THE COSTS OF IMPLEMENTING THE DODD-FRANK ACT: BUDGETARY AND ECONOMIC

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE COSTS OF IMPLEMENTING THE DODD-FRANK ACT: BUDGETARY AND ECONOMIC

Wednesday, March 30, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:11 p.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Fitzpatrick, Posey, Hayworth, Renacci, Canseco; Capuano, Baca, Himes, and Carney.

Ex officio present: Representative Bachus.

Also present: Representative Green of Texas.

Chairman NEUGEBAUER. The subcommittee will come to order. Thank you for coming today.

I wanted to announce, before we get too far in the hearing, that we are going to have a little bit of a change in schedule here. We are going to commence with the hearing. We are going to do opening statements from members.

Then, as you know—some of you may know—there is a classified briefing for our Members of Congress that starts at 2:30. We expect that to go for about an hour, and so we are going to—in agreement with the ranking member—recess from 2:30 to 3:30 and then we will come back and resume the hearing at that time.

There is a potential that we will have a vote somewhere in this process. That is yet to be determined.

But it is the intention for us to continue with this hearing today. It is unfortunate that we had to have this little interruption here but I think it is important for Members of Congress to go and hear from the Secretary what is going on.

So with that, we will begin. And I will begin with my opening statement.

To kind of give you a visual of how large a piece of legislation that this Dodd-Frank legislation is, if we were to stack the Securities and Exchange Act of 1933, the Securities and Exchange Act of 1934, Gramm-Leach-Bliley, Sarbanes-Oxley, and all the amendments that were tacked onto those Acts, we would have to add 600 pages to that stack to equal the amount of legislation that is in the Dodd-Frank bill.

And so this is no small piece of legislation; it has far-reaching impacts on our markets and on the cost of doing business and on the cost of capital. And so a lot of what this hearing is about today is about analyzing those, and particularly analyzing the cost-benefit of this piece of legislation.

One of the things that I think we should have done before we passed Dodd-Frank was to really go through the crash or the downturn of our financial markets and ascertain where the fallacies and where the holes in the existing system were before we threw this large blanket over those markets. But we didn't do that.

But more importantly, what we also should have done was to, as we were beginning to put this piece of legislation together, begin to look at the cost-benefit analysis of what we were trying to accomplish, making sure we had—clearly defining what the goals were, what the cost of that was, both in implementation but also the cost in the economy, and I think we are going to hear from a number of witnesses today who have taken an opportunity to look at that.

We are not talking about any small numbers here. We are talking about the potential of taking $27 billion out of the economy. And what we know is when we take money out of the economy, we take away the capital needed to create jobs in this country.

So as we look at the implications and some of the consequences of this legislation, not only is it costing money but it also has the potential to cost jobs. And particularly at the time in our country right now where jobs are an important commodity to the American people, I think this deserves our closest attention.

This is a great panel that we have today and I look forward to their testimony, and I think that we are going to have a very productive hearing because I think this is a process that Congress in the future must give more attention to; that it is easy sometimes to pass legislation. But sometimes I am not sure we give these votes the attention that we need to, and we aren't making decisions with all of the information. Particularly, I think, as these agencies are promulgating these rules, it is important that some kind of standardization tool would be available to them so that we will know truly what the cost and the benefit analysis of these transactions are.

With that, I will yield to my good friend, Mr. Capuano, the ranking member of the subcommittee.

Mr. CAPUANO. Thanks, Mr. Chairman.

First of all, I want to thank the witnesses for being with us and bearing with us today. You are all familiar with congressional timetables, and I apologize, but I also know that you understand.

I welcome this hearing as well, and I think that this committee has done too little oversight over the last—well, since I have been here, to be perfectly honest. I think oversight is an appropriate and a good role.

As far as this particular piece of legislation, I never measure anything by its length or by its shortness; that is really secondary to me. It is whether it works or whether it doesn't work.

And I think everyone who is in this room knows how legislation is passed. You start off with an idea and you keep adding things because you have to satisfy somebody somewhere along the line to get their vote, and you end up with a piece of legislation that no individual would pass in and of itself as a whole.

There are things in the bill that I don't like. There are things in the bill that I think could have been stronger, could have been clearer. But overall, the legislation was a very good piece of legislation that will move this country forward and maintain a stable economy moving forward.

That doesn't mean it will be done without bumps. There will certainly be bumps.

There is a lot of need for oversight and continuing refinement as we go forward and working with the regulators, and I think that is why these hearings are very important. I look forward to the testimonies; I have read the testimonies and the other material related to this hearing.

I think I agree with most of the things that are said in these testimonies, and I think that there is going to be a lot of ground for common understanding. And I look forward to that as well.

So with that, Mr. Chairman, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the chairman of the full committee, Mr. Bachus, for 2 minutes.

Chairman BACHUS. Thank you, Mr. Chairman. Let me say that much of what I am going to say is not criticism of anything you have done; it is criticism of Dodd-Frank and some problems I have with that. And I will associate myself with the remarks that you have made in your written testimony.

When the House voted to approve Dodd-Frank, I asked the simple question on the Floor of the House, "What does it cost?" The bill's proponents did not have an answer to that question, because during committee consideration of the bills which would eventually be incorporated into the Dodd-Frank Act, Members never had a real opportunity to debate its costs or to weight those costs against the legislation's purported benefits.

As Commissioner Sommers says, the derivative rules are tremendously complex and almost immediately after passage we heard that some of those requirements could take $1 trillion or more out of our economy and cost really hundreds of thousands of jobs, according to the Chamber. And those are costs of regulation.

But then there is the cost to the taxpayers of actually the regulation itself, of enforcing the regulation. And I think yesterday we learned from the Government Accountability Office that it is going to cost about $3 billion to implement the bill over the next 5 years, and I think that is probably a low number. It normally is a low number.

The Federal Government workforce will increase by 2,600 new full-time employees, and I think about 1,200 of those will be at the Consumer Financial Protection Bureau. One question I have about that is, we are going to have—prudential regulators are going to come in and if they are doing what they are doing today, they are going to ask, "Why didn't you require a higher downpayment?" or "Why didn't you charge more of an interest rate?" or "Why did you make this loan?"

And then they may be followed the next day by someone from a consumer financial protection agency who is going to ask, "Why did you set such a high interest rate? Why didn't you make this loan?" or "Why aren't you making these loans?" or "Why didn't you give a better interest rate?" And you are going to be getting two different government agencies with sometimes diametrically opposed advice to our community banks, which really were the collateral victims, in most cases, in what happened in 2004.

The Federal budget and businesses of all sizes will have to contend with the cost of implementing and with complying Dodd-Frank for years to come. One matter of great concern to me is that Congress will not be able to rein in some of the more substantial costs imposed by the Act.

And Governor Lacker, one of those costs is to the Federal Reserve, right out of the budget. You have as much as $500 million that can be given to the Consumer Financial Protection Bureau and then you have the Office of Financial Research, and I am not sure that I have found a figure there. It just says that they—there is no limit on its budgetary authority and it just asked the Federal Reserve to provide as much funding as needed for that office.

So I don't know how you function with the $700 million hole and your increased duties under Dodd-Frank. That is going to be interesting.

Commissioner Sommers, you mentioned the cost-benefit analysis. I think we are going to have to closely scrutinize the Dodd-Frank rulemaking process and the adequacy and accuracy of the cost-benefit analysis that will be submitted under these rules, or in some cases won't be submitted. We won't have them.

And former and current SEC and CFTC Commissioners, academics, and business leaders have all gone on record to point out a lot of deficiencies in the agency's rulemaking processes and the inaccuracies of the agency's cost-benefit analyses. And some of this is just the speed. How could you possibly do a credible job in the little time you have?

Because we all agree this is a tremendous, major reform, and we are doing it in lightning speed. It took 2½ years to do Sarbanes-Oxley, which had 16 rules. We are going to try to do this in a fourth of the time, with 300 rules. It just staggers the imagination.

And I am afraid, just like on the highway, speed is going to kill. It is going to kill the economy; it is going to kill deployment of capital; and then it will—because capital is not there, the workforce won't be there.

Let me close by saying, Governor Lacker, you point out something a lot of us ask about—what happens when one of these significantly important firms gets in trouble and they are—what you said about the Fed, the Treasury can invoke orderly resolution for the firm, but use of funds to limit loss to some creditors by the FDIC and, what, are they going to loan them money? Are they going to—and is there going to be that expectation?

So I appreciated your comments on that, and I think we are all wondering if they get in trouble what is it going to cost the taxpayers? And it is going to cause them to get in trouble because they are under this safety net.

Thank you.

Chairman NEUGEBAUER. I thank the chairman.

Mr. Baca?

Mr. BACA. Thank you very much. I want to begin by first thanking you, Chairman Neugebauer, and Ranking Member Capuano for calling this hearing. The hearing is titled, "The Cost of Implementing the Dodd-Frank Act." We should call it, "The Cost of Not Implementing the Dodd-Frank Act."

Why? Because before the Frank-Dodd bank cost the American people 8 million jobs—I state 8 million jobs—and $17 trillion in retirement savings and net worth. Do we want that to happen again? The answer is no.

I want to, again, by sharing some of the unemployment situations from March 2011, which is scheduled to be released on April 1, 2011. Americans, here is some good news: All in all, Americans just need more opportunities to work. Americans want jobs.

Today's hearing is not moving us one step closer to increasing jobs. Yesterday's vote on the House Floor killed the HAMP. Not only does it do away with life-life, many Americans need to stay in their homes. The vote did not move us one step closer to increasing jobs.

The recent CBS News poll found that 63 percent of Americans are saying creating jobs should be the priority now compared to 26 percent who said cutting spending. Now, there is a difference between those who said cutting spending and those who want jobs.

Why? Because families are hungry. Families are homeless. Families need jobs.

The challenge we face now is how to build businesses and investor confidence. Does today's hearing topic build business and investor confidence? I say no.

I voted in support of Dodd-Frank to help restore common sense—and I state common sense—to Wall Street, to end taxpayers' bailout of big banks, create consumer financial protection bureaus that protect consumers first. Working families in California and across the country have lost their homes—and I state, have lost their homes.

You have to put yourself in their situation—those individuals who lost their home or lost their job. Put yourselves in that situation if you were the one who lost a job, and your retirement savings as a result of Wall Street's recklessness and greed that led to it.

My friends on the other side of the aisle and the Bush Administration looked the other way as big banks made bucks at the expense of the average American. The Dodd-Frank provides the American people with an oversight—and I state, it provides us with an oversight necessary to prevent another collapse of our financial market. It protects consumers from predatory practice and holds—I state holds accountable those institutions which actions led to the greatest economic downturn since the Great Depression.

Wall Street may be bouncing back but we all know from experience that they are not going to be policing themselves, and they haven't. CBO says that Frank-Dodd has the net effect of reducing the deficit by $100 billion over 5 years and has said a net effect of reducing the deficit—and I state, reducing the deficit by $3.2 billion over 10 years.

As I stated earlier—I may take as much time as the other gentleman did, if you don't mind—as I stated earlier before, the Dodd-Frank bank cost the American people 8 billion jobs and $17 trillion in retirement savings net worth. Families are forced into foreclosure with job loss.

In my district in California, the 43rd district, we have had double-digit unemployment for a long time and the foreclosure rate is around fourth in the Nation. My question to the panel today will be basic: Were you forced into foreclosure? Did you lose your jobs because of the meltdown?

Because if you have, then you can speak to the American people in your testimonies. Then, you can talk about the costs of implementing Dodd-Frank. Because I have heard of the crises of hundreds of Americans who know and have felt the heartbreaking costs of not having something like Dodd-Frank.

Again, I thank the chairman and the ranking member for their leadership, and I look forward to a productive discussion on this issue. And I yield back the balance of my time.

Chairman NEUGEBAUER. I now yield 2 minutes to the gentleman from Pennsylvania, Mr. Fitzpatrick.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I believe this entire committee is in agreement that the Dodd-Frank Wall Street Reform Act was the most ambitious overhaul of our financial institutions in 75 years. However, responding to Mr. Baca of California, I believe also that the problem with these massive comprehensive bills is that they are often fraught with unforeseen consequences and costs. And add to that the intended results of the bill, the massive new regulations of our financial system and the effects on our economy will be extensive.

Certainly, the financial industry deserves serious scrutiny after the meltdown of 2008 exposed serious flaws in our regulatory system. But by overreacting and overreaching, we are absolutely going to continue to slow the economy.

I am very concerned about the $27 billion clawed out of the economy, as outlined by the chairman in his remarks, and its impact upon job creation back home in Pennsylvania. So I thank the chairman for calling this important hearing.

Chairman NEUGEBAUER. I thank the gentleman.

And now to the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman, and thank you for allowing me to be a part of this hearing. I thank the ranking member as well.

Mr. Chairman, I am concerned about unintended consequences and I am also concerned about intended consequences. There were some intended consequences associated with Dodd-Frank that were important to the American people.

The American people wanted and intended that we pass legislation to deal with "too-big-to-fail" 3/27s, 2/28s. The American people were concerned about prepayment penalties that coincided with teaser rates. The American people were concerned about the whole notion that consumers were not being protected.

So the intended consequences of Dodd-Frank have to also be measured, and as we move forward, I look forward to hearing from the witnesses so that if there are things that we need to change, I think we should change them. I think that we can reach a consensus about some things that have to be changed.

But I don't think that we are at a point now where we can conclude without empirical evidence—and I haven't seen any to support this position—that Dodd-Frank is costing us too much to implement. I just have not seen empirical evidence to support this.

All major legislation costs something. The CBO seems to be indicating, based on my latest intelligence, that Dodd-Frank is not going to be cost-prohibitive. They may not use that type of terminology.

But I look forward to hearing from the witnesses, and I thank you again for the opportunity. I yield back.

Chairman NEUGEBAUER. And I thank the gentleman.

And the gentleman from Texas, Mr. Canseco?

Mr. CANSECO. Thank you, Mr. Chairman.

And thank you for coming here, witnesses. I look forward to hearing your testimony.

The passage of the Dodd-Frank bill was more about making history than it was about making our economy stronger and more competitive. The previous Congress must have believed their primary responsibility was to draft as large a bill as possible without any regard to the economy or the U.S. taxpayer.

A few days ago, the National Journal noted that as a result of Dodd-Frank, "The U.S. Government may have become the guarantor of last resort for even larger global banks over which it has even less control and oversight than before." The CBO has stated that Dodd-Frank will extract $27 billion from the economy over the next decade.

This is capital that cannot be used to lend in order to grow our economy and create jobs. Therein lies the legacy of Dodd-Frank: a piece of legislation that will have enormous costs both to the economy and to the taxpayer.

Today, I am eager to hear from our witnesses an estimate of just how much this legislation is expected to cost our economy, taxpayers, and future generations.

I thank you, Mr. Chairman, for having this hearing. I yield back.

Chairman NEUGEBAUER. Thank you.

I want to remind all members that all of your opening statements can be made a part of the record if you desire to do that. As we mentioned before, now we are going to recess until 3:30, and we will reconvene back here in this room.

And I again appreciate the witnesses' tolerance in this issue. Thank you.

[recess]

Chairman NEUGEBAUER. And so thanks again for your patience. We will probably have some more members join us here shortly, but we want to go ahead and start with the testimony from our witnesses.

It is my pleasure to introduce the Honorable Jill Sommers, Commissioner of the Commodity Futures Trading Commission.

Commissioner, I am glad to have you here, and thanks for coming.

STATEMENT OF THE HONORABLE JILL E. SOMMERS, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION (CFTC)

Ms. SOMMERS. Good afternoon, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. Thank you for inviting me today to testify in this hearing on the cost of implementing Dodd-Frank.

My name is Jill Sommers, and I have worked in the derivatives industry for over 15 years, and I have been a Commissioner at the Commodity Futures Trading Commission since August of 2007. The views I present here today are my own and not those of the Commission.

The Dodd-Frank Act is the most far-reaching financial reform effort we have seen since the 1930s. Its scope and complexity are unparalleled.

Over the past 8 months, the CFTC has been busy. We have held 8 public roundtables, 12 open Commission meetings, and have issued more than 50 proposed rules, notices, or other requests seeking public comment on Dodd-Frank-related issues.

This pace and level of transparency is a first for the Commission and it has been challenging for us and for the public. I constantly hear from interested parties that they do not have a meaningful opportunity to comment on the proposal. Their view is that with so many comment periods open at the same time for proposals from multiple regulatory agencies, they do not have the opportunity to provide meaningful comment on how various rules taken together will impact the market and market participants.

I am sympathetic to that view for three reasons: first, this is a tremendous amount of complex materials to digest in a very short period of time; second, I take all comments very seriously and I want the commenters to provide me and the Commission with the highest-quality analysis for us to consider before we vote on final rules; and third, the Commission has not released proposed rules in a logical order. For instance, as we sit here today, we have proposed nearly 50 rules, yet we still haven't proposed a rule that defines what a swap is.

Adding to our regulatory challenges, the Dodd-Frank Act requires us to promulgate final rules within 1 year, and in some cases earlier. It is our job to make the best decisions possible as we craft a regulatory regime that advances the public interest and protects these vital markets.

Achieving these reforms will take time, and comprehensively changing the regulatory landscape in such a short period of time will not be easy. To help us evaluate our decisions, the Commodity Exchange Act requires the Commission to consider the costs and benefits associated with each of our regulations and orders.

Section 15(a) of the Commodity Exchange Act requires that before promulgating a regulation or issuing an order, the Commission shall consider the costs and benefits of the action of the Commission. However, when promulgating regulation, the Commission typically does not perform a robust cost-benefit analysis at either the proposed rule stage or the final rule stage.

We do not quantify in detail what the costs of complying with the rule may be. Instead, proposals usually contain a statement that the Commission is only required to consider the costs and not required to quantify them or determine whether the benefits outweigh the costs.

While we do ask for comment from the public on the costs and benefits at the proposal stage, we rarely, if ever, attempt to quantify the costs before finalizing a rule. As we add layer upon layer of rules, regulations, restrictions, and new duties, my preference is that the Commission include in each proposed rule a thorough cost-benefit analysis that attempts to quantify the costs associated with compliance.

This would give the public an opportunity to comment on our analysis. To me, that is good government. If we wait until we issue a final rule to conduct a thorough cost-benefit analysis, the public is deprived of the opportunity to comment on our analysis because there is no comment period associated with a final rule.

Before I finish, I would like to say that I wholeheartedly agree with the President's Executive Order on improving regulation and regulatory review. In that Executive Order, the President called upon agencies to, among other things: use the best, most innovative, and least burdensome tools for achieving regulatory ends; propose or adopt regulations only upon a reasoned determination that its benefits justify its costs; take into account benefits and costs, both qualitative and quantitative; and specify performance objectives rather than a particular manner of compliance.

Although as an independent agency, the CFTC is not bound by the President's Executive Order, I am hopeful that we will undertake this type of analysis before we get to the stage of finalizing rules in order to provide stakeholders with a meaningful opportunity to review and comment on the requirements.

I recognize that it is imperative that we get this right. It is our goal as regulators to provide smart regulation. We can do damage to these vital markets without that goal, and I fully intend to do everything I can to make sure that we don't get it wrong.

Thank you, and I am grateful for this opportunity to speak about these important issues and I am happy to answer any questions.

[The prepared statement of Commissioner Sommers can be found on page 117 of the appendix.]

Chairman NEUGEBAUER. Thank you, Commissioner.

And now, it is my pleasure to introduce Mr. Douglas Elmendorf, Director of the Congressional Budget Office.

STATEMENT OF DOUGLAS W. ELMENDORF, DIRECTOR, CONGRESSIONAL BUDGET OFFICE (CBO)

Mr. ELMENDORF. Thank you, Chairman Neugebauer, and Congressman Capuano. I appreciate the opportunity to talk about CBO's cost estimate for the Dodd-Frank Wall Street Reform and Consumer Protection Act.

My statement summarizes CBO's estimate for the legislation, as enacted last July. I will offer an even briefer summary now.

As you know, the Dodd-Frank Act made significant changes to the regulatory environment for banking and thrift institutions as well as for financial markets and their participants. The Act expanded existing regulatory powers, granted new ones, and reallocated regulatory authority among several Federal agencies with the aim of reducing the likelihood and severity of future financial crises.

Figure 1 summarizes CBO's estimate of the budgetary effects of the legislation during the 2010 to 2020 period. Certain provisions of the Act were estimated by us to increase direct or mandatory spending by $37.8 billion over that period. Most of those costs—$26.3 billion—would result from a new program created to resolve insolvent or soon-to-be insolvent financial entities, which would be financed through an Orderly Liquidation Fund, or OLF. Other provisions would increase spending by an additional $11.5 billion, we expected.

At the same time, different provisions of the Act were estimated to reduce direct spending by $27.6 billion during the coming decade. The biggest share of those savings, $16.5 billion, would result from changes to Federal Deposit Insurance programs. The remainder of the saving, or $11 billion, would arise from the decrease in authority for the Troubled Asset Relief Program, or TARP.

In addition, we estimated that the legislation would increase revenues during the 2010 to 2020 period by $13.4 billion. The extra revenues would stem primarily from fees assessed on various financial institutions and market participants.

On net, CBO estimated that the changes in direct spending and revenues would reduce deficits by $3.2 billion between 2010 and 2020.

A different way to tote up these same figures is provided in the table, which groups budgetary effects by the aspects of the legislation that generate them. First, the Dodd-Frank Act created several new Federal organizations to regulate financial matters. We estimate the cost of the new organizations would widen deficits by $6.3 billion over the 2010 to 2020 period.

Next, the legislation restructured the authority of existing financial regulators. Together, those provisions were estimated to add $0.1 billion to deficits on net through changes in direct spending and revenues over the period.

Separately, the legislation provided additional funding for existing programs that provide mortgage relief, neighborhood revitalization, and grants. Those provisions were estimated to have a cost of $1.5 billion.

The Act also modified Federal Deposit Insurance Programs, including increasing the maximum amount of deposits in an individual account that can be insured and directing the FDIC to increase the size of its insurance fund by 2020. Those changes would reduce deficits by $16.6 billion during the 2010 to 2020 period.

Still other provisions of the law created the Orderly Liquidation Fund and authorized the FDIC to resolve systemically important financial firms under certain conditions. Our estimate of the cost of those provisions, about $20 billion over the period, represents the difference between the expected values of the net cost to resolve insolvent firms and the additional assessments collected to cover those costs. Those expected values represent weighted averages of the outcomes of various scenarios regarding the frequency and magnitude of systemic financial problems.

Additionally, as I have noted, the legislation reduced the spending authority of the TARP, saving $11 billion, and made a number of other changes to current law that would have a net reduction deficit of $3.8 billion with the same overall effect, of course, as the summary I offered a moment ago of a reduction in deficits of $3.2 billion.

In addition to those changes in direct spending and revenue, we estimate that the Act will lead to an increase in discretionary spending of about $2.5 billion over the 5-year period ending in Fiscal Year 2015, assuming the Congress provides necessary appropriations in the future.

Let me make two final points. First, once legislation is enacted the agency's involvement with that legislation is quite limited. New statutes join the body of existing law to form the basis for our baseline projection.

We don't usually identify the effects of individual statutes at that point. In any event, we have learned nothing so far about the implementation of this Act that would cause us to significantly change the cost estimate we provided last year.

And second and finally, depending on the effectiveness of the new regulatory initiatives and new authorities to resolve and support a broad variety of financial institutions, implementing the Dodd-Frank Act could change the timing, severity, and Federal cost of averting and resolving future financial crises. However, CBO has neither analyzed the regulatory impact of the legislation nor have we attempted to determine whether the estimated costs under this act would be smaller or larger than the costs of alternative approaches to addressing such crises.

Thank you.

[The prepared statement of Mr. Elmendorf can be found on page 58 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Elmendorf.

And now, it is my pleasure to introduce Mr. Jeffrey Lacker, President of the Federal Reserve Bank of Richmond.

Mr. Lacker, we are glad to have you here.

STATEMENT OF JEFFREY M. LACKER, PRESIDENT, FEDERAL RESERVE BANK OF RICHMOND

Mr. LACKER. It is an honor to speak to the subcommittee about the Federal Government's financial safety net and how the Dodd-Frank Wall Street Reform and Consumer Protection Act seeks to address it.

To start, I should note that within the Federal Reserve System, the Board of Governors has sole authority to write rules implementing the requirements of the Dodd-Frank Act and Reserve Banks supervise financial institutions under authority delegated to them by the Board of Governors. And in keeping with Board of Governors guidance to us, I will not address the specifics of any current or potential Federal Reserve rulemaking.

My views have been informed both by my leadership at the Federal Reserve Bank of Richmond over the last 7 years and my experience as a research economist, having studied banking policy for the prior 25 years. I should note that my comments today are my own views and do not necessarily reflect those of the Board of Governors of the Federal Reserve or my colleagues at other Federal Reserve banks.

The Dodd-Frank Act was a response to the most dramatic financial turmoil in our country's experience in generations. In my view, this crisis resulted from a mismatch between the regulatory structure designed for the explicit safety net consisting mainly of deposit insurance and the extent of moral hazard induced by the much broader implicit safety net. Given precedents dating back to Continental Illinois in the 1980s and beyond that, market participants made inferences about what government protection might be forthcoming in future instances of financial distress—that is to say, which institutions were likely to be viewed by authorities as "too-big-to-fail."

This lack of clarity about the safety net grew in decades leading up to the crisis and came about because policymakers hoped that constructive ambiguity would dampen the markets' expectations of bailouts but preserve their option to intervene if necessary. Other factors contributed to the crisis, but I believe that ambiguity of safety net policy was the major driver.

Researchers at the Federal Reserve Bank of Richmond have estimated, based on conservative assumptions, that the implicit safety net covered as much as 40 percent of all financial sector liabilities by the end of 2009. When combined with the explicit protection in place for depository institutions and other firms, the broad Federal financial safety net now covers 62 percent of the financial sector, compared to about 45 percent a decade earlier. For additional information, I would refer you to the table at the end of the written statement that I have submitted to the committee.

Dodd-Frank contains provisions that will help close the gap between the scope of prudential regulation and the scope of the implicit safety net. It allows the Financial Stability Oversight Council to designate large non-bank financial firms as "systemically important," and subjects those firms to more rigorous constraints on risk-taking. The Act also seeks to limit the implicit safety net by empowering the FDIC to liquidate troubled non-bank firms and placing new constraints on the Fed's lending powers.

But the FDIC retains considerable discretion in the use of funds to limit losses to some creditors, and the Treasury can invoke orderly resolution for firms that have not been subject to enhanced regulation under the systemically important designation. The Fed also retains some discretionary powers to lend to non-bank entities. This creates continued uncertainty about possible rescues as well as impediments to our ability to provide clear, credible constraints on the safety net.

In the near term, I believe regulators have a firm grasp on the industry and are taking strong steps to tighten risk management at regulated firms, but there are significant risks in the long term because firms seen as enjoying broad safety net protection will have strong incentives to take on excessive risks and firms will have an incentive to bypass regulation if they can still enjoy some degree of implicit protection. This desire to operate just outside the perimeter of regulation but within the implicit safety net will present ongoing supervisory and regulatory challenges and may make it difficult to prevent or limit the magnitude of future crises.

Continued ambiguity would thus pose risks to financial stability and the economy, including risks of new costs to taxpayers. But I believe the risks to the effectiveness of our financial system are even more significant. Over time, the devotion of resources to bypassing regulation can create new sources of financial instability and can divert resources from the pursuit of financial innovations that are genuinely beneficial to consumers. In the long run, economic growth and job creation would likely suffer.

Creating clear and credible safety net constraints is likely to be a difficult task. One approach is to tightly limit discretion, including the discretionary use of public funds to shield creditors. The Act takes important steps in that direction, yet as I said, substantial discretion remains around the preferential treatment for certain creditors.

A far more challenging course is for regulators to retain discretion but establish a credible commitment on their own to following clear, pre-announced rules in times of crisis. For example, limiting FDIC resolution authority to firms that are regulated as systemically important, designated so by the FSOC, would help block regulatory bypass. The credibility of such a commitment, however, would require policymakers to allow significant creditor losses in cases in which they otherwise might have provided support.

Some believe that without intervention, the economy is too vulnerable to spillover damage from the financial system. I have argued that such spillovers are, in large part, the consequence of ambiguous government rescue policy. If we can establish clear expectations about the Federal financial safety net and live up to our commitment to limit rescues then we can have more confidence, I think, that the financial system will contribute positively to economic growth.

Thank you, and I would be pleased to take your questions.

[The prepared statement of Mr. Lacker can be found on page 81 of the appendix.]

Chairman NEUGEBAUER. Thank you.

And without objection, your written statements will be made a part of the record as well.

Commissioner Sommers, I want to start off with you because you alluded to the President's recent Executive Order about—where the President said we should propose or adopt regulations only upon a reasoned determination that its benefits justify its costs and take into account the benefits and the costs both quantitative to and qualitatively. And I heard you say a couple of things. One is that you don't think that the CFTC is really quantifying that.

And when you think about some of the provisions that the CFTC is supposed to make rules on, it can have a tremendous impact on our capital markets moving forward. What is the appropriate posture and process that the CFTC should be going through now, with particularly the importance and the number of rules that are coming out of that agency?

Ms. SOMMERS. Thank you, Mr. Chairman. I think that I will address that by saying that the President's Executive Order, I think, gives regulatory agencies an appropriate blueprint to—and some of the most important things we should be looking at before proposing regulations.

A cost-benefit analysis—a thorough and meaningful cost-benefit analysis—is not an argument for or against a specific regulation;

it just gives us a good basis to be able to justify the regulations and the benefits that those regulations can be weighed against the costs. It is my view that before we finalize any of our rules that we have proposed, we allow the public to have an opportunity to comment on both a qualitative and quantitative cost-benefit analysis in a meaningful way.

In the proposals that we have put out so far, we have asked for comment from the public, and I am hopeful that we will get real cost estimates from the public with regard to our proposals, but we haven't given them any substantive analysis to comment on. We are looking for the public to give that back to us.

Chairman NEUGEBAUER. So in your opinion, is the Commission not in compliance with 15(a)?

Ms. SOMMERS. I think that we are complying with 15(a). However, 15(a) does not prevent us from going further than just considering costs or benefits; 15(a) gives us the flexibility to decide if a thorough and meaningful cost-benefit analysis is appropriate, and I believe that in many of the rules that we have proposed under Dodd-Frank, it is incumbent upon us to provide that kind of information for the public.

Chairman NEUGEBAUER. And recently—I also sit on the House Agriculture Committee, and so it is kind of hard to get away from these financial issues, but Mr. Gensler said that he believes that you all are doing suitable quantitative and qualitative analysis. Do you agree with that statement?

Ms. SOMMERS. It is not something that we have included in our proposal so far, and I believe that that is where we are lacking—giving the public the ability to comment on any kind of analysis that we may have done or that we intend to do for the final rule stage, we should put out and allow the public to comment on that.

Chairman NEUGEBAUER. And in fact, I have heard those very statements, that in many cases what we are finding is some of the people are finding it hard to respond to some of the rules because they understand exactly the logic or the benefit that is going to be derived. And so I think that is a problem.

Before my time is up, Mr. Lacker, I want to go to something that—it was in your testimony in both written and oral, and that is this issue of FSOC and whether—we said there wasn't going to be a list when we were putting together Dodd-Frank. How do you have an operation of determining which of these entities are going to be systemically risky without having a list and treating them differently than you are treating people who "aren't on the list?"

Mr. LACKER. I think it is really hard for there to be clarity about what safety net policy is without some designation of what firms are going to benefit from the type of support that is available in the orderly liquidation authority and what firms are not. And I think it is most natural to pair that set of firms—the ones who could benefit from the orderly liquidation authority—with the set of firms that are subject to more rigorous scrutiny. And that goes back to the problem of mismatch that really drove this crisis, where the safety net was broader than our regulatory reach.

Chairman NEUGEBAUER. I think the other is is it is going to be hard to determine—and I think you used the terminology of bypass—it is going to be interesting to see if it is good to be inside the box or outside the box and what are the consequences of each. Because if you are outside the box, you may not be subject to the same regulatory scrutiny as those people inside the box, but there also may be continued—and I agree with you, that there continues to be somewhat of an implicit thought there that we—these are systemically risky entities and that there is, in fact—we just heard Mr. Elmendorf said he budgeted for the taxpayers to get involved in that.

Mr. LACKER. I think that is a definite issue. I think that there is going to be a clear tension. I think firms are going to want to be benefiting from the lower short-term funding costs that would come from being perceived as eligible for the orderly liquidation authority but I think they are going to want to escape the FSOC designation if they can do that.

Chairman NEUGEBAUER. Thank you.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

Again, I want to thank the panelists for being so understanding of today's limitations and timeframes.

Mr. Elmendorf, I just have a very simple question. I want to make sure that I am reading your documents correctly. As I read your document, I think the words are pretty clear, but I need to hear the words underlined and bold.

When everything is said and done, the Dodd-Frank Act will actually reduce the deficit by $3.2 billion. Am I reading this correctly?

Mr. ELMENDORF. That is our estimate of the effects of the changes in direct spending and revenues on the deficit—$3.2 billion over the 2010 to 2020 period.

Mr. CAPUANO. So the 20 million pages of bill actually reduces the deficit by $3.2 billion?

Mr. ELMENDORF. You are reading the table correctly, Congressman.

Mr. CAPUANO. And "billion" has 12 zeros?

Mr. ELMENDORF. Quite a few, Congressman, yes.

Mr. CAPUANO. That is what I thought. I just wanted to make sure I was reading correctly, that is all. Because I have heard lots of different things and some of the opening statements have made me believe that maybe it was ruining the country.

Ms. Sommers, honestly, I just—I don't disagree with anything that is in your testimony but I want to be clear: I am not terribly familiar with the CFTC—a little bit, but not too much because it is not in the purview, directly, of this committee. Is there anything in the law that prohibits or prevents the Commission from doing the things you suggest?

Ms. SOMMERS. No, sir.

Mr. CAPUANO. So that you could do in your own—so have you or anybody else made those suggestions as part of the procedure or the rules of the Commission?

Ms. SOMMERS. Absolutely.

Mr. CAPUANO. Okay. Because I think that is important. I don't know enough about the Commission to know whether you are right or wrong and I would be happy to listen to others. It certainly sounds right to me—a cost-benefit analysis is pretty normal; we do it all the time.

I know we can get into a debate of what is a cost and what is a benefit. That is another argument for another day. But the concept is 100 percent correct and I look forward to hearing from some of the other Commissioners to see what they think.

Governor Lacker, honestly, it is my problem with the Fed. I love you guys, but I have a hard time reading or figuring out exactly what any of you are saying at any given moment. So I just want to understand.

I read some things here and I heard you say some things that actually sounded like you like the concept of Dodd-Frank; not the specifics, but the concept of what the Dodd-Frank bill is trying to do. Is that a fair read or an unfair read of what you were saying?

Mr. LACKER. The Dodd-Frank bill does a lot. Some of what it does is try and address the mismatch between the scope of regulation and the scope of the implicit safety net. So to the extent that it addresses that, and it has in some areas, I think that is good.

It also limits Fed lending power—discretionary Fed lending power—and I think those measures are good. I think it could have gone farther and I think it is—what I was highlighting in my testimony was the extent to which there is a residual amount of discretion that is going to make life hard for us going forward, I think.

Mr. CAPUANO. I actually agree. I think clarity is critically important as best you can. I would—a little bit that there has to be some degree of ambiguity in any more regulation because you never know what is going to happen tomorrow that you can't foresee, so it has to be some degree. But as much clarity as you can provide on any law or regulation, I generally agree with that concept. So I tend to agree with your comments today.

I guess I also want to be clear: It is my belief that no matter—even if you are as clear as you think you can be on any given item, there will always be somebody who tries to get around whatever that might be. We existed for 40, 50 years with, I think, relatively clear banking rules, and what that ended up in was non-bank banks—ended up in the creation of hedge funds; it ended up in the creation of mortgage brokers and everybody who could find any way they could—Goldman Sachs was created to get around regulation.

And so therefore, my expectation always is, whatever regulation we create, or laws followed by regulation, there will always be somebody there ready to find a way around it, and that is why it is an ongoing, living process. So I don't disagree at all. I actually agree with your concept.

I would also ask, do you believe that the Fed and other regulators are sufficiently empowered under the Dodd-Frank Act and other current laws? I actually think that a lot of the Dodd-Frank Act probably wasn't necessary. I think a lot of it we are just kind of making you do this stuff that you already had the power to do.

I would argue that the Fed currently has the power if they choose to do it—not just the Fed, but others as well—to be a lot more clear than the law is. And I think that is the way regulation generally works. Do you think that is a fair read of the law? It may not be able to fill every gap, but conceptually the law is a little bit broad-brushed, but the idea being that the regulators are then the ones who kind of fill in more gaps, therefore tightening everything up? Is that a fair—

Mr. LACKER. It is a fair reading. So I distinguish between the regulatory side and the orderly liquidation authority. Liquidation authority, Congress provided flexibility for the FDIC to use if they so chose in writing rules. And the way they have written the rules, they have reserved a substantial amount of that discretion to themselves going forward, that flexibility. But that flexibility, the flip side of that is ambiguity about just where they are going to draw the line in a crisis and going into the next crisis, which firms will benefit from support—

Mr. CAPUANO. So your concern is less with the specifics of the law than the way the FDIC has interpreted it and submitted regulations pursuant to it. Is that a fair—

Mr. LACKER. As I said, there are two approaches to achieving that clarity. One is to tie regulators' hands; the other is to give them a free rein but hope that they can achieve clarity on their own.

Mr. CAPUANO. Thank you very much.

Chairman NEUGEBAUER. Quick followup: Mr. Elmendorf, if you had taken out the TARP offset, what would the impact have been on your calculation?

Mr. ELMENDORF. The TARP offset, as I said, was $11 billion. If that $11 billion had not been there, then you can just take the $3.2 billion reduction that we estimated and put the $11 billion back in and we will end up with an increase in deficit of $7.8 billion.

Chairman NEUGEBAUER. Thank you.

Mr. CAPUANO. Mr. Chairman, would you yield for 1 second? I would like to ask Mr. Elmendorf another question.

Mr. Elmendorf, if monkeys could fly, what do you think would be the relevance to that? The law is the law, is it not?

Mr. ELMENDORF. I don't think the monkeys flying would be relevant, Congressman.

Mr. CAPUANO. I didn't think so either.

Chairman NEUGEBAUER. Mr. Fitzpatrick?

Oh, he is not here. Okay.

Mr. Posey is not here. Okay.

Mr. Renacci? Sorry.

Mr. RENACCI. Thank you, Mr. Chairman.

It is interesting because I was going to ask that question, too, on the budget deficit, because it is—sometimes down here in Washington we add and subtract, but ultimately you have given us a cost of—what was it again, to the budget deficit?

Mr. ELMENDORF. So from the changes in direct or mandatory spending and revenues we estimate a $3.2 billion reduction in deficit over the 2010 to 2020 period.

Mr. RENACCI. But if you did not have the TARP offset—

Mr. ELMENDORF. Yes. Then you would have a net increase in the budget deficit.

Mr. RENACCI. Exactly.

Mr. ELMENDORF. But as the testimonies show and as you discussed in terms of the complexity of the bill, there are an awful lot of moving parts—

Mr. RENACCI. I understand.

Mr. ELMENDORF. —and we try to put them all together for you, but you can envision particular pieces of them as you would like.

Mr. RENACCI. Thank you.

And again, thank you all for testifying. I am a CPA so I do understand that sometimes you can present things certain ways and that is why I re-asked the question again, because there is a cost to Dodd-Frank, no question, and that is one of my concerns.

I do want to go to—President Lacker, you said in your testimony, "Creating clear and credible safety net constraints is likely to be difficult." Do you see the implementation of Dodd-Frank—and you had some percentages there and I just want to make sure I understand them. You went from 42 percent to 62 percent. Was this in comparison to adding Dodd-Frank or just—go ahead and answer that.

Mr. LACKER. The explicit part of the safety net includes deposit insurance, and the changes that Dodd-Frank made were taken into account; they are raising the deposits permanently. On the implicit safety net side our estimates are based on official statements and action, and there the main driver are two things. One is the GSEs, which, you know, back in 1999 when we did that estimate, were included in the implicit safety net because they were widely regarded as likely to benefit from government support should they fail. And then the other part is in the new estimate—they are in the new estimate, too, the 2009 estimate.

In the 2009 estimate, it includes all the holding company liabilities of the 19 banks that were part of the so-called SCAP stress test in 2009 because the government announced that should any of them be deemed to be holding insufficient capital it would be supplied by the government through a capital injection and we interpreted that as an implicit promise of government support for those institutions to support the creditors. So that precedent having been set, we count the 19 largest holding companies as part of the implicit safety net even though their liabilities don't benefit from explicit government support of insurance.

Mr. RENACCI. Okay.

We have all talked about the cost of Dodd-Frank, and I know you have indicated some of that from the CBO's standpoint, but can all three of you kind of give me your thoughts on the indirect costs of Dodd-Frank, if you have some thoughts on that—the cost of jobs, the cost for these financial institutions, whatever they are, to ramp up? What are your thoughts on—because we know there is a cost.

Any time you add legislation of this mass there is going to be a cost. What are some of your thoughts on the costs when it comes to jobs, jobs creation, and the opportunity for some financial institutions to do those things? If any one of you would like to comment.

Ms. SOMMERS. Congressman, I can't comment directly on an impact to jobs. What I can say is the proposals that we put out we get comments back from market participants that we regulate and they give us estimates with regard to what it would cost them to comply with the regulations.

There are assumptions that you can build into that that if those market participants are paying an increasing amount of money to comply with the regulations, there is a chance they will pass that on to either their customers—

Mr. RENACCI. So you are getting that feedback. Because I am, too, from the banks and many institutions, the number of dollars it is costing them to ramp up.

Ms. SOMMERS. We are getting feedback from commenters in their comment letters to our proposals. It is just that we haven't provided them with an estimate that we have personally done at the CFTC.

Mr. ELMENDORF. So Congressman, I am sorry, we have not tried to evaluate the broader economic effects of the legislation. You are raising very important questions but we just haven't had the resources to go beyond the budget cost to the Federal Government in the cost estimates that I have talked about already.

Mr. LACKER. I am very worried about the distortions to economic activity that will—that could result from implementation of Dodd-Frank. As Doug Elmendorf said, there are a lot of moving parts here.

The safety net, which is what was the focus of my remarks, has the potential—not necessarily that it is going to happen, but the potential to distort credit flows and give rise to things analogous to the housing boom and bust, which arguably just had devastating costs and consequences for the American economy.

Mr. RENACCI. Thank you.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

Now the gentleman from Texas, Mr. Canseco?

Mr. CANSECO. Thank you, Mr. Chairman.

I want to follow up, Commissioner Sommers, on the jobs issue, but I want to come at it from a different angle. The GAO has estimated that about 2,600 new Federal jobs will be needed in order to implement Dodd-Frank. How many staff has the CFTC had to hire in order to implement the new rules?

Ms. SOMMERS. Sir, as you know, we are currently operating under our 2010 budget of $168.8 million. We currently have a staff of approximately 675 full-time employees, but that is not with the additions that were included in the President's request for either Fiscal Year 2011 or for Fiscal Year 2012, of course, that included additional FTE to implement Dodd-Frank.

Mr. CANSECO. And before the end of the year, 2011, how many more of those positions are you going to have to fill?

Ms. SOMMERS. We currently are under a hiring freeze, so—

Mr. CANSECO. Okay.

Ms. SOMMERS. —we are not filling any.

Mr. CANSECO. What type of positions are being filled or created at CFTC with—

Ms. SOMMERS. I think typically we hire attorneys and economists at the CFTC to surveil the markets and to implement the law.

Mr. CANSECO. Okay.

Let me switch subjects on you right now, Commissioner, while I have you here. Sarbanes-Oxley resulted in a dramatic decrease of public offerings in the United States. Companies that would have listed or raised capital in the United States began to do so in other countries because regulation became too burdensome here.

Do you have an opinion whether or not Title 7 of Dodd-Frank will have a similar effect on derivative markets?

Ms. SOMMERS. I think, Congressman, it is a very important issue for us to make sure that what we are implementing in the United States is on a consistent level with what the rest of the world is implementing. These markets are global markets. The derivatives markets are—the same markets trade all over the world.

And because the G-20 countries made the same commitment to mandatory clearing and trade execution of over-the-counter derivatives we are working very closely with our global counterparts to make sure that there is not going to be regulatory arbitrage. But we are currently in the middle of that at this point.

Mr. CANSECO. Do you think that the American businesses will find the derivatives tradings and hedges—and hedging in the United States overly burdensome and therefore begin trading in places like Europe or Singapore?

Ms. SOMMERS. I hope not.

Mr. CANSECO. Let me call your attention to something that came out yesterday in the Financial Times. It is an op-ed piece written by Alan Greenspan, published yesterday, March 29, 2011, and it is titled, "Dodd-Frank Fails to Meet Test of Our Times."

I am not going to read the whole article, but in some portions here he says more recently concerns are growing that without immediate exemption from Dodd-Frank a significant portion of the foreign exchange derivatives market would leave the United States. The U.S. Treasury is pondering an exemption but some bank regulators insist the statute be implemented as is.

And then he concludes that the Act may create the largest regulatory induced market distortion since America's ill-fated imposition of wage and price controls in 1971, and concludes by saying, and pressing forward the regulators are being entrusted with forecasting and presumably preventing all undesirable repercussions that might happen to a market when its regulatory conditions are importantly altered. No one has such skills.

Now, do you agree or disagree, in general, with what Alan Greenspan says in that op-ed—

Ms. SOMMERS. I think taking it in two parts, the first part with regard to the Treasury Department's decision that they are making, that is a concern for a lot of market participants, and I agree that is an important decision that people would like to have certainty with regard to how those products will be regulated. I think on the second part of the question, for regulators it is important for us to understand that overregulation can lead to unintended consequences, so we have to be very careful when we are crafting the regulation that helps us achieve the goals that were in Dodd-Frank, and that is to increase transparency and reduce systemic risk. So we have to keep those goals in mind every time we are looking at a proposal.

Mr. CANSECO. One more question: Do you believe that a rule requiring so-called end users to post collateral and derivatives transactions would result in job losses for those employed by end users?

Ms. SOMMERS. I think that if the Commission were to impose capital and margin on end users it could have a devastating effect, but I am under the impression that is not where the Commission will head.

Mr. CANSECO. Thank you very much.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

I want to thank this panel. What I would like to do, with your indulgence, is since we kind of had to do this in—convoluted afternoon here, and with that, I will—about 5 minutes away from missing that vote, so we are going to run over there, have these votes, and when we return we will start with the second panel.

Mr. ELMENDORF. Thank you, Mr. Chairman.

[recess]

Chairman NEUGEBAUER. We will reconvene the hearing. I want to say to our second panel, thank you very much for being very patient and fluid here. One of the things I learned when I got to Congress is that it is hard to plan up here. Even the best plans sometimes go awry.

But we are glad to have you here, and I have had a chance to read your testimony and I am excited about hearing your oral testimony. I want you to know that your full text of your written testimony will be, without objection, made a part of the record.

And so with that, we will start with our panel, and Dr. Douglas Holtz-Eakin, president of American Action Forum, you are recognized for 5 minutes.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, and Mr. Capuano. I appreciate the chance to be here today. You have my written statement.

In discussing the costs, there are really three kinds of costs that have come up today. One is budget costs, which, while very important, I think for the Dodd-Frank bill will end up being the least central aspect of discussion.

The second would be compliance costs visited on the private sector, where there are really a couple of points that I wanted to make. The first is that in some cases the flip side of budgetary impacts are the compliance costs—fees paid by firms and the like. The second is that those compliance costs end up being transmitted, in large part, to customers outside the financial sector, and thus are the impetus for a lot of the larger economic costs that I want to focus on.

The third is that these are often the costs that are the hardest to project. And the example I used in my written statement was the cost of compliance under Sarbanes-Oxley, where they were radically underestimated, and where my concern is that the same could happen with the Dodd-Frank legislation.

And then the last is then those are the costs that are going to be most affected by the ongoing rulemaking process and where I believe this committee has the greatest opportunity to make sure that the costs don't become excessive, given the goals of the legislation. So I am encouraged to have this hearing.

And then the last, which I tried to scope out in the written testimony, is the larger economic implications of a piece of legislation as large as Dodd-Frank. You are going to have substantial budgetary and compliance costs, but you also have significant economic costs.

And the way I tried to get a handle on those was to recognize that the financial services industry that will bear the direct impacts acts as an intermediary between savers, investors, and those wishing for hedging operations and provides these services. And then ultimately I think the economics are, these costs will be transmitted to those activities in the economy, whether they be saving, investing, hedging, whatever.

I used some estimates from Standard & Poor's for the larger of the bank holding companies that suggested that the direct impacts would lower their rate of return by 18 percent, and that is not going to survive in competitive markets so they will be forced to pass those costs along. A rough estimate is they will have to pass along a 20-odd percent increase in, if it is a loan, interest rates, if it is an operation like a hedge, of—fees. But broadly, they are going to have to push forward their costs.

If it is all interest rates, which means a 4 percent interest rate turns into a 4.9 percent, and so forth. And then I used some estimates done by Macroeconomic Advisers about what happens if you have an exogenous—an increase in interest rates that comes from a non-economic source, not just from a recovery or tightening of credit, but from a policy move. That suggested economic growth slows in very substantial ways, especially early, and that this translates, if you believe the Congressional Budget Office estimates of growth and the links to jobs, into something that looks like 900,000 jobs over the near term.

And so that gives you the ballpark win. Given the slow recovery and the millions of people out of work, I think this is worth careful attention. The economic costs can be substantial.

Now, that estimate will be both too high in some ways and too low in others. It will be too high because I think the large banks will get the least of the impacts because they are viewed as "too-big-to-fail" and can borrow on preferential terms. I am not sure that is a good thing but they are not going to be the most affected.

And it is going to be too large in some cases because—or too small in some cases because we will have differential impacts which are actually in and of themselves not beneficial to the economy. The fact that we have differential regulatory impacts means we are moving activities strictly on the basis of policy, not on the basis of economic merit. That is, in any other circumstance, an economic bad and a cost that ought to be counted toward the legislation.

So given the late hour, I see no point in a long-winded economics tutorial, but I would stress to the committee that this merits closer investigation. These are potentially significant costs. They are costs at a time that matters in our economic history, and that if we can hone this legislation to have minimal economic drag that would be much more desirable than to hone it in the other direction.

I thank you for the chance to be here and look forward to your questions.

[The prepared statement of Dr. Holtz-Eakin can be found on page 75 of the appendix.]

Chairman NEUGEBAUER. Thank you very much.

Dr. Angel, it is good to have you back again.

STATEMENT OF JAMES J. ANGEL, ASSISTANT PROFESSOR OF FINANCE, MCDONOUGH SCHOOL OF BUSINESS, GEORGETOWN UNIVERSITY

Mr. ANGEL. Thank you very much. It is an honor to be here, and I am very grateful that your committee is looking at these very important issues because they have huge ramifications for our economy.

As you well know, the Dodd-Frank bill is a very complex piece of legislation, and unfortunately, our regulators do not have a perfect track record in implementing complex pieces of legislation. And we have hundreds of rulemakings coming down the line, and the possibility for a misfire is pretty large.

I think the history of Sarbanes-Oxley Section 404 is a classic example. It seemed like a good idea at the time. Tell us how good your controls are.

The SEC at the time didn't think it was a big deal, and yet it turned into an inordinately expensive mandate that has really raised the burden of being a public company. This and a number of other factors in our economy really raised the burden of being a public company, and the result is we have far fewer U.S. public companies.

There is a graph in my testimony, which, if you look on the monitor, shows you the number of exchange-listed companies on—that are U.S. companies, not foreign companies—listed on our exchanges over the last 15 years, and you can see there has been a steady decline. We have gone from nearly 8,000 public companies down to approximately 4,000 exchange-listed U.S. companies.

This is a crisis in capital formation. We are losing our public capital markets, and these provide important capital to young and growing companies. It provides important exit strategies for the venture capitalist who helped support the growth of our technologically-innovative company. And if we don't do something about this, we are in serious trouble.

The Dodd-Frank bill has many features which could turn into another Sarbanes-Oxley 404, and a lot of them sound like good ideas but if they are implemented badly, they could turn into a disaster. For example, the pay-it-back provision—who could argue with the idea that somebody should be able to pay back their mortgage? But if the regulators set the standards too high, even people with good credit who can pay it back won't be able to qualify for a mortgage.

Things like the over-the-counter derivatives—again, if the regulations are too burdensome, businesses—good, operating businesses—will be deprived of the risk management tool they need to reduce their risk. The risk retention features in the—with regard to securitization sound like a great idea, but if implemented badly could actually increase systemic risk in our economy.

I could go on for a long time about that. And, I am somewhat pessimistic that our regulators have the human resources they need to really implement this law in an intelligent manner. They just don't have enough people who really understand markets. They have plenty of lawyers, but very few chartered financial analysts and other people with the kind of industry experience and know-how to really understand the impact of what their proposed rules are going to do.

So what can you do about it? First of all, you are starting right now by doing the right thing. This requires a lot of congressional oversight.

Regulation is not a set it and forget it kind of deal, and I think that was the big mistake in Sarbanes-Oxley. Many Congressmen expressed the attitude, "Well, we passed the law; we will see how it works," and as the Section 404 debacle was unrolling, there was a lack of oversight to sort of stop the train wreck before it was too late.

So you really do need to be watching carefully because I can't predict which of the 2,300 pages will be the Section 404, but there are so many of those moving parts at least one of them will be, and prompt congressional action will be necessary.

Another thing you can do is realize that our regulatory structure has to evolve with the markets, and the markets are evolving rapidly. Even if we came up with the absolutely perfect structure this year, in a few years it will be obsolete.

So we should have 5-year reauthorizations not only for the CFTC but also the SEC and the new CFPB to come back, look at the agencies, say what is going right and what is going wrong, and then fix it.

And I have plenty of other ideas, which I will be happy to share with you and your staff at any time. And once again, I want to thank you for the opportunity.

[The prepared statement of Dr. Angel can be found on page 44 of the appendix.]

Chairman NEUGEBAUER. Dr. Overdahl, thank you for being here, and you are recognized for 5 minutes.

STATEMENT OF JAMES A. OVERDAHL, VICE PRESIDENT, NATIONAL ECONOMIC RESEARCH ASSOCIATES (NERA)

Mr. OVERDAHL. Thank you. And thank you to the committee for the invitation to appear here today.

I am going to speak in more general terms about the rulemaking process at the SEC and the CFTC. These two agencies combined will be implementing approximately 150 rules under Dodd-Frank, and so I think that process is important to understand. And I will be doing this based on my experience as a former chief economist of these two agencies and describe some of the obstacles that are limiting the effective application of economic analysis to the rulemaking process and offer some suggestions on how this process might be improved.

It is important to note that neither the SEC nor the CFTC has a formal requirement for including economic analysis in their rulemaking procedures aside from the cost-benefit requirements of the Paperwork Reduction Act. However, the outcome of recent court decisions have turned on the adequacy of economic analysis that is considered by the SEC when adopting new rules, and this has forced the Commission to pay more attention to how it conducts this analysis.

The message from the courts is that the SEC's economic arguments need to be adequately supported and that vigorous assertion is not a substitute for rigorous economic analysis. And even though the court cases have dealt with the SEC, I think the same reasoning would apply to any regulatory agencies subject to the Administrative Procedure Act, including the CFTC.

Economic analysis can be used for more than satisfying procedural and court requirements; it can help improve regulatory decision-making. I have found that Commissioners at both the SEC and the CFTC welcome rigorous, data-driven economic analysis. Such analysis enhances the ability of Commissioners to ask better questions, better understand the tradeoffs and consequences associated with the proposed rule, and make more informed decisions.

In my view, economic analysis encompasses more than what is typically called cost-benefit analysis. Under my interpretation, economic analysis goes beyond what is readily quantifiable, such as out-of-pocket compliance costs, and includes consideration of tradeoffs, potential effects, and unintended consequences of regulatory actions, including identifying potential changes in behavior by market participants. It can be helpful at the very earliest stages of the rulemaking process by helping frame the problem that is being addressed by a proposed regulatory action.

Although there are currently no formal requirements for including economic analysis, there have been many attempts in the past to formalize such requirements. These attempts have foundered because they have been up to the preferences of individuals chairmen, and when these chairmen have left these requirements were discontinued or forgotten.

I believe that one obstacle to effectively applying economic analysis to the rulemaking process has been the lack of relevant data. The SEC and the CFTC have often relied on public comments to supply the data analysis, and although public comments can be extremely valuable for providing some types of information they rarely include the type of data and analysis that can serve as substitute for the Commission conducting its own analysis.

And I will note that the quality of information supplied through the public comment has improved in response to recent court decisions. I have found that parties affected by proposed rules now regard the notice and comment period as if it were a legal proceeding.

Affected parties are placing on the public record factual information about likely compliance costs and offering studies and analysis to help inform regulators. They are doing this because of the potential for litigation and directing their comments not only to the members of the regulatory Commission involved but also to judges who may be reviewing the public record if these rules are challenged in court.

In closing, I would like to offer just a few suggestions about how economic analysis can be better utilized by the SEC and the CFTC. First, I believe that some type of formal requirement is necessary to institutionalize economic analysis at these two agencies. Experience has shown that good intentions alone are not sufficient to sustain a consistent role for economic analysis.

Second, economic analysis needs to be included in the rulemaking process at an early stage, and I believe it would be useful to include some type of high-level economic review of both the rule and the problem that the rule is aimed at addressing. This is important for allowing the economic staff to gear up to gauge the complexity of the problem and to begin gathering data that would be helpful in analyzing the proposed rule.

Third, the collection of data for analyzing proposed rules must be improved. One way to do this would be to streamline the process by which regulators can survey firms for information about potential compliance costs.

Fourth, I believe that it would be helpful for some type of regulatory guidance along the lines of what, for instance, the FSA has, and what I referred to in my written testimony.

Finally, I think that economic analysis needs to become a higher priority at both the SEC and the CFTC. Economic analysis at these two agencies is necessary because it enhances the ability of these Commissions to make informed decisions, and an added benefit is that it will also help the overall transparency and accountability of the rulemaking process.

Thank you, and I look forward to your questions.

[The prepared statement of Dr. Overdahl can be found on page 111 of the appendix.]

Chairman NEUGEBAUER. Thank you, Dr. Overdahl.

And now, Mr. David Min, associate director of financial markets policy for the Center for American Progress Action Fund.

Mr. Min, welcome.

STATEMENT OF DAVID K. MIN, ASSOCIATE DIRECTOR OF FINANCIAL MARKETS POLICY, CENTER FOR AMERICAN PROGRESS ACTION FUND

Mr. MIN. Thank you, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. As you mentioned, I am with the Center for American Progress Action Fund, and I appreciate the opportunity to testify today on the important topic of the costs of Dodd-Frank implementation.

I think it goes without saying that in analyzing costs, we also need to look at the benefits. In this case, I think we need to note that the Dodd-Frank Act was, itself, intended to address some fairly large costs associated with financial instability and systemic risk.

In case we have forgotten, I will just recount a few of these costs: over $10 trillion in household wealth destruction; nearly 10 million lost jobs; 12 million expected foreclosures and the associated costs of those on families and communities; and the opportunity costs, of course, of providing trillions of dollars in TARP and Federal Reserve support to restore and maintain liquidity in the financial markets.

It is also important to recognize that if we do not implement Dodd-Frank or something analogous, we can expect to incur these types of costs on a regular basis going forward. As experts across the ideological spectrum have noted, leaving a status quo in place will almost certainly lead to regular recurrences of this type of financial crisis. That factor must be considered in any legitimate analysis of Dodd-Frank implementation.

Indeed, prior to the New Deal, when we did not have meaningful regulation of financial markets, we experienced such crises every decade or so. The regulatory costs during this period were de minimis, but in fact the associated costs of the resulting volatility were exceedingly high.

The last of these crises, of course, was the one that preceded or triggered the Great Depression. And in response to that, your New Deal Era predecessors established a system of strong regulatory oversight for banking and capital markets that essentially established the modern U.S. financial system that we take for granted.

At the time, many of these reforms were heavily criticized for being too costly, creating too large a Federal bureaucracy, and potentially stunting capital formation. Critics warned that these types of reforms would deter financial investment and stunt economic growth. And in fact, what the United States actually experienced was an unprecedented period of financial stability and prosperity, which lasted for roughly 50 years.

This Golden Age or Quiet Period of banking, as it was known, was marked by extraordinarily high economic growth—in fact, the greatest in our Nation's history—and the notable absence of any major financial crisis. As David Moss, a professor at Harvard Business School, has noted, this was also a period of significant financial innovation, with U.S. financial institutions quickly becoming the envy of the world.

This, in fact, was true in the SEC capital markets as well as investor confidence reached unprecedented heights due to regulatory uncertainty and the knowledge that there would not be fraud in U.S. capital markets. Unfortunately, as time passed we forgot the lessons of our past and allowed large areas of unregulated financial activity to develop through a combination of deregulation and regulatory inaction.

Unsurprisingly, this led, over time, to a major bubble-bust cycle and the financial crisis of 2008. Obviously, it was in this context that Dodd-Frank was passed through Congress.

Without going into all the details of this very comprehensive bill, I would essentially describe it, as I think it was done on the earlier panel, as an attempt to extend meaningful prudential regulation to all parts of the financial system and increase financial transparency. While there has obviously been considerable debate as to whether Dodd-Frank is a silver bullet that solves all of the problems revealed by the financial crisis, there should be no question that by significantly reducing leverage and increasing transparency, it will meaningfully reduce systemic risk, provided that it is fully and effectively implemented.

So returning to the question posed by this hearing, what are the costs of implementing Dodd-Frank and how do they compare to the costs of not implementing Dodd-Frank, I believe our Nation's economic history provides a very clear lesson—one that I would urge the members of this subcommittee to heed: The costs of good financial regulation are far outweighed by the benefits of financial stability. Or to put this in a modern context, an ounce of regulation is worth a pound of bailout.

This is even more true when we recognize that the various agencies created by or given new mandates by Dodd-Frank can easily be self-financed with extremely small assessments on the many trillions of dollars that flow through the financial system. For example, the CFTC's entire proposed budget of $312 billion amounts to approximately one one-hundred-thousandth of the notional amount of credit default swaps alone, which is obviously just one part of the broad mandates the CFTC has. To put that in context, for a household making $50,000 a year, that is the price of a cup of coffee, and not at Starbucks but at the local store.

In fact, I think that Dr. Angel makes a good point about the CFTC and the SEC not having enough resources. I think that this would be one easy way to adapt that.

In this light, I think that Dodd-Frank appears extraordinarily cost-efficient. The most pessimistic cost estimates for implementing Dodd-Frank constitute just a small fraction of a percentage of the probable benefits in financial stability.

Even if one does not believe that Dodd-Frank solves all of our financial market issues, it is clear that by reducing systemic risk and thus the likelihood of financial crises, Dodd-Frank pays for itself many times over.

In closing, I would like to commend the chairman and the other members of this subcommittee for holding this hearing. I think today's discussion should clearly demonstrate the excellent return on investment that we as taxpayers receive from the relatively few dollars we spend on financial regulation.

I hope that the facts generated out of this subcommittee today encourage Americans to avoid taking a penny-wise, pound-foolish approach to financial regulation and support the full funding and effective implementation of Dodd-Frank.

Thank you.

[The prepared statement of Mr. Min can be found on page 102 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Min.

I now recognize myself for 5 minutes.

I think one of the things, when we talk about Dodd-Frank, that I think even Mr. Min acknowledged, is we are not sure whether this is going to prevent any future financial crises from happening again. And what we don't know either is if we had Dodd-Frank in place, whether we would have foregone the downturn that we just experienced in this country.

And I think one of the things that seems to be an overriding theme, we had Ms. Sommers here, and Dr. Overdahl, she is a Commissioner, and you are a former chief economist for the agencies for which she is a Commissioner, and she said she could make better decisions as a Commissioner if she had better economic analysis of what is at stake and what the consequences are.

I was thinking about this as I have been listening to this testimony today, and I was thinking how interesting it is that when we want to introduce a new drug in this country, we require an extreme amount of analysis because we want to make sure that if we issue or we approve that drug, if we put that drug on the market, it is going to do what it says it is going to do with the least amount of consequences to the people.

Yet, we have thrown out a huge piece of legislation that has far-reaching consequences with really very little, if any, analysis from a legislative standpoint, and now we are seeing that same scene play out at the regulatory level. And I think this is probably something—and I don't want to speak on behalf of my colleagues—but

I think this is something that there should be bipartisan support in that we may disagree on the policy, but what we have to have is well-documented data to make these decisions on and not whims of people, thoughts of "This might be a good idea." There are a lot of good ideas out there, but what we need to do is make sure that we road-test, or at least analyze some of these ideas.

Dr. Holtz-Eakin, I wanted to ask you a question. When I think about all of the parameters and the consequences of Dodd-Frank and the implementation and the fact that we have not done analysis and some people think that this could hurt job creation, raise the cost of capital, as has been mentioned, do you think there is a potential here that the Dodd-Frank bill will hamper the economic recovery in the next few years?

Mr. HOLTZ-EAKIN. That is my deep concern. Mr. Min framed the decision-making correctly. In the benefit-cost analysis, there are benefits to better financial regulation, but there are costs. And my deep concern is that this has the potential to hamper the recovery in a way that the costs exceed what we gain in the way of prudential financial regulation.

Chairman NEUGEBAUER. Dr. Angel, do you agree with that?

Mr. ANGEL. I agree with that. It is not a question of regulation versus no regulation; it is a question of more intelligent regulation. Many of the good-sounding ideas in Dodd-Frank have some merit, but if they are not implemented well, it could be a disaster.

Chairman NEUGEBAUER. Dr. Overdahl?

Mr. OVERDAHL. I think to your point about getting data, many times you will find that the data simply are not there at that moment, which I know in other instances where it is appropriate, you can sometimes do pilot programs to try to generate that data and then evaluate whether it is worth proceeding on a more permanent basis. That may be one way to get at the problem.

Chairman NEUGEBAUER. The other issue about some of these rules and rulemaking processes, and the cost-benefit analysis—and as the President said, we need to make sure they make sense, basically was—to paraphrase his—is I worry about the scalability for some of these regulations and the ability of smaller—and when I think about Sarbanes-Oxley, that was one of the things and we look at those charts and we see that a lot of very—small number of small companies now can afford to go public, and so we have kind of frozen them out of the market.

What I worry about is scalability of compliance with a lot of these issues and what that does to the smaller capital providers versus the larger ones, and as you pointed out, the model of replacing that income.

And I think what the little secret here that nobody ever really says is ultimately the consumer of financial products pay for whatever things that we do. And when we look at—we had the CBO folks in here earlier and what they don't tell you is that we are taking $27 billion out of the economy. Yes, it is revenue-neutral, but we are using some Washington gimmicks to get to that point. But the bottom line is we took—we are going to take $27 billion out of the economy, and that is capital that we could create jobs with.

Thank you.

Ranking Member Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Chairman, I actually agree with many of the things you said. No one wants to run willy-nilly into important things like this. I agree with you.

But there is also a balance. It has been 2½ years since the fiscal collapse, and in 2½ years, we have all thought about this a lot. And now whether what we are about to do or not is a fair question. I have concerns like everybody else does. But concern doesn't mean the fear of trying something new.

There is no question that what we had did not work. It is a fair question about whatever we do whether it will work, and if it doesn't work, hopefully we will change it again. And I have always agreed that all regulation, all laws should be reviewed on a regular basis because the world changes. I think all those things are very fine.

Mr. Holtz-Eakin, on compliance costs, I totally agree with you. There are absolutely compliance costs to everything, including when I drive my automobile, there is a compliance cost to meet safety standards. There is a compliance cost to the SEC. There is a compliance cost to the FDIC.

So the concept of compliance cost in and of itself, I presume you were not suggesting that the fact that there is a compliance cost means we should never do anything. That is not—

Mr. HOLTZ-EAKIN. Not at all.

Mr. CAPUANO. I didn't think so, but I wanted to be clear on that. It means it is a factor to be considered and I think a fair factor to be considered.

Mr. Angel, I just want to point out a couple of things. I actually appreciate, and I think somebody from the other panel said it too, the fact that we are doing oversight. As I said earlier, I think this committee didn't do enough oversight, and I want to be very clear: This committee did not have a Subcommittee on Oversight until Chairman Frank took over, so this is a new subcommittee in the last 4 years, I think it is. I think it is long overdue and I think so far the chairman is doing a great job getting us started in this new session.

There is something in your testimony that I wanted to ask: You made a comment that the SEC—and I would actually say this about all agencies—you want capable, thoughtful, professional people in those jobs. Yet, are you familiar that the continuing esolution that was passed for the remainder of Fiscal Year 2011 would have—if adopted by the Senate and signed by the President—cut the SEC's budget by almost $50 million?

Mr. ANGEL. I haven't been following the exact details but I understand that yes, that those are some of the proposals coming forth.

Mr. CAPUANO. Do you think that is a wise move?

Mr. ANGEL. I think we need to be very—the SEC needs more resources but we need to make sure they are spent properly.

Mr. CAPUANO. That is a fair point.

Mr. ANGEL. So if all they do is hire lawyers fresh out of law school, that would be a waste. If they hire people with market experience who know what they are doing, they are badly needed.

Mr. CAPUANO. So do you think the—if I were to make you the SEC czar tomorrow—though I know "czar" gets all my Republican friends worked up—if I were to make you the SEC czar tomorrow and said to you what would be your budget, would it be the same budget as you have now or to be able to hire whomever you thought was the appropriate person to hire?

Mr. ANGEL. What I would try to do is to hire more people with market experience, more people who have MBAs—

Mr. CAPUANO. Do you think you could get them at the salaries we currently pay SEC employees?

Mr. ANGEL. I would look carefully at the budget and work very hard also, since in the civil service environment, it is very hard to lay people off, what I would do—

Mr. CAPUANO. The SEC is not subject to civil service. So are you telling me that—

Mr. ANGEL. In a government environment, what I would try to do is to upgrade the skill level of the people that we have.

Mr. CAPUANO. And I agree. If you upgrade the skill level, you think you can get them for the same salary as somebody less skilled?

Mr. ANGEL. We are going to have—we have been penny-wise and pound-foolish—

Mr. CAPUANO. So basically, you are telling me I should call the SEC Chairman tomorrow and have her call you and offer you the same $50,000 a year that we are paying most people who work there, and you will take that job?

You are a good man, Mr. Angel.

Mr. ANGEL. My students at Georgetown would miss me.

Mr. CAPUANO. I appreciate that.

I totally agree with the concept, but in order to get those people—I am fortunate enough to represent a lot of people who would be qualified in your criteria, and they would require a significant change in salary. And I appreciate that.

Mr. Overdahl, again, your concept—there is nothing in the current law that prohibits the things you suggest because all the things you suggest to me, early analyzing, more detailed—there is nothing there that prohibits either the SEC or the CFTC from doing that now is there?

Mr. OVERDAHL. No, there isn't. And in the past, there have been attempts to do this. It is just that it hasn't been sustained.

Mr. CAPUANO. Because I read your testimony and I agreed with pretty much everything you said. They all made sense and I would agree with you.

Mr. Min, I guess I just want to be clear: You are not going to sit there and tell me you are 100 percent satisfied with everything in Dodd-Frank or everything that has been discussed or potential from it at the moment are you?

Mr. MIN. No. I agree with many of the comments of my fellow panelists. I think we could have gone further. There are certainly parts of it that could have been done differently.

As I think you mentioned earlier, with a bill like this, there is obviously a lot of compromise in place. I think the general principle was sound, though, and it is extending prudential regulation to parts of the market that didn't have it and including transparency.

Mr. CAPUANO. I guess I would also ask the panelists—because I have actually made this point myself—Mr. Min made the point the period, give or take, from 1940 to give or take 1990, that 50 years, did you see a problem with the American financial system then? A serious systemic problem such that we had to throw the whole thing out and start from scratch because it was terrible and somebody was eating our lunch?

Mr. ANGEL. We experienced the beginning of the great inflation and we had the savings and loan crisis, which—

Mr. CAPUANO. I know there were problems, but did you think that we had such serious problems that we had to adopt the Japanese model? Because it is my impression that during that 50-year period, the entire world was trying to copy us and get ahead of us, as opposed to us copying them and trying to get ahead of them.

And during that period we had—that was kind of—most of that period, as I understand the history, and I will be happy to be corrected—in general, most of the financial institutions that were big players were relatively regulated and there weren't hedge funds of any significant nature. There weren't sovereign wealth funds of significant natures. There weren't non-bank banks.

They were there, but they just weren't significant players. They didn't become significant players until after that period of time, and therefore—and that is what got to the systemic risk. That is, again, my general read. I am just—a matter of history, and I am just wondering, do you see the history any differently than I do?

Mr. HOLTZ-EAKIN. I would see the history slightly differently. I think if you look back at that period, the macroeconomy—the real economy—experienced several recessions, some of them quite sharp, and that was real distress, many of them attributed to what you used to call disintermediation, the failure of capital markets at different points in time. We had Regulation Q, which was viewed as a real impediment to getting funds flowing in the correct way.

So it is easy to look back and say, "Gee, we didn't have a great disaster. It was perfect." But I think if you look back in time, we had lots of problems with exposures to Latin America and our large money secure banks. We had lots of problems with the real economy and lots of problems that are less, I think, benign than looking back seems to suggest.

Mr. CAPUANO. Do you think those problems would have been better addressed with less regulation than we had at the time?

Mr. HOLTZ-EAKIN. I think it is, again, it is not a matter of more or less regulation. I was on the Financial Crisis Commission and we tried very clearly, in at least what I wrote, to talk about, it is not a more or less regulation question. It is about the appropriate nature of the regulation, and I think we really made some mistakes then and I believe we are also making some mistakes now.

Mr. CAPUANO. So it is not an all-or-nothing thing. It is trying to get it right.

Mr. HOLTZ-EAKIN. It is more complicated than that.

Mr. CAPUANO. I agree with that.

Thank you very much.

Mr. RENACCI. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony. It is kind of interesting from a business perspective, which is where I was the last

30 years—we have to do with the dollars we have. And it seems like down here in Washington, whenever we have a problem we add dollars, thinking that if we throw a bigger blanket over it, we are going to fix things.

The problem is, when I hear some of the testimony or I hear some of my colleagues speaking they always—there always seems to be an indication that, "Well, if we just threw more people and more dollars at it we would fix it," but some of the things I am hearing from you is that it is not about the dollars, sometimes it is about how the dollars are spent. Is that correct? Right.

Mr. ANGEL. Correct.

Mr. RENACCI. Mr. Min, you said something at the end of your testimony, or maybe it was in an answer to my colleague, that we could have gone further. And I am a little concerned because we haven't even gone—we haven't gone anywhere yet and all of a sudden you are talking about how we could have gone further.

Can you explain that a little bit? Because one of the problems we have is we are trying to justify what we are doing and the cost return and all of a sudden I am hearing, "We could have gone further."

Mr. MIN. What I meant by that is I think there is a general concern about large, systemically important financial institutions, and I think there are some people, including myself, who believe the Dodd-Frank bill could have gone further as far as penalizing being large and systemically important.

I believe that those firms enjoy a subsidy of cost advantage as a result of their size and systemic importance, and I think we could have, through heightened capital requirements, perhaps breaking them up, or other measures, tried to address that problem more aggressively. I also believe that we could have had a resolution fund to help allow these funds to fund this—prefund something that I believe already exists, which is the promise that if they are on the verge of failure the government will bail them out regardless of who is in charge.

Mr. RENACCI. You also made the comment, a penny-wise, pound-foolish approach, and I agree with that. The question is—and I don't know if anybody on this panel could answer this—if we are spending a penny to get a pound or are we spending a dollar to get a pound? Because the interesting thing is that is one of the things that is concerning of me. I am having banks, financial institutions coming to me saying that we are gearing up—we are putting $200,000, $300,000 in new people and personnel to try and gear up for all these regulations.

How much is the right amount for the financial institutions to spend to be prepared? I don't expect you to answer that question, but it is the debate that we keep going back and forth on, and it is a concern for banks in my district, financial institutions in my district—the concern is if the dollars are being spent, then let's spend the penny, let's not spend the dollar.

Mr. MIN. In response to that, I would simply note that I think from the period of the 1940s to the 1980s, financial services made up a small percentage of GDP and of corporate profits. I think that was an efficient model of directing capital to productive investment. Currently, I think it makes up 40 to 60 percent in any given year of corporate profits.

I think the question is, should finance be the primary source of job creation or should the capital that it directs to productive investment be the primary source of job creation? I tend to favor the latter approach.

I think that if we simply focus on jobs in the financial sector and profits in the financial sector, we are ignoring the point of finance. We accept a certain level of systemic risk in finance because we want it to direct capital to places where it can be used efficiently.

Mr. RENACCI. But you would admit capital out of the financial markets is a necessity to job creation?

Mr. MIN. I think that a well-regulated financial market serves the purposes that it is intended to efficiently, and I think that is what was missing in the last 2 decades.

Mr. RENACCI. Dr. Angel, you had a chart here on Sarbanes-Oxley, and I had the opportunity to deal with many clients as a CPA with Sarbanes-Oxley. Do you think the chart will look like this when it comes to the opportunity for business growth in the country when it comes to being able to get financing with all the restrictions? Do you think there will be a chart someday that will look, based on the costs and the expenses or providing capital, that will have less ability to finance and create jobs?

Mr. ANGEL. I hope not, but if we do what we have always done, we will get what we have always gotten. And if we continue to load disproportionate costs on public companies, we are going to have fewer public companies.

Mr. RENACCI. It is an interesting concept because public companies were in—over the last 25 years for me were the driver of job creators, and when I see a chart like this it is very concerning that we are losing the ability for IPOs, public companies, and it sounds like you would testify that Dodd-Frank will also lead to some of this less growth, less public companies, it will add to the Sarbanes-Oxley problem.

Mr. ANGEL. Correct. For example, if you look at the conflict minerals section—now, what is going on in the Congo is a horrific abuse of human rights and I am glad Congress was concerned about this. But we have put a potentially costly disclosure on public companies but not on the private companies doing deals in the dark.

Now, it sounds innocuous, just like Sarbanes-Oxley 404 did, "Oh, give us a report that tells us what kind of conflict minerals you use from the Democratic Republic of the Congo." It sounds like another little boring report. But things like copper and cobalt are in virtually every electronic device.

If badly implemented, this could turn into another Sarbanes-Oxley 404. There needs to be some common sense to say that, for 95 percent of public companies, their use of conflict minerals is de minimis, and there needs to be some intelligence among the regulators to say, "Okay, we need to make sure that this can be implemented in a cost-effective manner."

Mr. RENACCI. Thank you.

Thank you, gentlemen.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman for his questions.

Now the gentleman from Texas, Mr. Canseco?

Mr. CANSECO. Thank you, Mr. Chairman.

And thank you, gentlemen, for participating in this panel for our subcommittee. I just have some follow-up questions that have already been brought up.

Beginning with you, Dr. Angel, in your testimony you bring up something very interesting and point out some fundamental flaws in the SEC. The agency is staffed primarily by lawyers, not financial experts, and in recent years has been less than excellent in regulating our Nation's securities market.

The SEC also does not have a great track record in considering economic costs when drafting rules. For example, when the SEC went about implementing Section 404 of Sarbanes-Oxley, they did not understand at the time the tremendous impact the rule would have on small companies.

From your viewpoint, Doctor, has there been any significant change in the way the SEC considers economic costs in the rules it is writing for Dodd-Frank versus the rules it wrote for Sarbanes-Oxley?

Mr. ANGEL. I actually have a high opinion of many of the current people at the SEC. I think they have a number of intelligent, hard-working, honest people. But I don't think they have enough of the right people to do the job.

So my fear is that with the hundreds of rules they are dealing with, one or more of those rules will turn into another Section 404.

Mr. CANSECO. And who would those right people be, in your opinion?

Mr. ANGEL. You need people who understand markets, who understand technology, who understand economics. And rookies fresh out of law school don't necessarily fit that bill.

Mr. CANSECO. Dr. Holtz-Eakin, one of the main concerns about overregulation in the financial market is that market participants will choose to do business in countries that do not have stringent rules. As a result of Dodd-Frank, do you see other nations going a different route than the United States in order to attract business and capital to their economy?

Mr. HOLTZ-EAKIN. I think it is a real concern. I think the basic structure of the intent was to build a more extensive but safer financial system, and the end users are going to try to avoid that expense if they can. They will go elsewhere.

And one of, I think, the big mistakes in the diagnosis of the crisis was to forget that it was global in its scope and the kinds of failures we saw in the United States, whether they were large financial institutions or housing bubbles, occurred elsewhere under very different regulatory regimes. And so it is not obvious that it was the regulatory regime that caused the problem.

So I would expect us to see capital flow to Canada. I would expect us to see some of these transactions move offshore quickly to those other regimes. And I think it is a misdiagnosis of what caused the problem.

Mr. CANSECO. Is there a way that we can measure the costs of business lost in the United States due to all of this overregulation?

Mr. HOLTZ-EAKIN. It is one of the hardest things to measure because it is the thing you don't see. My concern about these cost issues are the budget costs are going to be trivial here, compliance costs can be measured—you can count what a business spent. But sometimes it is the things you don't do and you can never measure that are actually the greatest costs.

My preferred diet is Diet Coke and Twizzlers. I believe I could live on that forever. But if they had a regulation that said I could only eat the ones that were individually wrapped, I am too lazy to open them, and I would go eat something else.

I wouldn't incur any measurable cost because I wouldn't actually be buying the thing, but I would be—my life would be diminished. That is what we are going to do. We are going to regulate things; we won't see the costs, they won't be measured, but we will have foregone some hedging, some growth, some investment, and that is the concern I have about the regulatory structure.

Mr. CANSECO. Thank you, sir.

Mr. Overdahl, you note in your testimony that in the past, the SEC has attempted to include economic analysis in an early-stage term-sheet review. However, this type of review was never institutionalized. In your opinion, why was it never institutionalized?

Mr. OVERDAHL. It really was the preference of individual chairmen who always will control the resources of the Commission and direct them, and to institutionalize it would—in the first instance, I think having a policy statement would go a long ways toward it and it could always be changed. But perhaps even at some stage a more formal requirement that—right now the requirements on independent agencies are not there; it is really up to the individual agency and the individual Commissioners at that time on what they do.

Mr. CANSECO. And just a follow-up question, what can be done to make the SEC more conscious of the economic costs of the rules of rights?

Mr. OVERDAHL. I think one thing that has happened in the last few years has been some of the challenges in court that have made them more conscious of the economic impact of their regulatory activities. If you have looked at some of the decisions, there have been now—I cite them in my written testimony—I think five different rules that have been sent back to the Commission on the grounds that they have not adequately considered economic analysis. That has gone a long way to getting their attention.

Mr. CANSECO. Thank you very much. My time has expired.

And Mr. Min, I am sorry I couldn't have a question for you.

Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

I think we are going to do just kind of a little lightning round here for some follow up and then we will let you go. And by the way, when we get through here go ahead and take the rest of the day off. You have earned it.

[laughter]

But a couple of things—I think one of the things that was brought up when we see the number of companies that are going—that aren't going public that—and the listings going down and we look at the—for example, the Facebook example here just the other day, and where we had companies—and I hear this a lot, and I think it is one of the reasons we have seen a lot of growth in private equity companies is because people are just finding it less competitive, or more friendly to go private than to go public.

Dr. Angel, do you want to comment on that just a little bit?

Mr. ANGEL. Yes. We have made the public market so unattractive for raising capital that small growing companies have no alternative but to go to private equity shops, but private equity is a lot more expensive than public capital should be. If you look at almost any valuation text they will say the big discount for illiquidity, so when entrepreneurs go to sell their companies they get a lot less for them. When they try to raise capital they get a lot—they get it on much more expensive terms, and so this is a major loss for our economy.

Chairman NEUGEBAUER. And I want to go back to something that Mr. Min said, and I wasn't sure I agreed with it. I wanted to get the panel's—but he suggested there was too much money in the financial sector, and our—if I understood you, that all of the investment in the financial sector was draining money from other sectors of the economy.

Mr. Holtz-Eakin, what is your response to that?

Mr. HOLTZ-EAKIN. I have no idea what the right amount of money in any sector of the economy is. In an efficient, functioning market economy we see that shift over time. So I have no idea how to make that judgment.

I am concerned that in the end we will produce a financial sector that doesn't meet what we really want, which is the finance—the risk management and investment needs of the underlying economy. Its scale is less important than that.

Chairman NEUGEBAUER. That is my—

Mr. MIN. —I actually did not mean too much money in the system. That is obviously just an amount of stored wealth because that needs to be invested.

But if you look at the percentage of corporate profits, that obviously indicates how much the intermediaries are taking as their take. How much are they taking for doing credit default swaps or private-label securitization, etc.?

When you have that much money what is existing is inefficient markets and perhaps the growth of the shadow banking system. And so, yes, I don't think the financial sector, when we look at it, should be the source of jobs but I think an efficient financial sector would be directing capital to other industries, such as construction, or housing, etc., in a way that doesn't create bubble-bust cycles.

Chairman NEUGEBAUER. Dr. Angel?

Mr. ANGEL. Yes. I would like to add that in the late 20th Century, we had a technological revolution in financial services, and just as we had a technological revolution in information technology so now we are spending a lot more money on IT because there are more things to spend money on. We developed a number of very useful risk management tools. Now you can say, "Oh, they don't do anything," but when real companies can reduce their risk they are likely to produce more.

When a farmer sees the price fluctuating of crops and says it is too risky, but if they can lay off the risk with a forward contract then they can lock in the price they know they are going to get, they know they will cover their cost of production, and they can plant that wheat or that corn. Or that oil company can drill that well because they know what they are going to get paid for it.

So yes, we have put a lot more resources into finance in recent years, but we have a lot more financial tools to deal with and many of these tools are extremely useful to the economy.

Chairman NEUGEBAUER. Yes, and haven't we—because we have had such a robust financial system, haven't we been an importer of capital because people have been attracted to our markets? I think one of the things that I get concerned about here is something that has been a major economic engine for our country. We are trying to kind of throw a little water on that fire in the sense that it is going to dampen the competitiveness in a very global, fluid financial marketplace.

With that, I am going to yield back my time so we can—does the ranking member want to take a follow up?

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Angel, I just want to clarify—your testimony and everything you said except for one thing is your concern about what could happen—all very on point. But at one point you said something about—I don't remember exactly what you said, but the Dodd-Frank bill will result—you say—is your testimony today that the Dodd-Frank bill as it is should not have been passed?

Mr. ANGEL. I would have preferred to have seen it passed in a—

Mr. CAPUANO. No, no. Excuse me. That is not my question. I would have preferred different things too.

Mr. ANGEL. Yes.

Mr. CAPUANO. The bill that we had is the bill that we had. Should we have passed that bill or should we have done nothing? Should that bill have voted yes or no as it was, knowing that if you voted no, it would be nothing else?

Mr. ANGEL. Sometimes, you have to go back to the drawing board. There are some—

Mr. CAPUANO. So you would have voted no and let nothing go on, which is fine. It is a fair answer.

Mr. ANGEL. Yes. Correct. I would have voted no because if you look at what we did in the New Deal, or I should say our parents' generation—

Mr. CAPUANO. No, no, no, Mr. Angel, you don't get it—

Mr. ANGEL. —they did it year after year—

Mr. CAPUANO. I am not asking you—I didn't make you the emperor. Believe me. Maybe I wouldn't mind—

Mr. ANGEL. That is good for this planet.

Mr. CAPUANO. It may not be. I wouldn't mind being emperor. I would have a different bill as well. But that is not the world I live in. I live in the world where you have an imperfect bill—

Mr. ANGEL. I would have kept working on it to get it right.

Mr. CAPUANO. I would have, too, if I could have passed something. But the option of doing something versus nothing, you choose nothing?

Mr. ANGEL. No. I would have continued to work on it because if it hadn't passed in July—

Mr. CAPUANO. Maybe you should pay a little more attention—

Mr. ANGEL. —it could have been passed in August or September.

Mr. CAPUANO. —we don't get that choice. The choice is something or nothing. That has been my choice for 12 years and 1,000 different bills.

Sometimes I choose something; sometimes I choose nothing. In this case I chose something, and I understand if you would have chose nothing. That is fine. But you would have nothing today.

So the past regulations would currently be in place, and that is why I—

Mr. Holtz-Eakin, the only thing that you said that I want to be clear on, there are some things we forego with regulation. That is what we are trying to do. There are certain things we don't want to happen.

In this case, for me it was excessive systemic risk. No, I don't want that here. Yes, excessive systemic risk also brings some rewards, but I think it is not worth it.

So yes, that is a judgment call and there are certain activities that I do not want, and that is what regulation is always about. So I don't think—I am not that far off in the concept of it of foregoing something. The question is, what are we foregoing?

I guess I do want to ask—maybe I am wrong, but I am under the impression that the European markets are heading in similar directions that we are. Not exact; we are never in lockstep.

But they are doing things that are quite similar to what we are doing. I am not going to get into details. Everybody at that panel knows more about the details than I do.

But am I reading this wrong that the European markets are similarly trying to tighten things up, trying to move things around, trying to limit excessive systemic risk? Is that a wrong read, or do you read the European markets differently? Does anybody?

Mr. MIN. I don't. In fact, I think Europe learned the same lesson that we learned, that if there was excessive risk, you need to regulate more. That is what Basel 3 is about. Some countries are obviously going further than Basel 3.

One note I would make on Dr. Angel's testimony, I think that London in particular attracted more stock market IPOs. One lesson they are learning was that the race to the bottom in regulation is not a good idea.

They are trying to aggressively regulate. They view the United States and Dodd-Frank perhaps as being too weak. I think that is a lesson that is learned in other countries as well.

Mr. ANGEL. And my point is not more or less regulation, it is the fact that, let's face it—Dodd-Frank is the law. Chances are it won't be overturned. So now we have to make it work; we have to fix the parts that are broken—

Mr. CAPUANO. I totally agree.

Mr. ANGEL. —and we have to make sure the regulators have the right kind of people to make it work.

Mr. CAPUANO. I agree with everything you have said on those issues. And the concerns you have expressed? I have similar concerns.

Even though I voted for the bill, you don't think I am concerned with certain aspects of it or how it is going to be implemented? There are lots of concerns I have. But again, my choice was something or nothing. That is always my choice and something was better than nothing, in my opinion.

I guess the last point I want to make, we heard it a couple of times tonight—this afternoon—maybe tonight, whatever—the term overregulation, I want to be really clear: I am not afraid of regulation. I am not in favor of overregulation.

However, I am also not in favor of underregulation. I agree with you, Mr. Angel. The right amount of regulation is the goal.

And it is a moving target because things change and people can disagree, and you try to do something and it doesn't work and you change the law. But is there anybody here who thinks that underregulation is a good thing?

So we all agree that some regulation is desirable.

Mr. HOLTZ-EAKIN. Sometimes your regulation—but underregulation would be even less than that, so it is a hard question to answer, sir.

Mr. CAPUANO. Fair point.

Do you think that the financial markets should be totally unregulated, the Federal Government should just walk away, turn its back on the financial markets and let everybody do whatever they want to do?

Mr. ANGEL. No. The first thing I teach on the first day of Finance 1 is that financial markets are creations of our legal system. You cannot have an unregulated financial market because it is the law and the regulation that actually defines what our financial products are.

Mr. CAPUANO. So is it a fair statement to say that we are all sitting here trying to find the right balance for a thoughtful regulated system that will help all of us continue to have this country be a lead and maintain stability in the market? I am under the presumption that—maybe I am making a false presumption—that a stable market—a relatively stable market is a good thing and a desirable thing. Is that a fair generalized statement?

Mr. OVERDAHL. Yes.

Mr. ANGEL. Yes.

Mr. HOLTZ-EAKIN. I guess I am the only one who disagrees. I don't care if financial markets are stable and if Wall Street loses their hair every day as long as the real economy serves the American public well.

Mr. CAPUANO. I don't care what Wall Street—but Wall Street, unfortunately, impacted my life in the last couple of years, and that is when I—I don't want to regulate it just for the fun of it. I want to regulate it because they have found a way to interfere in my life even though I don't play there.

Mr. HOLTZ-EAKIN. If prices and volumes don't change, which looks like instability, financial markets aren't doing their job. Worry a lot about the basic mentality that says instability is bad.

Mr. CAPUANO. Fair point. I don't think we are that far off.

This is a great hearing because I have agreed with 99 percent of everything that has been said. Good job.

Chairman NEUGEBAUER. I appreciate that.

Oh, by the way, just for the record, we did have an Oversight Subcommittee before Mr. Frank—

We will go back to it.

We will go to the gentleman from Texas again, Mr. Canseco?

Mr. CANSECO. Thank you, Mr. Chairman. I just have one very brief question.

Dr. Holtz-Eakin, you say that Dodd-Frank imposes a set of taxes on the economy?

Mr. HOLTZ-EAKIN. Yes.

Mr. CANSECO. Who ultimately pays these taxes?

Mr. HOLTZ-EAKIN. Consumers.

Mr. CANSECO. In your estimation, how big will the tax burden get under Dodd-Frank?

Mr. HOLTZ-EAKIN. This, I think, is the crucial question, and it is not one that I can easily answer. I tried to, in my testimony, show the growth and jobs impact, because that is the measure that matters.

It is not compliance costs. It is not any of the things that are easily measured. It is the overall economic impact.

It is the notion that we now have financial innovations in recent years that allow us to do risk management that was unheard of a decade ago, and if we lose the next generation, that is the real cost and that is the tax on the economy. And because we may never see it, it is very difficult to measure, but I worry it is substantial and I think it deserves careful scrutiny.

Mr. CANSECO. Thank you very much.

And I yield back my time.

Chairman NEUGEBAUER. And I thank the gentleman.

I think this has been a very good hearing, and again, I wanted to say to the witnesses, we appreciate you accommodating us today because we were—we didn't want to cancel this hearing because you have gone to a lot of work and done a good job on your testimony.

I would make a couple of observations here with the ranking member, is, I think what we have heard overriding today is that evidently within the institutions there is either not the will or always the desire to have the kind of analysis and study going on inside the rulemaking process. And possibly, as much as I hate to talk about putting any more legislation out there, but possibly there are some things that Congress can do to encourage that kind of behavior, because it becomes a check to us because in many cases people either vote for or against a piece of legislation and they believe if they vote for it they believe that they are doing the right thing, and if—as the ranking member said, if it is not implemented properly, then we have defeated the purpose.

And so I think we may want to look at some things down the road that possibly encourage—there are ways to encourage that kind of behavior that Congress can use and we may want to do that.

The Chair notes that some members may have additional questions for the panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

If there is not any other business to be brought before the committee, this hearing is adjourned.

[Whereupon, at 6:10 p.m., the hearing was adjourned.]

A P P E N D I X

March 30, 2011

Testimony of James J. Angel, Ph.D., CFA

Associate Professor of Finance

McDonough School of Business

Georgetown University

Washington DC

House Financial Services Committee

"The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic"

March 30, 2011

Testimony of James J. Angel

I wish to thank the Committee for investigating these important questions. My name is James J. Angel and I study financial markets at Georgetown University. I am the former Chair of the Nasdaq Economic Advisory Board, and I formerly served on the Nasdaq OTCBB Advisory Board. I have visited over 50 financial exchanges around the world. I am currently a public member of the board of directors of the Direct Edge Stock Exchanges.[1]

Today's hearings are on the costs of the Dodd-Frank legislation. These costs fall into three categories:

First, there is the opportunity cost of what could have been done with the political momentum for financial reform that was expended on Dodd-Frank. We missed the opportunity to rationalize the fragmentation of our financial regulatory system. For the most part we loaded additional duties onto an unwieldy structure. Without fundamental reform, something will inevitably fall between the numerous cracks until it is once again too late to avoid another financial crisis.

Second, there is the direct cost of implementation to the taxpayers and others. I understand other witnesses will address this issue.

[1] These remarks are my own and do not necessarily represent those of Georgetown University or the Direct Edge stock exchanges.

Finally and most importantly, there are the indirect costs stemming from the impact on the economy. I will focus my remarks on these indirect costs, as they can be the largest costs that matter the most. However, the CBO report to Congress during the deliberations over Dodd-Frank did not even attempt to address the indirect costs or impacts on our economy, but focused solely on the near-term impact on the federal budget.[2]

Our capital markets perform vital functions in our economy and if we mess them up our economy will suffer. Businesses depend on the capital markets to provide the capital needed to grow. Congress has wisely recognized the importance of capital formation and directed the SEC to consider economic efficiency, competition, and capital formation in its rulemakings.[3] At times, the SEC does little more than pay lip service to this Congressional mandate in its rule filings and proclaimed strategic goals.[4]

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[2] http://www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf

[3] . Section 3(f) of the Securities Exchange Act of 1934 states:

> (f) CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.— Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[4] For example, the SEC's strategic goal #2 is "Establish an Effective Regulatory Environment". Most of the measurable outcomes relate to measures of regulation, such as the number of foreign regulators trained. There are only three measures devoted to the related sub goal, "Outcome 2.2, The U.S. Capital markets operate in a fair, fair, efficient, transparent, and competitive manner, fostering capital formation and innovation." The three measures for this sub goal are:

The Devil is in the Details of Implementation

Congress has delegated the all important details of Dodd-Frank to several regulatory agencies. I am very concerned that our regulatory structure is not up to the task of implementing Dodd-Frank in an appropriate manner. Why am I concerned?

Previous implementations of Congressional mandates have not all gone well.

Our regulators have an imperfect track record in implementing large complex laws like Dodd-Frank. One classic example is the implementation of Sarbanes Oxley §404. Sarbanes Oxley, like Dodd-Frank, was a piece of complex legislation enacted in response to problems in our financial markets. Title IV, Enhanced Financial Disclosures called for more disclosure of transactions involving management and principal stockholders, disclosure of the existence of an audit committee financial expert, along with §404 disclosure of a management assessment of internal controls.

- Percentage of transaction dollars settled on time each year
- Average institutional transaction costs for exchange listed stocks on a monthly basis.
- Percentage of market outages at SROs and electronic communications networks (ECNs) that are corrected within targeted timeframes

While it is a great step forward that the SEC is beginning to look at these important indicators, there are many more measurable outcomes regarding capital formation. None of these measurable outcomes deal directly with capital formation. Other potential measurable outcomes related to efficiency and capital formation are 1) number of IPOs, 2) number of exchange-listed US public companies, 3) number of firms that voluntarily delist, 4) amount of capital raised in US public markets, 5) amount of venture capital raised, 6) transactions costs in US capital raising v. other countries, 7) compliance costs for US public companies

Sarbanes-Oxley §404 called for an "assessment ... of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." [5] Congress did not specify any particular level of controls, just a report on how good they were. This seems like a pretty simple and innocuous requirement. What could be wrong with asking companies how good their controls were? One former senior SEC official from that era said the Commission and staff thought §404 was "no big deal."

An assessment could be as simple as a report card with letter grades: One firm's controls might be graded A, while another's might be graded B+. There could also be a report card that puts different grades on different types of controls. A black-and white-judgment that controls are either effective or ineffective is ludicrous. There is a whole spectrum of quality between a total lack of controls and wasteful overkill. Yes this section was interpreted by accountants and regulators as a *de facto* requirement for wasteful overkill. The SEC itself admitted that the implementation was "overly conservative." [6] Yet the SEC at the time lacked the fundamental understanding of the impact of its rules to see what was happening and to react in a timely manner as this mess was occurring. Even though the SEC had explicit

[5] To be precise, the law reads as follows:

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.
(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d))
to contain an internal control report, which shall—
(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

[6] http://www.sec.gov/rules/concept/2006/34-54122.pdf, page 9.

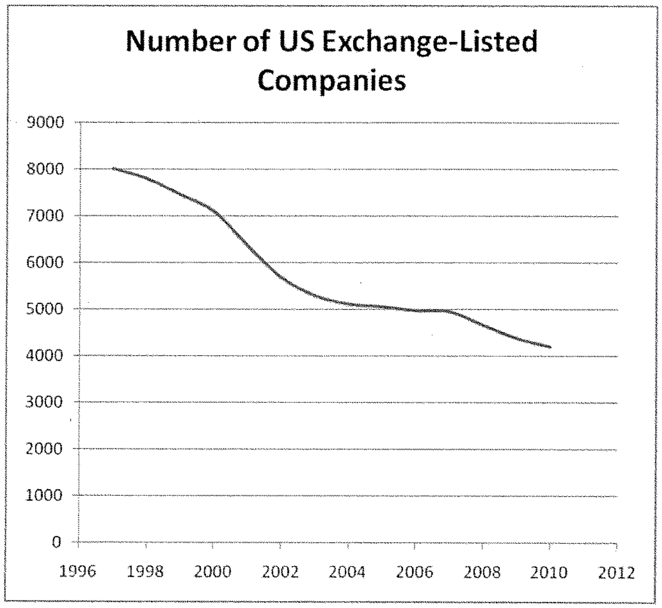
rulemaking authority in §404 itself, and also broad exemptive authority in Section 36 of the Securities Exchange Act of 1934, the SEC did little to prevent the damage and Congress had to step in with §989(g) of Dodd-Frank which exempts firms with a market capitalization of $75 million or less from §404 and calls for the SEC to study the matter further. Given that the SEC already had very broad rulemaking and exemptive authority here, it is not likely that enough will change as a result of §989(g).

The upshot is that compliance costs for public companies, especially smaller ones, jumped significantly. Few people thought that the benefits outweighed the compliance costs. One study by Foley and Lardner found that the average cost of being public for a firm with less than $1 billion in revenue jumped from $1.05 million before Sarbanes-Oxley to $2.88 million by 2005 – a 171% increase.[7] This is a major cost item for these smaller firms.

The result has been a decline in our public equity markets.

Why does this matter? By making it more expensive to be a public company, fewer companies are going public. One of the major trends in the last few years is that our public equity markets have been shrinking. The number of domestic U.S. companies listed on our exchanges is roughly half of what it was 15 years ago, as seen in the following graph:

http://www.foley.com/publications/pub_detail.aspx?pubid=3420



Source: CRSP database

Most of the growth in our economy comes from newer and smaller companies. If we make it harder for these companies to get the capital they need to get started and grow, then we will have fewer jobs and less economic growth. This is already happening. Our exchange-listed public companies now employ approximately two million fewer workers than they did 15 years ago.

Facebook demonstrates the problems facing our capital markets.

The recent Facebook financing is an example of what is wrong with our capital markets. Facebook was seeking capital to expand its successful and rapidly growing business. Facebook is a well known company and would have little trouble raising substantial sums of money from thousands of investors. This would be one of the easiest IPOs to sell. However, Facebook chose to do a private deal in which Goldman Sachs invested $500 million, and Goldman arranged for foreign investors to invest $1 billion.[8] Although the deal was originally going to be open to US investors, in the end it was only offered to foreign investors to avoid having to become an SEC registrant with all of the disclosure and other obligations that entails.

This illustrates the nature of the problems facing public companies. The US has placed such high burdens on public companies that fewer US companies are going public. The numbers of IPOs we have are not enough to offset the attrition that occurs in our financial markets through bankruptcies and mergers. The increasing burdens on US-listed companies have become so great that many companies are voluntarily delisting, and many foreign firms are exiting the U.S. exchanges. How did the SEC respond? They did not even think about the reasons firms no longer want to be public, but passed a rule making it easier for foreign firms to delist.

One of the basic lessons in entrepreneurial finance is to have an exit strategy. Investors want to know how they will get their money out when they need to. No investor wants a "Roach Motel" investment in which they can get in but they can't get out. Typical exit strategies are to sell to a "strategic buyer" such as another firm in the same industry or to go public. By reducing the

[8] http://www.prnewswire.com/news-releases/facebook-raises-15-billion-114383494.html

attractiveness of the public markets, entrepreneurs have fewer choices when raising capital and fewer buyers when selling their companies. This will reduce the returns to successful innovation, which will reduce the amount of investment made in the U.S. This means fewer jobs and less economic growth, along with less tax revenue.

Sarbanes Oxley was but one of the many factors affecting public companies. Changes in market structure have an impact as well. In the early 1990s, the market mechanism for trading small companies on NASDAQ was very different from the auction market of the NYSE. The SEC has fostered many well meaning rule changes that had the effect of eliminating differences between the two markets. This has greatly improved the market quality for larger firms, but has also reduced the incentives for the financial services industry to market smaller firms to investors.

To be sure, there are other contributing factors to the decline in the size of our public equity markets. The litigation environment, the collapse of the dot-com bubble, and overall market conditions have also contributed to the decline of public companies. Private equity has stepped in as a partial and more expensive substitute, but even private equity firms need an exit strategy. They cannot keep flipping companies back and forth between each other indefinitely.

Dodd-Frank has many provisions which could backfire like Sarbanes-Oxley.

Dodd-Frank contains many provisions which, if implemented badly, could be much more costly than anticipated and have serious adverse consequences for our economy. Here are a few:

Volker rule

The "Volker rule" places limits on "proprietary" trading by banks, with the implementation of the limits left up to the regulators. If "proprietary" is interpreted too broadly, it will severely limit the range of products that US banks can sell to customers around the world, while foreign competitors are not so restricted. This will hurt the competitiveness of U.S. firms.

Risk retention

Another troublesome area is the risk retention provision requiring securitizers to retain 5% of the risk of securitized deals. While this sounds attractive from a distance, the details are left up to the regulators. If poorly implemented, this could actually increase the systemic risk in the system as large highly leveraged securitizers keep the riskiest slices of their deals and then precipitate a crisis after it suffers major losses. Indeed, this is partly what happened to many large banks in the recent crisis. As they needed to raise cash, they sold the less risky but easier to sell securities. As the crisis reached the panic stage, they were left with the "toxic" securities that declined the most in value and that could not be sold or borrowed against. Another danger of a clumsy implementation is that excessively high risk retention requirements could slow down the needed rebuilding of a non-GSE dominated mortgage industry.

OTC derivative regulation

If not well thought out, the OTC position limits in derivatives could reduce the ability of legitimate hedgers from using these important risk management tools to reduce their risks. If producers cannot offload their risk, they may choose not to produce.

Ability to repay requirements

The "ability to repay" requirements for mortgages are another area where an overly stringent interpretation could preclude good credit risks from obtaining mortgage finance.

The SEC needs the right human resources.

Another reason to be pessimistic about Dodd-Frank implementation is that the SEC does not have enough good people to do all the things Congress wants it to do. It needs more experienced staffers who really understand how financial markets work. The SEC is making efforts to increase the level of staff expertise, but it still has a long way to go. The SEC is just getting around to measuring how many of its staffers have industry designations such as the Certified Fraud Examiner, Chartered Financial Analyst (CFA), or FINRA Series 7. Alas, in their FY2010 annual report they were unable to report the number and reported it as N/A, and listed the goal for FY2011 as "TBD".[9] I searched the CFA Institute's directory and found that only about 60 CFA charter holders are listed as working for the SEC. How can the SEC really review the filings from over 35,000 registrants (public companies, mutual funds, RIAs, broker-dealers, transfer agents, securities exchanges, and rating agencies) with only 60 Chartered Financial Analysts? The SEC seems to be able to hire lots of lawyers, but not enough people with financial expertise.

Suggestions for improvements in rulemaking

[9] http://www.sec.gov/about/secpar/secpar2010.pdf, page 70.

1. *Congress needs to be engaged in regular and active oversight of the regulatory bodies.* Regulation is not a "set it and forget it" activity. Hearings such as this one are useful. My observation is that agencies like the SEC generally pay close attention when they see that Congress is paying attention. Some, but not all, of this oversight can be outsourced by requiring that the GAO and/or outside consulting firms conduct regular studies of the agencies overall performance. These studies would include measures of capital formation, measures of fraud and abuse, and surveys of the experience of market participants with the regulators.
2. *Congress should require reauthorization of all financial regulators every five years, as it does for the CFTC.* Our financial markets are evolving so quickly that even a perfect regulatory structure today will soon grow obsolete. This is especially true for new agencies such as the CFPB, whose performance is yet unknown, but would also be useful for older agencies like the SEC. Agency cultures can become hidebound and dysfunctional over time. Regular reauthorization will force Congress to keep our regulatory structure up to date.
3. *Support reliable, quantitative economic analysis in rulemaking by getting the right people into the agencies.* One of the problems with the SEC is that is has earned a reputation as a lawyer-heavy agency with poor understanding of the markets it regulates. For example, the agency has been operating for some time without a chief economist who reports directly to the Chairman. While the SEC clearly needs more money to perform its mission properly, that money needs to be spent properly.[10] As part of the budget process,

[10] Since its inception in 1934, the cumulative budget of the SEC has been approximately $16 billion in current dollars. This is less than investor losses from one Bernie Madoff. We have been penny wise and pound foolish in underfunding the SEC and allowing the SEC to misallocate its scarce resources.

Congress should specify that the additional funds be spent not on more lawyers, but on people with the appropriate professional credentials such as the Series 7 or CFA designation, along with the technology people needed to understand our technology driven markets and to digest the huge amounts of data coming into the Commission.

4. *Congress should require regulators to pay attention to the rest of the world.* The United States is not the only jurisdiction that wrestles with the many issues that our financial regulators face. There once was a time when the U.S. was so far ahead of the rest of the world that we didn't have to pay attention to what the rest of the world was doing. However, many other countries have caught up and are leapfrogging us. A tremendous amount of fresh thinking has been going on around the world and we should pay attention to it.[11] Alas, most SEC rulemakings pay no attention to the experiences of other jurisdictions. Congress should amend the Administrative Procedures Act to require regulatory agencies to explicitly consider how other jurisdictions both inside and outside the United States have addressed the issue at hand and whether those solutions would be appropriate for the United States.
5. *Support more use of the Intergovernmental Personnel Act (IPA) mobility program.* It may take quite some time for Congress to rationalize our incoherent mishmash of overlapping regulatory agencies. In the meantime, some virtual rationalization can be achieved by strongly encouraging the different regulatory silos to swap personnel among different regulatory agencies. It should be clear that an appropriate career ladder for the professional staffs of the various agencies is that career staffers should expect to move

[11] We should pay attention to the thinking in the debates, although I would be the first to say that the decisions made by foreign jurisdictions may not be the right ones for the U.S.

often between different regulatory agencies. This will give the human resources of these agencies a broader perspective on financial services and reduce myopic decision making.

6. *House the various financial regulatory agencies in one building.* Regulatory fragmentation can be minimized by housing the regulators in a single building. This will make it much easier for the people in these agencies to have both formal and informal interactions, and to make maximum use of the IPA mobility program.
7. *Move the financial regulators closer to the heart of the financial markets.* Even in this electronic age, physical proximity matters. It is no accident that NASDAQ chose to move its headquarters from Washington DC to New York. Pipeline Trading, which was founded by scientists from the Santa Fe Institute in New Mexico, chose to set up shop in New York because that is where the customers are as well as a labor pool that understands financial markets. By being closer to market participants, it is easier for regulators to find out what is going on. The regulatory agencies will also be able to draw from an experienced labor pool of people who have a financial markets background. I have heard that, because of the current budget situation, SEC staffers in DC cannot go to New York to personally see what is going on in the markets. Regulators need to be physically closer to the markets they are regulating, so the financial regulatory apparatus should be in New York City, not Washington DC.

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Review of CBO's Cost Estimate for the Dodd-Frank Wall Street Reform and Consumer Protection Act

before the
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives

March 30, 2011

This document is embargoed until it is delivered at 2:00 p.m. (EDT) on Wednesday, March 30, 2011. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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Notes

Unless otherwise noted, all years referred to in this testimony are federal fiscal years, which run from October 1 to September 30.

The numbers in the text, table, and figure may not add up to totals because of rounding.

Chairman Neugebauer, Congressman Capuano, and Members of the Committee, thank you for inviting me to review the Congressional Budget Office's (CBO's) cost estimate for the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203). My statement summarizes CBO's cost estimate for the legislation as enacted on July 21, 2010.

As you know, one of CBO's primary responsibilities is to provide the Congress with the information and estimates required as it considers legislative proposals during the Congressional budget process. To that end, CBO prepared cost estimates for several versions of the Dodd-Frank Act. The most descriptive cost estimate, released on June 9, 2010, was for H.R. 4173, the Restoring American Financial Stability Act, as passed by the Senate. Later, CBO prepared a shorter, updated cost estimate for the conference agreement on H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act; that estimate was released on June 28, 2010. Finally, before the House passed H.R. 4173, CBO prepared a cost estimate for the conference agreement after an additional amendment was adopted by the conferees; that estimate was released on June 29, 2010. All of those cost estimates are available on CBO's Web site.[1]

The Dodd-Frank Act made significant changes to the regulatory environment for banking and thrift institutions as well as for financial markets and their participants. The act expanded existing regulatory powers, granted new regulatory powers, and reallocated regulatory authority among several federal agencies—with the aim of reducing the likelihood and severity of future financial crises. The act also established new agencies and programs and provided grants to help communities address high foreclosure rates and subsidies to assist homeowners facing foreclosure.

CBO estimated that, over the 2010–2020 period, the Dodd-Frank Act would increase both revenues and direct (or mandatory) spending—by $13.4 billion and $10.2 billion, respectively. On net, those effects were projected to reduce deficits by $3.2 billion (see Table 1). The revenues would stem primarily from fees assessed on various financial institutions and market participants. Certain provisions of the act were estimated to increase direct spending by $37.8 billion over the 10-year period; most of those costs, $26.3 billion, would result from a new program created to resolve insolvent or soon-to-be insolvent financial entities, which would be financed through an Orderly Liquidation Fund (OLF). CBO also estimated that other provisions of the act would reduce direct spending by $27.6 billion over that period by decreasing authority for the Troubled Asset Relief Program (TARP) and making changes to federal deposit insurance programs (see Figure 1 on page 4).

1. See Congressional Budget Office, "CBO Estimate of the Net Deficit Effects of H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act" (June 29, 2010); cost estimate for H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act (June 28, 2010); and cost estimate for H.R. 4173, the Restoring American Financial Stability Act of 2010 (June 9, 2010).

Table 1.

CBO's Estimate of the Impact on Budget Deficits Over the 2010–2020 Period From Enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act

(Billions of dollars)

	Direct (2010–2020)	Discretionary (2010–2015)
Cost of New Federal Organizations (CFPB, FSOC, OFR, ONI)		
Estimated outlays	6.8	*
Estimated revenues	0.5	
Net Change in Deficits	6.3	
Changes to the Existing Regulatory Structure (CFTC, FDIC, Federal Reserve, OCC, PCAOB, SEC, SIPC)		
Estimated outlays	2.7	0.3
Estimated revenues	2.6	
Net Change in Deficits	0.1	
Additional Funding for Existing Programs[a]		
Estimated outlays	1.5	0.2
Estimated revenues	0	
Net Change in Deficits	1.5	
Changes to Federal Deposit Insurance		
Estimated outlays	0	0
Estimated offsets to outlays	-16.6	
Estimated revenues	0	
Net Change in Deficits	-16.6	
Orderly Liquidation Fund		
Estimated outlays	26.3	0
Estimated revenues	6.0	
Net Change in Deficits	20.3	
Troubled Asset Relief Program		
Estimated offsets to outlays	-11.0	0
Net Change in Deficits	-11.0	
Other Budgetary Effects[b]		
Estimated outlays	0.5	2.1
Estimated revenues	4.3	
Net Change in Deficits	-3.8	

Continued

Table 1. **Continued**

CBO's Estimate of the Impact on Budget Deficits Over the 2010–2020 Period From Enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act

(Billions of dollars)

	Direct (2010–2020)	Discretionary (2010–2015)
Total Effect on Deficits		
Estimated outlays	37.8	2.6
Estimated offsets to outlays	-27.6	
Estimated revenues	13.4	
Net Change in Deficits	-3.2	

Source: Congressional Budget Office.

Notes: Components may not sum to totals because of rounding.

For the changes in deficits, positive numbers represent an increase in deficits and negative numbers represent a decrease in deficits.

CFPB = Consumer Financial Protection Bureau; FSOC = Financial Stability Oversight Council; OFR = Office of Financial Research; ONI = Office of National Insurance; CFTC = Commodity Futures Trading Commission; FDIC = Federal Deposit Insurance Corporation; OCC = Office of the Comptroller of the Currency; PCAOB = Public Company Accounting Oversight Board; SEC = Securities and Exchange Commission; SIPC = Securities Investor Protection Corporation.

* = less than $50 million.

a. The Dodd-Frank Act provided funding for subsidies to help homeowners in foreclosure and for grants to stabilize communities with many foreclosed properties.

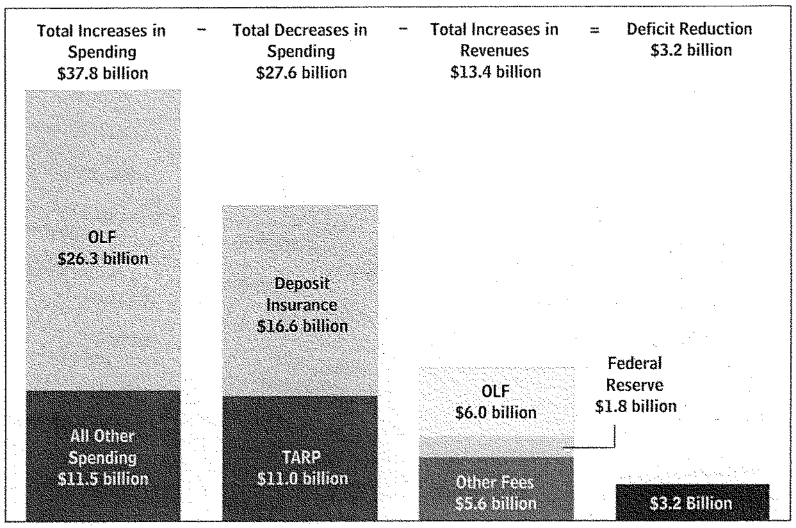
b. The Dodd-Frank Act provided the Securities and Exchange Commission with permanent authority to collect certain fees and to spend a limited amount of those collections; adjusted the regulation of fixed income annuities; exempted swaps and other derivatives from certain provisions of the Internal Revenue Code; and authorized funding for counseling and legal assistance programs for certain homeowners and tenants.

In addition to those changes in direct spending and revenues, CBO estimates that the Dodd-Frank Act will lead to an increase of $2.6 billion in discretionary spending over the five-year period ending in fiscal year 2015, assuming that the Congress provides the necessary appropriations in the future.[2] In CBO's cost estimates, the effects of legislation on discretionary spending are shown separately from the effects on direct spending and revenues because the former occur only if funding is provided in future appropriation acts.

2. CBO did not include an estimate of the effect on discretionary spending in the cost estimates released on June 28, 2010, and June 29, 2010, because the agency was unable to complete such an estimate before the legislation was scheduled to be considered in the House of Representatives. On the basis of analyses prepared for a previous version of the act, S. 3217, the Restoring American Financial Stability Act of 2010, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs, and for H.R. 1728, the Mortgage Reform and Anti-Predatory Lending Act, as ordered reported by the House Committee on Financial Services, CBO estimates that the discretionary provisions of H.R. 4173 as enacted will cost $2.6 billion over the 2011–2015 period, if the necessary funds are provided in appropriation acts.

Figure 1.

CBO's Estimate of the Effects on Direct Spending and Revenues of the Dodd-Frank Wall Street Reform and Consumer Protection Act Over the 2010–2020 Period



Source: Congressional Budget Office.

Note: OLF = Orderly Liquidation Fund; TARP = Troubled Asset Relief Program.

CBO's Role in the Legislative Process

Before providing you with details on CBO's cost estimate, I would like to give a brief overview of the agency's role in the legislative process.

One of the agency's chief responsibilities is to provide information that helps the Budget Committees enforce the budgetary rules established by law or adopted by each House. CBO nearly always provides formal estimates for bills that are reported out of committee, but it also often provides the Congress with estimates of the cost of bills at other stages as they proceed from consideration by the relevant committees through passage. (The estimated impact of most legislation on revenues is determined by the staff of the Joint Committee on Taxation [JCT]. CBO uses estimates provided by JCT in its cost estimates.) During the 111th Congress, CBO prepared 1,137 formal estimates, primarily for legislation reported by authorizing committees.

A CBO cost estimate typically includes information about the budgetary effects of a bill in two broad categories: budget items that are subject to the pay-as-you-go rules (that is, direct spending and revenues), which are shown for the current year and the following 10 years; and separately, discretionary spending, which is subject to future action in appropriation bills and is usually shown for the current year and the following five years. In addition, a CBO estimate typically includes a statement about the bill's effect on state, local, and tribal governments and on the private sector. For the Dodd-Frank Act, CBO and JCT completed seven formal cost estimates for different versions of the consolidated bill and nine cost estimates for other bills that included specific provisions of the consolidated bill and that were marked up separately by the Committee on Financial Services and other committees (see the Appendix). Prior to and during deliberations on the bill, CBO provided many informal estimates as the authors were drafting various provisions of the legislation—a long-standing practice of the agency to assist committees and sponsors as they develop legislative language.

Once proposed legislation is enacted, however, the agency's involvement is quite limited. New statutes join with the whole body of existing law to form the basis for CBO's baseline projections. Those projections are generally prepared for programs as a whole; therefore, the effects of individual statutes cannot ordinarily be separately identified. The agency generally revisits a specific law again only if the Congress considers new legislation to amend it.

Major Provisions of the Dodd-Frank Act and Their Budgetary Effects

The Dodd-Frank Act significantly changed the way the federal government regulates entities and transactions associated with the financial markets. Specifically, the act did the following (with the resulting net additions to or reductions in federal deficits from changes in direct spending and revenues over the 2010–2020 period shown in parentheses):

- *Created several new federal organizations to regulate financial matters:* the Consumer Financial Protection Bureau (CFPB), the Financial Stability Oversight Council (FSOC), the Office of Financial Research (OFR), and the Office of National Insurance ($6.3 billion);

- *Restructured the authority of existing financial regulators,* including the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) ($0.1 billion);

- *Provided additional funding for existing programs* that provide mortgage relief, neighborhood revitalization, and grants to encourage individuals to move from nonbank financial services to traditional banks ($1.5 billion);

- *Modified federal deposit insurance programs,* including increasing the maximum amount of deposits in an individual account that can be insured and directing the FDIC to increase the size of its insurance fund by 2020 (-$16.6 billion);
- *Created the Orderly Liquidation Fund and authorized the FDIC to resolve systemically important financial firms under certain conditions* ($20.3 billion);
- *Reduced the spending authority of the TARP* (-$11.0 billion); and
- *Made a number of other changes to current law,* including reclassifying the budgetary treatment of certain fees collected by the SEC, modifying the regulation of certain types of tax-deferred annuities, and authorizing grants to provide counseling and legal assistance to homeowners facing foreclosure (-$3.8 billion).

The remainder of this testimony discusses CBO's cost estimate in more detail.

Cost of New Federal Organizations

The Dodd-Frank Act established several new regulatory entities, including the Consumer Financial Protection Bureau, the Financial Stability Oversight Council, the Office of Financial Research, and the Office of National Insurance.

The CFPB is an autonomous agency funded by transfers from the Federal Reserve, which is a self-financing governmental entity. CBO estimated that the cost for the CFPB over the 10-year period would be $5.9 billion. Of that amount, about $1.2 billion represents costs for activities previously performed by the Federal Reserve that are being transferred to the CFPB under the act.

How will those costs appear in the budget? Each year, the Federal Reserve determines the amount of its income that exceeds its operating costs and transfers most of that amount to the Treasury. Those Treasury receipts are recorded in the budget as revenues. If the Federal Reserve's costs increase and its income is unchanged, it transfers less to the Treasury, decreasing the amount of revenues recorded in the federal budget.

One option for presenting the budgetary effects of this action is to record the funds provided by the Federal Reserve to the CFPB as reductions in revenues because they will reduce the Federal Reserve's transfers to the Treasury. In CBO's estimate, however, the costs of the CFPB were classified as additional direct spending, from the standpoint that such information would more accurately reflect the true nature of the transactions. (The Office of Management and Budget reached the same conclusion: The President's budget for fiscal year 2012 presents the costs of the CFPB as spending in a new budget account.) Either approach, however, arrives at the same end: Spending by the CFPB represents an increase in budget deficits.

The FSOC and the OFR also will be funded by transfers from the Federal Reserve, but only for the first two years after enactment; after that, they will be supported by fees assessed on certain financial companies. As was the case with the CFPB, CBO categorized the costs for those new entities as additional direct spending and estimated that those costs would total $900 million over the 2011–2020 period. That amount includes the general operating costs of the two new entities and the cost of a provision allowing the OFR to enter into certain lease agreements. CBO estimated that fee collections to offset the costs of the FSOC and the OFR would total about $500 million over the same period, assuming that fees would not be assessed to cover the OFR's leasing and construction costs. Those collections would be counted as revenues.

Finally, the act established the Office of National Insurance at the Department of the Treasury. CBO estimates that this new office will cost less than $20 million over the 2011–2020 period, assuming appropriation of the necessary funds.

All told, CBO estimated, establishing the CFPB, FSOC, and OFR would, on net, increase budget deficits by $6.3 billion over the 10-year period. That amount does not reflect savings for the Federal Reserve, which I will discuss later.

Changes to the Existing Regulatory Structure

The act changed the regulatory regime for financial activities by rearranging the responsibilities of federal banking regulators and by broadening the authority of the agencies that oversee financial markets. CBO estimated that—through their effects on direct spending and revenues—provisions making changes to existing regulatory agencies would increase deficits by $0.1 billion, on net, over the 2011–2020 period. Those changes were expected to add about $2.7 billion in spending, most of which would be offset by additional revenues totaling $2.6 billion. The spending would consist of additional outlays for the SEC, the CFTC, bank regulators, the Public Company Accounting Oversight Board (PCAOB), and the Securities Investor Protection Corporation (SIPC). Of the total revenue amount, about $0.8 billion would result from fees collected by the PCAOB and the SIPC; the balance, about $1.8 billion, represents additional revenues generated by the Federal Reserve from new fees required by the act ($0.6 billion) and from the increase in its net income that would result from the transfer of personnel to the CFPB ($1.2 billion). In addition, CBO estimates that the SEC and CFTC will incur additional net discretionary costs of $0.3 million over the 2011–2015 period, assuming future appropriation of those funds.

Financial Market Regulators. The act established programs at the SEC and CFTC to reimburse individuals who provide information that leads to successful prosecution of violations of securities and derivatives regulations. CBO estimated that the whistleblower provisions would add $1.1 billion to direct spending over the 2011–2020 period.

Further, the act expanded the authority of the SEC and CFTC to regulate entities and transactions associated with registered financial markets. Both agencies receive funding annually through the appropriation process. CBO estimates that changes to the regulatory authority of those agencies (not including the authority to compensate whistleblowers) will increase discretionary spending by $1.3 billion, under an assumption that the added spending authority will be provided in appropriation acts. That amount will be partly offset by discretionary fees totaling about $1.0 billion to be collected by the SEC if the authority to collect those fees is provided in appropriation acts. Therefore, CBO estimates that the net discretionary cost of those provisions will total about $300 million over the five-year period ending in 2015.

Federal Bank and Thrift Regulators. The act abolished the Office of Thrift Supervision (OTS), transferring its functions to other regulators, including the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve. CBO estimated that, excluding the effects on the Federal Reserve, those provisions would increase budget deficits by $0.3 billion over the 2011–2020 period because of provisions that allow the OTS to spend unobligated balances for the transition and that authorize the OCC to enter into agreements without regard to existing laws governing the disposition of real or personal property.

The Federal Reserve. The act also broadened the authority of the Federal Reserve to include the supervision and examination of thrift holding companies—activities previously overseen by the OTS. The act requires the Federal Reserve to charge fees for the examination of large thrift and bank holding companies but not for the examination of smaller thrift holding companies. CBO estimated that the net effect of those changes to the Federal Reserve's regulatory structure would be an increase in revenues of about $580 million over the 10-year period. The fees that large bank holding companies will pay account for most of the projected revenue increase, because the Federal Reserve did not previously charge fees for its examinations of bank holding companies and the new fees will represent reimbursements for costs the Federal Reserve would have incurred under prior law. The fees that large thrift holding companies will pay will compensate the Federal Reserve for the additional costs of their supervision and examination, resulting in no net impact on revenues. The examination and supervision of smaller thrift holding companies represent additional costs to the Federal Reserve, which will partially offset the income from the fees paid by large bank holding companies.

Additionally, the Federal Reserve will transfer personnel and consumer-protection functions to the Consumer Financial Protection Bureau. CBO estimated that more than 500 positions would be transferred to the CFPB, raising revenues by about $1.2 billion over the 2011–2020 period by reducing costs to the Federal Reserve by the same amount.

The Federal Reserve also will incur additional costs, which CBO estimated would total $50 million over the 10-year period, for the following additional duties required by the act:

- Supervision of certain securities holding companies;
- Additional joint rulemaking responsibilities; and
- Supervision of financial market utilities.[3]

3. A financial market utility is an organization that transfers, clears, or settles payments, securities, or other financial transactions among financial institutions.

Other Financial Regulators. The act also expanded the oversight authority of the PCAOB and increased the amounts the SIPC can borrow from the Treasury. Both agencies charge fees to offset operating costs. CBO estimated that these provisions would increase direct spending by $1.3 billion and revenues from additional fees by $0.8 billion over the 2011–2020 period.

Additional Funding for Existing Programs

The Dodd-Frank Act appropriated funds for grants to state and local governments to purchase and redevelop abandoned properties and for subsidies to provide mortgage relief to certain homeowners. CBO estimated that these provisions would increase direct spending by $1.5 billion over the 2011–2020 period.

The act also authorized funding that will be subject to future appropriation action for a program to encourage consumers to use traditional banking services rather than alternative financial services, such as nonbank check cashing and payday lending. CBO estimates that the added discretionary spending will amount to about $200 million over the five-year period ending in 2015, assuming appropriation of the necessary funds.

Changes to Federal Deposit Insurance

The Dodd-Frank Act made several changes to federal deposit insurance programs. CBO estimated that those provisions would reduce net outlays by $16.6 billion over the 2011–2020 period.

Over half of the estimated savings—about $9 billion—will result from provisions that permanently increased the maximum amount of insured deposits for individual accounts (from $100,000 to $250,000). Raising the level of deposit insurance coverage will reduce federal outlays because of the way those programs are funded. By law, the FDIC and the National Credit Union Administration (NCUA) are required to maintain balances in their insurance funds equivalent to a specified percentage of insured deposits. Thus, increasing the volume of insured deposits will require a corresponding increase in the size of the insurance funds, which will require an increase in premiums paid by depository institutions. Those premiums are recorded as collections to the FDIC's Deposit Insurance Fund (DIF) and the NCUA's Share Insurance Fund and offset direct spending.

CBO's cost estimate also included savings of nearly $6 billion resulting from provisions that directed the FDIC to increase the size of the Deposit Insurance Fund by 2020. Before the enactment of the Dodd-Frank Act, the FDIC was charging premiums at rates necessary to have DIF balances equivalent to about 1.25 percent of insured deposits by the end of the decade. The act established a higher target for 2020, requiring DIF balances equivalent to 1.35 percent of insured deposits. Increasing the size of the DIF by 2020 will reduce the FDIC's net outlays as depository institutions pay higher premiums to increase the capitalization of the fund.

Finally, the act repealed the FDIC's authority to guarantee certain types of debt unless specifically authorized by future legislation. In 2008, the FDIC established a temporary program to guarantee certain obligations of insured depository institutions, holding companies that include insured depository institutions, and some affiliates of those firms. The Dodd-Frank Act repealed the FDIC's prior authority for such assistance and provided a new framework for similar, but potentially much broader, assistance. Use of those new authorities, however, would be contingent on the enactment of subsequent legislation. As a result, the estimated budgetary impact of enacting those provisions reflects the effects of eliminating the FDIC's prior authority but does not include the estimated cost of the new program. CBO estimated that this change would reduce net direct spending by the FDIC by about $2 billion over the 2011–2020 period.

Orderly Liquidation Fund

The Dodd-Frank Act provided new authority for the federal government to liquidate large, systemically important firms that become insolvent or are in danger of becoming insolvent. Firms will be considered systemically important if their failure is determined to threaten the stability of the nation's financial system. Under the act, the FDIC is authorized to borrow funds from the Treasury to liquidate such firms and to levy fees on large bank holding companies and other financial firms to cover any losses; those transactions would occur through the Orderly Liquidation Fund.

If those authorities were invoked, the transactions would be recorded in the budget on a cash basis. Spending for resolution activities would increase outlays in the initial years of a liquidation, but that spending would be offset in subsequent years by income received from selling the assets of the failed firm and collecting fees to cover any losses. As a result, a snapshot of cash flows in any given 10-year budget window is unlikely to net to zero because the spending to liquidate a firm would occur before the income was received to cover those costs.

CBO's estimate of the cost of the resolution authorities provided by the act represents the difference between the expected values of the net costs to the OLF to resolve insolvent firms and the additional assessments collected by the OLF. Those expected values represent weighted averages of the outcomes of various scenarios regarding the frequency and magnitude of systemic financial problems, taking into account an estimated probability of each scenario. Although the estimate reflects CBO's best judgment on the basis of historical experience, the cost of the program will depend on future economic and financial events that are inherently unpredictable. Moreover, the timing of the cash flows associated with resolving insolvent firms is also difficult to predict. It might take several years, for example, to recoup the funds spent to liquidate a complex financial institution. As a result, for a liquidation occurring in the 2011–2020 period, some of the proceeds from selling assets acquired in the liquidation process or from cost-recovery fees might be collected beyond that period.

Although the probability that the federal government would have to liquidate a financial institution in any year is small, the potential costs of liquidating a systemically important firm could be large. On an expected-value basis, CBO estimated that net direct spending for potential liquidation activities, which includes recoveries from the sale of assets acquired from liquidated institutions but excludes revenues from assessments, would be $26.3 billion through 2020. CBO estimated that the expected value of revenues from assessments paid to cover any losses would total about $6.0 billion through 2020, net of effects on payroll and income taxes. Because liquidation activities are so unpredictable, actual spending and assessments in each year would probably vary significantly from the estimated amounts—either higher or lower than the estimate provided.

Troubled Asset Relief Program

The Dodd-Frank Act also prohibited the Treasury from incurring new obligations under the Troubled Asset Relief Program after June 25, 2010. On the basis of several factors—the acceleration of the expiration date for the program, the amount of money that CBO had previously projected would be used for new purposes, and the subsidy costs for other initiatives under the TARP—CBO estimated savings of $11.0 billion in 2010 from the legislation.[4]

Other Budgetary Effects

Several other provisions of the Dodd-Frank Act will also have significant budgetary effects in CBO's estimation:

- The act provided the SEC permanent authority, starting in 2012, to collect certain fees and spend a small portion of the receipts, thus changing the budgetary classification of those fees. (They currently make up a portion of the fees collected by the SEC under authority provided annually in an appropriation act. Prior to enactment of the Dodd-Frank Act, all fees collected by the SEC were authorized annually in an appropriation act and were netted against discretionary spending.) The act also lowered the amount of those fees that the SEC would be required to collect each year. With the SEC's new authority, the affected fees will be recorded as revenues rather than as offsets to discretionary spending; nonetheless, over two-thirds of the fees collected by the SEC will remain discretionary. CBO estimates that this provision will increase revenues by $5.2 billion and increase direct spending by $0.5 billion over the 2011–2020 period. CBO estimates that, if the necessary funding is provided in future appropriation acts, this provision will increase discretionary spending by $5.6 billion over the 10-year period (including $1.9 billion over the first five years) because fewer collections will be available to offset discretionary appropriations.

- Several other provisions will also affect revenues. Specifically, one provision exempts certain derivative contracts from the effects of certain provisions of the Internal Revenue Code; JCT estimated that this provision would increase revenues by $0.1 billion over the 10-year period. Another provision exempts certain annuities from regulation by the SEC, leaving regulation of those investment vehicles to the states. CBO estimated that that provision would reduce revenues by about $1.0 billion over the 10-year period because more income would be earned from tax-deferred annuities rather than from taxable instruments. CBO and JCT estimated that, taken together, these provisions would increase budget deficits by $0.9 billion over the 2011–2020 period.

4. CBO values the TARP's asset purchases and guarantees using procedures similar to those specified in the Federal Credit Reform Act of 1990, but with an adjustment for market risk as directed by section 123 of the Emergency Economic Stabilization Act of 2008.

- Other provisions of the act established programs to support efforts to provide homeownership counseling and legal assistance to certain homeowners and tenants. Assuming appropriation of the necessary amounts, CBO estimates that those programs will increase discretionary spending by $200 million over the 2011–2015 period.

Uncertainty in CBO's Estimates

CBO's estimates of the costs of different provisions of the Dodd-Frank Act involve different degrees of uncertainty. For example, estimates of the costs of provisions that specify amounts of spending or that direct agencies to do more of an activity already being performed under current law tend to have relatively low degrees of uncertainty. In contrast, estimates of the costs of provisions that require federal agencies to carry out activities with a broad range of possible outcomes, such as the provision requiring the creation of the OLF, are highly uncertain.

Under the legislation, as under prior law, there is some probability that, at some point in the future, large financial firms will become insolvent and a liquidity crisis will arise, and that those financial problems will present significant risks to the nation's broader economy. The cost of addressing those problems under prior law is unknown and would have depended on how the Administration and the Congress chose to proceed when faced with the prospect of a financial crisis; they could, for example, have changed laws, created new programs, appropriated additional funds, and assessed new fees. Depending on the effectiveness of the new regulatory initiatives and new authorities to resolve and support a broad variety of financial institutions, implementing the Dodd-Frank Act could change the timing, severity, and federal cost of averting and resolving future financial crises. However, CBO did not attempt to determine whether the estimated costs under the act would be smaller or larger than the costs of alternative approaches to addressing future financial crises and the risks such crises pose to the economy as a whole.

The Administration's Implementation of the Dodd-Frank Act

CBO has just issued its *Preliminary Analysis of the President's Budget for 2012*. In preparing its analysis of the budget, the agency gleaned no information that would cause it to significantly change the cost estimate that it provided prior to the enactment of the Dodd-Frank Act. From the budget justifications for the SEC and the CFTC, CBO learned that those agencies are deeply involved in implementing the numerous rules that are required under the legislation. The President's budget also provided information regarding expected staffing levels for the Consumer Financial Protection Bureau and the financial regulatory agencies.

In cost estimates for earlier versions of the act, CBO discussed expected staffing levels and overhead costs. Those estimates were based on information from the affected agencies as well as from a review of historical spending patterns for similar, though unrelated, activities. It is not possible to assess the accuracy of CBO's overall estimate of the effects of the Dodd-Frank Act on spending and revenues by evaluating the various agencies' 2012 budget requests and plans because the full costs of implementation will not be realized for several more years. CBO can, however, provide a few snapshots of what it has learned so far:

- CBO estimated outlays of $167 million in 2012 for the Consumer Financial Protection Bureau; the President's plan calls for spending $267 million that year.

- CBO estimated that about 500 people would transfer from the Federal Reserve to the Consumer Financial Protection Bureau; it now appears that the number of individuals who will transfer might be significantly smaller.

- CBO estimated that the FDIC would spend an additional $40 million in 2011 to implement the act, net of transfers from the OTS; actual spending this year appears to be in that vicinity. In addition, CBO estimated that the FDIC would collect $140 million in additional assessments in 2012 as a result of the act; however, the agency does not anticipate increasing assessments until later in the 10-year period.

- CBO estimated that the SEC would fill an additional 800 staff positions over several years if the necessary amounts were appropriated; the agency requested an additional 352 positions in 2012 to start implementing the act.

- CBO estimated that the CFTC would ultimately fill an additional 235 full-time staff positions if the necessary amounts were appropriated; the agency requested an additional 238 positions in 2012 to begin implementation of the act.

Appendix: List of Estimates Completed for Provisions Incorporated in the Dodd-Frank Act

1. H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act
   Estimate prepared: June 29, 2010
   www.cbo.gov/ftpdocs/116xx/doc11601/hr4173amendment.pdf

2. H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act
   Estimate prepared: June 28, 2010
   www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf

3. H.R. 4173, the Restoring American Financial Stability Act of 2010
   Estimate prepared: June 9, 2010
   www.cbo.gov/ftpdocs/115xx/doc11560/hr4173senatepassed.pdf

4. H.R. 3817, the Investor Protection Act of 2010
   Estimate prepared: June 8, 2010
   www.cbo.gov/ftpdocs/115xx/doc11558/hr3817.pdf

5. S. 3217, the Restoring American Financial Stability Act of 2010
   Estimate prepared: May 3, 2010
   www.cbo.gov/search/ce_sitesearch.cfm?criteria=&filt_congress=111&bill=s3217&filt_func=any&filt_committee=any&filt_paygo=0&filt_intergov=0&filt_doctype=any

6. S. 3217, the Restoring American Financial Stability Act of 2010
   Estimate prepared: April 21, 2010
   www.cbo.gov/ftpdocs/114xx/doc11454/s3217.pdf

7. H.R. 2609, the Federal Insurance Office Act of 2009
   Estimate prepared: March 11, 2010
   www.cbo.gov/ftpdocs/113xx/doc11339/hr2609.pdf

8. H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009
   Estimate prepared: December 9, 2009
   www.cbo.gov/ftpdocs/109xx/doc10996/hr4173rules.pdf

9. H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009
   Estimate prepared: December 4, 2009
   www.cbo.gov/ftpdocs/108xx/doc10826/hr4173.pdf

10. H.R. 3890, the Accountability and Transparency in Rating Agencies Act
Estimate prepared: December 3, 2009
www.cbo.gov/ftpdocs/108xx/doc10833/hr3890.pdf

11. H.R. 3818, the Private Fund Investment Advisers Registration Act of 2009
Estimate prepared: November 13, 2009
www.cbo.gov/ftpdocs/107xx/doc10727/hr3818.pdf

12. H.R. 3795, the Derivatives Markets Transparency and Accountability Act of 2009
Estimate prepared: November 6, 2009
www.cbo.gov/ftpdocs/107xx/doc10717/hr3795ag.pdf

13. H.R. 3126, the Consumer Financial Protection Agency Act of 2009
Estimate prepared: November 3, 2009
www.cbo.gov/ftpdocs/108xx/doc10830/hr3126.pdf

14. H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009
Estimate prepared: November 3, 2009
www.cbo.gov/ftpdocs/107xx/doc10703/hr3795hfs.pdf

15. H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009
Estimate prepared: July 30, 2009
www.cbo.gov/ftpdocs/104xx/doc10490/hr3269.pdf

16. H.R. 977, the Derivatives Markets Transparency and Accountability Act of 2009
Estimate prepared: February 23, 2009
www.cbo.gov/ftpdocs/100xx/doc10006/hr977.pdf

The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic

Douglas Holtz-Eakin, President
American Action Forum*

March 30, 2011

Introduction

Chairman Neugebauer, Ranking Member Capuano and members of the Committee, I am pleased to have the opportunity to appear today to discuss the economic and budgetary costs of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank", Public Law 111-203). In this testimony, I wish to make four main points:

- Financial regulation imposes budgetary costs on the taxpayer. In addition, it imposes direct compliance costs and its distortions induce economic costs in the form of reduced capital investment, inferior risk-sharing, and lost competitiveness. Because of its scope and scale, Dodd-Frank will impose substantial costs of each type.

- Budgetary costs are the least difficult to estimate, and likely the smallest cost associated with Dodd-Frank. The most important aspects of the law from a budgetary perspective were its failure to include reforms to the Government Sponsored Enterprises and the creation of the Consumer Financial Protection Agency. The former will likely have significant budgetary consequences, while the latter has be inexplicably placed outside the annual appropriations and oversight process.

- Compliance costs are an important burden on the affected firms and industries. Moreover, past episodes such as the passage of the Sarbanes-Oxley (SOX) legislation suggest that these can be substantially larger than

* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Sam Batkins, Cameron Smith, and Ike Brannon for assistance. All errors are my own.

anticipated. SOX compliance for one provision of the Act was estimated at under $100,000; the reality for most firms is easily 10 to 40 times greater.

- The economic consequences of Dodd-Frank will be to reduce investment in the United States.

Let me pursue each in additional detail.

Budgetary Costs

Dodd-Frank will be an expensive federal endeavor. The Congressional Budget projects federal budget costs of $1.1 billion over the first 5 years.[1] In part, this reflects the fact that the law creates 122 new councils, advisory committees, other panels, and consultation requirements. In addition, the Congressional Research Service (CRS) estimates there are up to 330 rule-makings that will have open-comment periods. These are costly undertakings that will require taxpayer resources.

In a June 28, 2010 cost estimate for the Dodd-Frank Conference Agreement, the Congressional Budget Office and the Joint Committee on Taxation (JCT) estimated enacting the bill would increase revenues by $17.1 billion over the 2011-2015 period and by $26.9 billion over the 2011-2020 period and increase direct spending by $14.9 billion and $26.9 billion, respectively, over the same periods.

The CBO's estimate includes estimated changes in direct spending over the 2011-2020 period for the following Dodd-Frank provisions:

- Consumer Financial Protection: estimated outlay of $6 billion
- Derivatives Regulation: estimated outlay of $200 million
- Financial Stability Oversight: estimated outlay of $200 million
- Other Financial Oversight and Protection: estimated outlay of $2.2 billion

Still, when viewed in the context of annual federal outlays totaling $3.6 trillion it is clear that Dodd-Frank is not a key driver of federal deficit or debt accumulation. Indeed, the two most significant budgetary aspects of Dodd-Frank are those costs that are *not* on the federal budget.

The Congressionally-created Financial Crisis Inquiry Commission (FCIC) recently completed its investigation and reported to Congress.[2] As has been widely reported, the FCIC was unable to agree upon a single set of causes of the financial crisis. Instead, the majority report was accompanied by two separate dissenting views.

[1] The CBO cost estimate for the Dodd-Frank Conference Agreement is available at http://www.cbo.gov/ftpdocs/115xx/doc11596/hr4173.pdf

[2] See http://www.fcic.gov/report.

Importantly, however, all three reports assign a significant role to housing market policy, in general, and the housing government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, in particular. Thus, one might have expected Dodd-Frank to have GSE reform at its core and that this reform might have substantial budgetary impacts. In fact, no such reform has taken place and the Administration continues to exclude the GSEs from its Budget.[3]

Similarly, the costs of the new Bureau for Consumer Financial Protection (CFPB) will not appear on the budget. Instead, the CFPB will draw from Federal Reserve resources and, thus, be exempted from the annual appropriations process and associated appropriations oversight process. One *might* be able to defend the creation of the CFPB as a matter of financial market regulation – I cannot – but it is mystifying that Congress would choose to fund such an entity in such a opaque and unaccountable fashion.

Compliance Costs

The cost for firms affected by Dodd-Frank is both highly significant and highly uncertain. The uncertainty is exacerbated by the fact that rule making is ongoing and very substantial. For this reason, the true compliance cost will not be apparent for years into the future.

In light of this, whether the actual costs of Dodd-Frank remain smaller than the public policy benefits will depend importantly on an ongoing monitoring and assessment of the rule making under the law. To date, there exists only fragmentary information regarding the potential costs.

- The total costs to date as reported in Federal Register are $836.6 million. The largest single item is $245 million for a security-based swap data repository registration.
- Standard & Poors estimates that Dodd-Frank would result in a $22 billion reduction in aggregate pre-tax earnings among large banks.
- International Swaps Dealers Association: $1 trillion in capital and liquidity requirements.

If recent history is any guide, there is reason to be concerned about the ultimate scale of these estimated compliance costs. When the SOX legislation passed, CBO noted (as part of its obligations under the Unfunded Mandates Reform Act) that the

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[3] The CBO has (correctly) concluded that the combination of taxpayer funding and their use for housing policy purposes makes Fannie Mae and Freddie Mac *de facto* government agencies and includes them in its budget projections.

private-sector costs would exceed the $115 million threshold. The costs as published in the Federal Register totaled $1.29 billion, and the Securities Exchange Commission (SEC) estimated that compliance would cost each company $91,000.[4]

As it turns out, SOX is incredibly expensive. Financial Executives International estimates that the annual compliance costs average nearly $2 million and for larger firms exceed $4 million.[5]

Economic Costs

From an economic perspective, the financial services industry provides important services to a market economy:

- It implicitly matches savers and borrowers, permitting households of each type to choose a spending pattern that suits them best;

- It funnels net savings to productive investments in skills, innovation, equipment and structures, thereby enhancing growth and future standards of living; and

- It permits risks – credit risks, operations risks, investment risks, and so forth – to be shifted from those averse to risk to those willing the bear risk.

Importantly, in each of these economic functions, the financial services industry, and its constituent firms, act as *intermediaries* between other economic actors – households, entrepreneurs, pension funds, firms, and so forth. Accordingly, when costs are imposed on the industry, these costs are ultimately borne by savers and investors.

Thus, one can think of Dodd-Frank as imposing a set of implicit taxes on these groups. As with any "tax" issue, there are two important components to understanding its economic costs: (a) who bears the real burden of the new costs, and (b) in what ways does the presence of the new costs deter valuable economic activity that would have otherwise occurred?

In tracing through these effects, it is useful to recognize that the costs of Dodd-Frank are analogous to a tax on capital transactions (saving, investment, hedging risk, etc.) that occur through the formal financial services sector. Because U.S. firms operate in globalized financial markets, participants in the financial services sector will have a limited capacity to absorb costs by reducing returns to shareholders. Instead, additional costs will be shifted to workers – in the form of fewer jobs and reduced

[4] SEC Release No. 33-8238, June 5, 2003.

[5] See http://www.financialexecutives.org/eweb/DynamicPage.aspx?site=_fei&webcode=adv_sox

compensation – and financial services customers – in the form of fewer free services, higher fees, and increased borrowing costs.

The dominant response is likely to be higher costs for customers. The "Finance and Insurance" component of national employment is relatively small (5.6 million or just over 4 percent in February 2011). Thus, on can best think of the economic costs of Dodd-Frank as equivalent to a tax on the return to saving, investment, and risk management.

The Dodd-Frank "Tax": Higher Costs, Slower Job Growth

There exists a large empirical literature documenting the impact of capital taxation on economic efficiency and growth.[6] It finds that a 5 percentage point increase in the top marginal tax rate reduces GDP growth by 0.3 percentage points annually. Viewed from another perspective, at any point in time the cost of a $1 of tax revenue is at least $1.30 and perhaps much more.

What does this tell us about the impact of Dodd-Frank. The S&P estimate that the pre-tax return on equity for affected large banks will fall by as much as 270 basis points, on a base return of roughly 15 percent. This suggests that it is equivalent to a "tax rate" of approximately 18 percent on earnings. In order to restore post-tax earnings to their previous levels, firms will be forced to raise pre-tax revenues by as much as 22 percent. Thus, for example, if the sole source of revenue for firms was interest earnings from loans to borrowers, those interest rates that previously were 4 percent would have to rise to 4.9 percent; those that were 5 percent must rise to 6.1 percent; and those that were 6 percent would be forced up to 7.3 percent. In short the impact of Dodd-Frank look similar to a roughly 100 basis point rise in borrowing costs.

This upward pressure on base interest rates, spreads for risky borrowers, and fees for financial activities will be spread pervasively through the financial system. In short, the Dodd-Frank "tax" will make capital market transactions more expensive.

As similar pervasive rise in financial costs occurs when overall interest rates rise because of Federal Reserve policy decisions or shifts in financial market conditions. Thus, for example, in a recent analysis of the impact of sovereign debt volatility on the U.S. economic outlook, the Macroeconomic Advisers, LLC estimated that a 50 basis point increase in risk spreads would lower the near term GDP growth rate by 0.65 in the first year and 0.43 in the second year.

This estimate can be used to translate the roughly 100 basis point rise from the Dodd-Frank tax to an impact on near-term growth rates of -1.3 and -0.86 percentage

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[6] A good summary is found in Katherine Baicker and Jonathan Skinner, "Health Care Spending Growth and the Future of U.S. Tax Rates," National Bureau of Economic Research, Working Paper 16772, February 2011.

points. Of course, slower near-term GDP growth from Dodd-Frank would also translate into slower labor market recovery. To get a sense of the magnitudes, note that in the context of evaluating the stimulus legislation, the Congressional Budget Office estimated that a 1 percent increase in GDP yielded 700,000 additional jobs. Using this as a rule of thumb, such a decline in GDP growth would lower employment by 900,000 jobs in the first year and an additional 600,000 in the second.

It is important to emphasize that this is a very rough estimate and assumes a pervasive impact on all interest rates, spreads, and fees of over 20 percent. Not every financial institution will be affected to the same degree as the largest banks, so the aggregate impacts are likely much smaller. At the same time, the fact that there is a differential rate of effective costs means that Dodd-Frank is creating purely policy-based winners and losers. Firms or activities that had created a competitive niche on the basis of market fundamentals will find themselves displaced by the costs of Dodd-Frank, while other activities or firms that had previously been less competitive will relatively benefit from the act. When policy, not fundamentals, determines what succeeds for fails, it represents a misallocation of resources across industry segments and firms.

These computations are intended to be illustrative, not definitive. However, their potential scale suggests that tracking the ongoing cost of the legislation is an important aspect of public policy.

Conclusion

Dodd-Frank will have dramatic impact on the evolution financial markets and the economy. It will impose budgetary costs on the taxpayer. In addition, it imposes direct compliance costs and its distortions induce economic costs in the form of reduced capital investment, inferior risk-sharing, and lost competitiveness. Because of its scope and scale, Dodd-Frank will impose substantial costs of each type. Thank you and I look forward to answering your questions.

Statement

Oversight and Investigations Subcommittee
of the Committee on Financial Services

March 30, 2011

Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond

The Committee on Financial Services
Rayburn House Office Building
Washington, D.C.

Good afternoon. I'm honored to speak to this Subcommittee about the federal government's financial safety net and how the Dodd Frank Wall Street Reform and Consumer Protection Act seeks to address it.

At the outset, I should point out that within the Federal Reserve System the Board of Governors has sole authority to write rules implementing the requirements of the Dodd-Frank Act. Federal Reserve Banks supervise financial institutions under authority delegated to them by the Board of Governors. In keeping with Board of Governors guidance, I will not discuss any current or potential Federal Reserve rulemaking. I also should say that my comments today are my own views and do not necessarily reflect those of the Board of Governors of the Federal Reserve or my colleagues at other Federal Reserve Banks. My views have been informed by both my leadership of the Fifth Federal Reserve District over the last seven years and my experience as a research economist, studying banking policy for the prior 25 years.

The Dodd-Frank Act was a response to the most dramatic financial turmoil our country experienced in generations. In my view, the crisis resulted largely from a mismatch between a regulatory structure designed for the explicit safety net (consisting mainly of deposit insurance) and the extent of moral hazard induced by a much broader implicit safety net. Given precedents dating back to Continental Illinois in the 1980's and beyond, market participants made inferences about what government protection might be forthcoming in future instances of financial distress—that is, which institutions were likely to be viewed by authorities as "too big to fail." This lack of clarity about the safety net grew in the decades leading up to the crisis—and came about because policymakers hoped that "constructive ambiguity" would dampen the markets' expectations of bailouts, but preserve their option to intervene if necessary. Other factors contributed to the crisis, but I believe the ambiguity of safety net policy was a major driver.

Researchers at the Federal Reserve Bank of Richmond have estimated, based on conservative assumptions, that the implicit safety net covered as much as 40 percent of all financial sector liabilities by the end of 2009. When combined with the explicit protection in place for depository institutions and other firms, the broader federal financial safety net now covers 62 percent of the financial sector, compared to about 45 percent a decade earlier. (See Table.)

Dodd-Frank contains provisions that will help close the gap between the scope of prudential regulation and the scope of the implicit safety net. It allows the Financial Stability Oversight Council to designate large non-bank financial firms as "systemically important" and subject them to more rigorous constraints on risk-taking. The Act also seeks to limit the implicit safety net by empowering the FDIC to liquidate troubled nonbank firms and placing new constraints on the Fed's lending powers. But the FDIC retains considerable discretion in the use of funds to limit losses to some creditors, and the Treasury can invoke orderly resolution for firms that have not been subject to enhanced regulation. The Fed also retains some discretionary power to lend to non-bank entities. This creates continued uncertainty about possible rescues, as well as gaps in our ability to provide clear, credible constraints on the safety net.

In the near term, I believe regulators have a firm grasp on the industry, and are taking strong steps to tighten risk management at regulated firms, but there are risks in the long-term because firms seen as enjoying broad safety net protection will have strong incentives to take on excessive risks. And firms will have an incentive to by-pass regulation, if they can still enjoy some degree of implicit protection. This desire to operate just outside the perimeter of regulation, but within the implicit safety net, will present ongoing supervisory and regulatory challenges—and may make it difficult to prevent or limit the magnitude of future crises.

Continued ambiguity thus would pose risks to financial stability and the economy, including the risk of new costs to taxpayers. But I believe the risks to the effectiveness of our financial system are even more significant. Over time, the devotion of resources to by-passing regulations can create new sources of financial instability and divert resources from the pursuit of financial innovations that are genuinely beneficial to consumers. In the long run, economic growth and job creation would likely suffer.

Creating clear and credible safety net constraints is likely to be difficult. One approach is to tightly limit discretion—including discretionary use of public funds to shield creditors. The Act takes important steps in that direction, yet substantial discretion remains around preferential treatment for certain creditors.

A far more challenging approach is for regulators to retain discretion, but establish a credible commitment to following clear, pre-announced rules in times of crisis. For example, limiting FDIC resolution authority to firms that are regulated as "systemically important" would help block regulatory by-pass. The credibility of such a commitment would require policymakers to allow significant creditor losses in cases in which they otherwise might have provided support.

Some believe that without intervention the economy is too vulnerable to spillover damage from the financial system. I've argued that such spillovers are in large part the *consequence* of ambiguous government rescue policy. If we can establish clear expectations about the federal financial safety net and live up to our commitment to limit rescues, then we can have more confidence that our financial system will contribute positively to economic growth.

Thank you. I would be pleased to take your questions.

Estimated Federal Financial Safety Net

	1999				2009			
	Explicitly Guaranteed Liabilities	Implicitly Guaranteed Liabilities	Explicitly & Implicitly Guaranteed Liabilities	Total Liabilities	Explicitly Guaranteed Liabilities	Implicitly Guaranteed Liabilities	Explicitly & Implicitly Guaranteed Liabilities	Total Liabilities
Financial Firms								
Banking and Savings Firms	2,840	820	3,660	5,963	6,536	7,276	13,812	16,249
(includes BHCs)	47.6%	13.8%	61.4%		40.2%	44.8%	85.0%	
Credit Unions	336		336	375	725		725	817
	89.6%		89.6%		88.7%		88.7%	
Government-Sponsored Enterprises								
Fannie Mae		1,199	1,199	1,199		3,345	3,345	3,345
Freddie Mac		870	870	870		2,333	2,333	2,333
Farm Credit System		74	74	74		188	188	188
Federal Home Loan Banks		477	477	477		973	973	973
Total		2,620	2,620	2,620		6,838	6,838	6,838
		100.0%	100.0%			100.0%	100.0%	
Private Employer Pension Funds	1,805		1,805	2,090	2,799		2,799	3,273
	86.3%		86.3%		85.5%		85.5%	
Other Financial Firms (includes MMF for 2009)				7,723		4,048	4,048	18,458
						21.9%	21.9%	
Total for Financial Firms	4,981	3,440	8,421	18,771	10,059	18,162	28,221	45,635
	26.5%	**18.3%**	**44.8%**		**22.0%**	**39.8%**	**61.8%**	

1999 and 2009 data from December, in billions of dollars. Figures may not sum exactly due to rounding. For details, see: John R. Walter and John A. Weinberg. 2002. "How Large is the Financial Safety Net?" *Cato Journal* 21 (Winter): 360-93; Nadezhda Malysheva and John R. Walter. 2010. "How Large Has the Federal Financial Safety Net Become?" Federal Reserve Bank of Richmond *Economic Quarterly* 96 (Third Quarter): 273-90.

The following definitions correspond to the 2009 data (for 1999 definitions see Walter and Weinberg, 2002):

- *Explicitly Guaranteed Liabilities of Banking and Savings Firms*: FDIC-insured deposits of all commercial banks and savings institutions including transaction accounts covered by the FDIC's TAGP, plus debt guaranteed by the FDIC's DGP

- *Implicitly Guaranteed Liabilities of Banking and Savings Firms*: Total liabilities of the 19 stress-tested institutions, less FDIC insured deposits and accounts covered by TAGP and debt covered by DGP for the 19 stress-tested institutions

- *Credit Unions*: National Credit Union Administration-insured shares and deposits

- *Government-Sponsored Enterprises*: Total liabilities, enterprise's mortgage-backed securities held by third parties, and other guarantees

- *Private Employer Pension Funds*: Pension liabilities backed by the PBGC

- *Other Financial Firms*: Total liabilities of AIG, less FDIC-insured deposits of AIG Federal Savings Bank, and total MMF balances

Economic Quarterly—Volume 96, Number 3—Third Quarter 2010—Pages 273–290

How Large Has the Federal Financial Safety Net Become?

Nadezhda Malysheva and John R. Walter

In 2002, Walter and Weinberg examined the federal financial safety net as it stood at the end of 1999 (Walter and Weinberg 2002). At the time, the authors estimated that approximately 45 percent of all financial firm liabilities were protected by the safety net. As one would expect in this article, the current estimate indicates that the size of the net has grown, as the financial market turmoil that began in 2007 led federal government agencies to expand the range of institutions and the types of liabilities protected by the safety net.

1. THE SAFETY NET: ITS DEFINITION, COSTS, AND BENEFITS

Walter and Weinberg defined the federal financial safety net as consisting of all explicit or implicit government guarantees of private financial liabilities. Private financial liabilities are those owed by one private market participant to another. As used by Walter and Weinberg, the phrase *government guarantee* means a federal government commitment to protect lenders from losses due to a borrower's default (Walter and Weinberg 2002).[1] Following this definition, we include in our estimate of the safety net, insured bank and thrift deposits, certain other banking company liabilities, some government-sponsored enterprise (GSE) liabilities, selected private employer pension liabilities, as well as

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[1] In addition to estimating the proportion of financial firm liabilities backed by the federal government, Walter and Weinberg also estimated the proportion of nonfinancial firm and household liabilities with such backing.

a subset of the liabilities of other financial firms. The details of why we chose to include these liabilities are provided below.

Effect of a Safety Net on Economic Efficiency

Government actions in the form of subsidies, taxes, or regulations change market outcomes, and in competitive markets such changes distort allocations and can reduce economic efficiency. Does the financial safety net cause distortions? As discussed in Walter and Weinberg, in principle, the government could design guarantees that mimic market outcomes. Typically, however, government intervention arises from a desire to alter market outcomes. In the case of guarantees, this means either expanding coverage or underpricing relative to private market guarantees. Underpricing means that the guarantor collects fees that are less than the expected value of its obligations. This underpricing subsidizes risk taking.

Underpriced guarantees tend to shift resources away from activities that are not covered toward those that are. In that way, a government guarantee is similar to a direct subsidy paid to those engaged in a particular activity. A guarantee is different, however, in the way it affects attitudes toward risk. By assigning to the government part of the risk in the activities being financed, the safety net reduces market participants' willingness to control risk. Overprovision of guarantees, while not necessarily drawing resources into an activity, does shift risk preferences in a way similar to underpricing. In short, guarantees lead to expanded risk taking.

Our calculation of the size of the safety net does not represent a measure of the size of the distortions to the allocation of resources and risk taking. Such a measure would require knowledge of the extent of underpricing or overprovision of government guarantees. Those would be difficult to measure, especially the latter, since government provision often preempts private market activity. We nevertheless believe that the extent of distortions is directly related to the size of the safety net. Other things being equal, the greater the share of private liabilities protected by the government safety net, the more likely it is that government guarantees are extending beyond the level of protection that would be provided in a private market.

Why Have a Safety Net?

If the safety net is distortionary, why have one? Proponents of the financial safety net, especially as it applies to banks, often argue that private risk-sharing arrangements tend to disregard the *systemic* consequences of large losses borne by an individual or a small group of institutions. The idea here is that such losses might spill over and generate further losses caused, for example, by a contagious loss of investor confidence. Under such a view, government protection for certain investors could prevent widespread financial panic or distress. While the potential systemic consequences of a large financial failure are difficult to assess, when faced with the possibility of widespread failures of financial firms, policymakers are likely to conclude that preventing such failures by protecting creditors of financial firms (providing safety net protection) is prudent.

Similarly, some observers maintain that the safety net protections can lower the costs of, and therefore encourage, certain highly beneficial financial arrangements. For example, Diamond and Dybvig (1983) argue that banks' performance of the *maturity transformation function* is highly beneficial to the economy but is more costly without government-provided deposit insurance. Banks perform maturity transformation by gathering money from numerous short-term depositors (those bank customers whose deposits *mature* soon after deposited—especially checking deposits, which are available, meaning that they mature, immediately after being deposited) to fund long-term loans to businesses and individuals. Without deposit insurance, which only the government has sufficient resources to provide, bank runs are likely to occur. A bank run happens when many depositors attempt to withdraw their funds simultaneously. Since banks make long-term loans, they cannot recover sufficient money from borrowers to meet a run and, therefore, fail. To protect themselves from runs, banks can undertake costly private measures, but Diamond and Dybvig argue that government deposit insurance is likely to be less expensive and therefore preferable to such measures.

2. LEGISLATIVE AND REGULATORY CHANGES THAT EXPANDED THE SAFETY NET

As shown in Table 1, we estimated the proportion of financial firm liabilities protected as of the end of 2009. By the end of 2009, a number of government programs had been established to address turmoil in financial markets. Employing methods similar to those used by Walter and Weinberg when they measured the size of the safety net for the end of 1999, we find that as of the end of 2009 about 59 percent of financial firm liabilities were protected by the federal safety net.

One of the most important reasons for the increase from 1999 to 2009 is the enlarged portion of banking firm liabilities that market participants are likely to consider protected: banking and savings firm liabilities with an implicit backing. In 1999, implicitly guaranteed liabilities of banks and savings institutions amounted to about 13 percent of all of these firms' liabilities (15.9 percent for commercial banks and 4.2 percent for savings institutions), or $820

Table 1 Estimated Federal Financial Safety Net

Financial Firms	Explicitly Guaranteed Liabilities	Implicitly Guaranteed Liabilities	Explicitly and Implicitly Guaranteed Liabilities	Total Liabilities
Banking and Savings Firms				
(Includes BHCs)	6,536	7,276	13,812	16,249
	40.2%	44.8%	85.0%	
Credit Unions	725		725	817
	88.7%		88.7%	
Government-Sponsored Enterprises				
Fannie Mae		3,345	3,345	3,345
Freddie Mac		2,333	2,333	2,333
Farm Credit System		188	188	188
Federal Home Loan Banks		973	973	973
Total		6,838	6,838	6,838
		100%	100%	
Private Employer Pension Funds	2,799		2,799	3,273
	85.5%		85.5%	
Other Financial Firms		748	748	15,158
		4.9%	4.9%	
Total for Financial Firms	10,059	14,862	24,921	42,335
	23.8%	35.1%	58.9%	

Notes: Data from December 2009, in billions of dollars. Figures may not sum exactly due to rounding. The figures in the column "Explicitly and Implicitly Guaranteed Liabilities" are the sum of the numbers in the first two columns, "Explicitly Guaranteed Liabilities" and "Implicitly Guaranteed Liabilities." See Appendix for table legend.

billion; in 2009, about 45 percent of banking and savings firm liabilities were implicitly guaranteed, by our estimate, amounting to \$7.3 billion.[2]

How did Walter and Weinberg determine which institutions to include as having an implicit guarantee and which liabilities issued by these institutions might be covered? As the authors noted, the critical question is whether market participants believe that a given institution will be protected, even though official policy may not state explicitly that all of these liabilities are protected. As of 1999, Walter and Weinberg argued that market participants were likely to assume that certain holders of liabilities in the largest 21 banking companies and the two largest thrift companies would be protected in the event that these firms became troubled. These 21 banking companies and two thrifts all had assets (in 1999 dollars) of more than \$50 billion, which was greater than the smallest of the 11 institutions identified by the Comptroller of the Currency in 1984 as potentially too big to fail (Walter and Weinberg 2002, p. 381). The liabilities that Walter and Weinberg assumed the market would be highly likely to view as protected were deposits of more than \$100,000 (deposits of less than \$100,000 are included in the "Explicitly Guaranteed Liabilities" column in the tables), federal funds loans made to the 21 banks and two thrifts, and repo transactions with these banks and thrifts. Though we intend to use a similar methodology for estimating the size of implicit guarantees for banking companies in 2009, events during the recent financial crisis required some adjustments.

Support for Stress-Tested Financial Companies

Given that the government had responded aggressively to problems in financial firms during the financial turmoil of 2008–2009, our challenge is to decide which institutions have implicit guarantees. Here we maintain that market participants were very likely to assume that the liabilities of the financial firms that were stress tested early in 2009 (participants in the Supervisory Capital Assessment Program—SCAP) had a strong likelihood of receiving federal backing if they suffered financial distress. Indeed, the announcement of the stress tests in February 2009 came with a promise of government-provided capital for stress-tested institutions that were shown to be in need of additional capital:

> Under [the Treasury's Capital Assistance Program] CAP, federal banking supervisors will conduct forward-looking assessments [SCAP stress tests] to evaluate the capital needs of the major U.S. banking institutions under a more challenging economic environment. Should that assessment indicate that an additional capital buffer is warranted, banks will have

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[2] An explanation of the factors underlying the large increase is provided below.

> an opportunity to turn first to private sources of capital. In light of the current challenging market environment, the Treasury is making government capital available immediately through the CAP to eligible banking institutions to provide this buffer. (FinancialStability.gov 2009)

Additionally, a number of these firms did, in fact, receive government aid in the form of capital injections in 2008 and early 2009 through the Treasury's Capital Purchase Program or in response to the stress tests (FinancialStability.gov 2010, pp. 21, 27, 67–80). This aid, both the aid promised under the CAP and aid received through the Capital Purchase Program, reduced the likelihood that *all* liabilityholders of the protected firms would suffer losses, so here we include *all* liabilities of the stress-tested banking institutions in our safety net calculation.

While some observers in 2009 may have viewed the likely passage of financial reform legislation as diminishing federal backing, we nevertheless count the liabilities of the stress-tested firms. Legislation that was intended to limit the chance that financial institutions would receive federal aid was being considered in the U.S. Congress during 2009. If market participants were convinced that such legislation would forestall any opportunity for the creditors of the largest financial institutions to be protected by the federal government, then our calculation might appropriately exclude the liabilities of stress-tested banking institutions. In fact, most of the legislative proposals included language that called for the closure of troubled financial firms with losses to equityholders and at least some creditors (though at least one leading proposal contained protections for creditors of financial firms if the failure of such a firm might create a systemic risk).[3] Nevertheless, legislative proposals contained provisions meant to establish a mechanism that could clearly identify "systemically important" financial firms. Such mechanisms seem likely to encourage market participant expectations of federal aid to the creditors of the largest (i.e., systemically important) firms. Given the ambiguous effect of the reform proposals on the probability of federal aid to the largest banking firms, and the clear protections provided for troubled firms and for their creditors during the financial turmoil, we retain their liabilities in our estimate of liabilities protected by the safety net, in keeping with Walter and Weinberg (2002). (In a later section we remove the liabilities of stress-tested institutions and re-estimate the size of the safety net—see Table 2.)

As indicated earlier, the total liabilities of the 19 stress-tested bank holding companies, less their liabilities that were explicitly covered by deposit insurance, summed to $7.3 trillion ("Implicitly Guaranteed Liabilities" column in

[3] See H.R. 4173 as of December 2, 2009, p. 370, available at: http://www.house.gov/apps/list/press/financialsvcs_dem/presscfpa_121109.shtml.

the tables). This sum equals about 45 percent of all banking and savings firm liabilities.

Increased Ceiling on Insured Deposits

Several Federal Deposit Insurance Corporation (FDIC) programs expanded the explicit portion of the safety net for banks and thrifts ("Explicitly Guaranteed Liabilities" column in the tables) beyond the long-standing $100,000 coverage for deposits (which are also included in the "Explicitly Guaranteed Liabilities" column in the tables).[4] For example, in October 2008 the Emergency Economic Stabilization Act of 2008 temporarily increased FDIC deposit insurance coverage from $100,000 to $250,000, until December 31, 2009. In May 2009, the $250,000 cap was extended to December 31, 2010, by the Helping Families Save Their Homes Act. In July 2010, legislation made permanent the $250,000 coverage limit (Federal Deposit Insurance Corporation 2010a).

Transaction Account Guarantee Program

Further, in October 2008 the FDIC implemented a program to insure uninsured deposits (those deposits in accounts containing more than $250,000) in noninterest-bearing transactions accounts for those insured banks and thrifts wishing to participate. The program is temporary. At first it covered such transactions accounts until December 31, 2009. Later the FDIC extended the program's coverage until June 30, 2010, and then extended it again until December 31, 2010, with a pre-announced option to extend it an additional 12 months (Federal Deposit Insurance Corporation 2010a).[5] This program, the Transaction Account Guarantee Program (TAGP), added $834 billion to our "Explicitly Guaranteed Liabilities" column in the tables for banking and savings firms (Federal Deposit Insurance Corporation 2009c).

Debt Guarantee Program

Last, in October 2008 the FDIC offered, to banking and savings institutions wishing to participate, the option to receive FDIC insurance coverage for senior unsecured debt issued by such institutions. This Debt Guarantee Program

[4] Since April 2006, deposits in certain retirement accounts at banks and thrifts have been protected by the FDIC up to $250,000 (Federal Deposit Insurance Corporation 2006). Deposits in such accounts, up to the $250,000 ceiling, are included in the "Explicitly Guaranteed Liabilities" column of our tables.

[5] The Dodd-Frank Wall Street Reform and Consumer Protection Act extended coverage for noninterest-bearing transaction accounts through December 31, 2012 (Federal Deposit Insurance Corporation 2010c).

(DGP) at first covered debt issued by June 30, 2009, and maturing by June 30, 2010. The DGP was later extended to cover debt issued by October 31, 2009, and maturing by December 31, 2012. As of December 31, 2009, the program was insuring $309 billion in debt (Federal Deposit Insurance Corporation 2009b).

3. OTHER COMPONENTS OF THE SAFETY NET

As in 1999, we include for 2009 the liabilities of government-sponsored enterprises (direct GSE liabilities plus the dollar amount of mortgage-backed security guarantees) in the "Implicitly Guaranteed Liabilities" column in the tables. Earlier we noted that government guarantees can often modify market prices. Though our article has made no attempt to measure the size of guarantees' effect on market prices, in the case of the GSEs' implicit guarantee, the size of the effect on market prices has been estimated by Passmore (2005) and others.[6] Passmore (2005) estimates that the average homeowner saved between 3 and 11 basis points on his or her mortgage because of the implicit guarantee. The subsidy lowers the GSEs' borrowing costs, and some of this saved borrowing cost is passed on to homeowners by the GSE in the form of lowered mortgage interest rates. Passmore calculates that about half of the guarantee's benefit flows to the shareholders of the GSEs. While the Treasury made clear its support for Fannie Mae and Freddie Mac once these two financial firms were placed in conservatorship in September 2008, the support was not as strongly stated as that given to insured deposits, so we leave these liabilities in the implicit column in the tables.[7]

We estimate the amount of private pensions explicitly guaranteed in 2009 by the Pension Benefit Guarantee Corporation (PBGC) based on the latest private pension data available, which are data for 2007 (Pension Benefit Guarantee Corporation 2010, pp. 83, 105). Our admittedly rough 2009 figure is derived by simply adjusting the 2007 figure by twice the average annual growth rate of private pension liabilities for the previous 10 years (1997–2007).

We also count all of the liabilities of American International Group (AIG) as implicitly guaranteed in the "Other Financial Firms" row in the tables.[8]

[6] Beyond Passmore, the Congressional Budget Office (2001) also developed estimates of the GSEs' guarantee on mortgage interest rates.

[7] We treat Fannie Mae and Freddie Mac as private entities and therefore include their liabilities in our table, consistent with the way Walter and Weinberg treated these entities, even though the status of Fannie Mae and Freddie Mac as privately owned firms is more ambiguous now than in 1999.

[8] The insured deposit liabilities of AIG's savings bank are not included in the "Other Financial Firms" row since these liabilities were included in the "Banking and Savings Firms" row. While AIG owns a savings bank, it is not classified as a bank holding company (and does not file a bank holding company report [Y9C] with federal regulators), so we do not include it in the Banking and Savings Firms row.

We count their liabilities as such because of the aid provided them by the Federal Reserve and the U.S. Treasury following AIG's financial problems in September 2008. Because there were no clear signals about whether aid might be forthcoming for other large, nonbank financial firms (beyond the stress test firms), we did not include the liabilities of any firms other than AIG in the "Other Financial Firms" row in tables.

4. ALTERNATIVE ESTIMATES OF THE SIZE OF THE SAFETY NET

As has been noted, Table 1 is based on several assumptions similar to those made by Walter and Weinberg in 2002. For example, we assumed that all liabilities of stress-tested bank holding companies would be protected, not just the liabilities representing FDIC-insured bank deposits. What would be the size of the safety net if these assumptions were changed?

Contrary to our assumption about the likely protection of liabilityholders of stress-tested companies, one can imagine circumstances under which such liabilityholders might be left unprotected. If one of these companies were to fail at a time when financial markets were broadly healthy, policymakers could more easily allow the company to be handled as a bankruptcy so that no government funds are employed to protect liabilityholders (of course, the holders of FDIC-insured deposits would still be covered given that such deposits are protected regardless of the circumstances surrounding the failure). In times of general financial market strength, the failure of a large holding company could perhaps be absorbed without worries of a cascade of additional failures. And at such times, if the firm were handled through the Dodd-Frank Act's orderly liquidation process, it is possible that neither the government nor other financial firms would provide funds to protect liabilityholders.[9]

While investors might expect large financial firm failures to typically occur in times of widespread financial weakness, and therefore anticipate that their investments would be protected, some large firms have failed in times of financial market health. One such example was London-based Barings Bank, which failed when financial markets were broadly strong in 1995. Its failure was because of the huge trading losses generated by one unchecked Barings trader who took large, unauthorized futures positions. Given that there are circumstances under which the holders of stress-tested company liabilities might be left unprotected, dropping the assumption of their coverage and recalculating our estimate of implicitly guaranteed liabilities seems worthwhile.

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[9] The Orderly Liquidation Authority section of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contains provisions that allow funds gathered from assessments on the largest financial firms to be used to protect liabilityholders.

Table 2 Estimated Federal Financial Safety Net, Narrowly Defined

Financial Firms	Explicitly Guaranteed Liabilities	Implicitly Guaranteed Liabilities	Explicitly and Implicitly Guaranteed Liabilities	Total Liabilities
Banking and Savings Firms				
(Includes BHCs)	5,392		5,392	16,249
	33.2%		33.2%	
Credit Unions	725		725	817
	88.7%		88.7%	
Government-Sponsored Enterprises				
Fannie Mae		3,345	3,345	3,345
Freddie Mac		2,333	2,333	2,333
Farm Credit System		188	188	188
Federal Home Loan Banks		973	973	973
Total		6,838	6,838	6,838
		100%	100%	
Private Employer Pension Funds	2,799		2,799	3,273
	85.5%		85.5%	
Other Financial Firms				15,158
Total for Financial Firms	8,915	6,838	15,753	42,335
	21.1%	16.2%	37.2%	

Notes: Data from December 2009, in billions of dollars. Figures may not sum exactly due to rounding. The figures in the column "Explicitly and Implicitly Guaranteed Liabilities" are the sum of the numbers in the first two columns, "Explicitly Guaranteed Liabilities" and "Implicitly Guaranteed Liabilities." See Appendix for table legend.

Large financial firms that are not bank holding companies might receive no protection in such instances, so we also drop liabilities of AIG from those liabilities with implicit backing.

Also, we included in our explicitly insured deposits category those deposits covered by the FDIC's temporary guarantee programs, since these programs were in place in 2009. But under the debt guarantee program no new debt issues were covered after October 31, 2009 (Federal Deposit Insurance Corporation 2010b). The TAGP was set to expire as of the end of 2010, though the Dodd-Frank Act extended it to December 31, 2012. In the case of future financial firm failures, such programs may not be in place, and might not be reinstated. Therefore, re-estimating our measure of the size of the safety net without considering these deposits as protected also seems worthwhile.

Table 2 contains our estimate of the size of the safety net without including the liabilities of the stress-tested bank holding companies, AIG, and the FDIC temporary insurance program deposits. These changes mean that, compared to Table 1, the proportion of liabilities receiving explicit and implicit guarantees falls to 37.2 percent.

Additionally, while we assume that the liabilityholders of the housing and farm credit GSEs will be protected from loss, as were such holders of Fannie Mae and Freddie Mac debt during the 2007–2009 financial crisis, under some circumstances such holders might be left unprotected. As in the case of the stress-tested companies, if a GSE were to fail during a period in which financial markets were healthy, policymakers might leave debtholders unprotected. Therefore, it is possible that one might want to exclude the liabilities of the GSEs from the calculation of the safety net. If the $6.8 trillion in liabilities of the GSEs were removed (which are the only implicitly guaranteed liabilities in Table 2), then our measure of the safety net would shrink to 21 percent of total liabilities in Table 2, the amount of explicit liabilities shown in Table 2.

Some readers might contend that one category of liabilities, which we have excluded from our safety net estimate, could legitimately be added: money market mutual fund liabilities. In the creation of our tables, and in Walter and Weinberg (2002), mutual fund liabilities are excluded because the principal value of mutual fund investments, including money market mutual fund investments, can decline, without the mutual fund defaulting, if the entity in which the funds are invested defaults. As a result, these investments are akin to equity and unlike private liabilities—the focus of our estimates—which typically must pay back full principal (or else be in default). For example, an investor in a money market mutual fund, which in turn invested in financial firm commercial paper, could lose principal if the commercial paper was not repaid, but the mutual fund can continue to operate (i.e., not default).[10] This

[10] Money market mutual funds are loath to pay back less than full principal ("break the buck" in mutual fund parlance), and few have done so over time. Instead, the money market

view of money market mutual fund investments as equity must be tempered, however, by events in 2008. Specifically, the Treasury stepped in and protected investors in mutual funds from losses, thereby treating investments in the funds like other guaranteed *liabilities*, in which losses are prevented by government assistance or guarantees. As a result, one might argue that our estimates of the fraction of total liabilities carrying a government guarantee—both the numerator and denominator—should include money market mutual funds. If one adds the amount of such fund balances outstanding at the end of 2009 ($3.3 trillion [Investment Company Institute 2010]) to our estimates in the column "Explicitly and Implicitly Guaranteed Liabilities" in Table 1, the proportion would increase to 67 percent. The Table 2 figure would increase to 45 percent.

5. CONCLUSION

Recent government actions by legislators and financial regulators expanded the federal financial safety net. Such actions include augmentation of deposit insurance, debt guarantees for banking companies, aid to stress-tested financial firms, and, perhaps, various regulatory reform legislative proposals. As discussed in Walter and Weinberg (2002), this expansion has likely encouraged a view that liabilityholders will be protected by the federal government in times of financial difficulty in the future. As a result of this expectation of government protection, liabilityholders will exercise less oversight over financial firm risk taking then they would without this expectation, financial firms will undertake more risk, and financial market decisions will be distorted and inefficient.

mutual fund's parent typically injects funds to allow the fund to pay back full principal. This behavior by mutual fund parent companies indicates that parent companies and investors may well view money market mutual fund investments more as liabilities than equity, regardless of the fact that money market mutual funds can break the buck without defaulting.

APPENDIX A: LEGEND TO TABLE 1

- Banking and Savings Firms[11]
  - Explicitly Guaranteed Liabilities
    * FDIC-insured deposits of all commercial banks and savings institutions including transaction accounts covered by the FDIC's TAGP, plus debt guaranteed by the FDIC's DGP
  - Implicitly Guaranteed Liabilities
    * Total liabilities of the 19 stress-tested institutions, less FDIC-insured deposits and accounts covered by TAGP and debt covered by DGP for the 19 stress-tested institutions
- Credit Unions
  - Explicitly Guaranteed Liabilities
    * National Credit Union Administration-insured shares and deposits
- Government Sponsored Enterprises
  - Implicitly Guaranteed Liabilities of:
    * Fannie Mae
      · Total liabilities
      · Fannie Mae mortgage-backed securities held by third parties
      · Other guarantees
    * Freddie Mac
      · Total liabilities
      · Freddie Mac participation certificates and structured securities held by third parties
    * Farm Credit System
      · Total liabilities
      · Farmer Mac guarantees
    * Federal Home Loan Banks
      · Total liabilities

[11] See Section 4 for a description of the differences between Table 1 and Table 2 estimates.

- Private Employer Pension Funds
  - Explicitly Guaranteed Liabilities
    - Pension liabilities backed by the PBGC
- Other Financial Firms
  - Explicitly Guaranteed Liabilities
    - Total liabilities of AIG, less FDIC-insured deposits of AIG Federal Savings Bank

APPENDIX B: DATA APPENDIX TO TABLE 1

Banking and Savings Firms—Explicitly Guaranteed Liabilities:

"Estimated FDIC-insured deposits" of commercial banks, savings institutions, and U.S. branches of foreign banks (Federal Deposit Insurance Corporation 2009a), plus "Amount Guaranteed" in the Transaction Account Guarantee Program (Federal Deposit Insurance Corporation 2009c), plus "Debt Outstanding" in the Debt Guarantee Program (Federal Deposit Insurance Corporation 2009b).

Banking and Savings Firms—Implicitly Guaranteed Liabilities:

Total liabilities of the 19 stress-tested institutions found in the Y9C (quarterly bank holding company financial reports), less 1) the explicitly guaranteed deposits of the banks and savings institutions owned by these 19 firms, and 2) the FDIC-insured debt (insured under the DGP) of each of these institutions. The estimated FDIC-insured deposits and the guaranteed amount in noninterest-bearing transaction accounts for each bank can be found on the FDIC's website in the "Institution Directory" (www2.fdic.gov/idasp). The amount of DGP debt of each firm can be found on the firms' 10Ks.

Banking and Savings Firms—Total Liabilities:

Total liabilities from the following sources: For large (consolidated assets of over $500 million) bank holding companies, Consolidated Financial Statements for Bank Holding Companies (FR Y9C); for small (consolidated assets less than $500 million) bank holding companies, Parent Company Only Financial Statements for Small Bank Holding Companies (FR Y9SP)—from which consolidated total liabilities can be derived; for banks not owned by a bank holding company, Consolidated Reports of Condition and Income for a Bank (FFIEC 031 and FFIEC 041); and for all thrift liabilities, Thrift Financial Reports.

Credit Unions—Explicitly Guaranteed Liabilities:

Total insured shares at the $250,000 limit (National Credit Union Administration 2009).

Credit Unions—Total Liabilities:

Board of Governors (2010), Table L.115—Credit Unions, "Total liabilities."

Government-Sponsored Enterprises:

Fannie Mae:

Total liabilities, plus Fannie Mae MBS held by third parties, plus other guarantees found in the Fannie Mae 10K, "Item 6. Selected Financial Data" (p. 70).

Freddie Mac:

10K report of Freddie Mac, "Total liabilities" ("Consolidated Balance Sheets," p. 209), plus "Total PCs and Structured Securities issued" ("Item 6. Selected Financial Data," p. 57), less "Total Freddie Mac PCs and Structured Securities held" in Freddie Mac portfolio (Table 28, p. 104).

Farm Credit System:

Farm Credit System (2010), "Total liabilities" ("Combined Statement of Condition Data," p. 3), plus "Farmer Mac guarantees" (p. 12).

Federal Home Loan Banks:

Federal Home Loan Banks (2010), "Total liabilities" ("Combined Statement of Condition," p. 194).

Private Employer Pension Funds—Explicitly Guaranteed Liabilities:

Liabilities of all pension funds insured by the PBGC (which insures only defined benefit plans) were $2,559 billion in 2007, the latest date for which data are reported (Pension Benefit Guarantee Corporation

2010, pp. 83, 105). This figure is inflated by twice (because 2007–2009 involves two years of growth) the average annual growth rate of PBGC-insured pension liabilities from 1997–2007 to obtain our estimate of all liabilities in pension funds insured by the PBGC as of December 31, 2009 ($2,946 billion). Since PBGC covers pensions only up to a specified maximum payment per year, a portion of beneficiaries' pensions in guaranteed plans—those with pensions paying above this maximum—are not insured. According to the PBGC, this portion is estimated to be 4–5 percent (Pension Benefit Guarantee Corporation 2007, p. 24; Pension Benefit Guarantee Corporation 1997, footnote to Table B-5). To arrive at the guaranteed portion of PBGC guaranteed pension fund liabilities, we multiplied total 2009 fund liabilities ($2,946 billion) by 0.95 to yield $2,799 billion.

Private Employer Pension Funds—Total Liabilities:

There appears to be no data on the total liabilities of all private employer-defined benefit pension funds. Therefore, we estimate our total liability figure based on PBGC data. To derive our figure, we begin with our previously determined estimate of all private pension fund liabilities that are included in PBGC ($2,946) and then divide it by 0.9 to arrive at our total liability figure of $3,273 billion. The PBGC insures only about two-thirds of private sector single-employer-defined benefit plans, but almost all multi-employer plans (Pension Benefit Guarantee Corporation 2009, p. 5). Among the types of defined benefit plans PBGC does not insure are small (fewer than 25 employees) plans maintained by small professional service employers like doctors, lawyers, and accountants. Since the PBGC excludes only the smaller single-employer plans, and includes most multi-employer plans, we assume that it covers well more than 66 percent (i.e., two-thirds) of all liabilities, setting our estimate at 90 percent.

Other Financial Firms—Implicitly Guaranteed Liabilities:

"Total liabilities of AIG" found in its 10K report, less "estimated insured deposits" of AIG Federal Savings Bank found on the FDIC's website in the "Institution Directory" (http://www2.fdic.gov/idasp).

Other Financial Firms—Total Liabilities:

Board of Governors (2010), Tables L.116—Property-Casualty Insurance Companies; L.117—Life Insurance Companies; L.126—Issuers of Asset-Backed Securities; L.127—Finance Companies; L.128—Real Estate Investment Trusts; L.129—Security Brokers and Dealers; L.131—Funding Corporations, less taxes payable whenever a figure for taxes was reported on these tables.

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Testimony before
Subcommittee on Oversight and Investigations of the House Financial Services Committee
on "The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic"

David K. Min
Associate Director for Financial Markets Policy
Center for American Progress Action Fund
Wednesday, March 30, 2011

Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, my name is David Min and I am the Associate Director for Financial Markets Policy at the Center for American Progress Action Fund. Thank you for the opportunity to testify today on the very important topic of the costs of Dodd-Frank implementation.

In analyzing the costs of Dodd-Frank implementation, we should recognize that the Dodd-Frank Act was itself intended to reduce the very large costs associated with financial instability and systemic risk. Lest we have forgotten, let me recount some of these costs:

- Over $10 trillion in household wealth destruction,[1] with the average household losing 23 percent of its stored wealth[2]
- Nearly 10 million lost jobs[3]
- Wage losses of approximately $3,250 per household[4]
- 12 million expected foreclosures[5]
- 30 percent peak to trough decline in home prices[6]
- 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 this type of major financial crisis, and the level of losses it caused, was once a regular occurrence in the United States prior to the passage of the New Deal-era banking and finance laws. Importantly, as experts across the ideological spectrum have concluded, we can expect to continue to regularly experience this type of financial crisis going forward unless we re-establish strong and effective regulatory oversight over our entire financial system. This fact must be considered in any cost-benefit analysis done on Dodd-Frank implementation.

The costs of a completely unregulated financial system

Perhaps the best way to understand the benefits provided by strong financial regulation is to consider the costs that accrue in the absence of such regulation.

Prior to the New Deal, we had such a situation, where a laissez-faire approach to financial regulation was the order of the day. While regulatory costs during this period were minimal, the external costs to investors and the larger economy were high. As has been well documented, the financial system experienced major bubble-bust cycles every 7-to-10 years during this era, culminating in financial crises in 1792, 1797, 1819, 1837, 1857, 1873, 1884, 1890, 1893, 1896, 1907, 1914 and 1929-33.[7]

These regular bubble-bust cycles caused enormous losses to investors and consumers, eroded confidence in the financial markets, and retarded economic growth.[8] The last of these crises, of course, caused the Great Depression, resulting in catastrophic losses to the financial sector and broader economy that were even larger, in real terms, than the costs we just incurred from this past financial crisis.

In short, this period provides clear evidence that unregulated financial markets result in regularly occurring bubbles and busts, which have large negative impacts on capital markets and the broader economy. While the regulatory costs of this approach are *de minimis*, the costs of the financial volatility that accompanies this approach are exceedingly high.

The benefits of financial regulation

In response to the failures of unregulated financial markets, your predecessors in Congress established a system of strong regulatory oversight for banking and capital markets, through a series of New Deal banking and financial laws that created a number of financial regulators with broad new authorities. At the time, critics argued that these laws would be highly costly and deter financial activity and economic growth. Instead, this new regulatory architecture led to an unprecedented era of financial stability, which spurred unusually high economic growth from the 1940s to the 1990s.

The upshot: regulatory costs during this period were high, but these were miniscule when compared to the very large benefits of financial stability, which created greater confidence in our capital markets, more efficiently allocated capital to productive investments (rather than asset bubbles), and promoted high economic growth.

The adoption of New Deal financial regulation (including the Banking Acts of 1933 and 1935, the Securities Act of 1933, the Securities and Exchange Act of 1934 and the Investment Company Act of 1940) finally tamed the cycle of bubbles and busts that had historically plagued financial markets. It did so by carving out banking activities from other less risky areas (securities and insurance), and heavily regulating banks. As part of this approach of deliberately fragmenting the financial system, the New Deal-era reforms and subsequent legislation created a fragmented financial regulatory architecture, the so-called "alphabet soup" of financial regulators that included the FDIC, or Federal Deposit Insurance Corporation; FSLIC, or Federal Savings and Loan Insurance Corporation; OCC, Office of Comptroller of the Currency; OTS, Office of Thrift Supervision; SEC, Securities and Exchange Commission; and CFTC, Commodities Futures and Trading Commission, among others.

Many of these reforms were heavily criticized at the time for being overly onerous for financial institutions, creating too large a federal bureaucracy, and potentially stunting capital formation.[9] In fact, what the United States experienced was an unprecedented period of financial stability, lasting roughly 50 years. This "Golden Age" or "Quiet Period" in banking was also marked by extraordinarily high economic growth—the greatest in our history—as capital was allocated efficiently to productive investments. Moreover, as Harvard Business School professor David Moss notes, "This was also a period of significant financial innovation, with U.S. financial institutions—from investment banks to venture capital firms—quickly becoming the envy of the world."[10]

The experiences of the post-New Deal era provide a clear lesson, one that I would urge the members of this subcommittee to heed: The costs of good financial regulation are far outweighed by the benefits of financial stability. Or to put this in a modern context, an ounce of regulation is worth a pound of bailouts.

The costs of financial deregulation and regulatory indifference

Unfortunately, we forgot the lessons of our past, and re-embraced the hands-off approach to financial regulation that had previously caused us so much economic damage. Beginning in the 1980s, we allowed pockets of un- and under-regulated financial activity to emerge, both through deregulation as well as through regulatory inaction.

This led to the rapid growth of the "shadow banking system," which emulated the core intermediation functions of the banking system but without the prudential regulation that had kept banking stable for so many decades. By the mid-2000s, shadow banking accounted for many trillions of dollars in risk. This shadow banking system emerged in part due to deregulation, such as with the Commodities Futures Modernization Act of 2000, which exempted swap derivatives (which became a key instrument in transferring risk in the shadow banking system) from oversight, and in part due to regulatory indifference, such as with the regulators' lax treatment of off-balance sheet risks. Origination level risks, including the proliferation of unregulated lenders, poor and often fraudulent underwriting, and misaligned incentives, also increasingly fell outside the scope of regulatory oversight during this period.

Unsurprisingly, this lack of regulation led to a large buildup of systemic risk. Shadow banking conduits, and their holding companies, became excessively leveraged, with investment banks becoming leveraged as much as 40 to 1. At the same time, risks were poorly understood because of the opacity of much of the financial markets. Unsurprisingly, when the boom turned to a bust, much of the financial system was unable to cover their losses, leading to the financial crisis of 2008.

Unfortunately, regulators and policy makers trusted that the market, left to its own devices, would produce efficient outcomes. They had forgotten the key lesson of pre-New Deal economic history—that unregulated financial markets do not necessarily produce efficient outcomes. The costs of this miscalculation were, as I mentioned previously, staggering. Many trillions of dollars in losses, an economy left in ruins, 15 million unemployed Americans, a complete loss of investor confidence in private U.S. capital markets, and counting. (see chart 1)

Importantly, if we do not address the problems in the financial system, we can expect to see more major financial crises. There is a consensus among virtually all respected analysts—both liberal and conservative—that maintaining the status quo will result in regular bubble-bust cycles, of the sort we experienced regularly prior to the New Deal. (see chart 2)

The Relative Costs of the Dodd-Frank Act

The Dodd-Frank Act is the first major attempt to improve financial regulation since we began deregulating the financial system some 30 years ago. Without going into all of the details of this comprehensive bill, it can be described as an attempt to update and extend the old fractured regulatory system created by the New Deal to the modern financial system, particularly with respect to those parts of the system that had become unregulated or under-regulated. In particular, Dodd-Frank attempts to implement prudential risk regulation on the shadow banking system and improve transparency throughout the larger financial system.

While there has been considerable debate as to whether Dodd-Frank is a silver bullet that fully addresses all of the problems made evident in the financial crisis, there should be no doubt that it will meaningfully reduce leverage and increase transparency—and thus reduce systemic risk—provided that it is fully and effectively implemented.

Conversely, measures that inhibit and limit the full and effective implementation of Dodd-Frank will increase the systemic risk in the financial system and substantially raise the probability that we experience another major financial crisis in the near future.

So returning to the question posed by this hearing, what are the costs of implementing Dodd-Frank and how do they compare to the costs of *not* implementing Dodd-Frank? In other words, what are the costs of financial regulation and how do they compare to the costs of the financial crises that occur in the absence of such regulation?

History has taught us that the costs of regulation are minimal when compared with the trillions of dollars in economic devastation and wealth destruction that result from the bubble-bust cycles that accompany inadequate regulation, as we just witnessed. This lesson is even more apt when we recognize that the various agencies created by or given new mandates by Dodd-Frank can easily be self-financed with extremely small assessments on the many trillions of dollars that flow through the financial system on a daily basis. The taxpayer does not need to directly fund the regulatory activities of Dodd-Frank, as these can be funded from the industries being regulated.

In that light, it appears that the Dodd-Frank Act is extraordinarily cost-efficient. Even the most pessimistic cost estimates for implementing Dodd-Frank constitute just a small percentage of the probable benefits of financial stability. Even if one does not believe Dodd-Frank solves all of our financial market issues, it is clear that by reducing systemic risk, and thus the likelihood of financial crises and the large losses that accompany these, Dodd-Frank pays for itself many times over.

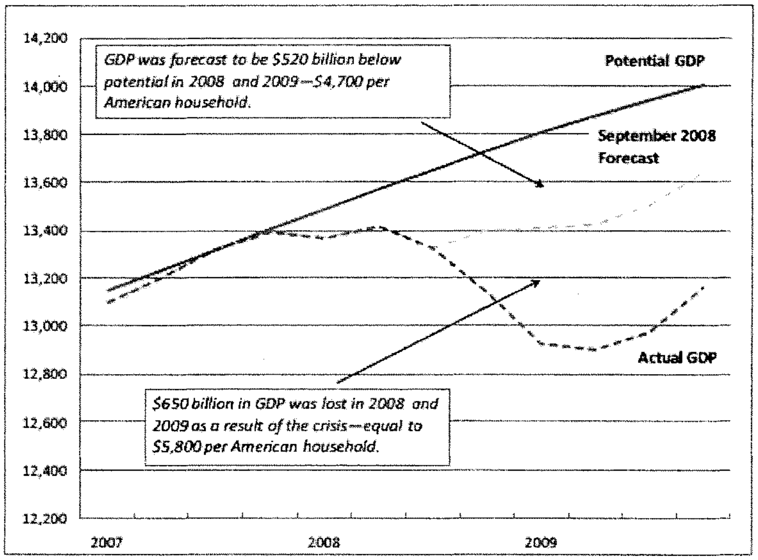
Conclusion

The available historical evidence tells us in no uncertain terms that unregulated financial markets lead to high volatility, while well-regulated financial markets lead to stability. And as we have learned time and time again, the excessive volatility that results from unregulated financial markets is extraordinarily costly to investors, consumers, taxpayers, and the broader economy. In contrast, the economic and market stability provided by good and robust financial regulation confers significant economic benefits that are far greater than any regulatory costs that might be incurred. To remind this subcommittee of the obvious, our greatest era of economic growth and prosperity coincided with the period when financial stability was at its greatest, and this of course was when financial regulation was at its strongest and most effective.

When it works well, the financial system efficiently allocates surplus capital from investors to productive investments. In a properly functioning capitalist society, the financial system creates jobs through the investments it funds—whether these are new factories, new technologies, or new distribution channels—not through the fees it charges or profits it makes. The fact that we are having a debate about the costs of financial regulation in the aftermath of the largest financial crisis in our lifetimes, in a time when the financial sector accounts for 40 percent of corporate profits, suggests to me that our capitalist economy is not working well, and that we have lost sight of the forest for the trees.

I would like to commend the chairman and the other members of this subcommittee for holding this hearing. I think today's discussion should clearly demonstrate the excellent return-on-investment that we as taxpayers receive from the relatively few dollars we spend on financial regulation. I hope that the facts generated out of this subcommittee today encourage Americans to avoid taking a penny-wise, pound-foolish approach to financial regulation and support the full funding and effective implementation of the Dodd-Frank Act.

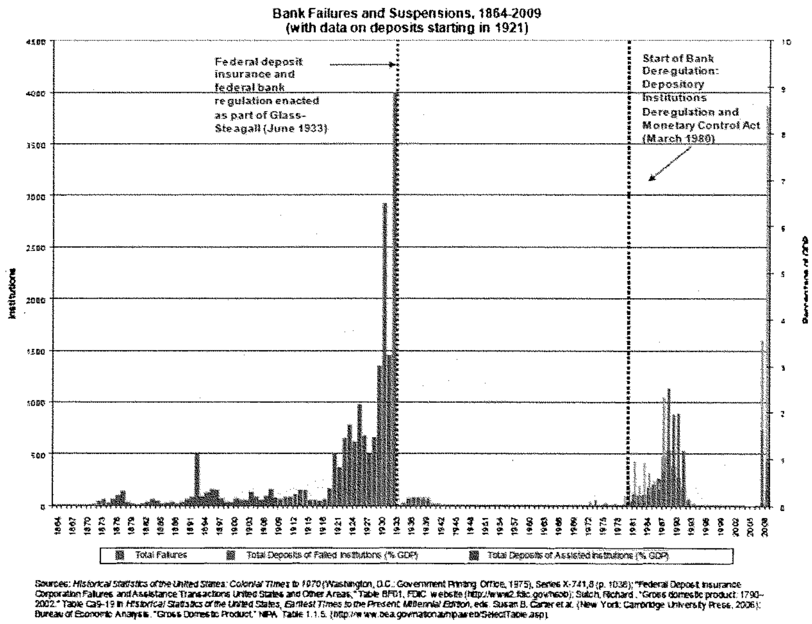
Chart One: Impact of the crisis on the economy-wide output. September 2008 forecast



Note: GDP as plotted in the chart is in billions of 2005 (real) dollars at a seasonally adjusted annual rate. The dollar figures in the boxes, however, are translated into 2009 dollars.

Source: The original title of above chart is "Impact of the Crisis on Economy-Wide Output", source is: 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), available at http://www.pewfr.org/admin/project_reports/files/Cost-of-the-Crisis-final.pdf.

Chart Two: Bank failures and suspensions, 1864-2009



Source:: David Moss, "Reversing the Null: Regulation, Deregulation, and the Power of Ideas," Working Paper, No. 10-080, (Harvard Business School, 2010), p. 3. XXX

Endnote

[1] Anthony J. Crescenzi, "Cyclical Tailwinds, Secular Headwinds and the Market of Bonds," Pimco (originally published on CNBC.com), April 7, 2010, available at http://www.pimco.com/Pages/Viewpoints%20Crescenzi%20April%202010.aspx.
[2] 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).
[3] 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), available at http://www.pewfr.org/admin/project_reports/files/Cost-of-the-Crisis-final.pdf..
[4] Ibid.

[5] Center for Responsible Lending, "Snapshot of a Foreclosure Crisis" (2010), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/snapshot-of-foreclosure-crisis.pdf.
[6] See Case-Shiller/S&P Home Price Index, for example at http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245288910516.
[7] Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007" (Atlanta: Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference: *Financial Innovation and Crisis*, May 9, 2009); David Moss, "Reversing the Null: Regulation, Deregulation, and the Power of Ideas." BGIE Working Paper No. 10-080, (Harvard Business School, 2010).
[8] See, for example, Gorton, "Slapped in the Face;" Moss, "Reversing the Null;" David C. Wheelock, "The Federal Response to Home Mortgage Distress: Lessons from the Great Depression," *Federal Reserve Bank of St. Louis Review*, May/June (2008): 134-39.
[9] For example, as SEC Chairman Joseph Kennedy noted in a 1934 speech to the Boston Chamber of Commerce, the dominant criticisms of the Securities and Exchange Act of 1934 were that it "imposes liability upon directors and corporate officers with unwarranted severity... [it] entails excessive and burdensome expense... [it] requires information, the securing of which entails disproportionate effort and that much of this information is irrelevant to the investor... [and it] operates adversely to the corporation." Joseph P. Kennedy, Chairman of the Securities and Exchange Commission, Address to the Boston Chamber of Commerce, November 15, 1934.
[10] Moss, "Reversing the Null," p. 4.

About the Author

David Min is the Associate Director for Financial Markets Policy at the Center for American Progress Action Fund. In this capacity, he leads the activities of the Mortgage Finance Working Group, a group of leading experts, academics, and progressive stakeholders in housing finance first assembled by the Center for American Progress in 2008 to better understand the causes of the mortgage crisis and create a framework for the future of the U.S. mortgage system. David also oversees financial market issues for the Center. He is frequently quoted on these and other topics in the national media, including print, television and radio.

Prior to joining the Center, he was a senior policy advisor and counsel with the Joint Economic Committee of the U.S. Congress, where he focused on policy solutions to the credit crisis, as well as other macroeconomic and financial markets issues. David was formerly the Banking Committee counsel for Sen. Charles Schumer (D-NY). Before coming to Capitol Hill, David was a securities litigator, first as an Enforcement Division attorney at the Securities and Exchange Commission, and later in the Washington, D.C. office of WilmerHale LLP.

David holds a J.D. from Harvard Law School, and received his undergraduate degrees from the University of Pennsylvania's Wharton School of Business and School of Arts and Sciences, where he graduated magna cum laude and Phi Beta Kappa.

Testimony of James A. Overdahl
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Before the Committee on Financial Services,
Subcommittee on Oversight and Investigations,
United States House of Representatives
March 30, 2011

Chairman Neugebauer, Ranking Member Capuano, and other members of the Subcommittee. I appear before you today in my current role as a Vice President of National Economic Research Associates, or NERA, and as a former Chief Economist of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). I thank you for allowing me a chance to share my observations about the role of economic analysis in the rulemaking process at these two regulatory agencies.

In my testimony today I will address three topics. First, I will describe the current role and importance of economic analysis in the rulemaking process at the SEC and CFTC. Second, I will describe some of the obstacles limiting the effective application of economic analysis to the process. Lastly, I will offer suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

I. The Current Role of Economic Analysis in the Rulemaking Process at the SEC and CFTC

The economics programs at the SEC and CFTC are staffed with small, but dedicated, teams of high-quality economists. Over the years, the SEC and CFTC have become destinations for some of the nation's best financial economists who find these agencies to be outstanding places to apply their analytical skills to important problems. Although these economists play an important role in each commission's rulemaking process, they perform other roles too. Economists at both the SEC and CFTC provide litigation support in enforcement proceedings, gather data and conduct analysis about emerging market issues, and respond to abnormal market events, such as the 2008 financial crisis, or last year's "flash crash." Considering the scope of their responsibilities and the size of their staff, it is not possible for them to provide the same level of analysis for each proposed rule or regulatory action. Determining priorities and allocating the resources of the economics program at each agency is the job of the Chief Economist, who must consider the Chairman's priorities, the complexity of analysis required, the urgency of the rulemaking calendar, the likelihood of the rule being challenged in court, and the staff-to-staff working relationship with the drafters of the rule. These considerations have contributed to the inconsistent application of economic analysis across the rulemaking agenda at both the SEC and CFTC.

During my time at the SEC and CFTC, neither agency had a formal requirement for including economic analysis in the rulemaking process, aside from the cost-benefit requirements of the Paperwork Reduction Act (PRA). Neither the SEC nor CFTC requires that its economics staff have formal sign-off authority before proposed rules are recommended to the commissioners for a vote. Although the Administrative Procedure Act (APA) requires that federal regulatory agencies justify their exercise of rulemaking authority to avoid actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law," this language has not been regarded by either commission as a formal requirement for the application of economic analysis to the rulemaking process. However, recent court interpretations of how the APA's language applies to the SEC's administration of the rulemaking process has come to be regarded, at least at the SEC, as a requirement to responsibly consider the expected economic impact of proposed rules—at least for those rules likely to be challenged in court.[1] Individual statutes, such as the Securities Exchange Act of 1934, may also require regulators to consider other economic effects, such as whether a regulatory action will promote efficiency, competition, and capital formation.

Aside from the contribution economic analysis can have to satisfying procedural requirements, its broader contribution is to improving regulatory decision making. I found that commissioners at both the SEC and CFTC welcomed independent, data-driven economic analysis provided by commission staff. One reason for this welcoming attitude, I believe, is because interested parties constantly bombard commissioners with iron-clad arguments on all sides of all issues. Transparent analysis, combined with high-quality data and rigorous analysis clearly enhanced the ability of commissioners to ask better questions, better understand the trade-offs and consequences associated with a proposed rule, and make informed decisions. At times, commissioners made decisions that more heavily weighed considerations outside the realm of economic analysis. Even in these cases, the accountability and transparency of the process was improved by having on-the-record economic analysis because it forced commissioners to publicly consider the economic evidence and then provide a reasoned basis for their decision.

Economic analysis can be useful at all stages of the rulemaking process, including the very earliest stage of identifying, clarifying, and framing the economic issues that can possibly be addressed by a regulatory action. Once an issue is identified, economic analysis can be helpful in evaluating alternative regulatory responses and in determining whether these responses improve upon the existing situation or dominate market-based solutions.

Within the regulatory process the role of what I am calling "economic analysis" is often referred to as "cost-benefit analysis" or "regulatory impact analysis." As my immediate predecessor at the SEC, Chester Spatt, has observed, the meaning applied to these terms is not universally shared among regulators.[2] As Professor Spatt has pointed out, a narrow interpretation would imply that economic analysis is limited to cases where regulatory impacts can be quantified in

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[1] See *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133 (D.C. Cir. 2005), and 443 F.3d 890 (D.C. Cir. 2006); *Am. Equity Investment Life Ins. Co. v. S.E.C.*, 572 F.3d 923 (D.C. Cir. 2009), and 2010 WL 2813600 (D.C. Cir. July 12, 2010); and *NetCoalition v. S.E.C.*, 2010 WL 3063632 (D.C. Cir. August 6, 2010).

[2] See Chester S. Spatt, "Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?" March 15, 2007. Available at http://www.sec.gov/news/speech/2007/spch031507.htm

dollars, such as out-of-pocket compliance costs. Under this interpretation, the analysis would involve toting up and comparing dollar costs and dollar benefits attributable to a proposed rule. However, a broader interpretation, shared by many regulators and judges, goes beyond what is readily quantifiable and includes qualitative factors associated with a proposed rule. Under a broader interpretation, economic analysis can enhance the regulator's understanding of the trade-offs, potential effects and unintended consequences of their actions, including identifying potential changes in behavior by market participants. The value of economic analysis to the regulator derives from its capacity to provide a clear, credible, and coherent framework for articulating the reasoned basis for regulatory action.

For the regulator, failure to adequately consider relevant economic evidence leaves an adopted rule vulnerable to a court challenge on the grounds that the agency's action lacked a reasoned basis. In recent years, the courts have identified weaknesses in the application of economic analysis to SEC regulatory decisions, resulting in rules being sent back to regulators for further consideration. The message from the courts has been that regulators' economic arguments need to be adequately supported—that vigorous assertion is not a substitute for rigorous economic analysis. Because the SEC has begun to take note of this heightened judicial scrutiny, economic analysis has come to be regarded as an important component for bolstering the Commission's arguments and ensuring that adopted rules have a sufficiently reasoned basis so as to be less vulnerable to court challenges under the APA.

II. Obstacles Limiting the Effective Application of Economic Analysis to the Rulemaking Process

Although there currently are no formal requirements for including economic analysis in the rulemaking process at either the SEC or CFTC, there have been attempts to formalize such requirements in the past. These attempts have foundered for a variety of reasons. First, the requirements were not institutionalized, but simply reflected the preferences of individual chairmen. When these chairmen left, the requirements were discontinued or simply forgotten. Second, the commissions were simply overtaken by events. For example, while I was at the SEC, there was a serious attempt to roll out a systematic approach for incorporating economic analysis in the rulemaking process. However, the financial crisis of 2008 diverted the Commission's attention to more urgent matters. Third, in my opinion, the rulemaking divisions of the SEC and CFTC have never fully bought into the idea of applying rigorous economic analysis to the rules they were drafting. In some cases, particularly in cases where good working relationships existed between the economics staff and the staff of the operating divisions, the process worked well. Economists were routinely included at an early stage and their analyses were welcomed and integrated into the process. In other cases, those in the operating divisions who "held the pen" in drafting rules would take a proprietary view and regard the rules as their turf. In these cases, intruders were not welcome until the process was sufficiently far along so that the rule would be recommended to the Commission with only superficial (and last minute) input from the economics staff.

Another obstacle to effectively applying economic analysis to the rulemaking process has been a lack of relevant data. In my view, this problem is related to the fact that economists are often not consulted in the rulemaking process with sufficient lead time to locate or generate useful data. Without useful data, the power of economic analysis is severely degraded.

Often, the SEC and CFTC have relied on public comments to supply data and analysis. Although public comments can be extremely valuable to providing some types of information, they rarely include the type of data and analysis that can truly inform the process and serve as a substitute for the Commission conducting its own analysis. Often, the most useful information from public comments is that which addresses compliance costs associated with proposed rules. To draw out this type of data, both the SEC and CFTC will often pose specific questions on these topics in proposed rules. As with Commission staff, members of the public also require sufficient lead time to locate useful data and conduct meaningful analysis of proposed rules. The time constraints of the public comment process often limit the ability of the public to provide useful analysis for the record before the comment period expires.

Another problem in obtaining useful data and analysis from the public are constraints imposed under the Paperwork Reduction Act (PRA) that limit the ability of regulators to survey members of the public who may possess useful data and information relevant to a proposed rule. The PRA requires OMB approval of surveys involving more than nine entities. The time required to gain OMB approval of a survey design that would include a larger group of respondents can take nearly as long as the Commission's rulemaking process itself. As a result, the SEC and CFTC rarely use surveys of more than nine people in forming cost estimates for proposed rules. This limitation necessarily reduces the quality of cost estimates. Both the SEC and CFTC will rely on the public comment process to challenge the cost estimates published as part of the proposed rule. A related problem involves the confidentiality of cost data supplied to the regulator to inform the rulemaking process. Businesses in a position to supply useful data and analysis often do not do so because they do not want to publicly disclose information that could deprive them of a competitive advantage.

I will note that the quality of information supplied through the public comment process has improved in response to recent court decisions. I have found that parties affected by proposed rules now regard the notice and comment rulemaking process as if it was part of a legal proceeding. Affected parties are increasingly using the comment process as an opportunity to place on the public record factual information about likely compliance costs and suggested alternative means of meeting the objectives of regulators. Because of the potential for litigation, parties commenting on proposed rules are directing their comments not only to the members of the regulatory commission involved in adopting rules, but also to the judges who may be reviewing the public record for rules that are challenged through the courts. Because the outcome of recent court challenges to federal rules have turned on the adequacy of the economic support considered by regulators when they adopted new rules, parties submitting comments to the public record are paying particular attention to the quality of their economic arguments.

III. Suggestions on How Economic Analysis Can Be Better Utilized to Craft Regulations

In closing, I would like to offer a few suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

First, economic analysis needs to be included in the rulemaking process at an early stage. It is at the early stages where a rule's "term sheet" is developed by the rulemaking division. The term sheet is a high level overview describing the proposed rule and identifying the market problem the rule is designed to address. I believe it would be useful at this stage to also include a high level economic review of both the rule and the problem. This review would be performed before the term sheet advances outside of the division proposing the rule. This review should include some analysis indicating whether the rule is likely to be a major or minor rule in terms of its economic impact. Determining at early stage whether a rule is likely to be major or minor can help devote sufficient resources to analyzing rules likely to have a major economic impact. An early review would provide lead time for the economics team to assess the complexity of the analysis required and to begin gathering data that could be applied to analyzing the proposed rule.

In the past the SEC has attempted to include economic analysis in an early-stage term-sheet review. However, this type of review was never institutionalized and the process foundered. Institutionalizing such a review, in my view, will likely require a formal policy adopted by each commission to guide the rulemaking process. A formal policy would help provide some consistency to the process. Crafting such a formal policy holds the potential for making an already cumbersome process even more cumbersome. However, without sufficient lead times, regulators cannot effectively use economic analysis to help them identify and frame problems, evaluate alternatives, and have data-driven analyses available to inform their deliberations.

Another way to improve the quality of economic analysis is to improve the data collection process. One way to do this would be to streamline the process by which regulators can survey firms for information about potential compliance costs. Another way to do this is to allow a process where firms could confidentially disclose to the regulator cost information that would be useful in evaluating the potential impact of a rule. Another way to gather data is for the regulator, whenever possible, to run pilot programs that can generate useful data for analysis. In the past, such pilot programs have proven useful to the deliberations of regulators. Finally, those providing public comments on proposed rules can improve the process by paying particular attention to the quality of their economic arguments and by providing data and analysis when appropriate.

Even in a rulemaking process that includes rigorous economic analysis, there will always be considerable uncertainty about a rule's economic impact. Therefore, it may be helpful to have an ongoing post-adoption review of rules to determine the actual economic impact of a rule's implementation.

I believe it would be helpful for financial regulatory agencies to develop a guide for the use of economic analysis in their rulemaking procedures. The Financial Services Authority (FSA) has produced such a guide that could serve as a useful starting point for developing a similar guide for the United States.[3] I believe that such a guide would be more helpful that current OMB guidance or the guidance offered in current or past executive orders that are difficult to apply directly to financial market regulation. I believe that such guidance can be useful to providing consistency to the process both across the rulemaking agenda and across time. Since the guidance would apply to independent regulatory agencies, each agency would need to independently adopt such guidance in their own internal policies and procedures.

In the end, economic analysis is more than about satisfying procedural requirements for regulatory rulemaking. Improving the power and consistency of economic analysis at regulatory agencies, like the SEC and CFTC, is important because it will enhance the ability of regulators to make informed decisions. An added benefit is that it will also help enhance the overall transparency and accountability of the rulemaking process.

I look forward to your questions.

[3] See Financial Services Authority Central Policy, "Practical Cost-Benefit Analysis for Financial Regulators" June,2000, available online at: http://www.fsa.gov.uk/pubs/foi/cba.pdf

STATEMENT OF JILL E. SOMMERS

COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

HOUSE COMMITTEE ON FINANCIAL SERVICES

March 30, 2011

Good afternoon Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee. Thank you for inviting me to today's hearing on "The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic." I am Jill Sommers. I have worked in the derivatives industry for over fifteen years and have been a Commissioner at the Commodity Futures Trading Commission since August of 2007. The views I present today are my own and not those of the Commission.

The Dodd-Frank Act is the most far reaching financial reform effort we have seen since the 1930s. Its scope and complexity are unparalleled. Similarly, Title VII of the Dodd-Frank Act, which ushers in a new era of regulation for derivatives transactions and market participants, is sweeping in its breadth. Notwithstanding its breadth and complexity, it requires the Commodity Futures Trading Commission to promulgate final rules within one year, and in some cases earlier than one year.

Since August, we have held eight public roundtables, twelve Commission meetings and have issued more than 50 proposed rules, notices, or other requests seeking public comment on Dodd-Frank related issues. While this pace has been a challenge for the Commission, I constantly hear from market participants and the public that they do not have a meaningful opportunity to comment on the proposals. Their view is that, with so many comment periods open at the same time for proposals from multiple regulatory agencies, they do not have the opportunity to provide meaningful comment on how the various rules, taken together, will impact the markets and market participants. I am sympathetic to that view for three reasons. First, this is a tremendous amount of complex material to digest in a very short period of time; second, I take all comments very seriously and want commenters to provide me and the Commission with the highest quality analysis for us to consider before we vote on final rules; and third, the Commission has not released proposed rules in a logical order. For instance, as we sit here today, we have proposed nearly 50 rules, but have yet to propose a rule that defines what a swap is.

Never before has the CFTC issued so many technical and complex proposed rules in such a compressed timeframe. While each proposed rule involves consideration of varying substantive issues, regardless of the issues involved, the Commodity Exchange Act requires the Commission to consider the costs and benefits associated with each of its regulations and orders.

Section 15(a) of the Commodity Exchange Act requires that, "Before promulgating a regulation . . . or issuing an order . . . the Commission shall consider the costs and benefits of the action of the Commission." Section 15(a) goes on to require that, "The costs and benefits of the proposed Commission action shall be evaluated in light of – (A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations."

When promulgating regulations, the Commission typically does not perform a robust cost-benefit analysis at either the proposed rule stage or the final rule stage. We do not quantify in detail what the costs of complying with a rule may be. Instead, proposals usually contain a statement that the Commission is only required to "consider" the costs, and is not required to "quantify" them, or to determine whether the benefits outweigh the costs. While we do ask for comment from the public on the costs and benefits at the proposal stage, we rarely, if ever, attempt to quantify the costs before finalizing a rule.

As we add layer upon layer of rules, regulations, restrictions and new duties, my preference is that the Commission include in each proposed rule a thorough cost-benefit analysis that attempts to quantify the cost associated with compliance. This would give the public the opportunity to comment on our analysis. To me, that is good government. If we wait until we issue a final rule to conduct a thorough cost-benefit analysis, the public is deprived of the opportunity to comment on our analysis because there is no comment period associated with a final rule.

I would like to point out that in proposed rules the Commission does attempt to quantify costs under the Paperwork Reduction Act, but this analysis is limited to the costs of any new recordkeeping or reporting requirements mandated by a rule.

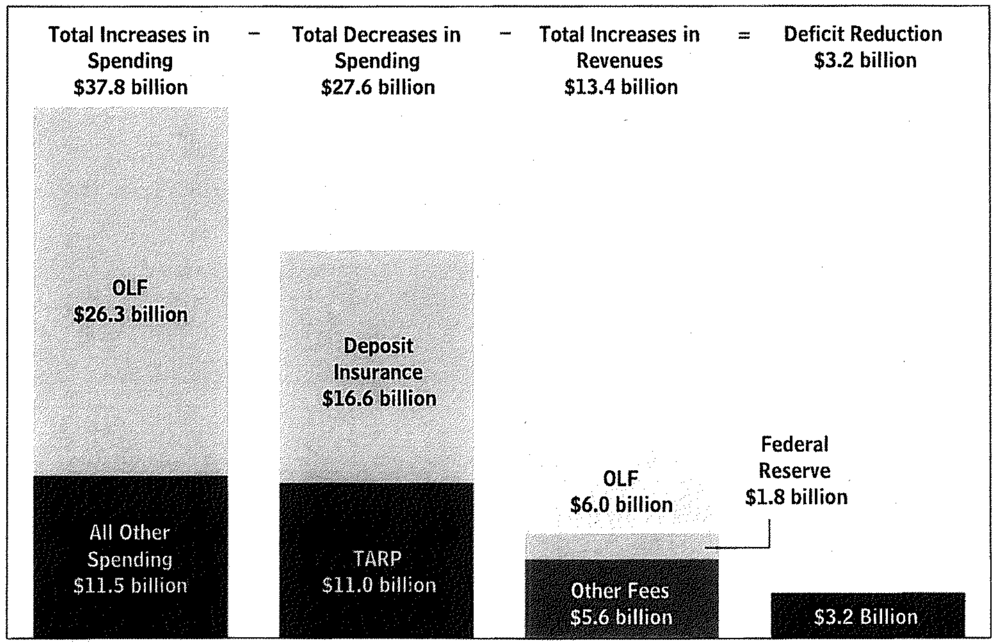
Quantifying costs for Paperwork Reduction Act purposes is not designed to quantify the overall cost of compliance. While the Commission has attempted to quantify this limited subset of costs in its Dodd-Frank proposals, many commenters have criticized the Commission's Paperwork Reduction Act analysis and have indicated that our analysis grossly underestimates the actual costs involved.

Before I finish I would like to say that I agree wholeheartedly with the President's recent Executive Order on "Improving Regulation and Regulatory Review." In that Executive Order, the President called upon agencies to, among other things: use the best, most innovative, and least burdensome tools for achieving regulatory ends; propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs; take into account benefits and costs, both quantitative and qualitative; specify performance objectives, rather than the particular manner of compliance, where feasible; identify and asses available alternatives to direct regulation; and identify and consider regulatory approaches that reduce burdens and maintain flexibility. Although as an independent agency, the CFTC is not bound by the President's Executive Order, I am hopeful that we will undertake this type of analysis before we get to the stage of finalizing rules in order to provide stakeholders with a meaningful opportunity to review and comment on the requirements

Thank you. I am grateful for the opportunity to speak about these important issues and am happy to answer any questions.

O

CBO's Estimate of the Effects on Direct Spending and Revenues of the Dodd-Frank Wall Street Reform and Consumer Protection Act Over the 2010–2020 Period



Note: OLF = Orderly Liquidation Fund; TARP = Troubled Asset Relief Program.

Table 1.

CBO's Estimate of the Impact on Budget Deficits Over the 2010–2020 Period From Enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act

(Billions of dollars)

	Direct (2010–2020)	Discretionary (2010–2015)
Cost of New Federal Organizations (CFPB, FSOC, OFR, ONI)		
Estimated outlays	6.8	*
Estimated revenues	0.5	
Net Change in Deficits	6.3	
Changes to the Existing Regulatory Structure (CFTC, FDIC, Federal Reserve, OCC, PCAOB, SEC, SIPC)		
Estimated outlays	2.7	0.3
Estimated revenues	2.6	
Net Change in Deficits	0.1	
Additional Funding for Existing Programs[a]		
Estimated outlays	1.5	0.2
Estimated revenues	0	
Net Change in Deficits	1.5	
Changes to Federal Deposit Insurance		
Estimated outlays	0	0
Estimated offsets to outlays	-16.6	
Estimated revenues	0	
Net Change in Deficits	-16.6	
Orderly Liquidation Fund		
Estimated outlays	26.3	0
Estimated revenues	6.0	
Net Change in Deficits	20.3	
Troubled Asset Relief Program		
Estimated offsets to outlays	-11.0	0
Net Change in Deficits	-11.0	
Other Budgetary Effects[b]		
Estimated outlays	0.5	2.1
Estimated revenues	4.3	
Net Change in Deficits	-3.8	

Continued

Table 1. Continued

CBO's Estimate of the Impact on Budget Deficits Over the 2010–2020 Period From Enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act

(Billions of dollars)

	Direct (2010–2020)	Discretionary (2010–2015)
Total Effect on Deficits		
Estimated outlays	37.8	2.6
Estimated offsets to outlays	-27.6	
Estimated revenues	13.4	
Net Change in Deficits	-3.2	

Source: Congressional Budget Office.

Notes: Components may not sum to totals because of rounding.

For the changes in deficits, positive numbers represent an increase in deficits and negative numbers represent a decrease in deficits.

CFPB = Consumer Financial Protection Bureau; FSOC = Financial Stability Oversight Council; OFR = Office of Financial Research; ONI = Office of National Insurance; CFTC = Commodity Futures Trading Commission; FDIC = Federal Deposit Insurance Corporation; OCC = Office of the Comptroller of the Currency; PCAOB = Public Company Accounting Oversight Board; SEC = Securities and Exchange Commission; SIPC = Securities Investor Protection Corporation.

* = less than $50 million.

a. The Dodd-Frank Act provided funding for subsidies to help homeowners in foreclosure and for grants to stabilize communities with many foreclosed properties.

b. The Dodd-Frank Act provided the Securities and Exchange Commission with permanent authority to collect certain fees and to spend a limited amount of those collections; adjusted the regulation of fixed income annuities; exempted swaps and other derivatives from certain provisions of the Internal Revenue Code; and authorized funding for counseling and legal assistance programs for certain homeowners and tenants.

QUESTION REGARDING COSTLY SEC OVERREACH IN IMPLEMENTATION OF DODD-FRANK ENGINEERING EXEMPTION FROM THE MUNICIPAL ADVISOR DEFINITION

Oversight & Investigation Sub-Committee Hearing

3/30/11

Congressman Michael Grimm

The implementation of the Dodd-Frank financial reform legislation comes at a time of extreme budget constraints in the federal government. We must ensure that every dollar of federal funds dedicated to the implementation of the Dodd-Frank legislation is being spent efficiently and effectively. A primary means of meeting these imperatives is to ensure that the regulatory program implementing the Act is focused on the objectives of the Act and does not overreach.

It has recently come to my attention that in December, the SEC issued guidance that proposes to require engineering companies to register as "municipal advisors" under section 975 of the Dodd-Frank Act for the provision of standard engineering services, despite the exemption provided in that section for "engineers providing engineering advice." Specifically, the SEC proposes to require energy service companies to register as "municipal advisors" whenever the company provides a cash flow analysis of proposed energy efficiency projects.

Energy service companies serve a vital role in the US economy by providing engineering solutions that furnish cost-effective, state-of-the-art power and energy efficiency services to their customers. Public sector entities have long looked to energy service companies to retrofit existing buildings to achieve energy savings that reduce the cost of powering, heating and cooling public buildings. In many cases, these retrofit projects are paid for with a portion of the cost savings that are achieved.

An energy service company typically will review a customer's current energy sources and uses, and then will propose engineering solutions designed to reduce the customer's energy expenditures, often while also upgrading the physical infrastructure. A cash flow analysis is required to determine whether the project makes economic sense for the client and is a basic engineering service provided by energy service companies. This cash flow analysis is an essential engineering service that is required for a client to make a determination of whether to undertake the project. This cash flow analysis has nothing at all to do with investment or other financial advice beyond whether the capital project should be undertaken.

Lf the customer accepts the proposal, the energy service company will build and install the energy project. Energy projects may involve providing new power sources such as solar and wind energy, and typically involve energy efficiency retrofitting (such as improved lighting and lighting controls, HV AC, energy management systems, motors, insulation, wiring and boilers) of existing infrastructure.

If the SEC persists in holding that even the provision of cash flow analyses and similar analyses as part of a proposed energy retrofit project does not come within the engineering exemption, not only will the nation's scarce financial resources be misdirected into expanding the overreach of the federal government, but also energy service companies that provide jobs and cost-saving retrofits to federal, state and municipal buildings could be driven out of business. For those that remain in the business, SEC compliance will impose an additional cost that will reduce the benefits of ESCO projects to federal, state and local governments.

This seems to me to be a perfect example of "mission creep" by a federal agency. The SEC is failing to weigh the benefits of requiring these entities to register under Dodd-Frank against the costs that would be incurred in developing and enforcing such a broad registration program as well as the lost jobs and lost energy cost savings that would be caused by such an overreach. From what you know of Dodd-Frank and providers of engineering services, does this SEC proposal seem like an overreach that might be avoided with the application of a relatively basic cost-benefit analysis?

Answer

I concur completely. Even a rudimentary cost-benefit analysis of the proposed rule would likely drive the SEC to the common-sense solution: a simple cash-flow analysis that is part of standard engineering services should be excluded from the Dodd-Frank rulemaking.

I must confess that I am not familiar with the details of the issue so that I can only respond in a general way. In general, when an independent regulatory commission like the SEC is required by statute to promulgate rules they should regard cost-benefit analysis to include a comparison of alternative means of achieving the goals of the statute. I cannot predict how such an analysis would come out with respect to this particular issue.

FINANCIAL PLANNING COALITION

March 8, 2011

The Honorable John Boehner, Speaker of the House
United States House of Representatives
Attn: Maura McGovern
1011 Longworth House Office Building
Washington, DC 20515

Dear Speaker Boehner:

On behalf of the Financial Planning Coalition (The Coalition), we write to strongly urge adequate funding for the activities of the Securities and Exchange Commission (SEC), which safeguard consumer financial protections that are badly needed in the financial sector. The Coalition is made up of the Certified Financial Planners Board of Standards, Inc. (CFP Board), the Financial Planning Association (FPA), and the National Association of Personal Financial Advisors (NAPFA). These organizations represent about 75,000 financial professionals across the country, including industry leaders, educators, authors, and professionals committed to serving the best interests of consumers.

The United States capital markets have long been the envy of the world. But for many, the recent financial crisis shook investors' faith in US markets. Ensuring that the capital markets are well-regulated – including oversight by adequately funded regulators – is essential to restoring the confidence that will help lead the nation's economic recovery.

We fully appreciate the challenge facing Congress in trying to manage the federal deficit and the debt burden. However, we note that the SEC is funded entirely through fees assessed to those who the SEC regulates; taxpayers do not bear the burden of funding the SEC. In short, SEC funding has no effect on the deficit. Due to current funding reductions, the SEC Enforcement Division is cutting back on investigations, important vacancies are going unfilled, and technology upgrades needed to deal with the daily influx of information have been cancelled. At the same time, the size and complexity of SEC oversight responsibilities are significantly outpacing SEC funding.

Simply put, to effectively oversee markets and market participants, the SEC needs Congress to authorize the additional funding needed to adequately meet its increasing responsibility and improve its oversight function. However, because the government is still operating under a continuing resolution, these anticipated increases have not occurred and there is continued pressure in the ongoing budget discussions to reduce the SEC's budget.

The SEC adjusts its fees several times a year to ensure that it receives the amount appropriated by Congress to cover its costs to supervise and regulate the securities market. A modest increase in appropriated fees would not hinder the creation of capital and would not place a burden on taxpayers. In contrast, level or reduced appropriations would jeopardize the agency's

ability to adequately police the securities markets and leave investors vulnerable to unscrupulous individuals engaged in financial scams and fraud. In the wake of the recent financial collapse and fraudulent Madoff episode, it is more important than ever to give the SEC the resources and tools it needs to protect investors, particularly our most vulnerable seniors, properly police the markets, and help restore investor confidence to our system.

Sincerely,

Marilyn Mohrman-Gillis

Marilyn Mohrman-Gillis

Managing Director, Public Policy

Certified Financial Planner Board of Standards