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Written Testimony of

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Before the House Financial Services Committee
Subcommittee on Oversight and Investigations

"Who's in Your Wallet? Dodd-Frank's Impact on Families, Communities and Small Businesses"

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Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, my name is David Min and I am an Assistant Professor at the University of California Irvine School of Law, where I teach and research in the area of banking law and financial regulation. I previously spent over a decade working in the law and policy of financial regulations, both in private practice and in the federal government, including as a Senior Policy Advisor for the Joint Economic Committee of Congress. I thank you for the opportunity to return here today to testify on the topic of the costs of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as I believe this is an issue that has been fraught with confusion.

Before I get into the issue of the impacts of Dodd-Frank, I would like to note that the entire concept of attempting to quantify the costs and benefits of financial regulations suffers from a number of critical flaws. As the Office of Management and Budget has noted, cost-benefit analysis is "highly speculative" and requires the use of many tenuous and uncertain assumptions.[1] Cost-benefit analysis is also quite costly and time-consuming for resource-constrained regulators. And it tends to be biased against all financial regulations, since the costs of such regulations are easily quantified, whereas the benefits are more difficult to quantitatively assess. What are the quantitative benefits of transparency, financial stability, and promoting investor confidence, which have been the main goals behind financial regulation in the United States since the 1930s? Whatever these benefits

[1] OFFICE OF MGMT & BUDGET, 2011 REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND UNFUNDED MANDATED ON STATE, LOCAL, AND TRIBAL ENTITIES, at 4 (2011).

are, they are not typically captured by cost-benefit analysis, as they are too diffuse, uncertain, and incalculable.[2]

Because the use of cost-benefit analysis tends to stack the deck against financial regulation, you and your colleagues in Congress expressly chose not to include a cost-benefit analysis requirement in Dodd-Frank when you passed this bill in 2010.

But let's ignore the problems with cost-benefit analysis, and try to answer the question posed by this hearing. What are the impacts of Dodd-Frank for communities, families, and small businesses? I would like to make three main points in my testimony.

First, the negative impacts of Dodd-Frank to date have been greatly exaggerated. The fact is that Dodd-Frank has not had much of an impact to date, because most of it has not yet been implemented, due to a successful campaign by Wall Street lobbyists, who spent a record $302 million in 2010 alone to delay and undermine the implementation of this law.[3] As of July 2, 2012, <u>less than 30%</u> of the rules mandated by Dodd-Frank had been issued in their final form.[4] Most of these have only been issued in the last few months.[5] It is difficult to understand the claim that Dodd-Frank has resulted in large burdens for consumers and small businesses, given that it has mostly not yet taken effect.

Second, most of the burdens attributed to Dodd-Frank by its critics are misplaced or highly speculative in nature. Because of the severe delays in implementing Dodd-Frank, it is

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[2] An upcoming brief by the policy think tank Better Markets provides a robust discussion of cost-benefit analysis and its flaws as a tool for evaluating financial regulations.

[3] *See* Bobby Caina Calvan, *Two Years Later, Dodd-Frank Law is Largely Stalled*, THE BOSTON GLOBE, July 16, 2012, *available at* http://articles.boston.com/2012-07-16/nation/32686074_1_dodd-frank-law-volcker-rule-rule-making-process.

[4] Davis Polk LLP, *Dodd-Frank Progress Report*, July 2012, available at http://www.davispolk.com/files/Publication/8bc2b1c4-c800-45b1-8324-0381454f6ceb/Presentation/PublicationAttachment/b9462d4e-0be9-4eee-9829-0455bca61e9a/July2012_Dodd.Frank.Progress.Report.pdf.

[5] *Ibid*.

impossible to know what the actual impacts of Dodd-Frank will be. Thus, most of the claims about the costs of Dodd-Frank are based on unfounded speculation, and many of these claims are flat-out wrong. For example, as I discuss below in greater detail, many critics of Dodd-Frank have agued that the law's regulation of swaps would result in greatly increased costs for end users who utilize swaps for legitimate hedging purposes. In fact, this argument is baseless, as the Commodity Futures Trading Commission specifically exempted such end users when it released its final rule in this area last week.

Moreover, there has been a high degree of confusion between negative impacts caused by Dodd-Frank and those caused by the financial crisis. Most of the burdens on consumers and small businesses being blamed on Dodd-Frank are actually the result of the financial instability that led to the enactment of this law. For example, many have blamed Dodd-Frank for tightening underwriting standards and reducing the availability of credit for consumers and small businesses. In fact, the lack of liquidity in the credit markets was clearly caused by the financial crisis and predates Dodd-Frank,[6] which has still not finalized its rulemaking on issues that might actually impact underwriting and the cost of consumer credit, such as the "Qualified Mortgage" standard for mortgage lending.

Finally, to state the obvious, in considering the impacts of Dodd-Frank on families, communities, and small businesses, we should consider the many positive impacts that this law may have. The increased financial stability, improved investor confidence, and enhanced consumer protection created by Dodd-Frank should lead to a myriad of benefits, both small and large. As has been well documented, the benefits of financial stability for families, communities and small businesses are enormous. The recent financial crisis

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[6] *See, e.g.*, Meta Brown and others, *The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit*, Federal Reserve Bank of New York Staff Report no. 480, Dec. 2010.

resulted in lost household wealth of approximately $10 trillion.[7] While many critics have focused on the length of Dodd-Frank—2300 pages—if this law prevents a similar financial crisis from occurring, it would save American households approximately $4.3 billion per page.

Dodd-Frank has had minimal impact so far, because it has not yet taken effect

It is important to note that, to date, the actual impacts of Dodd-Frank, either positive or negative, have been de minimis, because this law has mostly not yet taken effect. According to the law firm Davis Polk LLP, which has been tracking Dodd-Frank's implementation, as of July 2, 2012, less than 30% of the rules required by Dodd-Frank had been issued in their final form, with most of these final rules have only been issued in the last few months. More than 35% of the rules required by Dodd-Frank had not yet been proposed in any form.[8]

The extremely slow implementation of Dodd-Frank, which on Saturday will have been signed into law exactly two years ago, is due in large part to a coordinated strategy by Wall Street, which has sent an army of lobbyists to slow down the pace at which these new rules have been implemented.[9]

As a result of its delayed implementation, Dodd-Frank has so far had minimal impact on families, communities, and small businesses.

Most of the negative impacts attributed to Dodd-Frank are unfounded

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[7] Anthony J. Crescenzi, "Cyclical Tailwinds, Secular Headwinds and the Market of Bonds," PIMCO (originally published on CNBC.com), Apr. 7, 2010, available at http://www.pimco.com/EN/Insights/Pages/Viewpoints%20Crescenzi%20April%202010.aspx.

[8] Davis Polk LLP, *Dodd-Frank Progress Report*.

[9] Calvan, *Two Years Later*.

One of the problems with the debate over the impacts of Dodd-Frank is that, to date, there has been too much uninformed hyperbole and too little actual data. We do not actually know the impact of Dodd-Frank on families, communities, and small businesses because virtually all of the changes envisioned by Dodd-Frank have not yet or only recently been implemented. As a result, we simply do not have a reasonable basis to know what the impacts of Dodd-Frank will be. Almost all of the claims being made about the negative impacts of Dodd-Frank have been based on unfounded, and frequently wildly incorrect, speculation.

For example, many critics of Dodd-Frank have claimed that its proposed regulation of derivatives would dramatically increase the costs for end users who currently utilize these derivatives for hedging.[10] This argument has been based on pure speculation, as the Commodity Futures Trading Commission, the regulatory agency responsible for promulgating the derivatives regulations envisioned by Dodd-Frank, did not release its first salvo of final rules on this issue until last week. Moreover, this argument has proven baseless, as the CFTC's actual final rules defining the scope of its derivatives regulations crafted a broad exemption for end users seeking to use derivatives for hedging purposes, as well as for small banks with less than $10 billion in assets.[11]

Similarly, while there has been much grumbling about the compliance costs for small depository institutions, such as community banks and credit unions, it is not clear that Dodd-Frank will actually lead to increased compliance costs for these lenders. The primary evidence that Dodd-Frank will lead to greater compliance costs is its 2300 page

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[10] *See, e.g.*, *Think the Dodd-Frank Act's Impact is Felt Only on Wall Street?*, House Financial Services Committee website, *available at* http://financialservices.house.gov.

[11] Commodity Futures Trading Commission, *End User Exception to the Clearing Requirement for* Swaps, Final Rule, 17 C.F.R. Part 39.

length. But Dodd-Frank is primarily targeted at non-bank activities, such as securitization, derivatives trading, and proprietary trading, or the activities of very large bank holding companies with at least $50 billion in assets. Of the 16 titles in the Dodd-Frank Act, only two might potentially lead to in higher compliance costs to small banks—Title X, which creates the Consumer Financial Protection Bureau; and Title XIV, which aims to establish standards for mortgage origination and servicing. Neither Title has yet led to final rules that would substantially affect the vast majority of small banks. Furthermore, it is likely that the final rules implementing these Titles will frequently contain exemptions for small banks.

It is also important to recognize that neither Title X nor Title XIV creates obligations that are inconsistent with the past regulatory obligations owed by banks, which have long been subject to a high degree of regulation in return for the federal deposit insurance they enjoy. Many of the major changes being contemplated by the CFPB are derived from its authority under Regulation Z of the Truth in Lending Act; small banks were already required to adhere to Regulation Z, which imposed limitations on the lending practices and loans that could be originated by banks.[12] Indeed, the limitations on high cost loan features proposed by Dodd-Frank under Titles X and XIV are actually perfectly consistent with the regulations that governed banks during the Quiet Period. For example, the prohibition on balloon payments in mortgages, which has been protested by many as an unprecedented

[12] Federal Reserve, Regulation Z, *available at* https://www.federalregister.gov/articles/2010/09/24/2010-20665/regulation-z-truth-in-lending.

assault on the banking system, was actually a major feature of the regulation of thrifts from the 1940s to the 1980s.[13]

Indeed, it is possible that Dodd-Frank may actually reduce compliance costs for small banks and other small depository institutions, since it consolidates various authorities, which had previously been scattered among the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Trade Commission, among others, into one central body, the CFPB.

There has also been a considerable amount of conflation between the impacts of the financial crisis and the impacts of Dodd-Frank. Most of the negative impacts being attributed to Dodd-Frank are actually the result of the financial crisis, which Dodd-Frank was intended to address. For example, some have argued that consumer credit and mortgage credit have been constrained because of Dodd-Frank.[14] In fact, the lack of liquidity in these credit markets predates the passage of Dodd-Frank,[15] let alone the implementation of Dodd-Frank's rules impacting consumer and mortgage credit, which has yet to occur. Tighter credit availability runs across all credit categories, including consumer credit, commercial real estate, small business, and home mortgage loans, and is primarily

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[13] *See* Richard Green and Susan Wachter, "The Housing Finance Revolution," Paper Presented at *Housing, Housing Finance and Monetary Policy*, Federal Reserve Bank of Kansas City 31st Economic Policy Symposium (Aug. 30 – Sept. 1, 2007), at 19-20; Robert Van Order and Lynn Fisher, *Economics of the Mortgage and Mortgage Institutions: Differences between Civil Law and Common Law Approaches*, ROSS SCHOOL OF BUS. WORKING PAPER SERIES, No. 1081 10-11 (2006); and John M. Quigley, Federal Credit and Insurance Programs, FED. RES. BANK OF ST. LOUIS REV. 88 (4), 281, 282-88 (2006).

[14] *See Think the Dodd-Frank Act's Impact is Felt Only on Wall Street?*

[15] *See, e.g.*, Meta Brown and others, *The Financial Crisis at the Kitchen Table: Trends in Household Debt and Credit*, Federal Reserve Bank of New York Staff Report no. 480, Dec. 2010.

due to credit losses, both realized and anticipated, that have occurred as a result of the financial crisis.[16]

Claims about Dodd-Frank's impacts on economic growth are similarly contradicted by the facts. The Bureau of Labor Statistics continuously surveys employers to understand why they are laying off workers. In 2010, only 0.2 percent of lost jobs were attributed to government regulation. This compares to 30 percent who were let go because of a drop in consumer demand.[17] This data is consistent with the findings of economists, who have universally found that a drop in aggregate demand, attributable to the effects of the recent financial crisis, is primarily responsible for the anemic economic growth we are currently experiencing.[18]

We should not ignore the many positive impacts of Dodd-Frank

In the rush to point out the negative burdens that Dodd-Frank may create, we have forgotten the plethora of positive impacts that this law is certain to create, which I think can generally be put into three categories. First, Dodd-Frank increases financial stability. Second, it improves investor confidence and promotes market transparency. Third, it provides significant benefits for consumers, which in turn help to promote financial stability. I briefly discuss each of these below.

The positive impacts of increased financial stability

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[16] *See* Office of the Comptroller of the Currency, *Survey of Credit Underwriting Practices*, June 2011, *available at* http://www.occ.treas.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/pub-survey-cred-under-2011.pdf.

[17] BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, REP. 1038, EXTENDED MASS LAYOFFS IN 2010, at Table 6 (Nov. 2011).

[18] *See, e.g.*, Jia Lynn Yang, *Does Government Regulation Really Kill Jobs? Economists Say Overall Effect is Minimal*, WASH. POST, Nov. 13, 2011; Lawrence Mishel, *Regulatory Uncertainty Not to Blame for Our Jobs Problem*, THE ECON. POL'Y INST. BLOG, Sept. 27, 2011, *available at* http://www.epi.org/blog/regulatory-uncertainty-jobs-problem.

The overriding goal of Dodd-Frank was to increase financial stability and prevent another financial crisis of the sort we just experienced. Financial instability is extraordinarily costly, as our recent experience suggests. The recent costs of the financial crisis we just experienced include:

- Over $10 trillion in lost household wealth,[19] approximately 23 percent of the average household's total stored wealth.[20]
- 9.5 million lost jobs.[21]
- An average decline in income of $5,800 per household.[22]
- 10.9 million homes in foreclosure proceedings.[23]
- 33% peak-to-trough decline in home prices.[24]
- The opportunity costs of providing trillions of dollars in TARP and Federal Reserve support to restore and maintain liquidity in the financial markets.

It is important to note that these types of losses were regularly incurred by U.S. households, as major financial crises occurred every five to ten years until your predecessors in Congress decided to stringently regulate banking and other risky financial activities in the 1930s. At the time, much like today, Wall Street and its allies criticized these financial regulations as "unwarranted" attacks that would devastate the country, impede economic growth and inhibit capital markets activities.[25] In fact, what we saw was

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[19] Anthony J. Crescenzi, "Cyclical Tailwinds, Secular Headwinds and the Market of Bonds," PIMCO (originally published on CNBC.com), Apr. 7, 2010, available at http://www.pimco.com/EN/Insights/Pages/Viewpoints%20Crescenzi%20April%202010.aspx.

[20] Jesse Bricker and others, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009," Washington: Federal Reserve Board Finance and Economics Discussion Series, 2011.

[21] Philip J. Swagel, "The Cost of the Financial Crisis: The Impact of the September 2008 Economic Collapse," Briefing Paper No. 18, Pew Financial Reform Group, 2010, p. 11, available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Cost-of-the-Crisis-final.pdf?n=6727.

[22] Ibid, at 9.

[23] "The Impact of Dodd-Frank's Home Mortgage Reforms: Consumer Market Perspectives," *Hearing Before the H.R. Comm. on Fin. Services Subcomm. on Fin. Inst. and Consumer Credit*, 112th Congress (2011) (statement of Eric Stein, Center for Responsible Lending), available at http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/Stein-Testimony-for-House-Financial-Institutions-Subcommittee-Hearing.pdf.

[24] *See* S&P/Case-Shiller 10-City Composite Home Price Index.

[25] *See* Marcus Baram, *The Bankers Who Cried Wolf: Wall Street's History of Hyperbole About Regulation*, THE WATCHDOG, HUFFINGTON POST, June 21, 2011, *available at* http://www.huffingtonpost.com/2011/06/21/wall-street-history-hyperbole-regulation_n_881775.html.

the exact opposite, as we experienced an unprecedented period of financial stability and market transparency that led to the greatest period of prosperity and efficient capital formation in the history of the world.[26] The benefits of increased financial stability, in other words, are enormous.

Dodd-Frank aims to increase financial stability in a number of important ways, including: expanding prudential regulation to non-bank activities and entities that pose systemic risk, such as derivatives trading or hedge funds; heightening regulation for systemically important, or "too big to fail," financial institutions; and removing other sources of systemic risk. Most of these are relatively uncontroversial propositions outside of Wall Street. For example, imposing heightened capital requirements on large, systemically important financial institutions will certainly lead to greater costs for these firms, but it is also basically undisputed that the value added by reducing the leverage of these firms and thus reducing the risk of another financial meltdown is much greater than these costs.

The positive impacts of improved investor confidence and greater transparency

Dodd-Frank also seeks to restore investor confidence and introduce greater transparency in the U.S. financial markets. The 2008 financial crisis exposed a number of critical flaws in the U.S. financial system, including how asset-backed securities (and derivatives based on these securities) were created, rated, and sold. As a result, since the crisis, investors have stayed away from so-called private-label securities—those not backed by the federal government. Since the fall of 2008, there have been only two new

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[26] *Ibid*. *See also* Nicholas Economides et al., *The Political Economy of Branching Restrictions and Deposit Insurance: A Model of Monopolistic Competition Among Small and Large Banks*, 39 J.L. & ECON. 697, 698 (1996) (quoting Francis H. Sisson, the president of the American Bankers Association at the time of the passage of Glass Steagall, who predicted that bank deposit insurance and heavy regulation would ruin the banking system).

issuances of mortgage-backed securities, both from the same firm, accounting for less than $600 million. By way of comparison, there were approximately $1.2 trillion in private-label MBS issued in 2005, at the height of the market.

Dodd-Frank proposes a number of important changes meant to fix the problems illustrated by the crisis, and thus bring back investors into the marketplace. Among these are increased regulation of credit rating agencies and a risk retention requirement meant to align the interests of MBS sponsors and investors. These will undoubtedly result in some increased regulatory burdens for affected parties, but they should also create large positive effects as well, particularly if they restore investor confidence in U.S. capital markets.

Dodd-Frank's attempt to increase transparency in the derivatives market, by requiring that certain classes of heavily traded swaps be centrally cleared and exchange traded, should also lead to outsized benefits. These financial instruments currently trade in opaque over-the-counter markets controlled by the largest Wall Street firms. Adding a degree of transparency to these products should not only improve financial stability, but it should also lead to lower costs, as open, transparent, and competitive markets have almost always resulted in better pricing than opaque, closed, and uncompetitive markets.

To the extent that they promote increased investor confidence and greater transparency, the changes contemplated by Dodd-Frank in this area will likely engender large positive impacts for all of us.

The positive impacts of greater consumer protection

Perhaps the most controversial changes contemplated by Dodd-Frank are those intended to protect consumers, as it has been claimed that these will lead to greatly increased compliance costs that will end up hitting small banks, small businesses, and

households. It is curious that in this regard, we only hear about the regulatory burdens involved (which I would again emphasize have to date been mostly unfounded speculation and largely overstated). Lest we have forgotten, the financial crisis was driven in large part by credit losses associated with bad loans that were frequently provided to consumers with misleading or hard-to-understand terms. The losses resulting from defaults on predatory, high cost loans are exponentially higher than even the most exaggerated estimates of increased compliance costs.

By improving the disclosures that consumers receive, and limiting the ability of lenders to engage in predatory lending practices or offer high cost products, Dodd-Frank should help to prevent another subprime lending boom of the sort we just saw, and the resulting collateral damage it caused. Moreover, these changes should also help level the playing field for small banks in particular, which were forced into a race to the bottom with unscrupulous non-bank lenders during the housing bubble of the 2000s. The benefits of enhanced consumer protection must be weighed against any regulatory burdens that are considered.

Conclusion

The actual impacts of Dodd-Frank have unfortunately been minimal so far, because the implementation of Dodd-Frank has been held up by an unprecedented and successful Wall Street lobbying campaign. The impacts of Dodd-Frank, once it has been fully implemented, are likely to be significant and positive, insofar as it will reduce the likelihood of another major financial crisis, improve the transparency of our financial markets, restore the shaken confidence of investors, and empower consumers so as to avoid a reprise of the subprime lending boom, that proved so devastating.

I urge the members of this Subcommittee to make all efforts to help facilitate the full and prompt implementation of Dodd-Frank. Once Dodd-Frank is fully implemented, we will have a better idea of where and how it might be improved, to accentuate its positive impacts and pare down its regulatory burdens where appropriate. I thank you for giving me the opportunity to testify, and I look forward to your questions.