San Sebastian, Spain, and immigrated with his family to Cuba in 1939. In 1952, you might not notice it unless he stands up, then of course you will. Judge Bea served on the Cuban national basketball team at the Helsinki Olympics. Wish I could do that.

Judge Bea became a naturalized citizen of the United State in 1958. He taught courses in civil litigation, advocacy at Hastings Law College of Law and Stanford Law School. From 1990 to 2003, Judge Bea served as judge of the San Francisco Superior Court. Judge Bea was nominated by President George W. Bush to the United States Court of Appeals for the Ninth Circuit and confirmed in 2003. Please welcome Judge Bea.

JUDGE BEA:

Thank you very much for that kind introduction. I think that we're required to give disclaimers at this point. I played in the Olympic games in '52, but I was a tourist. We went two and five in the games. I'm happy to say our son, Sebastian, however, is a real athlete. He won a silver medal in Sydney, in the men's pair for the United States.

Also, I don't want there to be any misconceptions. A gentleman walked up to me recently at a cocktail party and said, "I greatly admire the opinions you write," and I told him that I thought he was operating under a case of mistaken identity, because I write only dissents on the Ninth Circuit.

Today's subject, financial regulation: the apotheosis of the administrative state is concerned with a regulatory state, often focuses on reforms of formal institution structures and legal doctrines such as the Chevron Deference. But arguably, these formal constraints are only the tip of the iceberg regarding the issues of individual liberty and the rule of law raised by concerns of the regulatory state.

We have a distinguished set of panelists today. Knowledgeable about the financial industry, financial regulations, and the effect of the administrative state. Your programs will have extensive resumes and biographies, and I will essentially give you name, rank, and serial number.

To my right Professor Hal Scott, Nomura Professor of International Financial Systems and Director of the Committee on Capital Regulations at the Harvard Law School. Professor Scott will talk on contagion, a nicer word than panic, that can cause a run on economic system as being at the heart of the 2008 Great Financial Recession, how the crisis was ended by the Federal Reserve System acting as a lender-of-last-resort to banks and non-banks, and using other tools, and how the Dodd-Frank legislation may impede such future actions by the feds in the future if they're necessary.

Next will be Arthur Wilmarth, a Professor of Law at George Washington Law School who describes himself as a conservative with a small "c." Professor Wilmarth will discuss the need to prevent the creation of government-sponsored enterprises, GSE's, and of measures that allow the creation of firms that are too big to fail. How we should limit federal safety nets and federal subsidies, and how we should take another look at universal banking, the combination of banks, security firms, and insurers into one entity, and perhaps consider the merits of the former Glass-Steagall legislation.

To my left is Peter Wallison, Senior Fellow and Burns Fellow in Financial Policy of the American Enterprise Institute, who is currently writing a book on the growth of the administrative state. Mr. Wallison will discuss a system for the designation of firms as systemically important financial institutions, or SIFI's, by the Dodd-Frank Act[1] that's created the financial security oversight council to include banks and non-banks. The standards, or lack of standards, used to designate firms and the effect of such designation as an example of the growth of standard administration power.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

Last, but not least: Professor Richard Epstein. The Tisch Professor at NYU Law School, senior lecturer at Chicago Law School, and Bedford Senior Fellow at Hoover Institution whose most recent book is The Classical Liberal Constitution: The Uncertain Quest for Limited Government. Professor Epstein will center his remarks on the recent case of PHH versus Consumer Financial Protection Bureau, which was in the D.C. Circuit and was granted *en banc* review, and whether administrative agencies can be insulated from legislative, presidential, and judicial review. He will talk about the guaranteed budget of the Bureau from the Federal Reserve and how this bureau fits in with the independent agencies and multiple board members.

With that we give way to Professor Scott.

MR. SCOTT:

So, it's my pleasure to be here today. Contagion, which is a run on the financial system, was the heart of the 2008 financial crisis, and others in the past. The crisis was halted in large part by The Fed's provision of lender-of-last-resort assistance to non-banks as well as banks.

Lehman's failure generated a run on the market money funds, whether or not exposed to Lehman, which then quickly spread to all short-term funding in the financial system including commercial paper issued by non-financials, and funding of major investment banks, and bank-affiliated broker deals.

The Fed responded by creating new facilities under Section 13(3) of the Federal Reserve Act[2] to lend to these institutions. In addition, the FDIC raised deposit insurance levels from $100,000 to $250,000, and to infinity on demand deposit accounts so crucial to the payment system and the economy.

It also guaranteed senior debt of depository institutions, further assuring their access to funding. Treasury used its exchange stabilization fund to guarantee money market funds, and then ultimately Congress enacted the TARP, which was used to provide capital injections into the banks.

Now these measures stopped the crisis, but in the aftermath were criticized as propagating moral hazard and bailing out Wall Street. Now, I do not regard the use of a lender-of-last-resort where there is good collateral and a penalty rate as a bailout. Nor do I regard deposit insurance as a bailout, but both are clearly government support. Yet in my view, highly desirable.

[2] Federal Reserve Act, Pub. L. No. 111-203, 124 Stat. 2115 (codified at 12 U.S.C. § 343).

TARP is a bailout and should only be available if the failure of many large, important financial institutions at the same time would heavily impact the economy where their resolution as a group is not a viable option.

Now, there is potential moral hazard from all of these measures, but in the case of lender-of-last-resort and deposit insurance it is small. I do not see how institutions, which are victims of panic runs, which is often the case with contagion, as opposed to bad business decisions, will take more risk as a result of such support.

Do homeowners expose their buildings to the threat of fire from their neighbors because of the existence of a fire department? I don't think so. And we attempt, albeit imperfectly, to minimize the moral hazard from deposit insurance by charging premiums based on the riskiness of the insured, albeit that's a very difficult task to do.

But due to bailout concerns, major restrictions were placed on the measures we took during the crisis. First TARP abolished the Treasury authority to use The Exchange Stabilization Fund to guarantee the money market funds.

Dodd-Frank then placed major restrictions on the use of 13(3), of the Federal Reserve Act, to provide assistance to non-banks. Although, interestingly, the discount window, Section 10B of the Federal Reserve Act, continued to be available to banks without major restrictions.

Now what are these restrictions under 13(3) that apply to non-banks? By the way, non-banks today, in terms of runnables, short-term liabilities, account for about 66% of all runnable liabilities in the system, and they're going to grow as we see more and more disintermediation from the banking system into so-called "shadow banking."

So, the ability to lend to non-banks was important in 2008 and will be even more important in the future.

What are the restrictions that were put on the Fed? The Fed can only lend to non-banks with the approval of the Secretary of Treasury, significantly limiting Fed independence. By the way, such approval is not required under the discount window for banks. Such loans must be part of a "broad program," which may mean under The Fed's own regulation, that implements this section, that the Fed must wait for five institutions to be in trouble, thus making it harder to nip contagion in the bud.

Third, collateral is required for all loans. Previously, loans had to be collateralized to the satisfaction of the Fed, which allowed them to buy unsecured, highly-rated commercial paper from non-financials during the crisis.

Fourth, the Fed can only lend to a solvent borrower, which is a sound principle, but difficult to actually determine in a crisis where asset values are uncertain.

Fifth, loans to non-banks must be disclosed within seven days to the Chairmen of the House Financial Services and Senate Banking Committees, with the attendant risk that they may leak out, thus deterring borrowers from obtaining loans in the first place or accelerating the run when the news does leak.

Sixth, banks can no longer freely pass onto their broker-dealer affiliates loans obtained from the discount window, instead such pass-throughs are now subject to 23(A) of the Federal Reserve Act, which allows them only to be ten percent of the bank's capital. And even further restrictions on 13(3) have since been passed by the House although not by the Senate.

In addition, the FDIC's authority to raise deposit insurance limits in crisis have been taken away, only to be restored upon request by FDIC through a joint resolution of Congress, making it impractical in a timely way, and the authority to make new loans under TARP has expired.

So, let me just say a few words about lender-of-last-resort. Am I happy with how the Fed operates as a lender-of-last-resort? No.

First, we need better coordination between fiscal authorities, the Treasury and the Fed, where there is a reasonable possibility that the borrower may be insolvent, or clearly is insolvent, as was the case with AIG. At the very least, we should regard any investment in equity by the Fed as outside their authority, which of course they did in AIG. That should be a fiscal decision reserved for the Treasury.

Second, we need more of a rule of law for the operations of the Fed as lender-in-last-resort, in the sense that the Fed should articulate its general policies, including facilities and programs, how they determine solvency, what a broad program really is, penalty rates, collateral, et cetera. Not only is ambiguity not constructive in this instance, it is positively harmful. With weapons deployed in advance, the very use of a lender-of-last-resort might not be necessary.

This is a lesson from Draghi's Eurozone declaration, that the ECB would do whatever it takes to stop contagion. Critics legitimately criticize the Fed for operating without articulated constraints and doing so in a non-transparent way. This is not tenable if the Fed is to have support for the powers it needs. A rule of law need not unduly confine discretion but should articulate the principles for exercising such discretion.

Finally, I would require that those institutions borrowing from the Fed, or receiving fiscal report, pay a sensible price, particularly where their own losses trigger the need for support. And this price could range from penalty rates to enhanced supervision, or even the replacement of management. The failure to impose a cost on institutions benefiting from public support is a major factor for popular opposition to the use of these measures that we so successfully employed in 2008. Thank you.

MR. WILMARTH:

Good afternoon. I would like to thank The Federalist Society for inviting me to participate in this panel discussion.

Madisonian conservatives among whom I would classify myself as a Madisonian conservative, which I believe is equivalent to Professor Epstein's reference to classical liberals. I will argue that Madisonian conservatives should embrace the following four principles of financial regulation.

First, we should stop allowing privately-owned financial institutions to operate, in effect, as government-sponsored enterprises with implicit federal guarantees. We all know about the disasters at Fannie Mae and Freddie Mac, which were privately-owned, government-sponsored enterprises and imposed huge costs on the federal government and taxpayers. I contend that too-big-to-fail financial conglomerates are today's government-sponsored enterprises.

Second, to be faithful to the first principle, we have to end government policies that encourage financial institutions to become too big to fail, and that reward them for doing so.

Third we must strictly limit the scope of the federal safety net for banks. Most would agree that banks perform essential social services by accepting deposits from savers, providing payment services, and making loans to small and medium-sized business firms that are not able to raise funds by selling securities in the capital markets. Those are legitimate and important functions for banks to perform.

Banks are subject to depositor runs, partly because they have a maturity mismatch between their short-term deposit liabilities, and their longer-term assets. The Great Depression proved, and the recent crisis also proved (if you look, for example, at the Northern Rock episode in the United Kingdom), that we need deposit insurance for chartered and supervised banks.

I also agree with Professor Scott that we need lender-of-last-resort assistance for chartered and supervised banks. However, I differ with him on whether non-banks should be given the same assistance. In my view any additional forms of federal support for banks should be carefully scrutinized, because support means subsidy.

Fourth, we should oppose any federal subsidies for non-bank financial institutions and non-bank financial activities, because federal subsidies distort market pricing, provide unfair competitive advantages to non-bank firms that receive them, and undermine the effectiveness of market discipline.

In my view, if non-banks want to be protected by the federal safety net, they should become chartered banks and accept the same types of supervision and regulation applied to banks. Non-banks should not expect to receive the same kind of federal support when they are not subject to the same regulation and oversight that banks must accept.

Universal banking, which allows banks to combine with securities firms and insurance companies, and to engage in a full range of capital markets activities, violates all four of the principles I have described.

The last crisis demonstrated that you cannot limit the federal safety net to banks when they are affiliated with non-bank firms engaged in significant capital markets activities. When a major crisis occurs, the federal government will inevitably decide to save the entire conglomerate to save the bank.

For example, the federal government provided $850 billion of combined support to save two giant bank-centered financial conglomerates, Citigroup and Bank of America. That support included capital infusions, lender-of-last-resort assistance, sales of commercial paper to the Federal Reserve, and debt guarantees provided by the FDIC. That $850 billion of support for Citigroup and Bank of America was only a small part of the total bill we paid to save troubled financial conglomerates during the financial crisis.

The problem with Dodd-Frank is that it does not change the universal banking model. Unlike the Glass-Steagall Act of 1933, which responded to the Great Depression by requiring banks to separate from securities firms, Dodd-Frank basically says, “We have these nuclear reactors (called universal banks) that blew up. Rather than prohibiting such reactors or requiring an entirely different form of reactor, let’s just improve all the valves and controls. If we have better valves and better controls, maybe they won’t blow up next time.”[3]

In my view, Dodd-Frank’s approach is unsound, and unviable. The last 20 years have made clear that giant financial conglomerates cannot be effectively managed or regulated. If we don’t change the business model of

[3] The nuclear reactor metaphor for universal banks was borrowed from Neel Kashkari, President of the Federal Reserve Bank of Minneapolis.

universal banks, I am quite sure that we will have a comparable financial crisis within the not-distant future.

I believe we have two choices. One is to adopt what I would call an "internal Glass-Steagall" approach, which is similar to the ring-fencing legislation adopted by the United Kingdom. An "internal Glass-Steagall" policy would put strong firewalls around the bank and say to the bank, "You cannot make any loans or other transfers of funds to your affiliates, except for paying lawful dividends to your parent holding company. In addition, the federal government is not going to protect your affiliates."

That's a defensible approach, but I think there are two big problems with making it work. First, will regulators actually monitor and enforce those firewalls over the longer term? Second, when a large financial conglomerate is threatened with failure, will the government actually refuse to bail out the affiliates outside the bank's ring fence?

The second approach would be to go back to 1933 and reestablish an "external Glass-Steagall" policy. That policy would say, "We want banks to be strictly separated from the capital markets. We want capital markets to operate outside the banking system and not to depend on any subsidies related to the banking system."

I agree with Professor Scott that we have a major problem with shadow banking. The problem is that non-bank companies are essentially engaged in taking deposits. Section 21 of the Glass-Steagall Act, which is still in force, provides that non-banks are prohibited from accepting any deposits, period. In fact, it's a criminal offense for anyone other than a chartered bank to accept deposits.

What are deposits? They are short-term, debt instruments, payable at par on demand. We have trillions of dollars of de facto deposits today in the form of short-term commercial paper, repurchase agreements (repos), and money market funds.

I agree with Morgan Ricks, who has written a very persuasive book called The Money Problem. Ricks argues that short-term money claims, including de facto deposits, should be limited to banks. In fact, we didn't any significant volume of de facto deposits and shadow banking before 1965.

Regulators have ignored Section 21 over the past 50 years and have allowed non-banks to create massive amounts of de facto deposits, thereby creating the shadow banking system. De facto deposits and shadow banking are distorting our entire system. In addition, many shadow banks are closely connected to, and are often affiliated with, our big universal banking conglomerates.

We have to get back to the point where we say, "If you want to issue a short-term debt claim, payable at par on demand, you have to be a chartered and supervised bank." Whether the dividing line for deposit status is 60 days or 90 days, we have to stop non-banks from issuing short-term debt claims that function as de facto deposits.

I look forward to our discussion after our presentations. Thank you.

MR. WALLISON:

Well, it's a great pleasure to be here and I want to thank The Federal Society for sponsoring this. This is a massive organization that's done wonderful work. And I'm just delighted to be a part of it.

I'm going to talk about basically the subject that I'm writing a book about now, which is the growth of the administrative state and why it has come about. And since I specialize in regulation of financial institutions, it will be from that perspective.

I'm going to be talking about the Dodd-Frank Act, and the provisions of the Dodd-Frank Act, which allows a group of financial regulators to designate certain institutions as systemically important financial institutions, and then to regulate them very strictly.

I'm going to go through some of the background, which many of you know if you are part of the regulatory process, the financial regulatory process, but just for those who are not, I want to go through some of the background here, so you will understand it.

The Dodd-Frank Act created a new agency called a Financial Stability Oversight Council, or FSOC to coordinate and oversee financial regulation in the wake of the 2008 financial crisis. The agency is headed by the Secretary of the Treasury, and consists of all the federal financial regulators, The Fed, the FDIC, the SCC and others, and was given the power to designate any non-bank financial firm, non-bank financial firm, for special, stringent regulation by the Federal Reserve.

The firms that are designated are generally described as systemically important financial institutions, or SIFIs because their financial structure, their financial failure or distress could in theory create a systemic breakdown in the United States economy.

The precise language of Section 113 of the Act says that a financial firm may be designated by the FSAC if its material financial distress or its activities could pose a threat to the financial stability of the United States.

The provision was a response to the mistaken belief in Congress and elsewhere that Lehman's bankruptcy in September 2008, caused the financial crisis. The idea was that large firms are interconnected, and the failure of one, like Lehman, will drag down others, creating a systemic condition.

To prevent this, special, stringent regulation by The Fed was considered necessary. In reality, however, no other firm failed as a result of Lehman's failure. So, the interconnectedness theory is wrong. But the law, as often happens, is still in effect. Accordingly, under the material financial distress or activities standard, the FSOC has designated four large non-bank institutions: AIG, Prudential Insurance, GE Capital, and MetLife.

Designation can be a seriously destructive event to a firm because it gives The Fed virtually unlimited authority to control the firm's business. In fact, after having experience[d] Fed regulation, GE virtually terminated the business of its huge subsidiary GE Capital, in order to hopefully eliminate its designation, which was successful. But at the same time, it eliminated a significant source of funding for small firms.

MetLife, on the other hand, did not agree to its designation and sued the FSOC in the D.C. District Court. In March 2016, the court overturned MetLife's designation, and the FSOC applied to the DC Circuit, which has not yet rendered a decision.

Now, the relevance of all this about Dodd-Frank to the apotheosis, what a title, the apotheosis of the administrative state, and that of course means, all you Greeks out there know, that it means the high point of the administrative state. If it were the high point of the administrative state, I would be happy. I'm afraid it's only the beginning.

To repeat the statutory language again, any non-bank financial firm can be designated as a SIFI and subjected to this designation this special regulation, if it poses a threat to the stability of the United States. The act contains no standards that restrict the discretion of the FSOC. There is no definition of material financial distress, no definition of activities, no definition of threat, or what was meant by "the financial stability of the United States." Nor does the act contain any statement of what size a firm must be before it can be designated as a SIFI.

Yet, in the case of bank holding companies, Congress was able to set at least that much of a standard for these firms if a bank holding company has more than $50 billion in assets, it will be subject to the stringent regulation of The Fed as a SIFI. In other words, to designate a firm as a SIFI, FSOC was authorized to predict that at some unknown time in the future, in an unknown future, the financial distress of a particular firm or its activities, will have an adverse effect on the entire US financial system.

This is impossible to know. No matter how skilled or expert the members of an administrative agency might be, they cannot predict the future. The decision is pure discretion. Moreover, the ability to stop certain activities can apply to a whole industry, giving FSOC the authority to control whole, entire markets.

But when the Congress gives these extraordinary discretionary powers to an administrative agency, it is further empowering the administrative state. The courts could stop this process, but they have not. Although the broad discretion given to the FSOC in this case could be considered an unconstitutional delegation of legislative power, the Supreme Court has not invoked this concept since 1935, and many people think it's simply dead.

One of the reasons for the court's reluctance is that we don't have a very good definition of the difference between legislation on the one hand and administrative action on the other. But this should not be impossible for a court to decide and determine in individual cases.

A legislative decision has one distinguishing characteristic: it can be wholly arbitrary, taking from some and giving to others, and does not require any justification as long as the Constitution is not violated.

Just like Congress setting a $50 billion threshold for treating a bank holding company as a SIFI, that's an example of a legislative standard-setting decision that is completely arbitrary. $50 billion makes no more sense than $200 billion in this context. So, bank holding companies cannot and have not challenged that. They've challenged it legislatively, they have not challenged it in the courts, because Congress is allowed to make those kinds of arbitrary decisions which an administrative agency cannot.

Once these key decisions are made, the administrative agency can be tasked to carry them out. This goes back to Chief Justice Marshall's decision in *Wayman v. Southard* in 1825, when he was also faced with this question of, "What's the difference between an administrative and a legislative decision?" And his point was that the important issues, the important decisions are made by the legislature. The administrative agency can have some delegated responsibilities, but not for the important ones.

This, of course, means someone has to determine what the important decisions actually are, and that is the responsibility of the courts under Article Three of the Constitution.

The unwillingness of the courts to make these decisions is responsible for the growth of the administrative state that we have seen now and will see in the future. Because Congress has been happy to send difficult decisions to the administrative agencies.

The framers, it turns out, were wrong in this respect. Congress will not jealously guard its powers. In addition, as Chief Justice Marshall said in Marbury and Madison, and we heard this from the Attorney General it is emphatically the province and duty of the Judicial Department to say what the law is.

Yet, if anything, the Supreme Court has gone the other way. In the Chevron line of cases, for example, they have deferred to the administrative agencies' interpretation of what Congress authorized, and in effect, they are allowing the agencies to say what the law is.

So, in the MetLife case, when MetLife won, the District Court did actually not give the FSOC any deference, but they didn't decide that it had received excessive discretionary powers, either. Instead, it said that FSOC's decision was arbitrary and capricious, because it didn't consider the costs of designating MetLife something actually that was not required by the statute.

In other words, although MetLife created an opportunity for the court to consider the scope of discretion Congress gave to the FSOC. This decision does nothing to restrain that growth.

Until the Supreme Court begins to use the authority to define where legislation ends, and administration begins, the administrative state will continue to grow. Thanks very much.

MR. EPSTEIN:

Peter speaks in his usual dramatic way, and I think essentially has been a consistent and accurate prophet of doom over these many years. My job is to continue, and to see if I can find some horror story that will one-up his, explaining how it is that there are other horrors in the administrative state.

The difference between us is I think the horrors that I'm about to talk about do have solutions, where the ones that he has talked about are extremely difficult. And the thesis that I'm going to propose using *PHH Corporation v. Consumer Financial Protection Bureau*[4] as a vehicle, if at least I can remember some of its facts, which I can, is as follows.

Whenever you put together an administrative agency which as an independent status, lawfully it can only do two things. It can issue regulations and it can prosecute cases, but it cannot internalize inside the organization the functions of a federal district court by putting together a panel or commission. Or, in the case of the Consumer Financial Protection Bureau—I got that right, it took me a long time to memorize that—you cannot put

[4] PHH Corp. v. Consumer Fin. Prot. Bureau, 839 F.3d 1 (D.C. Cir. 2016), *rev'd*, 881 F.3d 75 (D.C. Circuit 2018 en banc) (decided after this panel conversation). *See also*, Richard A. Epstein, *Regulatory Enforcement Under New York's Martin Act: From Financial Fraud to Global Warming*, 14 N.Y.U. J.L. & BUS. 805, 810-813 (2018) (Professor Epstein discussing the larger issues of the administrative state).

these people together to give them the power to adjudicate so that the only kind of judicial review that you can receive is that which comes from an appellate court.

This is an issue that starts in financial regulation with the CFPB and, but it continues everywhere else. Many of you, I think, have followed *Oil States Energy Services, LLC v. Greene's Energy Group, LLC*,[5] case, where exactly the same pattern takes place, where only now it's the PTAB, which is the Patent Trial and Appeal Board, which is essentially designed to substitute for the adjudicative system. And as we heard from Attorney General Sessions earlier on today, separation of powers is indeed a very important protection of liberty, because you'd never want to have a situation, which one person holds all the keys to the safe, and if that person is very, very good, things may go pretty well. But if that person is very bad, then things will turn out to be horrid, and that's the risk that you always have to guard again, systematically, in all these cases.

Now the situation that we have with the Elizabeth Warren legislation having to do with the CFPB, is, in fact, an absolute architectural masterpiece if you want to adhere to the aggressive playbook on how it is that administrative agencies ought to be organized. Essentially, it rests on the assumption that there are people out there who are disembodied experts, but who, in fact, often turn out to be very vigorously partisan. But the dominant conceit today is that what we have to do is to insulate them from political pressure so that they can protect the public from various kinds of private abuses that are going to be inflicted upon them.

There is no question that a very powerful metaphor in the United States is the relationship between Wall Street on the one hand and Main Street on the other hand. Wall Street is essentially thought to be an object of disapprobation, and therefore extensive regulation. And so, when they put the CFPB together, what they did is they managed to do everything within their power to insulate it from various kinds of oversight. They gave its head

[5] Oil States Energy Servs., v. Greene's Energy Grp., 138 S. Ct. 1365 (Apr. 24, 2018). For further discussion on *Oil States,* see Richard A. Epstein, *The Supreme Court Tackles Patent Reform*: *Why the Supreme Court Should End Inter Partes Review in* Oil States*,* 19 FED. SOC. REV. 116 (2017); Richard Epstein, *The Supreme Court Tackles Patent Reform: Further Reflections on the* Oil States *Case after Oral Argument in the Supreme Court*, 19 FED SOC. REV. 124 (2018); and Richard A. Epstein, *The Supreme Court Tackles Patent Reform: Post-Decision Article:Inter Partes Review Under the AIA Undermines the Structural Protections Offered by Article III Courts*, 19 FED. SOC. REV.132 (2018).

a five-year term; they gave it guaranteed budget protection by funding it through The Federal Reserve, and essentially, they gave the single commission a total autonomous power to decide cases.

And in the *PHH* case, you could see the powers that came through, there was a rather complicated financial transaction in which I thought liability was rather questionable. It had to do with the application of rules that had been put together by a predecessor organization and the extent to which they bound the CFPB. And it turns out that Mr. Cordray not only said that did he have the power, but unilaterally he decided to increase the fine from about $4 million to about $104 million, saying, as it were, "I really think that this is a perfectly ideal situation to give a public spanking to a corporation which probably committed no kind of violation at all."

And then the case comes up to the District Circuit on Appeal, Judge Kavanaugh essentially decided that he was going to give the Congress a choice. He said, as it were, "If, in fact, what you want to do is to have single commissioner then you must be prepared to accept is that this person can now be removed at the pleasure of the President," at which point the Wall Street Journal began a remove Cordray campaign on the grounds that he could be dismissed, not only for cause, but certainly at the will of the President. And, at the other hand, Kavanaugh said if you want to have these people insulated, as you may do, unfortunately, the appropriate way in which to do that is to have a commission which has multiple members on it so as to blunt the force of a single individual.

In my own view, this is not a perfect protection, to put it mildly, because if you start to look at the many commissions that are put together, with three-to-two majorities, the President's party having the deciding vote, you discover that there's a rigid partisan separation on virtually every major issue, and that the so-called expertise essentially is a cloak for very sharp political divisions and bias.

The common practice in courts of general jurisdiction is for judges to sit on cases by way of rotation, which makes it much less likely that you could have this particular sort of fixed division, and so I think, in effect, that the mistake in the Kavanaugh opinion was not that it went too far in trying to upset this particular feature of the administrative state. Rather, I think it did not go far enough, and that what we have to do is to come up with a consistent and powerful consensus that calls for the complete separation of the enforcement and regulatory function on one side, and the adjudicative function on the other.

But this does not solve all of your institutional problems, to be sure. Because there's then always that further question, exactly what kind of body do you want to put together? And there is the further question of whether you want specialized courts, like those that exist in taxation or bankruptcy, or whether you want to put these matters in the hands of courts of general jurisdiction.

Now on that question I'm relatively agnostic, at least on this particular occasion, because the long terms that are associated with these Article I courts, I think, gives them a certain insulation from political pressure, and the fact that these particular judges tend to be appointed by judges in the judiciary rather than the President, tends to soften the very sharp political divisions that otherwise take place.

But make no mistake about it: we have agency after agency from the New Deal that present this very difficult situation of three-two commissions, or one-zero commissions, and what is the problem associated with this? Well, not only do you have the problem of bias, but you have the problem of flip-over. Every time there's a change in a presidential administration, the majority now goes from one party to another, and then you see the commission trying to undo the particular decisions that were made somewhere else.

So, you have exactly the same thing in the Securities and Exchange Commission, as with the CFPB, and so forth. And indeed, in many ways the Securities and Exchange Commission is one of the worst offenders on this particular situation, because it has now institutionalized the process under which it turns out it can bring prosecutions before an administrative law judge of its own appointment.[6] Of course, these internal do not have unanimous success for the SEC, but if you're winning 97% of your cases in front of your own tribunal, the only conclusion that you can reach, is that you're playing with, shall we say, a deck of marked cards. Socially, you do not want to allow that kind of a situation ever to exist.

So, as I have three learned companions here, all of whom spoke about the arcana of various issues associated with financial regulation, I'm basically making a rather simple-minded point that goes back to the principles of separation of powers at the beginning of the Republic, in financial areas, but it seems to me carries over pretty much everywhere else. It is not possible, nor even desirable, to undo the administrative state, given the complexity of functions that government has to discharge. But none of these complexities justify the current amalgamation of adjudication, legislation, and prosecution in the same agency. It is critical to hive off the adjudicative function, and the agencies will run just fine, and the rest of the

[6] Lucia v. Sec. & Exch. Comm'n, 138 S. Ct. 2044 (2018) *Lucia* was decided in the Supreme Court after this talk was given.

public can take a deeper breath and sleep more quietly and contentedly at night. Thank you.

JUDGE BEA:

I'd like to open up the conversation among the members of the panel, but one thought struck me. When we first had a conference call a couple of weeks ago, and I was waiting for somebody to say something on this subject. Does anybody have anything nice to say about Dodd-Frank?

MR. EPSTEIN:

Yes, it's short! I have another nice thing to say about it. Most of the regulations under it have yet to be issued since it's only been seven years since its adoption.

JUDGE BEA:

Alright. Professor Scott, I was thinking as you were talking about the lender-of-last-resort. The classical theory of lender-of-last-resort as I remember my economics history, was Mister Walter Bagehot, who was the publisher of The Economist magazine, and he said, "Lend freely, but at high rates." We've lent freely at very low rates. Is this emblematic of a new economic theory?

MR. SCOTT:

Well you're making a good point. Let's go back to the 2008 crisis. This was a particular problem for banks under the discount window. The Fed had a 50-basis point penalty rate for borrowing at the window when the crisis occurred, and lo and behold, nobody came to them to borrow. They knew the banks were in trouble, so they lowered the rate to 25 basis points, still a penalty, this is over market rate. Still nobody came. Why?

Because the banks were concerned that if they came to the Fed for money, even though the Fed had no obligation to disclose the identity of particular borrowers, that this would leak out, through reports that the Fed issued where you could kind of infer who the borrower was.

If somebody borrowed in the North Carolina area, it must be Bank of America. So, they still did not borrow. So, what the Fed then did is create something called a Term Auction Facility where anybody could borrow at an auction rate. And then they borrowed because you couldn't tell the good banks from the bad banks who were borrowing.

So, here is the dilemma, that was exposed in 2008. If the penalty rate is high, or if you specifically penalize the borrower, and then that particular borrower could leak out they won't borrow, the situation gets worse, and, you even have a more difficult problem.

So, in principle, they should pay a penalty, whether it should be a penalty in the form of a penalty rate or something else, for instance discipline or replacement of management, or some other consequence. There should definitely be a consequence. But maybe after the borrowing.

JUDGE BEA:

Was it just too much information out there? Just too much information out there, as to who's borrowing?

MR. SCOTT:

Well, it would leak out, that was the concern.

JUDGE BEA:

Okay.

MR. WILMARTH:

Judge Bea, I'd like to comment on your question, which I think is a very important one.

There are studies showing that the Term Auction Facility and other lending facilities established by the Federal Reserve allowed Bank of America to borrow huge amounts while paying an average interest rate of 0.8%. Goldman Sachs paid an average interest rate of 1.4%. No ordinary firm could have borrowed money at such ultra-low rates during 2008 and 2009. Thus, once the federal government allows too-big-to-fail institutions to exist, the government essentially decides that, like nuclear reactors, they're not going to allow those institutions to fail.

The Fed and the Treasury did everything necessary to subsidize and prop up big financial conglomerates after Lehman Brothers failed. Those institutions received enormous subsidies until the crisis was over.

MR. SCOTT:

Yes, in some cases.

MR. EPSTEIN:

I have another point, which is related to that. I mean, what Hal says is essentially the standard dilemma. We charge you a fair market rate, you're down to fail. If we charge you a lower rate, you're bound to get an excessive subsidy. One of the things that's wrong about the whole federal reserve lending system is that it only allows the government to act as a lender who is restricted to taking on interest on loans.

In my view, if you start thinking about the flexibility which was abused but nonetheless available to the Federal Housing Financial Agency, what they do is they allow the government to take an equity piece of some sort or another.

What you can say is, we're going to give you a situation where you've got 2% interest, but by the way, when this project goes up in value, welcome, my friend, to an equity kicker because we now own 15% of this business, which we may sell it in the open market at some point or another, but it will allow for the recoupment.

Essentially what happens is you don't want people in the lending business to have to make an all-or-nothing judgment at the front end on success or failure. You would rather have a workout with two components. An absolute fixed payment plus a contingent payment if all goes well.

Now, with the AIG situation, the Federal Reserved didn't have that flexibility, so Davis Polk essentially created a sham transaction in which you a third-party corporation announced that it was taking equity. The problem is that entity was owned completely by the United States government, and then you've got litigation before Judge Wheeler in D.C. and Erlenmeyer I think in New York.

You don't want to essentially force people to work under the wrong statutory framework, which will then lead to the wrong result. What you really have to understand, and this is my next-to-last sentence, is when you call The Fed the lender-of-last-resort, the word "lender" is a very dangerous term because it limits the way in which government could provide relief.

No private party, which is going to come and give some kind of assistance, would say either it's going to be a loan or nothing, and we should not handicap The Fed in that particular way.

JUDGE BEA:

All right.

MR. WALLISON:

I'd like to make a comment about this whole question of too-big-to-fail, because I don't think people are making enough in the way of distinctions on this issue.

When we say "banks," when you read in the press that the banks were too big to fail there's some distinctions that should be made. Bank holding companies are ordinary corporations. I don't think that they are too big to fail, and I think what we saw in the financial crisis when Lehman failed, was that there isn't any interconnection between these very large financial institutions so that when one fails it will drag down others.

Now, the too-big-to-fail institutions are the banks. The ones that are the deposit-takers, that have deposit insurance, and they are gigantic. We have four of them, that are over, about or over the trillion-dollar mark. Those institutions are too big to fail. They are not covered by the Dodd-Frank Act. They are still under the jurisdiction of the FDIC, which has nothing like the resources that is necessary to deal with the failure of a bank.

Let's leave aside bank holding companies. So, we are still in the position where we have no way of handling the failure of one of these very large institutions.

Now I'm not, at this point, trying to propose any kind of action, but what we ought to understand is that the Dodd-Frank Act, which was intended to deal with the too-big-to-fail problem, is a total failure at that, because it doesn't deal with the real institutions that could cause a financial crisis if one of them failed.

JUDGE BEA:

Professor Wilmarth, you are suggesting that we go back to a division under the Glass-Steagall Act. Because I remember when the Glass-Steagall Act was gotten rid of, the idea was that our banks here in America could not compete with the foreign banks that were doing universal banking, and that the reason we were abolishing Glass-Steagall, was to be able to compete in the universal globalist market. Is that not a problem?

MR. WILMARTH:

There's been a lot of discussion about whether U.S. banks could compete with foreign universal banks if we reestablished the Glass-Steagall Act. During the 1990's, European universal banks said they couldn't compete with our major institutions, including the specialized commercial banks like J.P Morgan & Co. and Citigroup and the specialized investment banks like Goldman Sachs, Morgan Stanley, and Merrill Lynch.

In other words, our institutions were doing extremely well in international markets before Glass-Steagall was repealed. I believe that if we go back to Glass-Steagall, we would have institutions that are more specialized, more focused, better managed, and more effective at what they do. In addition, we would not have the massive conflict of interests created by universal banking.

Giant universal banks have repeatedly gotten themselves into big problems because they're trying to do everything and the range of their activities create huge challenges for effective management. When you try to do everything, you tend not to do anything very well.

JUDGE BEA:

Professor Scott?

MR. SCOTT:

Banking crises are almost universally caused by bad loans, not by securities activities. So, if you want to make sure that you're not subsidizing the banking system, let them do everything but making loans.

The idea behind broadening their powers was in terms of risk, so that you would diversify their activities to decrease the overall risk of their enterprise. That idea, to me, is totally valid. And so, I don't think we want to go back to the world in which if the bank part goes down, the whole thing necessarily goes down. I think it's good that we have diversification in the banking system.

MR. WALLISON:

Can I add to that, also? And that is that the reason why there was permission for bank holding companies to acquire securities firms and other kinds of financial institutions, was because if you look at the data, you will see that most of the financing that is done in this country is done through the securities markets.

And the trend is all in that direction. The banks have been basically flat in terms of the financing that they provide to the corporate world.

So, if you want to have successful financial institutions, you cannot freeze them into a position where they are basically losing their role in the economy. They have to be allowed, as I see it, to compete in the areas that are growing, and that is the securities markets.

MR. EPSTEIN:

Yes, I agree with all of this, and I'd like to make one other point. You always want to reverse engineer past failures; it may not cure against future mistakes but at least you don't make the same dumb mistake twice, and certainly if you start looking back at, say, banking practices in the 1930's and 40's, it was very common to have situations where the loans would be limited to 50% of asset value, very low, and, it turns out you, don't get a lot of leverage and you don't get yourself a lot of failures. And what we then did, is we decided, no, we want to goose up home ownership as an independent ideal.

Anytime you have an end-state ideal, it's a mistake. If it turns out that home ownership is good, it should be able to survive without having to receive crazy subsidies, which arises when government tells the banks, "W-we would like you to lend at 80 or 90%, or sometimes even 98%."

Well, nobody's going to do that unless you give them a guarantee. So, what you do is you then have the implicit Fanny and Freddie guarantee. These implicit guarantees are always terrible because you don't know exactly how much they cost. They're not on the books. In addition, they also generate some collateral obligation on the ban, such as making risky community redevelopment loans, which are, generally speaking, a complete disaster.

And then the economic bill comes due because of the social failure. Going forward, you have to let banks compete in markets in which there is potential growth securities and so forth, but you cannot go back to another system in which there are any implicit guarantees of their risky loans.

If we were to take that unwise course again, we will see a repetition of what happened in 2008. Even if Fanny and Freddie may be out of that next round, there's some federal housing bureau that'll pick up the slack, because the political situation calls for subsidies for racial and non-racial reasons alike, as if we will beat the odds is we take a huge number of losing bets, and then somehow assume that through the law of large numbers that this new strategy will all work out.

Or, as in the old days in the Jewish garment businesses was the joke, "you don't make up what you lose on every piece by having large volume," and that's something that the lenders in the United States seems not to have learned.

MR. WILMARTH:

Could I provide a brief response? In my view, the key catalysts for the crisis were mortgage-backed securities, collateralized debt obligations and credit default swaps.

Banks securitized really bad mortgage loans, and they sold mortgage-backed securities around the world pretending that they were sound investments, just like the big universal banks that sold foreign bonds in the 1920's. Banks obtained credit default swaps, which were a form of insurance, from firms like AIG to convince people that "someone will step in to cover these mortgage-backed securities if things go wrong."

During the 2000's, as during the 1920's, we combined banking with securities and insurance, and allowed universal banks to sell what were really terrible securities as if they were sound, guaranteed investments. When everything blew up, Uncle Sam had to step in because the institutions that were securitizing bad mortgages and selling mortgage-backed securities were so gigantic that they couldn't be allowed to fail.

Universal banking also created perverse incentives because the big banks said to themselves, "We're not putting these loans on our own books. We can package them up into securities, sell them around the world, get triple A ratings by bribing the credit rating agencies, and pay some more fees to AIG to obtain credit default swaps to back up the securities."

Thus, I would emphasize the pervasive conflicts of interest and perverse incentives created by universal banking.

There was an interesting article about Deutsche Bank the other day. Deutsche Bank is one of the biggest European universal banks. The article pointed out that the shareholders of Deutsche Bank received something like 15 billion euros of dividends since 2001. In contrast, senior executives at Deutsche Bank received 71 billion of euros in bonuses. The universal banking franchise has been a bonanza for the insiders. They have made out like bandits. Shareholders have not done nearly so well. Meanwhile, governments and taxpayers have been left holding the bag for losses. Thank you.

MR. WALLISON:

Yeah, one comment, of course, on what you said. We've been debating this for years, but the way it was phrased is that the banks sold these mortgage-backed securities around the world.

In fact, they were bought, is the other way to look at it. They were bought around the world, and why were they bought around the world? Because the government's housing policy here in the United States caused a gigantic bubble.

A bubble that was far beyond any we'd ever had in the past, and what was happening in the bubble is that people were taking out mortgages with good, high rates on them, the banks were willing to lend to them, or others were willing to lend to them, because there were no defaults. There were never any defaults, or very few at least when there's a bubble. Because everyone can refinance in the United States without any problem.

So, you never see defaults, but you see high rates, and people in Europe and elsewhere around the world, wanted these obligations. So, the banks actually were running out of the available mortgages as things got hotter and hotter towards 2008 and began to use credit default swaps.

Now, I want to say one thing, you can use a credit default swap to imitate an actual mortgage-backed security, which is what they did. But I want to say one thing about credit default swaps, very complicated subject, of course.

But Lehman Brothers was a big player in the credit default swap market. When they failed, suddenly, without any warning, the credit default swap market kept operating all through the financial crisis.

So, don't get frightened by something like a credit default swap. It turns out that it is not as harmful as people suggest it is. And it is very useful for institutions to manage their risk. And what we've done with credit default swaps since the crisis in the Dodd-Frank Act is to make that much more difficult, and also to set up a set of institutions financial market utilities, they're called which are now backed by The Fed, and which will be the cause of the next crisis.

MR. EPSTEIN:

Next crisis. Yeah.

MR. WALLISON:

You've got it.

MR. EPSTEIN:

Just one sort of comment on this stuff. One of the things about regulation and about financial businesses is the way in which they look at their book of business.

Essentially, if you're a responsible financial company, you start thinking about diversification and all the rest of that stuff, by looking at an entire portfolio of assets to measure its internal stability.

You may have some credit default swaps or other kinds of derivative arrangements that may look highly loaded in one direction or the other, but if you've got physical assets on the other side of the portfolio, that to complement them. the volatility of the portfolio is far lower than the volatility of one of its components, taken in isolation.

When a regulator comes in, it turns out that there are often jurisdictional boundary lines. Hence it is often the case that the default swaps are going to be regulated by one guy and the physical assets are going to be regulated by another. Each, of them are going to see an unstable portfolio because each can't take into account the other portion of the combined operation. This form of regulatory provincialism tends to exacerbate risks for regulated market institutions.

The reason I chimed in with Peter is because essentially what we have now are these regulatory hothouses, which are going to have blinkered vision, because they are only getting limited information, which leads to systematic mistake with respect to the volatility of the portfolios, which in turn leads to erroneous regulations and market interventions, it's likely to get them wrong. Thank you.

No, I mean smart regulation. Trust it to Peter and me. And Arthur. And Hal. You know, we do a fine job.

JUDGE BEA:

I'd like to open the session to questions from the audience. Now, I would ask you two things: when you ask a question, identify who you are and where you're from. And secondly, make it a question. Thank you.

So, first of all, here in front.

AUDIENCE:

Thank you, my name is Bert Ely, I'm a banking consultant here in Washington, and very active with the Federal Society's financial institutions practice group.

Following up on Professor Wilmarth's comments, I have a very simple question for the panel: what should be the federal government's response, if any, should a funding crisis and consequent contagion erupt in the shadow banking world, and given the requirements of mark-to-market accounting, trigger substantial capital losses in FDIC insured banks, which in turn triggers the costly failure of some of those banks? Again, a very simple question.

JUDGE BEA:

Who wants to take this one?

MR. WALLISON:

I think it was directed at Wilmarth.

MR. WILMARTH:

My simple-minded response is to change the status quo. The status quo is unacceptable because I agree that our next crisis is likely to start within the shadow banking system and spread to banks, as the last one did.

Would it be a magic bullet to treat all short-term debt claims payable at par as deposits and to force all that short-term money into chartered and supervised banks? Maybe it's not a magic bullet, but at least you would know where the short-term money claims are, and you would have an opportunity to regulate them and charge deposit insurance premiums and do other things to control the growth of short-term money claims. Right now, we don't even know where a lot of those claims are.

The regulators don’t know, for example, the full scope of the repo market. Credit default swaps are still a mystery in many respects. The regulators’ lack of knowledge about short-term claims in the capital markets was a fundamental problem in 2007 and 2008. Regulators didn’t know that AIG had $80 billion of credit default swaps backing up collateralized debt obligations and another $500 billion of credit default swaps backing up loans made by European banks. In October 2008, regulators suddenly discovered that allowing AIG to fail would threaten many of the world’s leading financial intuitions.

In fact, $50 billion of the bailout money given to AIG was used by AIG to pay off credit default swaps to major financial institutions, including almost every leading financial conglomerate in the United States and Europe.

If AIG had defaulted on its credit default swaps, the CDS market would have collapsed, and a number of big institutions would have been in serious trouble. So, the AIG bailout was a CDS bailout, among other things.

JUDGE BEA:

A dissenting opinion from Professor Scott.

MR. SCOTT:

Well, just on that.

MR. WALLISON:

There’s so much to disagree with. Let me just say one thing and that is all of this, all of this faith in regulation is remarkable when you understand that the banks that got into trouble, as Arthur was talking about, were all heavily regulated, and the regulators were inside them every day.

And so, still they didn’t know what was going on. What happens with regulation is that people believe, like Arthur does, that regulation stops risk-taking, and as a result of that, they put more money in banks or make more investments in banks, when if they were ... aware of what the risks were, instead of relying on the regulators, they wouldn’t.

MR. EPSTEIN:

Look, I have another point. One of the things about these credit default swaps.

JUDGE BEA:

I’ve got to call on Professor Scott.

MR. EPSTEIN:

Oh, call on him. Why would I interfere?

MR. SCOTT:

Just a factual point. if you look at the exposures on the CDS portfolio of AIG and look at the major counterparties. You take Goldman Sachs as an example.

Goldman Sachs had 18% of its capital at risk from the failure of AIG. 18%. That's large number, but it's not close to insolvency. And that 18% number doesn't count the CDS's that Goldman purchased on AIG itself as a hedge against the inability of AIG to pay off on the CDS's. So, if you take that into account, that the exposure of counterparties was limited, is that surprising?

Risk 101. You don't put all your eggs in one basket to a counterparty. And I think Goldman understood that idea.

MR. EPSTEIN:

I was going to make a similar point, which is to say...

MR. SCOTT:

So, the fact of the matter is, Art, if AIG had not been saved by the Fed, Goldman would've been fine.

MR. WILMARTH:

Yes, Goldman would've been OK, but not some others.

MR. EPSTEIN:

Yes.

MR. SCOTT:

Other counterparties were in similar positions.

MR. EPSTEIN:

Yeah, look, I mean one of the other things to understand about Goldman is these were not just hedges as bare promises, they also took security interests of one kind or another, I'm not mistaken, right?

MR. SCOTT

That's counted in the 18%.

MR. EPSTEIN:

You know all the technical stuff, but the basic point that I'm trying to make is simple: that financial markets with their repos are organized in a way which allows for instantaneous foreclosures independent of the usual rules on mortgage markets. That also kind of protects things; you have to protect Goldman in order to get out of AIG because otherwise Goldman will protect itself.

The other point I wanted to make on mark-to-market, which is a two-fold answer. To the extent that you have readily ascertainable market prices on various assets, marking to market on a daily basis is perfectly sensible. But what happened in 1988, and which could happen again, is we're trying to mark-to-market those kinds of securities that do not have a ready market, and then in effect what you do is deny a regulated bank the thing that most of the banks want most, which is the ability to say, "I'm going to keep my assets off the market during a bad period of time, and wait 'til some time later."

And it's that inability to delay then forces them to sell into hostile markets, which then lowers the price even further, at which point the cycle starts to repeat. Instead of thinking of this bank as a regulated institution, think of it as a single owner of a particular asset, then ask yourself whether or not in bad markets the owner of a house is under the duty to sell. And I think in that last case, you' fundamentally want to reject the mark-to-market. It is valuable when prices are ascertainable; otherwise, it can prove quite perverse.

JUDGE BEA:

In the back. Question.

AUDIENCE:

About these systemically important institutions it seems to me that once they have been designated as that, the federal government's taking a lot of control of the internal governance away from the shareholders, and to me, that should really be classified as it is taking them.

You have the government instituting for public purposes and taking control away from people's private property interests in the company that they own share in. you know, I think changing that would really improve a lot of the things from the judicial philosophy, at least.

MR. EPSTEIN:

Did I hear you talk about takings? My answer for that takings is half the problem. But there's a second half of the problem, which is whether or not when the government takes, it gives you just compensation for the loss, so that the shareholders regard themselves as better off than before. And in fact, if you were running a sensible bailout program where you inject money into the situation, which gives you liquidity and takes back the senior interests, that's fine.

And that was maybe, but arguably the situation that you have with FHFA and Fannie and Freddie with its 2008 September bailout when it took a preferred stock with a 10% dividend on money that was put in. But when they then switched the terms of compensation in August 2012 so that the amount left over to the shareholders is nothing, ever, and then announce that since you're getting nothing, ever, you should be extremely happy. Which is the government's position.

The reason why a takings issue is always raised is that there are two sides to the problem, and what happens in many of these cases, most notably with the GSE's, is that nothing whatsoever is given to the shareholders when their wealth was confiscated. What was so terrible about this episode politically is that it revealed a bipartisan willingness to steal on both the Republican and the Democratic side. I've written about this problem for years, on behalf of these hedge funds.[7]

And I'm always amazed at the casual arguments that people make saying that we regard FHFA as a faithful agent of the individuals whom it's milking every dollar that they have.

JUDGE BEA:

Alright. Another question.

[7] *See*, *e.g.*, Richard A. Epstein, *D.C. Circuit Refuses To See Limits To Government Power And Inexcusably Upholds The Net Worth Sweep*, FORBES, Mar. 3, 2017, https://www.forbes.com/sites/richardepstein/2017/03 /03/d-c-circuit-refuses-to-see-limits-to-government-power-and-inexcusably -upholds-the-net-worth-sweep/#4c0899924167; *see also*, Richard A. Epstein, *Will Fannie and Freddie Shareholders Be Able to Set Aside the Third Amendment? Judge Royce Lamberth's Indefensible Decision Is Only One Battle in a Long War*, FORBES, Sept. 30, 2014), https://www.forbes.co m/sites/richardepstein/2014/09/30/will-fannie-and-freddie-shareholders-be-able-to-set-aside-the-third-amendment-the-recent-sweeney-decision-will-n ot-alter-the-basic-dynamics/#68b572967f67.

AUDIENCE:

I'm Kai Albert from Port Angeles, Washington. I'd like to ask the panelists, if you had a magic wand you could wave over Dodd-Frank, what parts of it would you amend or repeal, and then turning to reality, what, if anything, do you think, is it realistic to expect is likely to happen with regard to Dodd-Frank reform during the current presidential term?

MR. WALLISON:

Well, let me try that.

MR. SCOTT

I'll answer the second. It's easier than the first. There is a bipartisan bill that was introduced this week, which basically tries to reduce the burdens of Dodd-Frank and limit them to, in some cases to banks that are under $250 billion, and in other cases, even smaller banks. Banks at which, provisions of Dodd-Frank.

Bipartisan, I would say there's a very good chance it will pass. But I think that'll be it. There is such a narrow majority of the Republicans in the Senate, and such disagreement among those Republicans that I think any other practical change to Dodd-Frank other than for smaller banks, which I think we'll see, will not pass. If I were czar, I would sort of scrap Dodd-Frank and start over.

AUDIENCE:

Thank you.

JUDGE BEA:

Anybody else want to chime in?

MR. WALLISON:

Yeah, I'd mention two things right off the bat, and that is the Financial Stability Oversight Council should be closed down, it's a danger. And to the extent that they go into things such as activities, which many people have been for, that is a real danger when they are going to be able to stop entire markets from operating, or entire industries from operating, because they don't like the way they are operating.

Now, that probably won't happen in the Trump administration, but it could well happen in the next administration if it turns out to be from the Left.

MR. EPSTEIN:

First of all, I think the CFPB, you know, marked for extinction would not be a bad thing, and reassign its regulatory authority to other agencies, which are perhaps better able to do it. But the one that I particularly hate, which is self-contained and separate, is the Durbin Amendment, which sort of wrecked the debit card markets for many years by announcing that the interchange system, which had been the greatest success in financial innovation over the last 15 years was completely crazy because it allowed, essentially people to charge the debit card-holders a transaction fee, which the regulators wanted to drive as close as possible to zero.

That's separate. I mean, people like Todd Zywicki who may end up running, if the Lord is kind to us, the CFPB has essentially killed off all sorts of innovation in this particular banking section, and the reason why I think it may be reparable is not only are its effects particularly odious, in many cases, but because the Durbin Amendment is separable from the rest of the statute. And at that particular point, the interaction and overlap problems are much less severe than they are with trying to deal, for example, with SIFIs.

JUDGE BEA:

Arthur?

MR. WILMARTH:

I certainly agree that regulatory relief for traditional community banks is long overdue. Among other things, why are we imposing Basel's international capital requirements on traditional community banks? It makes no sense to do that. A strong leverage capital requirement would clearly be sufficient. Traditional community banks are doing what banks are supposed to be doing, and they're the lifeblood of most of our small or medium-sized communities.

If we want to have a culture that encourages start-up businesses, we need more community banks and we need our existing community banks to thrive. We're loading them down with way too many mandates. I hope regulatory relief for community banks can be accomplished, if nothing else.

MR. SCOTT:

Could I just add that I don't think the villain of the piece is all Dodd-Frank, and this is what Arthur has just alluded to, big villains of the piece reside outside the United States in the form of the Basel Committee and the Financial Stability Board.

The two major regulations that have really affected growth, economic growth in this country, are capital and liquidity requirements.

Those did not originate in the Dodd-Frank legislation, it came out of the Basel Committee and the Financial Stability Board.

So, how we deal with these international organizations going forward in terms of providing regulatory relief is absolutely crucial. This is not only an issue about Dodd-Frank.

JUDGE BEA:

Next question.

AUDIENCE:

Thank you, my name is Carl Domino. I am an attorney but since 1972 I've been a money manager in the equity markets, and as a general proposition I'd say that the big declines we've had always been caused by something different.

Inflation in the 70's, portfolio insurance, the dot com bubble, the financial crisis.

So, as a money manager I'm always looking for the next thing. I mean, everything you said is great, I've studied it, I'm not sure if that's not the last.

I don't know if any of you had looked at what Jamie Diamond said was a fraud, it's very small now, it's growing rapidly, and that's Bitcoin. It looks like the tulip bubble in Holland.

So, the question is this: have any of you looked at it, have a sense of the danger it poses to the capital of markets, and is there an administrative body that should be, if not regulating, at least closely monitoring the growth of Bitcoin?

JUDGE BEA:

Anybody want to talk on that one?

MR. WILMARTH:

I've read a little bit about the recent failure of a Bitcoin market in Japan. No one has yet explained why that market failed, but many investors lost their money and the money just disappeared. My feeling is that a market in which suddenly investors' money just disappears, and nobody has any explanation for it, looks like a Ponzi scheme.

I therefore think that Bitcoin could well be a Ponzi scheme, which is operating on the greater fool theory. I have yet to see any clear explanation about where expected payoffs on Bitcoin investments will come from. Everybody is promised payoffs, but where will the payoffs come from? And investors do not know who invented Bitcoin or who is behind it.

I am perplexed that a market like Bitcoin, which no one is vouching for, which no one is regulating or overseeing, and where some collapses have already occurred, can continue to attract a lot of money.

MR. WALLISON:

Let me. Yeah, I'd like to say something about that because, and probably Richard does too, but look, our economy is great because of innovation. And if people lose money on something like Bitcoin because they've speculated on it and they've lost. If it's a Ponzi scheme, then there's a criminal violation there, but let's not get into the business of regulating innovation. Let's let it work out, and if people lose money, that's their problem.

MR. EPSTEIN:

Now, I have the following explanation, I heard the following statement: you cannot possibly imagine how people are allowed to put in monies into a banking system which has systemic failures when there's no real accountability.

As I listen to that statement, it seems to me you have to close down every bank in the United States because they all have had very similar problems. Regulatory failure in this country is much more frequent overall than it is for example in Canada, where they've never had this particular problem.

And so, the danger that you really have about this is if you want to apply that to Bitcoin, you're going to have to apply it to everything else and at that particular point it may well be that we're going to start going back to only having gold bullion to run our exchange markets.

JUDGE BEA:

Last question.

AUDIENCE:

Thanks. Professor Wilmarth, first of all, thank you for coming today. you decry the tragedy of the federal government having to spend $850 million to bail out Citigroup and Bank of America, and I understand that your take on what happened in 2008 is a little different from the other panelists, but still, we can take certainly as a matter of just judicial notice, that there is a strong push coming out of Congress to readdress income inequality by asking financial institutions to make loans to people who otherwise would not be qualified.

And it's my understanding that FHA losses are astronomical in terms of, in comparison to other forms of loans, so in that sense the government spends plenty of money on behalf of the taxpayers for its own problems.

Could you take a position on that form of lending? Do you decry that socially-induced lending also, along with your other concerns?

MR. WILMARTH:

Oh, yes. I've said repeatedly that the idea about getting people into homes they can't afford makes no sense at all. After all, what is dishonorable about renting? We essentially made it possible for millions of people to buy homes they couldn't afford, and then their homes were foreclosed, they lost everything, they lost their credit ratings, meaning they're ruined for years.

Home ownership for everyone was a horribly misguided policy. I agree that the federal government and the largest banks share a lot of responsibility for the housing disaster.

Unfortunately, the biggest banks found that subprime lending was a very profitable business for about five years. It proved to be an unmitigated disaster over the longer term.

MR. EPSTEIN:

I have a one-sentence answer. One-word answer. It's called "rent."

JUDGE BEA:

On that optimistic note, I've got the hook over here. So, can we thank our panelists. Thank you very much.