

Restoring the Rule of Law in Finance

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The unraveling of the rule of law in finance is inherent in the system's discretionary process of regulation. Each financial crisis begets new regulations and new regulatory agencies with more expansive and discretionary powers. The general entanglement of finance, leftist interest groups, and the federal regulatory apparatus has created a threat to freedom that is almost unique in history. Leftist activists, “woke” corporations, and regulators and politicians have recognized and acted on the opportunity to use the financial regulatory system both to enact preferred policies through anti-democratic means and to silence their ideological opponents. As governmental power grows, the threat of its misuse grows concomitantly.

Adherence to the rule of law is essential for economic growth and personal liberty.¹ The maintenance of a stable order of rules, transparent and accountable legislative and regulatory processes, and rules announced in advance and consistently applied enables individuals to make plans and have confidence that they will carry them through to fruition. The rule of law enables private individuals to anticipate other people's behavior, including governmental officials, so that they can make their own plans, pursue their individual ends in life, and coordinate their activities with others in the economy.

Yet the rule of law is in steep decline in the United States as seen in a variety of actions of the current Administration in areas as diverse as

environmental regulation, immigration policy, public health measures, student-loan forgiveness, and even an assertion of the power to prevent landlords from evicting tenants, an action allegedly justified by the Covid pandemic. Although the demise of the rule of law in finance is not unique, it is representative, and because of the unusually convoluted and secretive nature of financial regulation, it is a particular exemplar of the clash between the rule of law and the modern regulatory state, a clash that affects every one of us but that most of us are not even aware is occurring.

The connection between finance, liberty, and the rule of law may not be immediately obvious, but the financial system is part of the essential infrastructure of society and the economy that enables people to have a bank account, buy a home, start a business, or simply make a purchase at the grocery store. As Ayn Rand observed, in a free society, money “is a frozen form of productive energy.”² When converted through the financial system into active energy, the financial system makes possible the pursuit of happiness for each of us and our families. The erosion of the rule of law in finance is thus a threat not only to our nation’s economic system, but also to our liberty and individual rights.

A series of government crises stretching back to the Great Depression has built the modern financial regulatory system, expanding government power and discretion and deeply entangling governmental regulation with purportedly private financial institutions. Increasingly, the Left is using this leverage over the financial system to pursue its social agenda for wealth redistribution and to enrich favored constituencies. In many instances, this process reflects an unholy alliance with mega-banks and entrenched special interests that benefit from the modern system of opaque and complex regulation and can use the costs and complexity of the regulatory system as a competitive advantage.

Even more sinister, the financial system increasingly is being used both to advance the Left’s agenda in the culture war, punishing those with disfavored political opinions and religious beliefs by stripping them of access to financial services, and to advance a broad and controversial climate change agenda through antidemocratic means. Faced with these unprecedented threats to freedom and the rule of law, conservatives must consider real solutions before it is too late.

Why the Rule of Law Matters for Finance

A defining characteristic of the rule of law is that rules are general, coherent, consistent, and simple enough that those who are governed by them

can actually understand and conform their behavior to those rules and anticipate how others will act.³ In turn, this enables affected parties to coordinate their plans with minimal friction and conflict. It is recognized that adherence to the rule of law requires that parties be able to conform their behavior to it. For example, it would violate the rule of law for an individual to escape criminal prosecution only if he can hold his breath for 15 minutes straight. It also violates the rule of law to create thick webs of inconsistent rules and regulations with which it is impossible to comply as an economic matter. “[E]conomics is subject to its own set of ‘laws,’ as in the physical world and...excessive economic regulation will run afoul of the empirical regularities of economics. As a result, excessive economic regulation simply cannot be applied consistently with the rule of law.”⁴

Although governance by the rule of law is essential for the operation and maintenance of a free society generally,⁵ it is especially important for the stability and efficiency of the financial system. At root, financial transactions of any sort are simply contracts; for loans or other financing arrangements to occur, it is therefore necessary that those contracts be enforceable in a predictable manner. In order to make a loan, for example, it is necessary either to price the loan terms efficiently in light of the risk, such as by pricing the interest rate or other terms based on the loan’s predicted risk,⁶ or to reduce losses, such as by lending smaller amounts to all borrowers or by refusing to lend to higher-risk borrowers. Poorly designed financial regulation that interferes with the ability to price risk effectively, such as interest-rate ceilings, will thus exert a drag on financial and economic activity by forcing financial institutions to raise the costs they charge to all borrowers or lending only to the most creditworthy borrowers.⁷ Raising the cost of capital will stifle new business creation, entrepreneurship, and economic growth. Thus, it is not surprising that the presence of the rule of law is correlated with economic growth and a country’s level of economic prosperity.⁸

Beyond the economic effects, however, the absence of the rule of law in finance can have spillover effects that chill an individual’s expression of freedom of speech and religion. During the era of the Soviet Union, it was often noted that the Soviets had a marvelous bill of rights that guaranteed freedom of speech and religion—but it was also noted that the guarantee of freedom of speech or press was meaningless if the government controlled access to financial capital and all of the paper and printing presses.⁹ If an author or website cannot receive payment for items they produce, then they are effectively subject to the political whims of the banks and payments providers that enable them to make sales and pay employees.

Consider, for example the case of Martin Luther King, Jr., and the Southern Christian Leadership Conference. What if banks of the era had been unwilling to provide financial services to King or the SCLC so that they could travel, pay employees and lawyers, or even post bail when arrested on the basis that they were effectively an organized criminal conspiracy designed to break the law through trespass and by creating a nuisance? Astonishingly, that is precisely what the government of Canada did to those who participated in the “Trucker’s Freedom Convoy” in Toronto last year when it froze their bank accounts. According to some reports, the government froze the bank accounts of those who merely *contributed* to the truckers’ accounts. Even more alarming, according to one poll, 65.7 percent of American Democrats approved of Prime Minister Justin Trudeau’s actions.¹⁰

Although adhering to the rule of law in finance promotes overall economic activity and facilitates access to financial services for all, there are interests that benefit from providing the government with greater regulatory discretion. Those who benefit from a system grounded on rule-of-law values are likely to be heterogeneous and largely disorganized, and the costs of such policies are spread widely.¹¹ Those who benefit from a more complex, discretionary system will be those with a comparative advantage in bearing the costs imposed by such as system and with superior power and influence that enables them to influence governmental decision-making.

First, government officials, both in Congress and the regulatory agencies, will support greater discretion in financial regulatory policy. More complex, unpredictable, and confusing regulation gives government officials greater power and ability to influence policy to pursue their own personal and policy agendas. Increased government power and discretion will also increase the market value of bureaucrats’ human capital if they leave the government and move into the private sector. A vague and complex regulatory framework places a premium on gaining access to governmental decision-makers and using those personal relationships to secure beneficial regulatory outcomes.

For example, empirical studies have found that the likelihood that financial institutions would acquire funds from the federal government’s Troubled Assets Relief Program (TARP)¹² during the 2008 financial crisis was substantially related to the extent of their political influence, such as their political campaign contributions to influential Members of Congress, the intensity of their lobbying operations, or the presence of former Treasury or banking regulatory officials on their boards of directors.¹³ The relevance of these political factors is notable in light of the fact that

eligibility for TARP funds was subject to specific formal requirements; nevertheless, those criteria were so vague and discretionary that they clearly provided little constraint on the ability of governmental officials to pick winners and losers.

Certain outside interest groups also benefit from a more discretionary and uncertain regulatory environment. It has long been understood that compared to smaller businesses, larger businesses can typically deal with more expensive and more complicated environments at relatively lower cost. Financial regulation is no exception. As several studies have documented, it has been easier for large institutions to absorb the immense regulatory costs imposed by the Dodd–Frank Act¹⁴ than it has been for smaller institutions. Thus, while Dodd–Frank has imposed higher costs on all elements of the financial sector, its costs are relatively more expensive for smaller banks than they are for larger banks.¹⁵ Larger banks can simply hire more compliance officers or lawyers or invest in expensive automated compliance systems; bearing these costs is much harder for smaller banks. Larger banks also have a standing army of lobbyists and government relations employees that can be brought to bear to influence efforts to reform the financial regulatory system to reduce these costs.

As a result, larger, too-big-to-fail banks have become even larger and more systemically important since Dodd–Frank’s enactment, while smaller banks have been driven out of business, have merged with larger institutions, or have abandoned certain product lines because of the regulatory risk associated with them.¹⁶ For example, since 2008, JPMorgan Chase’s assets have grown by 16 percent to \$2.6 trillion, and Bank of America’s assets have grown by 69 percent to \$3.1 trillion. As JP Morgan Chase CEO Jamie Dimon famously quipped, Dodd–Frank erected a “bigger moat” to protect large banks from competition from smaller banks.¹⁷

For similar reasons, non-financial businesses and consumers also bear unequal costs and benefits from financial regulation. Larger businesses, which are the clients of larger banks, gain a comparative advantage because they are more likely to rely on larger banks for financing and in general take larger loans. Smaller businesses, by contrast, tend to patronize smaller community banks and take smaller loans. As smaller and community banks have shrunk in number and significance, access to financial services for small businesses has likewise been reduced.

Financial regulation also can create regressive and arbitrary redistribution among different groups of consumers. For example, regulation that increases the costs of issuing or underwriting mortgages or real estate

closing procedures will have a greater relative impact on the cost of underwriting smaller mortgages and less expensive houses than it will on those for more expensive houses as those costs will have to be spread among a smaller overall loan value. New residential mortgage regulations mandated by Dodd–Frank increased the fixed costs and per-loan costs of originating a mortgage, and this proportionately increased the costs of issuing smaller mortgages relative to larger mortgages.¹⁸ At the same time, the Qualified Mortgage Rule, mandated by Dodd–Frank and issued by the Consumer Financial Protection Bureau (CFPB),¹⁹ imposed price controls on the fees and points that lenders can charge based on the loan size, thereby restricting the ability of lenders to recover these higher costs. The result has been that since Dodd–Frank was enacted, the overall number, size, and approval rate of small and medium-sized residential mortgages have been decreasing relative to large loans.²⁰

In addition, because larger lenders are more likely to make large loans than small lenders are, Dodd–Frank’s regulatory burden has tended to drive more concentration in the mortgage market toward larger lenders. Reviewing the overall impact of Dodd–Frank and other similar regulations in June 2014, Goldman Sachs concluded that “low-income consumers and small businesses—which generally have fewer or less effective alternatives to bank credit—have paid the largest price for increased bank regulation.”²¹ A similar trend toward greater concentration has been observed in investment banking and the financial management industry.²²

Over the past few decades, a third interest group has emerged that supports less rule-bound financial regulation. Various progressive interest groups and politicians have learned to exploit the ambiguities and discretion in the financial regulatory system to use the financial system as a means to accomplish broader social goals that they could not accomplish through democratic means.²³

These three forces—government self-interest, economic special interests, and progressive activists—all benefit from greater regulatory discretion, and they have combined both to erode the rule of law in the financial regulatory system and to oppose efforts to reform that system. The influence of these groups is often a contributing cause of an initial crisis; for example, housing activists, the self-interest of elected politicians, and certain elements of the financial system all supported expansionary housing policies in the run-up to the 2008 financial crisis. But the influence of these groups might be even more important in supporting a post-crisis consolidation of power and discretion in federal regulators.

Crises and Erosion of the Rule of Law

The rule of law in finance has eroded as a result of a series of financial crises, beginning with the Great Depression and the government's response in the New Deal, then continuing through the 20th century and into the trio of national crises in the 21st century: 9/11, the 2008 financial crisis, and the 2020 SARS-CoV-2 pandemic. In each of these instances, the financial crisis itself was triggered by errors in government policy (often by the Federal Reserve), and in each case, the government response resulted in greater governmental power, weakened rule of law, and greater influence of special interests and government bureaucrats.²⁴

During the crisis, it is argued that the government must suspend the rule of law and procedural and substantive restraints on government action so that it can act swiftly and decisively, with minimal deliberation, limited information, and often while short-circuiting procedures designed to promote consideration of long-term effects and limit the influence of special interests.²⁵ After the crisis has abated, it is further argued, Congress can return to the issue to address long-term concerns and prevent future reoccurrences. In fact, this reexamination rarely happens in practice. Once the government slips its constitutional reins to embrace broad discretion, it rarely surrenders this power but instead consolidates and extends it, and the regulatory ratchet is complete. As Friedrich Hayek observed, “‘Emergencies’ have always been the pretext on which safeguards of individual liberty have been eroded—and once they are suspended it is not difficult for anyone who has assumed emergency powers to see to it that the emergency will persist.”²⁶

According to regulators, increased discretionary power is necessary to anticipate and prevent future financial crises, but as will be seen, the presence of regulatory discretion is often the cause of government errors and reckless behavior by private industry. Simple rules grounded in rule-of-law principles would provide a superior regulatory framework for preventing future crises, constraining the arbitrary power of government bureaucrats, and limiting the influence of special interests.

The federal government responded to a cascade of bank failures during the Great Depression with a number of interventions, including the Glass-Steagall Act of 1932 and the creation of the federal deposit insurance system in 1933 accompanied by the creation of the Federal Deposit Insurance Corporation (FDIC). The provision of deposit insurance was intended to prevent runs against illiquid banks by ensuring depositors that they would be made whole,²⁷ but the presence of deposit insurance also creates a moral

hazard problem: If depositors (as creditors of the institution) know they will be made whole, then they will have an incentive to shirk their responsibility to monitor the bank's activities, which will encourage banks to take excessive risk. To mitigate this problem, the Banking Act of 1935 empowered the FDIC to supervise bank activities on an ongoing basis as a condition for participation in the deposit insurance system. "Supervision," as the CFPB Taskforce on Federal Consumer Finance Protection concluded in its January 2021 final report, "attempts to mitigate this moral hazard problem by monitoring the bank's ongoing performance and risk-taking activities to ensure that the bank is not engaging in overly risky activity."²⁸

Federal supervision had existed before the Federal Reserve and before the era of the Great Depression, but the supervisory apparatus took on a completely different tenor with the introduction of deposit insurance. Historically, the federal government had imposed certain minimum capital requirements and other simple rules to stabilize banks but otherwise had relied largely on market discipline as the primary means of policing unsound banks. As economic historian Eugene White writes, "The financial collapse of the Great Depression prompted the imposition of a new regulatory regime and a shift in bank supervision away from market discipline towards a supervisory regime with considerable discretion."²⁹

One manifestation of this new regulatory philosophy was the FDIC's decision to protect the safety and soundness of banks by limiting entry by new banks (as well as new branches by existing banks), restricting competition for deposits by limiting the interest rates banks could pay under Regulation Q, and otherwise ensuring their profitability. In addition, supervision increasingly came to be seen as a tool to aid in implementing monetary policy by taking into account general economic conditions and valuing bank assets to exert a countercyclical influence that would reinforce Federal Reserve actions with respect to inflation, deflation, or recessionary periods.

This system of protecting bank stability through government-created barriers to competition collapsed as interest rates soared in the 1970s. As assets flowed out of the banking system to alternatives, financial institutions responded by increasing their risk-taking in pursuit of higher yields. The inevitable result was a wave of bank and savings and loan institution failures and bailouts through the 1980s. These bailouts solidified the modern practice of discretionary bailouts of large, frequently politically connected financial institutions that are considered "too big to fail."³⁰ By the time of the 2008 financial crisis, politicization and inability to prevent bank failures had been prominent features of the supervisory process almost since its inception.

The 2008 Financial Crisis: End of the Rule of Law in Finance

The roots of the 2008 financial crisis trace back to the Federal Reserve's response to the combined shocks of concerns about a Y2K crisis, the crash of the NASDAQ stock market bubble, and disruption of the economy and financial system by the 9/11 terrorist attacks. These multiple shocks in a short period of time led then-Federal Reserve Chairman Alan Greenspan to fear that the United States would fall into a deflationary cycle like the one that occurred in Japan in the 1990s. As a result, the Federal Reserve made the decision to lower short-term interest rates dramatically in order to stimulate the economy. Greenspan later observed that when the Fed made this decision, he feared that it could eventually lead to inflation.³¹ He did not expect what actually happened, however, which was that the excess liquidity would flow into speculative asset investments—in this case, housing.³²

This flood of money into the housing market was furthered by a variety of government policies.

- First, a long-standing bipartisan political enthusiasm for promoting home ownership was pushed to new heights by President George W. Bush's "ownership society" agenda, a centerpiece of which was greater access to housing.³³
- These efforts were reinforced by similar efforts by government-sponsored entities such as Fannie Mae and Freddie Mac to reach certain "affordable housing goals."
- Finally, failures in the bank regulatory system that subsidized investor demand for housing-backed securities produced an excess demand for the generation of new mortgages.

All of these factors, together with others such as an excess of global capital flows into the United States during this period, led to a speculative bubble that then began to burst.

Violating the Rule of Law During the Financial Crisis. The government responded by bailing out the first bank to show signs of trouble, the investment bank Bear Stearns. Thus, when the larger and arguably more systemically important investment bank Lehman Brothers got into trouble in the summer of 2008, its management and market investors assumed that, based on the government's actions with respect to Bear Stearns, it too would be bailed out.

In fact, in the days leading up to its eventual bankruptcy, Lehman Brothers had ample opportunities to pursue private transactions that would have saved it; instead, it chose to hold out for a better deal in the belief that the government would not allow it to fail. As David Skeel has noted, this confidence was mirrored in capital markets as prices of Lehman's securities reflected almost no risk premium in the days preceding its eventual bankruptcy filing.³⁴ As a result, when the government chose *not* to save Lehman, its collapse was far messier and catastrophic than would have been the case otherwise. Although Treasury Secretary Hank Paulson tried to claim after Bear Stearns that under no circumstances would he bail out future institutions, his boast was not credible and was thus discounted by market actors.

Why did Paulson eventually relent and engage in wholesale bailouts? According to his memoir, Paulson's primary motivation was his belief that "the market" expected him to provide bailouts and that unless those expectations were met, market actors would lose confidence in the financial system. In short, the market's expectations became self-fulfilling; to the extent that Paulson held discretion to bail out failing firms, it was fully expected that he would exercise this discretion to do so. Sophisticated market actors understand the incentives that political actors face during periods of crisis: incentives to overvalue the importance of preventing a financial crisis in the short run even if that increases the moral hazard and the risk of an even larger financial crisis in the future. The only way to temper this dynamic is to deprive the government of the ability to engage in bailouts, and this in turn requires a credible commitment and adherence to the rule of law.

Following Lehman's collapse, the government implicitly decided to protect all large, purportedly systemically risky financial institutions against failure for the duration of the crisis, including not just depository institutions, but other investment banks and insurance companies as well. Paulson and the Bush Administration rushed to Congress to seek hundreds of billions of dollars through the TARP legislation to stabilize the financial system by having the federal government purchase mortgage-backed securities and other low-value assets from banks.

Ironically, even the TARP funds that Congress approved ended up being used for purposes other than those for which Congress initially authorized them, as they were used to make direct capital infusions into banks rather than to purchase "troubled assets." While the program itself purported to establish objective, rational criteria to determine a bank's eligibility for TARP funds, politically connected banks were more likely to receive bailouts than were those that were not so connected. Perhaps even more troubling was the U.S. government's decision through Secretary Paulson

to force certain banks to take bailout funds even though they did not want or need the support.³⁵

Still later in its response to the crisis, the United States government redirected TARP funds—authorized for support of financial institutions—to bail out the automotive companies Chrysler and General Motors.³⁶ In the unprecedented Chrysler bankruptcy case, the federal government used its leverage as Chrysler’s debtor-in-possession lender to strong-arm secured creditors into permitting their property rights to be plundered in order to prop up the United Auto Workers’ underfunded health care plans.³⁷ While this benefited the UAW workers in that case, the long-run effect was to create political risks in heavily unionized industries that creditors would risk having their property rights violated if the government felt it convenient to do so.³⁸ Subsequent empirical research found that in the aftermath of those cases, bond markets adjusted to price in the risk of government intervention in future cases—a political risk variable that had not previously been present in U.S. credit markets but is common in other countries.³⁹

After the Crisis: Failure to Restore the Rule of Law. Far from restoring the rule of law following the financial crisis, the government responded by enacting the Dodd–Frank financial reform legislation, which is the antithesis of the rule of law. Over 2,000 pages long, the law called for hundreds of required rulemakings that spawned tens of thousands of pages of regulations and tens of billions of dollars (or more) in regulatory compliance costs. Dodd–Frank contemplates a deep ongoing entanglement between banks and their regulators as the regulators ostensibly monitor those institutions for safety and soundness.⁴⁰

The intended central purpose of Dodd–Frank was the permanent elimination of future bailouts⁴¹ and the concept of too-big-to-fail financial institutions through a novel process for the resolution of a failed financial institution called the Orderly Liquidation Authority (OLA).⁴² But while Dodd–Frank provides a potential solution to the legal problem of averting bailouts, it fails to address the political problem: its inability to persuade the public that the government will be willing to risk a potential financial crisis if the OLA scheme is actually implemented.⁴³ As a result, it is widely recognized across the ideological spectrum that Dodd–Frank permanently entrenches the practice of too-big-to-fail rather than eliminating it.⁴⁴ The fact that despite Dodd–Frank, large banks still receive a too-big-to-fail subsidy that provides a competitive advantage in capital markets reflects market participants’ agreement with this assessment.⁴⁵

Any pretense that Dodd–Frank would “put a stop to taxpayer bailouts once and for all”⁴⁶ was eliminated when the federal government intervened

to backstop depositors of failed regional banks Silicon Valley Bank, Signature Bank, and Republic Bank in 2023. When depositor runs on those banks started, federal regulators swiftly moved to lift the FDIC's \$250,000 ceiling on insured deposits to guarantee the full amount of deposits. Although the enhanced insurance protection was to be funded by a special assessment on banks (and indirectly their customers) and not directly by the taxpayers, the implication was clear: If the FDIC's funds were inadequate to cover the full deposits of a failed bank, the government would not hesitate to turn to the taxpayers to provide additional funds as needed. Perhaps more striking, the perceived instability of regional banks spurred a massive shift of deposits to banks that were considered "too big to fail," which were perceived as safer because those large banks would be backed by the federal government in a crunch.⁴⁷

This divergence between the *de jure* law on the books (no bailouts) and the *de facto* reality expected by market actors (bailouts of large banks in a crisis) illustrates the dangers of departures from the rule of law. The problem stems from the government's inability to make a credible commitment not to bail out banks during an economic crisis. This challenge of enabling the government to make a credible precommitment by limiting its discretion and tying it to clear rules announced beforehand is precisely the problem the rule of law is intended to solve.⁴⁸ As Friedrich Hayek observed long ago, the principle of the rule of law, "[s]tripped of all technicalities...means that government in all its actions is bound by rules fixed and announced beforehand."⁴⁹

The Rule of Law in Finance Today

Other than a somewhat brief interlude during the Trump Administration, the use of federal regulators' supervisory powers to pursue the political agendas of regulators, interest groups, and social activists has accelerated in the Dodd-Frank era. Supervision in particular has been used aggressively to accomplish substantive purposes that regulators would have been unable to accomplish through more accountable or democratic means, such as enforcement actions in court or rulemaking. The growing use of supervisory powers to accomplish general substantive policy goals seems to be a strategic choice specifically to avoid the procedural checks associated with notice-and-comment rulemaking or due process protections for litigation. Agencies are able to use supervision, guidance, bulletins, litigation settlement consent decrees, and other informal means to act and potentially to evade these requirements.⁵⁰

Misuse of Supervisory Powers. During the Obama Administration, for example, federal regulators used supervisory powers to implement an initiative called Operation Choke Point, which effectively used the process of bank examination to prohibit federal banks from providing financial services to certain legal but politically disfavored (by the Obama Administration) industries such as payday lenders, pawn shops, firearms shops, fireworks sales, sellers of allegedly “racist materials,” and others.⁵¹ Although ill-defined, the asserted basis for targeting these industries was that they created a “reputation risk” for those who provided payments processing and other services to such institutions. This led to the sudden and unexpected termination of accounts for many merchants in these industries by their long-standing financial service providers. Moreover, in most instances, because supervisory decisions typically are considered confidential, banks generally were not permitted even to detail the reasons for the account terminations, leaving those who were affected in the dark with respect to why they were the targets of this adverse action.

During the Obama Administration, the Consumer Financial Protection Bureau also showed how it could use its powers to accomplish goals that it was unable to accomplish through legislative and official rulemaking processes. On March 21, 2013, the CFPB issued a bulletin on “Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act [ECOA].”⁵² Dodd–Frank expressly states that the CFPB has no jurisdiction over automobile financing contracts with consumers; such authority is retained by the Federal Trade Commission. To circumvent this limit on its authority, the CFPB issued the aforementioned bulletin that it intended to prosecute financial institutions that provided financing to auto dealers that enabled them to make loans that are alleged to violate the ECOA. The CFPB then pointed to the bulletin to signal to dealers how they could change their compensation structure to create a safe harbor from litigation (by adopting a flat-fee compensation system and abandoning the traditional scheme) and relied on the bulletin to try to extract litigation settlements from financial institutions that failed to adopt the CFPB’s preferred compensation structure.

The legal force and significance of an agency bulletin are unclear. What *is* clear is that the agency expected parties to follow the bulletin even though it was touted as a nonbinding general statement of policy, promulgated with no due process or protections such as notice-and-comment rulemaking. Moreover, it was unclear whether any private party had standing to challenge the legal authority of the bulletin, because its ambiguous nature left open the question of whether it was a legally binding final agency action or merely advisory and thus not ripe for challenge.

In 2017, however, Senator Pat Toomey (R-PA) requested from the U.S. Government Accountability Office (GAO) an opinion as to whether the “Indirect Auto Lending” bulletin should be considered a “rulemaking” process for purposes of application of the Congressional Review Act (CRA).⁵³ The GAO concluded that even though the bulletin was a nonbinding statement of policy, it was “designed to assist indirect auto lenders to ensure that they are operating in compliance with ECOA and Regulation B, as applied to dealer markup and compensation policies”⁵⁴ and was subject to disavowal under the CRA, a power that Congress exercised to vacate the bulletin through a joint resolution of the House and Senate that subsequently was signed by President Trump.⁵⁵

ESG. This use of authorities such as supervision, guidance documents, and the like to evade legal accountability (for example, through the Administrative Procedure Act⁵⁶) has accelerated under the Biden Administration. Two areas have been particularly problematic: use of the financial system to pursue environmental, social, and governance (ESG) policies and the continued aggressive use of supervision and other types of informal guidance by the CFPB.

Use of the financial system to pursue ESG policies is problematic because it evades the process of democratic deliberation over important economic and social policies that invariably involve trade-offs, such as the goal of advancing economic growth and security on one hand and certain environmental objectives (such as reducing carbon dioxide emission levels) on the other. In the United States, efforts to enact stricter laws regarding energy and the environment, as well as many other wide-ranging social goals, have largely failed, and efforts to end-run the legislative process through rulemaking have been blocked by judges, most notably through the Supreme Court’s “major questions” doctrine and various procedural and substantive obstacles imposed by the Administrative Procedure Act and other limits on agency rulemaking.⁵⁷

Frustrated by the inability to enact limits on emissions directly by legislation or regulation, government officials and their non-governmental environmental activist allies have turned increasingly to financial regulation to impose indirectly what they have been unable to accomplish directly. For example, the Securities and Exchange Commission (SEC) recently proposed a new rule that would require publicly traded companies to provide information about “climate-related risks that are reasonably likely” to have an impact on their business or financial condition, including “disclosure of a registrant’s greenhouse gas emissions.”⁵⁸ The agency’s proposal makes minimal effort to explain why this risk would be material to most investors;

quite obviously, its intent is to induce corporations to reduce emissions in order to prevent or alleviate climate change, not provide information to investors regarding financial risks.⁵⁹

If finalized, the SEC rule would require disclosures about such elements as “transition plans, scenario analysis, internal carbon prices, and climate-related targets and goals,” all of which bear minimal relevance to financial risk. The rule originally was scheduled to be published in December 2022, but its breadth and controversial nature have generated substantial public criticism. As a result, the SEC originally announced that it would postpone publication until April 2023, but it has subsequently been suggested that the rule might not finally arrive until late 2023 or early 2024.⁶⁰

Targeting the Banking System. Similar efforts have taken place with respect to the banking system. Again, these restrictions have come about not through legislation or regulation but through supervision and other similar means. As noted above, under the Operation Choke Point initiative during the Obama Administration, regulators relied on the ill-defined concept of “reputation risk” to shut off access to the financial system for certain politically disfavored industries. More recently:

- Under the Biden Administration, debanking has spread to include certain individuals and organizations that express disfavored political opinions such as My Pillow CEO Mike Lindell.⁶¹
- In October 2022, former Senator Sam Brownback, Chairman of the National Committee for Religious Freedom (NCRF), revealed that Chase Bank had closed the organization’s bank account and would reinstate it only if the NCRF would provide to the bank its donor list, a list of political candidates it intended to support, and a full explanation of the criteria by which it would endorse and support those candidates.⁶² This use of the supervisory concept of “reputation risk” to justify the termination of an individual’s or organization’s bank account constitutes a significant risk of chilling free speech and other democratic values.⁶³
- Recent reports also suggest that federal regulators, encouraged by Members of Congress, now are effectively executing an Operation Choke Point–style crackdown on providers of crypto financial services, pointing to the heightened safety and soundness risk these companies supposedly pose to traditional banks.⁶⁴

It is unclear whether these debanking decisions are initiated by the individual banks or whether regulators are pushing them, as banks routinely stand behind a claim of confidentiality when debanked customers request more information. That defense implies the presence of external pressure on the institutions, but regardless of the source of the pressure, the implications of these practices affect individual liberty, not just economics.

To be sure, the economic implications of being debanked are important in their own right, as it is impossible to start a business, run a nonprofit, or get a credit card or mortgage without a bank account. One cannot get access to the payments system to pay bills or write checks without a bank account. Being debanked is functionally identical to being “de-personed” because of the difficulty associated with living and functioning in society without a bank account. But the chilling effect of such severe and arbitrary sanctions on the willingness of individuals to express their ideas or practice their religion freely may be even more profound.

Misusing UDAAP. President Joe Biden’s CFPB has been particularly aggressive in pushing the limits of the use of supervision and other similar techniques to advance policy goals. Earlier this year, for example, the CFPB announced the unprecedented claim that its authority to regulate unfair, deceptive, and abusive practices (UDAAP) included the power to regulate allegedly discriminatory conduct. This is a highly debatable and novel claim, as the implication that UDAAP also encompasses discriminatory financial services practices would swallow up ECOA and other express prohibitions. At the same time that it asserted this novel authority to regulate discriminatory practices under ECOA, the CFPB also adopted the controversial “disparate impact” standard for evaluating discrimination, an issue that has been hotly debated in the context of anti-discrimination and fair lending law.

Finally, and perhaps most important, the CFPB announced this bold new standard not through the initiation of a notice-and-comment rulemaking procedure or even by filing a lawsuit, but rather by a small revision of a paragraph in its 2,000-page Supervision and Examination Manual.⁶⁵ As a result, regulated parties had no advance notice of the pending announcement of the new standard and, therefore, no opportunity to challenge the CFPB’s judgment before it took effect.

In October 2022, a collection of trade associations and private parties led by the United States Chamber of Commerce filed a lawsuit in the United States District Court for the Eastern District of Texas. They argued that the CFPB’s amendments to its supervisory manual regarding discriminatory treatment under UDAAP should be considered a legislative rule, thereby requiring that it be promulgated through notice-and-comment rulemaking,

not through a mere amendment to the agency's supervisory manual. As a result, the amendment to the manual was equivalent in effect to a final rule, making the issue one for which the parties could request judicial review.

The banking industry also has been put on the receiving end of ESG pressures from activists who are urging banking regulators to use their authority under the Basel accords⁶⁶ to manipulate risk-based capital rules to discourage continued financial support of fossil fuels projects and instead to subsidize green energy projects.⁶⁷ In particular, these proposals would require banks to hold higher capital reserves against loans and other investments in fossil fuels and other industries that are viewed as exposed to physical and "transition" risks involving climate change, including the financial risks associated with future changes in regulatory policies that are designed to force a transition to a "lower carbon economy."⁶⁸

As with the SEC's proposals, however, it is evident that these supposed financial risks are largely a fig leaf to cover what really is an effort to target and reduce fossil fuel investment. The objective of deeming these industries to carry significant investment risk is to increase the costs of financing firms in the relevant industries compared to those in other industries, including green energy. Increasing the cost of lending will in turn increase the cost of business for these politically unpopular firms, thereby reducing expected profitability and leading to a reallocation of capital away from these industries to alternatives and a correlative shrinking of their economic and energy significance.

So prominent has this idea of pursuing environmental goals through the regulation of the financial sector become that Saule Omarova, President Biden's first nominee to head the Office of the Comptroller of the Currency (OCC), famously boasted that this mechanism could be used to "bankrupt" the fossil fuels industry.⁶⁹ Once her statement came to light, it spawned great resistance among elected officials and eventually led to withdrawal of her nomination. Nevertheless, this ability to circumvent the rule of law to effectively bankrupt an industry that is essential to the lives and livelihoods of all Americans shows the profound lack of meaningful constraints on the financial regulatory system.

Central Bank Digital Currency. Looming on the horizon is the greatest threat of all to individual liberty through control of the financial system: the prospect of programmable central bank digital currency (CBDC). The emergence of CBDC would enable the government to exercise direct control over individuals' finances by limiting their ability to spend their own money. For example:

- In order to reduce fossil fuel use, the government could program CBDC to limit the amount of gasoline one could buy in a month;
- The government could restrict the reading materials that a person could purchase if it deemed certain opinions to be “misinformation” or otherwise socially dangerous; or
- Currency could be programmed to be worth more if spent at, say, a minority-owned business rather than other businesses.

Is such a threat to liberty unrealistic? One would hope so, but as the example of Operation Choke Point a decade ago and the more recent examples of debanking today (as well as the “Twitter Files”) reveal, where the rule of law is shaky, government authorities cannot be trusted not to abuse their power.

Restoring the Rule of Law to Finance

Can the rule of law be restored to finance, and if it can, what is to be done?

Bailouts. A primary goal of restoring the rule of law to finance should be to reduce the risk of bailouts for large financial firms. One option would be to force most non-depository financial firms simply to file bankruptcy. Unlike the Orderly Liquidation Authority system created by Dodd–Frank, bankruptcy is an orderly and predictable process that is designed to establish a resolution process swiftly and decisively, assess a firm’s value accurately, and minimize any future loss of value or dissipation of the assets. Moreover, despite its equitable nature, bankruptcy is a well-established process for resolving financial distress, thereby protecting it from the problems of discretion and arbitrariness that frustrate the rule of law.

As a result, regulators and politicians may be more willing to trust the bankruptcy system to resolve financial distress than they are to trust novel, untested processes. Both during and after the debates over Dodd–Frank, commentators have proposed adding a new Chapter 14 to the Bankruptcy Code that would be designed specifically for the resolution of financial firms.⁷⁰ That proposal, which has been largely ignored for political reasons, should be revisited.

Prudential Regulation. As chairman of the House Financial Services Committee during the latter part of the Obama Administration, Congressman Jeb Hensarling (R–TX) proposed an important set of reforms known as the Financial CHOICE Act that was designed to strengthen rule-of-law

values throughout the financial regulatory system by ending “too big to fail” and bank bailouts; ending government guarantees (including for government-sponsored enterprises); and simplifying the financial regulatory system to comport with the rule of law.⁷¹

One particularly noteworthy proposal would have created a voluntary regulatory “off ramp” from the comprehensive and expensive system of supervision by permitting strongly capitalized institutions to “elect” an elevated level of capital reserves (at least 10 percent) in exchange for relief from certain federal regulations that are more appropriate to more thinly capitalized institutions.⁷²

Several possible measures could be taken to restrict the abusive use of supervisory processes to impose substantive policy ends that should properly be pursued through notice-and-comment rulemaking.

- First, following the precedent set by Senator Toomey regarding the CFPB’s “Indirect Auto Lending” bulletin, Congress could be more assertive in using its Congressional Review Act authority to challenge initiatives that fit the definition of a “rule” as articulated by the GAO in that case. For example, the CFPB’s recent amendments to its supervisory manual to declare any perceived discrimination in the provision of any financial services an unfair, deceptive, or abusive act or practice seemingly fit that definition. As the GAO made clear, the *substance* of the initiative, not its form, and whether it is a generally applicable statement are the most relevant considerations.
- Second, courts should recognize that in practice, despite their ostensibly “nonbinding” nature, these various policy statements, bulletins, guidance documents, and general supervisory manuals effectively have the force of law for regulated parties. As a result, affected parties should have the opportunity to bring an action in court to challenge nonbinding policy statements that are in effect rules, following logic analogous articulated by the GAO regarding the auto dealer bulletin and the applicability of the Congressional Review Act.
- Third, Congress and/or the regulatory agencies should create a process for the swift and unbiased appeal of contested supervision decisions by independent third-party adjudicators. The current processes for appealing supervisory decisions at most federal financial regulatory agencies lack both basic protections for neutrality and fundamental fairness.⁷³

- Fourth, with respect to the growing risk of debanking in financial services for individuals and the use of the financial system to pursue non-financial ends (such as regulation of climate change), Congress should consider passing a version of the Fair Access to Financial Services Rule that the Office of the Comptroller of the Currency promulgated during the waning days of the Trump Administration.⁷⁴ The purpose of that rule was to address the problem of banks that employ “subjective or category-based evaluation to deny certain persons access to financial services.”⁷⁵ As the OCC noted in the introduction to the final rule:

These banks are often responding to pressure from advocates from across the political spectrum whose policy objectives are served when banks deny certain customers access to financial services. When a bank predicates a person’s access to financial services on factors other than quantitative, impartial risk-based standards, it has failed to act consistent with basic principles of sound risk management and...failed to provide fair access to financial services.⁷⁶

As a result, the rule required certain large banks to rely only on relevant financial and economic risk factors unique to the individual customer, such as the customer’s ability to pay. Publication of the rule was stopped upon President Biden’s inauguration, and the rule has subsequently been rescinded. The rule has been reintroduced as the basis for proposed congressional legislation, however, and legislative enactment would give the rule a degree of stability and legitimacy that would be stronger than if it were issued pursuant to the rulemaking process.⁷⁷

Congress should also place greater limits on the willingness of courts to defer to agency decision-making under *Chevron*.⁷⁸ For example, Dodd-Frank instructs courts to defer to the CFPB’s interpretation of statutes under its authority.⁷⁹ The CHOICE Act would eliminate this requirement and provide that in construing any financial statutory provision, a court should conduct a *do novo* and provide no deference to an agency’s interpretation. Adopting this admonition as a general instruction to courts would be useful in putting greater checks on agencies’ authority to construe statutes to expand their powers. On the other hand, reducing the scope of *Chevron* deference for agency rulemaking could be expected to prompt agencies to substitute greater use of less transparent and less accountable means of

control, such as supervision and guidance, thereby making it necessary to place further restraints on those government tools.

Finally, Congress should move immediately to prohibit the government from issuing a central bank digital currency.⁸⁰ The Federal Reserve's authority to issue a CBDC is hotly contested as a legal matter. As this essay has made clear, however, the fact that government lacks specific legal authority to intervene in the financial system has provided little obstacle to doing so, and there is even less reason to believe that courts would block such a power grab.

The most reliable way to prevent the government from seizing on an opportunity to issue a CBDC would be to prohibit it explicitly from doing so. In fact, in November 2022, the New York Federal Reserve Bank, in cooperation with nine major U.S. financial institutions (including Citibank, Wells Fargo, and Mastercard) and the Swift network, initiated a 12-week "proof of concept" trial of a digital dollar to facilitate interbank and international settlements of financial accounts.⁸¹ In short, U.S. financial regulators are already preparing for the introduction of digital currencies notwithstanding the absence of any formal legal authorization.

Expansion of the government's role in the financial system and the relentless attenuation of the rule of law as a restraint have come about through responses to crisis. It is not hard to imagine another crisis like the Covid pandemic with the government responding by issuing direct payments to millions of Americans who are not working. It is also not hard to imagine that this promise of faster access to "free money" through the establishment of a CBDC might induce many Americans to overcome their reluctance to adopt digital currency. Once established, it would be difficult to roll back the establishment of a CBDC, just as the issuance of "greenbacks" during the Civil War eventually led the Supreme Court to ratify the government's endorsement of paper money as having legal tender status notwithstanding constitutional prohibitions to the contrary.⁸²

Conclusion

The unraveling of the rule of law in finance is inherent in the system's discretionary process of regulation. The entrenchment of bailouts and the ever-growing use of informal regulatory tools such as supervision and guidance documents have increased the opportunities for regulators and interest groups to pursue controversial social policies without seeking democratic legitimacy. This web of complex, expensive, and unpredictable regulations also benefits large banks and large businesses at the expense of

smaller ones, stifling economic growth and dynamism. Yet each financial crisis begets new regulations and new regulatory agencies with more expansive and discretionary powers, all of which is why Congressman Hensarling warned during the debates on passage of Dodd–Frank that “[m]y guess is there are three unintended consequences on every page of this bill.”⁸³

The general entanglement of finance, leftist interest groups, and the federal regulatory apparatus has created a threat to freedom that is almost unique in history. Because of the inherently dense and technical nature of financial regulation, courts traditionally have been reluctant to intervene in financial regulatory decisions. Informal processes such as the power of supervision and vague standards such as “reputational risk” have been an inherent part of financial regulation almost since its inception. The danger that these vague powers could be misused has been latent as well.

Leftist activists, “woke” corporations, and regulators and politicians have recognized and acted on the opportunity to use the financial regulatory system both to enact preferred policies through anti-democratic means and to silence their ideological opponents. As governmental power grows, the threat of its misuse grows concomitantly. The rule of law is not a system of perfection, but as Michael Oakeshott has observed, “The rule of law bakes no bread, it is unable to distribute loaves or fishes (it has none)...but it remains the most civilized and least burdensome conception of a state yet to be devised.”⁸⁴

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Endnotes

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2. Ayn Rand, "The Sanction of the Victims," in *The Voice of Reason: Essays in Objectivist Thought*, ed. Leonard Peikoff (New York: New American Library, 1989), p. 154.
3. See Todd J. Zywicki, "The Rule of Law, Freedom, and Prosperity," *Supreme Court Economic Review*, Vol. 10 (2003), pp. 1–26, <https://www.journals.uchicago.edu/doi/epdf/10.1086/scer.10.1147136> (accessed May 10, 2023).
4. *Ibid.*, p. 9.
5. See Michael Oakeshott, "The Rule of Law," in *On History and Other Essays* (Totowa, NJ: Barnes and Noble, 1983), pp. 119–164.
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In addition, the CFPB has been given extremely broad and ill-defined substantive powers, including authority to prosecute all “unfair, deceptive, and abusive acts and practices.” The agency is also provided an array of regulatory tools to carry out its mission, including enforcement, rule-making, and supervision powers.

Given this vast scope of substantive powers, multitude of regulatory tools, and limited democratic accountability, then-Judge Brett Kavanaugh of the United States Circuit Court for the District of Columbia once observed, “[O]ther than the President, the Director of the CFPB is the single most powerful official in the entire United States Government, at least when measured in terms of unilateral power.” *PHH Corporation v. Consumer Financial Protection Bureau* (D.C. Cir. 2016).
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47. See Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, statement on “Recent Bank Failures and the Federal Regulatory Response” before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 28, 2023, <https://www.banking.senate.gov/imo/media/doc/Gruenberg%20Testimony%203-28-23.pdf> (accessed May 11, 2023) (“In general, the largest banks appear to be net beneficiaries of deposit flows, increasing the amounts on deposit, or held in custody, at the global systemically important banks and at large regional banks.”).
48. See Zywicki, “The Rule of Law, Freedom, and Prosperity.”
49. Hayek, *The Road to Serfdom*, Chapter 6, “Planning and the Rule of Law.”
50. Wayne Crews has referred to these various meanings, such as guidance, supervision, bulletins, circulars, blog posts, and others by which government actors steer the private sector through informal actions that are not technically binding as a legal matter but binding in practical effect as “regulatory dark matter.” See Clyde Wayne Crews Jr., *Mapping Washington’s Lawlessness: An Inventory of “Regulatory Dark Matter,” 2017 Edition*, Competitive Enterprise Institute *Issue Analysis 2017* No. 4, March 2017, <https://cei.org/sites/default/files/Wayne%20Crews%20-%20Mapping%20Washington%27s%20Lawlessness%202017.pdf> (accessed May 11, 2023). See also Jan M. Rybnicek and Joshua D. Wright, “Defining Section 5 of the FTC Act: The Failure of the Common Law Method and the Case for Formal Agency Guidelines,” *George Mason Law Review*, Vol. 21, No. 5 (2014), pp. 1287–1315, <https://geomasonirev.files.wordpress.com/2014/11/rybnicek-wright.pdf> (accessed May 11, 2023) (describing differences between articulating agency policies through litigation consent agreements compared to the common law method).
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