TESTIMONY OF

MARCUS M STANLEY

Policy Director, Americans for Financial Reform

On behalf of

AMERICANS FOR FINANCIAL REFORM

Re

“THE DODD FRANK ACT AND REGULATORY OVERREACH”

Before the

OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE

HOUSE FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

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Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

Chairman Duffy, Ranking member Green, and members of the Committee, thank you for the opportunity to testify before you today.

I would like to make several broad points in my testimony:

1) *The Dodd-Frank reforms should create significant benefits.* Attached to my testimony is a report that Americans for Financial Reform recently produced in response to claims by the American Action Forum regarding the costs of the Dodd-Frank Act. In this report, we document that financial regulations that reduce the probability of an economic crisis by 50 percent should produce $2.9 trillion in economic benefits over the next decade in financial stability benefits alone. Reducing the probability of crisis by 25 percent would produce $1.46 trillion in benefits. These figures do not even count the benefits of improved fairness for consumers and investors due to Dodd-Frank reforms. We believe that the Dodd-Frank Act will succeed in reaching these goals, and that these benefits will far exceed its costs.

2) *The Dodd-Frank Act should not be characterized as 'regulatory overreach'*. While the Act is indeed significant in its scope and length, examining the actual regulatory tools used in Dodd-Frank shows that they are traditional elements of financial regulation that have been used for many decades if not centuries. These tools have been tested over many years and are hardly radical departures. The Dodd-Frank Act is the product of compromise and incrementally advances past regulatory practices by increasing their stringency and applying them to additional areas of the financial sector. Furthermore, Dodd-Frank grants very extensive discretion to regulators to adjust the use of these tools as they are applied to different segments of the market.

3) *Rolling back Dodd-Frank would be a serious error*. We have supported changes in the Dodd-Frank Act where we believe such changes are called for. However, changes that roll back Dodd-Frank rules or create major new exemptions to them would in most cases have a negative impact on financial stability or consumer protection. Furthermore, regulators have extensive discretion to accommodate reasonable concerns without statutory change. Overall, the Dodd-Frank Act represents a valuable and long overdue strengthening of our regulatory system in basic ways.

Dodd-Frank Reforms Will Create Significant Benefits

The attached report by Americans for Financial Reform draws on a comprehensive survey of the costs of post-WWII financial crises performed by the international regulatory community over the 2008-2010 period. Based on the results of this survey, financial and banking crises were found to create average costs of 63 percent of annual economic output – a figure that amounts to approximately $10 trillion in the U.S. The survey also found that financial crises occurred every 20 to 25 years, for an annual probability of 4 to 5 percent. Taken together, these figures imply that improvements in financial regulation which lowered the probability of financial crises by just one-quarter would create $1.46 trillion in financial stability benefits alone over the next decade. If such reforms lowered the probability by half they would create $2.9 trillion in financial stability benefits. These figures are both far in excess of the Dodd-Frank costs estimated by the American Action Forum (AAF). Furthermore, as explained in the attached report, we also find that the costs estimated by the AAF were significantly inflated.

The financial stability benefits referred to above do not even include the distributional and fairness benefits created by improved consumer and investor protections. The Consumer Financial Protection Bureau has already returned billions of dollars to wronged consumers, and new and in progress rules should create tens of billions in additional savings.

It is important to note that the benefits documented here do not rely on the Dodd-Frank Act being flawless or working perfectly. Financial crises are so expensive that any significant reduction in their frequency produces very large benefits. And there is every reason to believe that the Dodd-Frank Act is having and will continue to have a positive effect on financial stability. The basic reforms in Dodd-Frank, ranging from the move to a forward looking stress testing approach to capital supervision and planning, to improved mortgage underwriting requirements, to new data reporting and risk management requirements in derivatives markets, to new attention to possible failures at credit rating agencies, are common sense measures that will significantly improve regulatory vigilance concerning potential financial instability. In many cases Dodd-Frank reforms simply formalize and institutionalize common sense lessons concerning the dangers of excessive leverage and poor risk management.

The Dodd Frank Act Should Not Be Characterized As 'Regulatory Overreach'

The Dodd-Frank Act is frequently described as the most significant set of financial reforms since the New Deal reforms of the 1930s. Simply by virtue of its broad scope and comprehensive nature, this is a reasonable description. But it is important to realize that the tools used in Dodd-Frank are hardly radical. Instead, they are generally the product of compromise and reflect a great deal of incremental continuity with past regulatory practices. The prudential requirements for banks in Title I of Dodd-Frank, including heightened capital standards, credit exposure limits, and stress testing, are familiar tools that have been used in bank risk management for decades if not centuries. Formal liquidity requirements are perhaps more novel but reserve requirements,

which played a similar role for commercial banks, are also long-familiar tools. The new central clearing and exchange trading requirements for over the counter derivatives markets are modeled on long-familiar institutions in the listed derivatives markets, and only for those over-the-counter swaps that are sufficiently liquid to make such requirements feasible.

Even Dodd-Frank regulatory changes that appear more novel are generally the result of compromise. For example, the Financial Stability Oversight Committee is certainly a new innovation in U.S. regulation. But it is a compromise solution. The financial crisis made clear that greater regulatory coordination was necessary, but beyond the elimination of the Office of Thrift Supervision Congress was unwilling to undertake major consolidation of U.S. regulatory agencies. Thus the creation of a coordinating council made up of heads of existing regulatory agencies. The delegation of designation authority to the FSOC reflects a compromise between the understanding that emerged from the 2008 crisis that non-banks had become central to financial stability, but a lack of consensus on exactly which if any entities should be designated for Federal supervision.

Likewise, the Volcker Rule, while novel, also represents a compromise solution, in that it separates banking and hedge-fund like proprietary trading activities without returning to the full Glass-Steagal separation between commercial banking and all financial market and trading activities.

Another key element of the Dodd-Frank Act is the very substantial role played by regulatory discretion in the actual implementation of new rules. In almost every case, Congress delegated authority concerning key details of the new rules to the various regulatory agencies, and granted these agencies substantial ability to provide exemptions to the rules where they felt it was justified. This extensive regulatory discretion means that the Dodd-Frank framework is in fact extremely flexible. It reflects and will continue to reflect the learning process engaged in by regulators as they examine the lessons of the financial crisis and the changes that have occurred in the financial sector since the crisis.

A notable element of this regulatory flexibility is the exemption from Dodd-Frank regulations, or the easing of such regulations, for community banks (generally defined as those banks with under $10 billion in assets). Not only does the Dodd-Frank Act statutorily exempt community banks from numerous requirements mandated for larger banks, but regulators have frequently used their discretion to exempt community banks from regulation or to modify such regulations for smaller banks. Examples include regulatory exemptions from margin and clearing requirements for derivatives for smaller banks, as well as small bank exemptions in CFPB rules for loan servicing and ability-to-repay standards for lending.

Rolling Back Dodd-Frank Would Be A Serious Error

Even post-financial crisis, between 25 and 30 percent of corporate profits come from the financial sector. There are often major profit incentives for financial companies seeking to roll

back new regulations, even at the cost of financial stability and consumer protection benefits for the broader public. But it would be very dangerous for Congress to yield to these pressures.

This does not mean that changes in the bill may not be reasonable in particular circumstances. We have supported changes in the law and its implementation when we felt it was called for to better protect the public. For example, AFR has joined Representatives Hensarling and Garrett in criticizing the Federal Reserve's implementation of new restrictions on 13(3) emergency lending, and we have supported Senator Warren in her call for Congress to act if the Federal Reserve does not place stronger pre-conditions on these loans. We have also supported higher capital requirements on banks and have criticized regulators for inadequate capital levels in new Basel rules. We have supported legislation that would create stronger divisions between commercial banking and financial market trading than are required in the Volcker Rule. We have also criticized regulation of credit rating agencies as inadequate given the scope of the problems revealed in the financial crisis and since. Other examples could be given.

But criticism of imperfections in Dodd-Frank should not blind us to the great value of the reforms made in the bill. The 2007-2009 financial crisis was marked by glaring failures in financial risk management by both government regulators and private banks. Very basic forms of financial risk, including poor underwriting and excessive leverage, were systematically overlooked for years. The Dodd-Frank Act contains numerous provisions designed to force attention to these issues, ranging from minimum ability-to-pay requirements for new mortgages to requirements for regulators to improve capital requirements and engage in forward-looking stress testing. The Dodd-Frank Act also institutes basic transparency and risk management requirements for over-the-counter derivatives, an enormous area of potential financial risk, replacing the plainly inadequate system of informal private regulation that previously governed them. Although these requirements were inspired by the hard-won lessons of the 2007-2009 crisis, they are so essential to effective risk management that if they are effectively implemented they will almost certainly prove useful in addressing future systemic risks as well.

In practice, the great majority of the changes we have seen proposed to the Dodd-Frank Act would not build constructively on the advances made by the legislation, but would instead roll back the clock by restricting new regulatory authorities and preventing regulators from effectively implementing the risk controls called for by the legislation. We believe this would be a grave error and would work to restore the failed status quo that gave us the 2007-2009 crisis.

Thank you for the opportunity to testify. I am happy to answer further questions, and in the future can be contacted at marcus@ourfinancialsecurity.org or (202) 466-3672.

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AFR Response to American Action Forum Study on Costs of Dodd-Frank Act

The American Action Forum has released a study claiming that the Dodd-Frank Act will reduce total U.S. economic output by $895 billion between 2016 and 2025.[1] But the study has multiple significant flaws. These include:

- **A failure to incorporate any of the benefits of improved financial sector regulation**. Extensive economic research shows that the benefits of greater financial sector stability alone will exceed the costs claimed by the AAF. As explained below, if Dodd-Frank cuts the annual probability of a financial crisis in half, it will create $2.9 trillion in economic benefits over the next decade. This figure alone is more than triple the costs claimed in the AAF study, and does not even count the substantial benefits that will accrue from improvements in consumer protection and economic fairness.

- **Exaggerating the growth impacts of regulation**. The AAF study exaggerates the cost of regulation in several ways. The study assumes that all regulatory costs will be subtracted from capital investment, even though some regulatory costs themselves involve capital investment and some compliance costs will be funded by spending reductions (e.g. cuts in top executive compensation) at financial institutions. The study also appears to assume that temporary transitional regulatory costs extend permanently. Finally, the study assumes that increases in bank capital (higher equity vs. debt in bank funding) are identical to a tax on investment, which is highly questionable.

In sum, the AAF study both exaggerates the growth costs of regulation and fails to include benefits from regulation that would substantially exceed even these exaggerated costs.

The Benefits of Financial Regulation

Studies have found that the 2007-2009 financial crisis created over $10 trillion in economic costs to the U.S. economy.[2] In their consideration of new capital rules, global regulators at the Basel Committee also performed an extensive analysis of the costs of financial crises and the benefits

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[1] Holtz-Eakin, Douglas, "The Growth Consequences of Dodd-Frank", American Action Forum, May 6, 2015.
[2] Luttrel, David, Tyler Atkinson and Harvey Rosenblum, "Assessing the Costs and Consequences of the 2007-2009 Financial Crisis", Federal Reserve Bank of Dallas, Economic Letter Volume 8, Number 13, September, 2013.

of reduced financial instability.[3] The analysis was based on a complete literature review on the impact of financial and banking crises in advanced economies since WWII. It found that[4]:

- Banking crises occur roughly once every 20 to 25 years, implying that each year there is a 4 to 5 percent chance of a crisis.
- The median or average estimated economic cost of a financial crisis is roughly 63 percent of economic output. This includes both the initial impact and the discounted cost from the loss of future growth over many years.
- Reducing the annual probability of a financial crisis by just one percentage point (i.e. from 4-5 percent to 3-4 percent per year) would lead to annual benefits of .63 percent of economic output. Reducing the probability of crisis by two percentage points would lead to annual benefits of 1.26 percent of economic output per year.

These figures imply that if the Dodd-Frank Act and associated regulatory changes reduced the annual probability of financial crisis by just one percentage point, this would create $1.46 trillion in increased economic output over the next decade (2016-2025). A two percentage point decline would create $2.9 trillion in economic benefits.[5]

It is important to understand that these estimates do not require that the Dodd-Frank Act completely eliminate the probability of financial crisis. A one percentage point decline in the probability of financial crisis corresponds to cutting the chance of a financial crisis by 20-25 percent (from 4-5 percent each year to 3-4 percent each year). A two percentage point decline in the probability of financial crisis corresponds to cutting the chance of a financial crisis roughly in half (from 4-5 percent each year to 2-3 percent each year).

The benefits from either scenario substantially exceed the costs estimated in the AAF study. For example, the benefits of a 20-25 percent reduction in financial crisis probability would create economic benefits that exceed the costs estimated by AAF by over 60 percent. *If Dodd-Frank cuts the probability of financial crises in half, then it will create economic benefits more than triple the costs estimated by the AAF*.

[3] Basel Committee on Banking Supervision, "An Assessment of the Long-Term Economic Impacts of Stronger Capital and Liquidity Requirements", Bank of International Settlements, August, 2010.
[4] The figures cited below can be found on pp. 8-15 and Tables 1-2 of the BIS report cited above.
[5] These figures are calculated by multiplying the BIS estimates of percentage losses in economic output given above by CBO estimates of U.S. GDP between 2016 and 2025. See Congressional Budget Office, "CBO's Economic Projections For 2015 to 2025". Table F-1

Furthermore, these financial stability benefits do not even include any of the benefits to consumers or investors created by greater fairness in the financial system. Such benefits can occur in many areas, and they cannot easily be summarized in a single total figure. But some quick examples can show their potential magnitude:

- A team of economists recently estimated that just one consumer protection law now enforced by the Consumer Protection Bureau – the 2009 CARD Act, which put new limits on credit card fees and interest rate increases – produced $11.9 billion in annual net savings to credit card consumers. The study found no evidence of increases in provider cost shifting that would have eroded those savings.[6]

- Research by the Center for Responsible Lending finds that abusive practices in the charging of overdraft fees cost consumers over $16.7 billion per year.[7] This is an area that falls under CFPB jurisdiction.

- Gains to investors from improvements in securities market regulation can also be considerable. During the financial crisis, even supposedly sophisticated investors took large losses due to deceptive practices in the markets for complex securities, another form of loss that reflects unfairness in the markets.[8]

If the lower costs to consumers and investors were also counted as benefits, the benefit-cost ratio for improved financial regulation would be even more lopsided.

Exaggerated Costs In The AAF Study

In addition to ignoring benefits, the AAF study exaggerates costs in several ways. It is first important to note the extreme sensitivity of these cost estimates to various assumptions made by the author. The U.S. economy is projected to generate $230 trillion in economic output over the 2016-2025 period.[9] The AAF estimate of $895 billion represents less than four-tenths of one percent of this total output (less than 40 cents per $100 of output). Even small assumed changes in growth will, when multiplied against this vast $230 trillion in projected output, generate large dollar figures. The AAF study appears to have made several assumptions that exaggerate the growth costs of financial regulations.

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[6] Agarwal, Sumit and Chomsisengphet, Souphala and Mahoney, Neale and Stroebel, Johannes, "Regulating Consumer Financial Products: Evidence from Credit Cards", Quarterly Journal of Economics, Volume 130, Issue 1.
[7] Center for Responsible Lending, "The State Of Lending: High-Cost Overdraft Fees", July 30, 2013.
[8] Taub, Jennifer, "The Sophisticated Investor and the Global Financial Crisis" (April 1, 2011). CORPORATE GOVERNANCE FAILURES: THE ROLE OF INSTITUTIONAL INVESTORS IN THE GLOBAL FINANCIAL CRISIS, James P. Hawley, Shyam J. Kamath, and Andrew T. Williams, eds., University of Pennsylvania Press, 2011.
[9] Congressional Budget Office, "CBO's Economic Projections For 2015 to 2025". See Table F-1

The first problematic assumption is that all compliance costs of the Dodd-Frank Act will be extracted directly from productive investment in the economy. One issue with this assumption is that some part of Dodd-Frank compliance costs are themselves productive investment. The financial crisis revealed severe weaknesses in the ability of large banks and other financial market actors to aggregate and understand their financial risks. Recent reports show that these weaknesses continue.[10] A substantial portion of Dodd-Frank costs involve additional investments in information technology and data reporting to better understand these risks. Such improved understanding of risk should permit the industry to be better operated across the financial cycle. The Dodd-Frank Act also sets up new market infrastructure such as derivatives exchanges and data repositories that will permit more competition and market openness, but involve significant technology investment.

While a part of compliance costs are oriented simply toward regulatory reporting, some portion of these investments will also be productive improvements. According to a 2012 survey by Accenture Consulting, “Many companies see beneficial results from Dodd-Frank; for example, 64 percent of respondents believe the Act will strengthen their competitive position, especially within the capital markets industry, and a strong majority believe Dodd-Frank will lead to greater profitability across the lifetime of the program.”.[11] This was true even though a majority also felt that Dodd-Frank would lead to some increased costs.

Another issue with the assumption that compliance costs directly reduce investment is that not all increased costs to banks or financial institutions are directly transmitted to real economy investors through reduced lending. Some compliance costs will be absorbed in the form of reduced compensation for top executives or other cost cutting measures. The assumption that every dollar of compliance costs represents a dollar of reduced investment by end users is an extreme one that would require much more justification than it is given in the study.

Second, the study seems to assume that transitional costs in the initial adoption of new regulations will extend permanently, or at least for the entire next decade. The study apparently takes the total regulatory costs reported in the Federal Register, converts this total cost into a tax rate, and projects costs over ten years based on the assumption that this tax rate will divert from capital investment. However, many of the regulatory costs reported in the Federal Register are temporary transitional costs that are projected to last for only a few years.[12] The assumption that these costs will last indefinitely is not justified.

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[10] Bank of International Settlements, “Progress In Adopting The Principles For Effective Data Aggregation and Risk Reporting”, January, 2015.
[11] Accenture Consulting, “Coming to Terms With Dodd-Frank: Balancing Strategic Considerations With Tactical Implications”, 2015.
[12] To take a typical example, the Securities and Exchange Commission, in their cost estimates for the rule on swaps reporting requirements, states that “The Commission believes that, once a respondent's reporting infrastructure and compliance systems are in place, the burden of reporting each individual reportable event will be *small* when compared to the burdens of establishing the reporting infrastructure and compliance

Finally, the AAF study assumes that increases in bank capital requirements are identical to taxes and directly reduce productive investment. This is a highly questionable and unusual assumption. Bank capital requirements do not by themselves restrict bank lending or asset growth; they only require that some minimum fraction of bank assets be funded with the bank's own equity. Such a requirement operates very differently from a tax and does not directly reduce investment. Indeed, bank capital requirements likely only reflect what the market itself would demand in the absence of government safety net support for banks such as deposit insurance and access to Federal Reserve liquidity. While banks claim that higher equity requirements will increase their funding costs relative to debt, it is also likely that equity investors will reduce their minimum return expectations as they see that banks are better capitalized. The assumption that bank capital requirements are identical to a tax drives over 20% of the assumed costs in the AAF study, accounting for almost $200 billion in the $895 billion cost estimate.

systems.". See Securities and Exchange Commission, "Regulation SBSR – Reporting and Dissemination of Security Based Swaps Information, Final Rule", 80 FR 15463, 14563-14737, Securities and Exchange Commission, March 19, 2015.