Needed: A Good Cost Benefit Analysis*

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Before we lose a large number of jobs and see consumers and small businesses lose access to credit, some group of substance and ability should analyze the costs and benefits of the regulatory reform legislation. While it would have been useful to have professionals make this analysis before the law is passed, we have come face to face with rule number "1" followed by those who make laws — "If you got the votes, vote." So much for a cost benefit analysis before the law is passed.

For the benefits, look first to the expectations of the sponsors. Both Chairman Dodd and Chairman Frank have articulated a few as most important: (1) End TBTF and bailouts; (2) Create an advance warning system; (3) Make financial transactions transparent and toughen enforcement; (4) Create a federal consumer agency; (5) Impose new restrictions on the riskiest financial products; and (6) Empower shareholders to limit executive compensation. The goal — create stability in the system, even, if necessary, at the cost of innovation.

The debate around the benefits, other than that surrounding the creation of a new agency, has not been about the goal, but about whether or not the bill achieves that goal. Is financial stability achieved if bailouts are always prohibited? Since rapid use of Lender of Last Resort facilities has been shown in the past to contain economic crises, will stability be hampered because of the diminution of the ability of the Federal Reserve to serve that role going forward? Is stability enhanced or reduced if the government decides what products and services will be denied consumers? Will squeezing risk out of the system deaden innovation and creativity, and if so, is that okay? Will stability imposed in this way make access to credit harder or easier for those persons meant to be benefited by the bill? Will "dumbing down" the U.S. financial system enhance or diminish our place in world economies? Time alone will answer those questions — the debates have not.

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With respect to costs, the Senate Banking Committee has made a point of saying that its bill will shift the costs of government to the largest institutions and away from the smallest, notwithstanding evidence that with the singular possible exception of AIG, the financial institutions not repaying TARP are the smaller institutions. Similarly, the failures that have cost the Deposit Insurance Fund so much money since passage of FDICIA in 1991 have been failures of small banks. But the Committee has not been impressed with those facts and has taken care to see that its bill dramatically increases costs to the largest banks. Here is a laundry list of some of those additional costs imposed on the largest financial institutions:

- Increased prudential standards that will include increased capital, increased leverage limits, and increased liquidity requirements;
- Adoption of a “living will” with potential mandated divestitures;
- Contingent capital requirements;
- Change in the DIF assessment base;
- Assessments to fund the Office of Financial Research and the Oversight Council;
- Creation of financial stability activity standards;
- Mandated cessation of activities and sales of assets to mitigate risks;
- Prohibitions on proprietary trading, no matter what its value;
- Creation of additional “Prompt corrective action” type rules for largest institutions;
- Multiplicity of examinations by BHC regulator, by primary agency regulator, by Bureau of Consumer Financial Protection, etc.
- Increased reporting requirements to OFR and to Fed;
- Limitations under Section 23A on interaffiliate derivatives transactions;
- Mandated credit risk retention that, in light of FAS 166 and 167, may make securitization of residential mortgages and perhaps other products unprofitable;

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- A variety of operational and regulatory costs associated with the BCFP; and
- Increased examination and enforcement activity.

Calculating the cost of this laundry list is difficult. The bill passed by the Senate Banking Committee contained a requirement that the largest banks fund a $50 billion resolution fund which would remain on the books of the government until needed. That would have been a $50 billion expense, and as a capital base would translate into a very large number of loans that would not be made, perhaps in the neighborhood of $300 billion to $600 billion, depending upon the then existing capital standards and the type of loans considered. It might well also have resulted in some loss of compensation to senior officials, but that is not clear. At a minimum, hundreds of billions of dollars of loans would not have been made that might otherwise have been made, and thousands of jobs would be lost or not generated, simply because the resolution fund was prefunded.

Fortunately, but for reasons unrelated to this analysis, this provision has been removed from the Senate bill; the other costs remain, however. Costs of organizational changes are always incredibly large, so any mandated divestitures will be in the billions of dollars. Studies have been conducted of the costs of examinations, and the findings have consistently been that examinations cost bankers a lot of money. We should anticipate that at this point in the business cycle, one could expect the examiners and their bosses to want to conduct extremely thorough exams; exam costs will increase noticeably.

Most of those making regulatory decisions will have been appointed by the current Administration that has been actively urging stricter regulations and tougher enforcement, so we can expect stricter regulations and tougher enforcement. Increases in capital are to be expected, and if the increase in capital is in the nature of 20%, then while there is not a simple direct and predictable relationship between capital and lending, lending will decrease by some significant factor (say 10%) as capital is increased. In addition, what lending does occur will probably be channeled to very ordinary products sought by very good credits because lenders will receive more favorable capital treatment. Where subprime or Alt A credits will go to get loans is not clear. Perhaps they won't get loans.

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Similar analysis could be made of each of the activities or restrictions on the list, but that is best done by professionals such as those at GAO or CBO or some of the private think tanks. It is clear, however, that the amount of additional expense is very, very large, and will have a direct negative effect on lending by large financial companies. More significant for the general economy, jobs will be lost or will not be generated. The large financial companies have assets of nearly $14 trillion dollars, and are the companies that drive the U.S. economy. Community bankers are simply not a viable substitute banking system to replace the reductions in lending by larger institutions that will follow from the accumulation of the costs inherent in the regulatory reform bills.

It is clear that there were obscene excesses in the operation of the financial system that led to the economic crisis the country experienced and a decided lack of prescience among the mainstream of the industry or its regulators or among Members of Congress with respect to the bubbles and impending economic collapse of 2007. This bill tries to address many of those issues, and others which have been on the wish list of various interest groups for some time. Unfortunately, no one has yet told us what it will cost to address them in this way, how that will effect financial stability and innovation, what effect it will have on our participation in the global economy, or whether other alternatives that would be just as successful would be less costly.

But as the Queen of Hearts said — "sentence first, verdict afterwards."

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