The Big Financial Problem: Mandarins Making Law

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Overzealous regulators are a big and growing problem in American finance.

In his seminal work *The Spirit of Laws,* published in 1748, French political philosopher Montesquieu argued that when legislative, executive, and judiciary powers in government aren't separated, there can be no liberty. His idea became the bedrock of American freedom in the constitutional separation of powers, with each branch of government checking and balancing the others, and laws clearly specified and enforced irrespective of the politics of the men in power.
In modern U.S. financial services, however, we have given power to unchecked and lawless regulatory mandarins.

The Dodd-Frank Act was the most consequential law in financial services since the Great Depression. Its 848 pages weren't read by the members of Congress voting for it, much less by average citizens. In contrast, the 1791 act setting up the first U.S. central bank was only five pages long.

Five years after the bill's enactment, the Davis Polk & Wardwell law firm noted that 22,296 pages of Dodd-Frank–related rules had been published, 13,115 of which were final. George Mason University's Mercatus Center reported that, as of the end of 2014, Dodd-Frank had imposed five times as many regulatory restrictions as any other law and more than all other laws passed during the Obama administration.

Banks must rely on their armies of lawyers to try to comply, but ultimately they are subject to regulatory caprice.

Channeling Montesquieu, James Madison warned that the accumulation of all powers, legislative, executive, and judicial, in the same hands was tyranny. The Consumer Financial Protection Bureau is Madison’s nightmare. By design, it is insulated from congressional and executive oversight. It writes its own budget, automatically drawing funds from the Federal Reserve. Unlike the Commodity Futures Trading Commission, the Securities and Exchange Commission, the Federal Trade Commission, the Federal Deposit Insurance Corp., and the National Credit Union Administration, the CFPB isn’t run by a bipartisan board. It’s headed by a single director who can be removed only for cause.

Rather than just enforcing law enacted by Congress, the CFPB essentially writes its own laws in directing industry.

Dodd-Frank mandated that “the bureau may not exercise any rule-making, supervisory, enforcement or any other authority” over auto dealers. A classic legislative insertion by a special-interest lobby, the text couldn’t have been clearer. The CFPB, however, didn’t let a mere statutory prohibition get in its way. Targeting lenders such as Ally Bank that provide wholesale finance to auto dealers, the bureau, in my view, fabricated racial-discrimination cases where there was no evidence of intent to discriminate—because there was no knowledge of the borrowers’ race. The CFPB rightly calculated that Ally, needing regulatory approval to keep its insurance business, would bend the knee rather than fight.

The CFPB proposes to forbid issuers of general-purpose, reloadable prepaid cards providing overdrafts to their customers without extensive new requirements. That’s law-making, not enforcement.

The CFPB is trying to destroy payday lenders. Yet out of the other side of its mouth, it suggested banks should provide risky small-dollar loans, and it’s pressing banks to eliminate legal overlimit charges.

The CFPB has used enforcement actions to make policy, rather than publishing rule-making and soliciting comments, and it has issued retroactive regulations contravening other regulators’ longstanding policy. Retroactive rules are unfair and at odds with centuries of Anglo-American law.

Of all federal regulators, the CFPB is the least checked and, not coincidentally, the most abusive. But it’s not the only regulator taking liberties by making law.

The Office of the Comptroller of the Currency tells prepaid-payment-card operators that they can’t provide credit at a rate greater than a 30% annual percentage rate. This is making law because states, not the OCC, determine permissible interest rates.

The FTC banned telemarketers from using remotely created checks, payment orders, and prepaid cash-reload services, claiming it was an unfair or deceptive practice. The Fed, however, permits remotely created checks for bank-to-bank transfer and presentment. Consistent rule-making would be more likely if laws were specific and clear and regulators understood that their job was enforcement, not law-making.

Regulators have choked off payments to legal businesses they don’t like, such as subprime credit providers, gun dealers, cigar shops, and health supplements. Now, the largest providers of credit-card acceptance avoid profitable business from sectors with “reputational risk,” a euphemism for businesses that regulators want to eliminate.

Even if they find a payment processor, such businesses pay more, driving up the cost of credit for risky consumers—the opposite of what policy makers profess to want.

Because of such regulatory pressure, bank-owned risk-management service Early Warning won’t sell access to its demand-deposit database to credit providers charging more than a 36% APR, making it more difficult to serve risky consumers.

While it’s easy to blame overzealous regulators and courts reluctant to check the administrative state, ultimately Congress is the problem: It delegated authority that the Constitution doesn’t allow it to delegate. Congress assigns the administrative state to make policies, taking credit for those that are popular. If policies prove unpopular, the congressional sponsors can blame the regulators.

The financial-services industry should be more willing to challenge lawless regulators in the public arena and in the courts, but if such challenges are to succeed, Congress must reclaim its institutional powers.

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