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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

[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.

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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.