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.

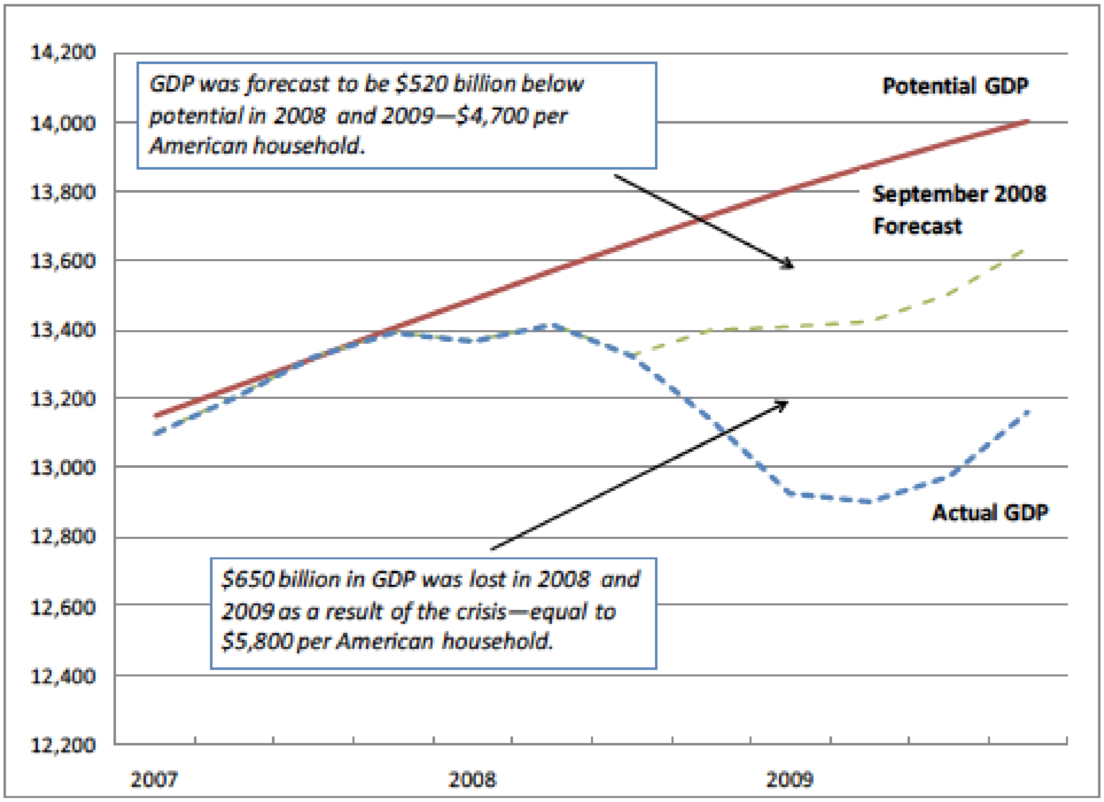
Conclusion

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.

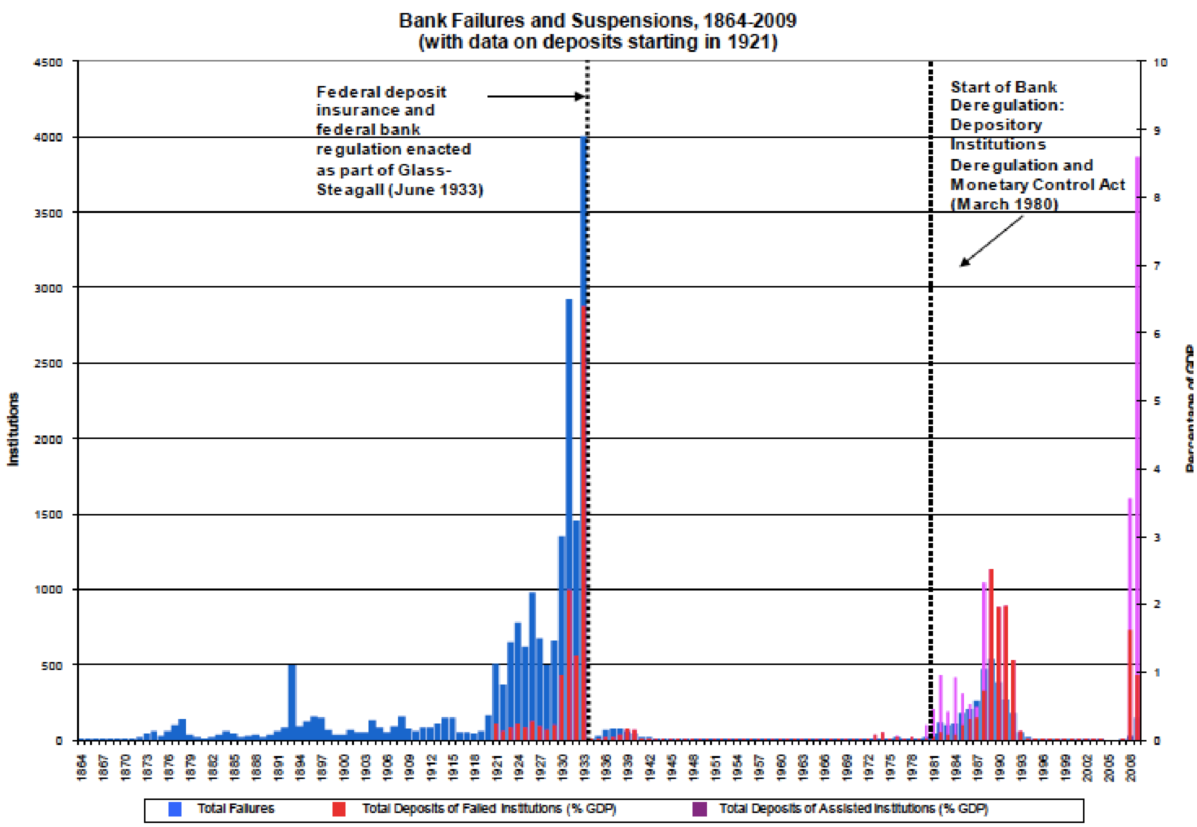
Chart One: Impact of the crisis on the economy-wide output. September 2008 forecast



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



Sources: *Historical Statistics of the United States: Colonial Times to 1970* (Washington, D.C.: Government Printing Office, 1975), Series X-741,8 (p. 1038); "Federal Deposit Insurance Corporation Failures and Assistance Transactions United States and Other Areas," Table BF01, FDIC website (http://www2.fdic.gov/hsob); Sutch, Richard, "Gross domestic product: 1790–2002." Table Ca9-19 in *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition*, eds. Susan B. Carter et al. (New York: Cambridge University Press, 2006); Bureau of Economic Analysis. "Gross Domestic Product." NIPA Table 1.1.5. (http://www.bea.gov/national/nipaweb/SelectTable.asp).

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.