Cumulative Weight

A compilation of reports and public statements related to the cumulative weight of regulations mandated by the Dodd-Frank Act

August 2011

THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

Cumulative Weight Analysis

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This paper is a compilation of reports and public statements related to the impact of the regulations mandated by the Dodd-Frank Act. These reports and public statements cited in this paper have been prepared by a variety of individuals and organizations, and are not necessarily representative of the views of the Roundtable or its member companies.

Copies of all the reports and public statements cited in the paper are hosted on The Financial Services Roundtable's Cumulative Weight Database, which can be found at www.fsround.org.

KEY TAKEAWAYS

1. The Dodd-Frank Act (DFA) reduces risk in our financial system – but at a cost;

2. The cumulative weight of the rules mandated by the DFA will restrict economic growth;

3. The cumulative weight of the rules mandated by the DFA will restrict the availability of credit;

4. The cumulative weight of the rules mandated by the DFA will put U.S. financial institutions at a competitive disadvantage internationally; and,

5. The cumulative weight of the rules mandated by the DFA will increase the cost of basic financial services.

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Letter from Steve Bartlett, President and CEO

It has been one year since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA).

The safety and soundness of our financial system has improved as a result of the changes made by DFA, as well as steps taken by the financial services industry itself. Risk has been reduced, capital and liquidity have improved, and failed firms are being resolved without cost to taxpayers. These are positive developments for the U.S. economy and the future of the financial services industry.

Yet, there is a flip-side to DFA. The sheer volume of new regulations mandated by the Act is generating uncertainty within the financial services industry and financial markets, and is complicating our economic recovery. The law firm of Davis Polk reports that DFA calls for no less than 385 new rules to be implemented in the next three years. Many of these rules will dramatically alter the ways financial services firms and other companies do business and the ways in which the U.S. economy functions.

Moreover, DFA is only one part of a larger changing regulatory environment that includes greater oversight and new international rules, such as Basel III capital and liquidity rules.

The combined effect of all these new rules on our economy could be significant, but unfortunately no one quite knows how to measure it. On June 7, 2011, Federal Reserve Chairman Ben Bernanke was asked if anyone had studied the cumulative effect of these new rules. He responded, “I can’t pretend that anybody really has. You know, it’s just too complicated.”

While the cumulative weight is unknown, The Financial Services Roundtable has collected nearly 100 reports and other public statements that provide a window into the weight of new rules on the economy, consumers, businesses, and international competitiveness.

This research is by no means comprehensive. Yet, the following themes emerge:

1. **The Dodd-Frank Act reduces risk in our financial system – but at a cost;**

2. The cumulative weight of the rules mandated by the DFA will restrict economic growth;
3. The cumulative weight of the rules mandated by the DFA will restrict the availability of credit;
4. The cumulative weight of the rules mandated by the DFA will put U.S. financial institutions at a competitive disadvantage internationally; and,
5. The cumulative weight of the rules mandated by the DFA will increase the cost of financial services.

As the federal financial regulatory agencies implement these new rules, it is critically important that they consider these cumulative effects now, rather than five or ten years after DFA is implemented. The financial crisis demonstrated the need for regulatory reform, but reform must be implemented in a way that does not inhibit economic growth and job creation.

I give special thanks to the Roundtable's Director of Research, Abby McCloskey, for directing and authoring this paper, which was pulled together with the assistance of many people.

This is an ongoing project. I hope that many more studies are undertaken to help us get our arms around the impact of the rules mandated by DFA. Please feel free to contact me at Steve@fsround.org or Abby at Abby@fsround.org with any questions or comments.

Sincerely,

Steve Bartlett

Steve Bartlett
President & CEO
The Financial Services Roundtable

Section 1: Review of Dodd-Frank

Financial complexity, speed, and risk-taking were increasing at exponential rates at the turn of the 21st century. It was like someone was turning the speed of the Wall Street merry-go-round faster and faster.

Eventually the system crashed, resulting in the financial crisis of 2008. Changes were needed to bring the pace of financial activity back to a productive level. In response, Congress developed the Dodd-Frank Act (DFA).

DFA was created to reduce risk in financial markets, bring greater transparency to financial transactions, and consolidate consumer protection. In many ways, the law has been successful. Because of DFA and related Basel reforms, there has been a massive increase in the amount of capital banks are holding on their balance sheets. Because of DFA, there is a broader perception that the days of "too big to fail" are over. Because of DFA, the Federal Deposit Insurance Corporation now has the authority to resolve or "wind-down" troubled holding companies and other systemic firms.

Yet, other rules mandated by DFA create new weaknesses in the system. For example, the derivatives rules would severely disadvantage U.S. banks if they are not applied internationally. The same goes for the Volcker Rule, which regulates proprietary trading even though proprietary trading had nothing to do with the financial crisis. Moreover, the Basel liquidity standards that have been proposed would have an enormous impact on lending and economic growth—much more so than the proposed capital requirements. DFA also included provisions designed to benefit small banks that have ended up placing them at a competitive disadvantage. The Durbin Amendment is chief among these examples.

But the sheer *volume* of rules to be implemented in a three-year time span is perhaps the most immediate concern for regulators and policymakers. DFA requires 385 rules to be written, commented on, and implemented in an incredibly compressed period of time. As of June 2011, only 6% of rules had completed the comment process and were final; 24% of the proposed rules had missed their statutory deadlines.

Trade associations and individual financial firms have been working overtime to keep up with this wave of new rules. The Roundtable has filed over 100 comment letters since the passage of the DFA, which may be found at www.fsround.org. This compares to an average of 12-14 comment letters in the years preceding the DFA.

Ultimately, financial firms and financial markets can and will adapt to the new rules. What is less clear is if financial firms and financial markets will be able to adapt to the cumulative weight of these new rules and the unforeseen interactions that they may have. The potentially toxic interaction of the rules may be compared to drug interactions. Consider someone taking stomach medication, heart medication, blood medication, and antibiotics. Separately, these medications may work, but their combined effects may negate each other, or worse.

Former Comptroller of the Currency, Gene Ludwig addressed the potential cumulative impact of rules mandated by the DFA at a recent Senate Banking Committee Hearing:

> *The cumulative impact of the entirety of the Dodd Frank Act reforms will have an immense, and not entirely predictable, impact. It is critical to take a thoughtful approach to the implementation of all of these reforms – domestic and international – with an eye towards maintaining the balance of the financial system and allowing the economy to recover and provide Americans with much needed jobs and opportunity.*
>
> *Former Comptroller of the Currency, Gene Ludwig, August 2011.*

At this critical time in our nation's economic recovery, we must carefully analyze the impact of each new rule and the cumulative weight of all these rules on the economy. We must preserve those parts of the DFA that make our system safer and stronger, while re-examining the provisions and combination of provisions that restrict economic growth, limit credit, make our companies less competitive internationally, and result in higher costs and reduced access to services for consumers.

Section 2: Economic Growth and Job Creation

Many studies claim that the cumulative weight of new rules mandated by the DFA will adversely impact economic growth and job creation. Quantitative estimates include:

- Total 2.6% decline in GDP from regulatory changes;
- 4.6 million jobs lost from regulatory changes;
- 0.19% decline in GDP for each 1% increase in capital requirements;
- 0.2% decline in GDP when SIFI surcharge is implemented; and,
- $1.25 billion of budgetary costs incurred by next year.

Before the DFA was passed, the Institute for International Finance (IIF) released a report claiming that the economy and jobs likely would be negatively impacted by the proposed rules. IIF estimated that the U.S. would lose 4.6 million jobs by 2015 if regulatory reform was implemented in the way it was being discussed. By 2015, the downward deviation of GDP would be about 2.6%. (These numbers were revised even higher after the actual text of DFA was released).

> *For the U.S., the path of real GDP would be lower than in a scenario of no regulatory change, with the negative impact rising fastest in the next five years when the economy is struggling to resume a solid growth against the headwinds of a fiscal policy reversal.*
>
> *IIF,* "Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework," *June 2010.*

The first official cost-benefit analysis of DFA was published in July 2010 by the Congressional Budget Office (CBO). In their report to Congress, CBO stated that over the next ten years, lenders and financial services companies would have to pay $27 billion in new fees and assessments to the federal government.

The CBO report did not address indirect costs or impacts on the economy, but the House Financial Services Committee began holding hearings specifically about the economic impact of the DFA in 2011. At the House Financial Services Committee's hearing about budgetary and economic costs of implementing the DFA on March 31, 2011, Dr. Douglas Holtz-Eakin, President of the American Action Forum and former CBO director, testified that DFA "imposes direct compliance costs and its distortions induce economic costs in the form of reduced capital investment, inferior risk-sharing, and lost competitiveness."

In terms of actual numbers, Morgan Stanley partnered with Oliver Wyman to study the future of capital markets post-DFA and reported that the pace of implementation could cause some disruption to trading, and sharp hikes in capital requirements (as much as +$2 trillion) could have the unintended consequence of reducing market liquidity.

New rules, like the SIFI surcharge for systemically important financial institutions, came under examination. IIF released a study specifically on SIFI surcharges and found that over the first 2 years of implementation of the SIFI surcharge, growth could be reduced by as much as 0.2 percentage points.

The budgetary impact of DFA also began being teased out in terms of actual taxation requirements. In July 2011, the House Financial Services Committee released its report, "One Year Later: The Consequences of the Dodd-Frank Act." The report stated that operating the Consumer Financial Protection Bureau will cost $329,045,000 for 2012 alone. This amounts to all of the income and payroll taxes paid by 26,000 average American workers. Additionally, the report noted that the Government Accountability Office (GAO) estimated that by July 2012 the budgetary cost for Dodd-Frank will have exceeded $1.25 billion, "which has the effect of siphoning off resources that might otherwise have gone toward deficit reduction or private sector job creation."

In addition to the costs associated with DFA, Basel III was being considered during 2010-2011. Under Basel III, capital could reach 13% of a bank's risk-weighted assets by 2018. "This is a level very few large U.S. banks were able to achieve at the height of their record level of profits in 2006," according to the Congressional Research Service. It will be expensive to get there.

In Bloomberg Government's analysis about how U.S. banks would fare under Basel III, they concluded that increasing capital levels by the amounts required under Basel III might affect economic growth, in addition to long-term profitability and loan growth.

Multiple groups came out with their own quantitative estimates about *how much* Basel III would impact economic growth. The Organisation for Economic Co-operation and Development (OECD) estimated the medium-term impact of Basel III implementation on GDP growth would be – 0.05 to -0.15 percentage points per year. The Macroeconomic Assessment Group estimated that for each percentage point increase in the target capital ratio implemented over a four-year horizon, the level of GDP relative to the baseline path declines by a maximum of about 0.19%. The IIF estimated that the cumulative effects of the various provisions in Basel III could lead to a decline in U.S. GDP of up to $951 billion over the period of 2011 to 2015.

Professor Hal Scott, Director of the Committee on Capital Markets Regulation at Harvard Law School, summarized these findings in his testimony to the House Financial Services Committee, saying that on average, "studies estimate the impact on global GDP of a 1 percentage point increase in bank common equity to have a peak negative effect of up to 1.1% of GDP, or up to $748 billion by 2019."

To put these numbers into perspective, if GDP drops by 1.1% as a result of Basel III restrictions, this will cost over 1 million people their jobs by 2019, according to the White House's rule-of-thumb that every 1% of GDP is linked to 1 million jobs.

Complicating matters is the economic environment. A former Senior Fed Official pointed out how dangerous it is to constrict credit during an economic recovery by comparing it to the actions taken after the Great Depression.

> *By insisting on higher and higher levels of required capital, regulators risk making precisely the same mistake as their predecessors at a very similar juncture in the current economic recovery -- with potentially disastrous consequences for the nation.*
>
> *Anonymous Senior Fed Official, June 2011.*

In fact, all estimates about the economic impact of Basel III and DFA must be considered in light of the economy. The economic recovery has been spotty, and the Bureau of Economic Analysis has consistently been revising GDP estimates downward for 2011 and beyond. The pace of job creation has also been disappointing and unemployment has hovered around 9.2%. Additionally, the U.S. is already experiencing its next economic crisis, caused not by the financial services sector, but by sovereign debt concerns. Federal debt will be over 100% of GDP by 2021, driven in large part by increasing entitlement and health care costs and an aging population. On August 5, 2011, Standard & Poors downgraded U.S. debt for the first time in U.S. history.

The economy needs all the certainty and encouragement that it can get to return to “business as usual.” Unfortunately, many studies show the cumulative weight of new rules could lead to an economic drag.

Section 3: Credit Availability

Many studies claim that the cumulative weight of new rules will impact the cost and availability of credit for consumers and small businesses. Quantitative estimates include:

- Over 75% of surveyed economists expect a negative impact on credit availability;
- Bank lending rates will increase by about 193 basis points by 2014; and
- Each dollar of capital supports between $7 and $10 of lending activity.

When asked about how the DFA would impact lending, over 75 percent of economists surveyed by the Securities Industry and Financial Markets Association expected a negative impact on credit availability.

Several research reports clue us into why: 1) the cost of credit could go up, and; 2) the availability of credit could decrease as a result of new rules.

The cost of credit could go up. A variety of provisions in the DFA may hurt the bottom line of financial institutions, including increased compliance costs, decreased revenue streams, and increased capital and liquidity requirements. All together, Standard & Poors estimates that DFA could cost the largest financial institutions as much as $20 billion annually, on aggregate.

To offset increased costs, it is likely that financial services institutions will raise the interest rates on loans and increase fees charged to consumers and businesses.

> *Because banks believe that Dodd-Frank will probably hurt their bottom line, they're already working on a range of offsets. These initiatives will likely take the form of additional charges for products and services that are currently now either free or at a lower cost for the consumer.*
>
> *Standard & Poors Report, November 2010.*

There are different estimates about how much interest rates could increase. Dr. Douglas Holtz-Eakin, President of the American Action Forum, estimates that the short-term impact of DFA would increase borrowing costs for individuals and households by roughly 100 basis points (1 percent). The Institute for International Finance estimates that the changes in funding costs resulting from regulatory reform would lead to an increase in bank lending rates of about 193 basis points (2 percent) by 2014.

To put these numbers into perspective, consider a 30-year fixed rate mortgage of $250,000. Under a 4% interest rate, monthly payments would be $1,193.54. If lending rates increase by 1% to 5%, monthly payments would be $1,342.05. Over the course of the 30 year mortgage, a consumer would pay an <u>additional $53,464 of interest payments</u> because of the 100 basis point increase.

The availability of credit could decrease. High interest rates will dampen the demand for loans on the consumer side. However, the DFA could encourage a direct reduction of the *supply* of bank loans.

First, underwriting standards have increased to a point that certain loans cannot be made. During the financial crisis, regulators and supervisors were criticized for allowing financial institutions to lend too much to risky borrowers. Now, supervisors have clamped down on underwriting standards, making it difficult for banks to offer even a previously "good" small business or consumer loan, according to some bank executives. "The No. 1 complaint that we hear from community bankers is that they feel that regulators have gone one step too far and are choking off lending," said Paul Merski, chief economist at the Independent Community Bankers of America, in a Wall Street Journal article.

Second, increased capital and liquidity requirements for the industry have a direct impact on lending. The rule of thumb is that each dollar of capital supports between $7 and $10 of lending activity. "Capital charges make it more expensive for banks to lend money or provide liquidity to U.S. businesses. The result inevitably will be higher cost of credit and less credit and less funding available," explained Tim Ryan, President and CEO of the Securities Industry and Financial Markets Association, in testimony to the House Financial Services Committee.

Acting Comptroller of the Currency, John Walsh, echoed Mr. Ryan's sentiment in his testimony, saying, "Failure to consider and balance the combined impact of all of the changes will have real consequences to the extent that constraints on liquidity translate into <u>constraints on bank lending and the availability of credit within the economy</u>."

The restriction of credit will be felt most acutely by those whose loans are deemed to be priced too low. But it will later be felt throughout the economy as cars are not bought, houses are more expensive, and college educations are not funded.

Section 4: Global Competiveness

Many studies claim that the cumulative weight of new rules will impact the competitiveness of the financial services industry internationally. Quantitative estimates include:

- No other industrialized countries in Europe or around the world plan to enact provisions that parallel the U.S. restrictions;
- U.S. banks represent 24 percent of the market share of the 50 largest global banks, down from over 50 percent only eight years ago;
- Chinese banks represent 22 percent of the global market share;
- Transaction volume in London already exceeds that in New York; and,
- U.S. emphasis on nonbanks could alter the competitive landscape for these firms relative to their foreign counterparts.

Domestic rules directly impact the way institutions compete on the global scale. Did you know Chinese banks do not participate in Basel III requirements? As the U.S. develops more restrictions that apply only to our domestic banks, we must be careful that U.S. companies do not lose ground to international competitors.

In many ways, the U.S. is implementing regulatory reform in a much stricter and quicker way than the rest of the world. In his testimony to the House Financial Services Committee, Stephen O'Connor, Managing Director of Morgan Stanley, spoke about how DFA was putting U.S. firms at a competitive disadvantage internationally.

Mr. O'Connor noted that the transaction volume of derivatives in London already exceeds that in New York. He also noted that the five largest US-based dealers reported a notional amount outstanding equal to only 37% of the total notional amount for interest rate, credit, and equity derivatives globally.

> *There are large and growing differences in the pace and scope of regulatory reform efforts in the U.S. [and] they put U.S. financial markets at a disadvantage by driving up costs and reducing liquidity. And they do so without demonstrating any clear benefit to equal or outweigh the considerable costs they impose.*
>
> *Stephen O'Connor, Managing Director, Morgan Stanley, June 2011.*

After numerous interviews with foreign regulatory bodies, the Government Accountability Office (GAO) reached the same conclusion in their recent report, "Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented." The GAO said that countries are looking at changing capital requirements for proprietary trading activities, but no other industrialized countries in Europe or around the world plan to enact provisions that parallel the U.S. restrictions.

> *If the U.S. restrictions were implemented in a way that restricts the ability of U.S. banking entities to serve their clients through market-making, underwriting, or in other ways, that U.S. banking entities could lose business to their competitors in Europe and elsewhere.*
>
> *GAO, July 2011.*

Regarding nonbanks, the Federal Reserve Board of Governors explained that "the differences between <G20 commitments and the Dodd-Frank Act> in their emphasis on nonbanks could alter the competitive landscape for U.S. nonbank financial firms relative to their foreign counterparts." This was explained in their International Finance Discussion Paper titled, "U.S. Domestic and International Financial Reform Policy: Are G20 Commitments and the Dodd-Frank Act in Sync?"

Additionally, to the extent that proposed international guidelines are not compatible with U.S. insurance regulation, this will put U.S. firms at a competitive advantage.

Andrew Furgatch, Chairman of the Board at Magna Carta Insurance Companies, discussed this in his testimony before the House Financial Services Committee.

> *This poses the risk that European Union systems will be applied to US insurers when those systems have been developed for different markets and corporate structures that are less conducive to economic growth than the US structure…The conflict could result in the addition of new layers of duplicative and inefficient regulation for US insurers.*
>
> *Andrew Furgatch, July 2011.*

Gary Hughes, the Executive Vice President and General Counsel of American Council of Life Insurers, testified that a number of *non-U.S*. financial firms have protected their domestic insurers from heightened regulation by not identifying any G-SIFIs in their home country jurisdictions.

The predicted result of stricter domestic regulation is that financial activity would move overseas to the detriment of U.S. firms.

This conclusion has been widely acknowledged. Acting Comptroller of the Currency, John Walsh, said in his testimony before the House Financial Services Committee that if some countries do not adopt the same high standards and enforce them with the same rigor, we could wind up with an unlevel playing field that gives an advantage to firms in countries with less stringent standards.

At the same House Committee hearing, Professor Hal S. Scott, Director of the Committee on Capital Markets Regulation at Harvard Law School, said that it will likely be late 2012 or 2013 before the E.U. completes its rules. If trading in the U.S. is more expensive, even for a year, participants may shift trading abroad in order to incur lower costs. Once trading has moved abroad it will be difficult to get back.

The Congressional Research Service has written that if bank profits drop at home because of the Volcker rule, U.S. banks may move their proprietary trading activities to their foreign operations. This transfer could have a negative impact on U.S. trade in financial services.

The transfer of financial activity from the U.S. to the rest of the world will have a significant impact on American companies. The Chief Risk Officer of our nation's largest and most profitable bank, J.P. Morgan Chase's Barry Zubrow, testified at the House Financial Services Hearing: "Financial Regulatory Reform: The International Context" in June 2011 about how regulatory changes would lead to the decline of the U.S. financial services sector.

> *The new regulatory environment has the potential to hasten rather than reverse the long-term competitive decline of the U.S. financial services sector, vis-à-vis our international competitors.*
>
> *Barry Zubrow, J.P. Morgan Chase, June 2011.*

From the Volcker Rule alone, "Citigroup will have to divest its interest in various hedge funds, such as its Mortgage/Credit Opportunity Fund, which climbed 16% in the first four months of 2011, almost doubling its pace last year. About 90% of the $395 million invested in the fund is the bank's own capital. None of these changes have been made by foreign competitors," noted Harvard Professor Hal Scott in his testimony.

Historically, the United States has benefited from a very robust financial services sector. The industry accounts for nearly 10% of GDP each year. But it is important to note that the U.S.'s presence in banking has been steadily declining over the last decade. This trend in the banking sector will likely continue as a result of the DFA. U.S. banks used to account for over 50% of the market share of the 50 largest global banks; now, they account for 24%, with China accounting for 22%. Currently, none of the world's five largest banks is a U.S. bank.

The competitive issues stemming from the DFA reach beyond the financial markets. The perceived unfairness and unpredictability of the U.S. legal system has driven companies away from our public exchanges, according to a recent Harvard Business Law article, "In Dodd-Frank's Shadow: The Declining Competitiveness of U.S. Public Equity Markets." In this article, 46% of executives surveyed believed the U.K. had more predictable legal outcomes compared with 16% for the U.S., and was thus a better place to conduct business.

Section 5: Cost of Financial Services

Many studies claim that the cumulative weight of new rules will increase the cost of basic financial services. Quantitative estimates include:

- Require 2,260,631 labor hours per year for compliance;
- Reduce earnings by roughly $20 billion annually for largest banks;
- Increase cost of certain retirement accounts by approximately 75% to 195%;
- Cost $1.8 billion in technology requirements alone; and,
- Cost $5 to $10 million per company per year to meet trading guidelines.

No one argues that the DFA will make financing less expensive. Rather, it is widely agreed upon that the DFA will have a substantial impact on the profitability of U.S. financial institutions and the cost of financial goods and services.

A recent speech by Securities & Exchange Commissioner, Kathleen Casey, warned about the increased costs of the DFA:

> *The breadth of Dodd-Frank makes it increasingly important that policy makers stay mindful of the costs and effects that the regulation in its totality will have on our markets. The costs of Dodd-Frank will be enormous, and we will have no idea of the actual total costs for years to come. Given prior experience, such as the original estimates about the cost of S-Ox, those actual costs will prove substantially more significant than legislators and regulators predicted.*

SEC Commissioner, Kathleen Casey, January 2011.

To comply with just three rules of DFA (capital, stress testing, and resolution planning), the financial services industry will be required to spend an estimated 2,260,631 labor hours every year. If this arithmetic is extrapolated out to all the rules required under the DFA, as it was in the House Financial Services Committee's report in July 2011, it will take 56,516 work weeks devoted solely to DFA's administrative burden, or more than 1,100 work years.

In addition to compliance costs is the increase in federal supervision: "It is difficult to overstate the increase in supervisory oversight for large financial firms" said Mr. Barry L. Zubrow, Chief Risk Officer of JPMorgan Chase. Chase underwent 218 examinations in 2010 and housed 75-135 examiners in the company's office, according to Mr. Zubrow.

Moreover, "to the extent that firms are then obliged to make changes to the business—to simplify structures, develop new IT and reporting, or to put in place additional assured sources of liquidity or capital, this will involve significant additional costs, including higher tax burdens, on the institutions concerned," reported the Institute for International Finance in their "Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework."

Estimates of increased financial services costs include:

- The proposed swaps rules under the DFA will cost the largest 15 dealers $1.8 billion to comply with information technology requirements, according to the Office of the Inspector General in an investigation about the cost-benefit analysis of the actions performed by the Commodity Futures Trading Commission in April 2011.

- The International Swaps and Derivatives Association estimated that the cost of proposed rulemakings for swap dealers could cost each such company approximately $5-10 million.

- The Department of Labor's proposed definition of "fiduciary" will increase the costs of brokerage IRA accounts by approximately 75% to 195%, according to an Oliver Wyman Report.

- Meeting the capital requirements required under DFA and Basel III will have a substantial impact on profitability. “The capital need is equivalent to almost 60 percent of all European and US Tier 1 capital outstanding, and the liquidity gap equivalent to roughly 50 percent of all outstanding short-term liquidity,” according to a McKinsey Report about Basel III.

- “The caps on debit-card transaction fees alone may cost the Minneapolis-based bank $400 million in annual revenue,” said Richard Davis, President and CEO of U.S. Bank, in June 2011. *(This was before the Federal Reserve issued the final interchange rule).*

Overall, Standard & Poors has estimated that the DFA will likely lead to a reduction in aggregate pretax earnings at the eight large, complex U.S. banks by roughly $19.5 billion to $22.0 billion annually before offsets. This loss represents roughly 18% to 21% of pretax earnings for these institutions.

Insurers are also facing increased costs. Results from a recent Property Casualty Insurers survey on the cost of regulatory and corporate compliance found that total compliance expenses grew almost 18 percent from 2008 to 2010, according to Andrew Furgatch, Chairman of the Board at Magna Carta Insurance Companies. “Smaller insurance companies continue to face the most significant challenges due to increased regulatory requirements—from 2008 to 2010, the cost of compliance grew 36 percent for small companies and 14 percent for large companies,” Mr. Furgatch reported.

In fact, the Congressional Budget Office recently estimated that the cost of the DFA for financial services companies will *exceed* the annual threshold established by the Unfunded Mandates Reform Act (UMRA) of 1995. UMRA was enacted to avoid imposing unfunded federal mandates on the state, local or private sector in excess of $141 million, (indexed for inflation for FY 2011). Technically, if a rule exceeds this threshold, the rule-writing agency must prepare a written cost-benefit assessment; a description of the macro-economic effects; and consider a reasonable number of regulatory alternatives and select the least costly, least burdensome, or most cost-effective option that achieves the objectives of the rule, or explain why the agency did not make such a choice.

This level of increased costs will change the structure of the banking industry. There will be huge pressures on bank earnings that can only be eased through consolidation (although there will be less mergers on top given the provisions that discourage size).

Moreover, DFA will raise compliance costs for smaller institutions that do not have the economies of scale to properly deal with it.

“Historically, the cost of regulatory compliance as a share of operating expenses is two and a half times greater for small banks than for large banks,” said Albert C. Kelly Jr., of the Americans Bankers Association, in his testimony at the House Subcommittee on Financial Institutions and Consumer Credit: “The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses,” on March 2, 2011.

Comments from small banks, as collected by the House Financial Services Committee, include:

- Tommy Whittaker, president of The Farmers Bank (Tennessee): “The cumulative burden of hundreds of new or revised regulations may be a weight too great for many smaller banks to bear.”

- Daryl Byrd, president and chief executive, Iberia Bank: “I think you’re going to see a lot of consolidation.”

- Wes Sturges, chief executive, Charlotte’s Bank of Commerce: “The other thing we’ll have to deal with - and we’re not sure how – is the Dodd-Frank bill. For a little bank like ours with 19 people, that could be a full-time job for somebody to make sure we comply with the provisions of the bill.”

- Thomas Boyle, Vice Chairman, State Bank of Countryside (Illinois): “Each new regulation…adds another layer of complexity and cost of doing business. The Dodd-Frank Act will add an additional, enormous burden, has stimulated an environment of uncertainty, and has added new risks that will inevitably translate into fewer loans to small businesses.”

- Brad Quade, regional president, Johnson Bank (Milwaukee branch): “We are going to have to invest a lot more money into people and resources to manage the heavier compliance load. Right now it’s requiring a great deal of additional resources to get our arms around what the expense will be going forward."

- Greg Ohlendorf, President and CEO, First Community Bank and Trust (Illinois): "Many community banks complain that the required capital level goalpost is unpredictable and regulators simply keep moving it further, making it nearly impossible to satisfy capital demands in a difficult economy and capital market place. As a result, bankers are forced to pull in their horns and pass up sound loan opportunities in order to preserve capital. This is not helpful for their communities and for overall economic growth."

In all likelihood, financial institutions will pass some or all of these costs along to consumers. The restriction of credit discussed in Section 3 is largely a reflection of these increased costs.

Section 6: Benefits of Dodd-Frank

Many studies claim that new rules make the financial system better. Quantitative estimates include:

- Capital for large banks has increased by $300 billion since 2008;
- Total leverage has fallen from $16 of assets for every dollar of common equity to $11;
- Assets in the shadow banking system are roughly half that of 2007; and,
- The DFA reduces federal deficits by $3.2 billion.

"By almost any measure, the U.S. financial system is in much stronger shape, not just relative to the depth of the crisis but also relative to conditions that prevailed before it hit," wrote Secretary Geithner in an editorial released on July 20, 2011.

Our financial system is undoubtedly safer and stronger than it was pre-crisis. In his editorial, Secretary Geithner reviews where we are one year after the Wall Street Reform and Consumer Protection Act was signed into law:

- The U.S. government has recovered most of the investments it made in financial institutions, gaining a $10 billion return on the Troubled Asset Relief Program.

- There was been global progress on new Basel III standards that require the world's largest financial firms to hold roughly three times more capital relative to risk than before the crisis.

- For the first time, we have the ability to extend these types of limits on risk-taking to firms that may not call themselves banks but could still pose catastrophic risk to the economy were they to fail.

- We have outlined the major elements of reforms to the $600 trillion derivatives market.

- The Federal Deposits Insurance Corporation has developed new tools to safely unwind or break up large nonbank institutions that fail in the future, without exposing the taxpayer to any risk of loss.

- The Consumer Financial Protection Bureau has proposed new ways to simplify disclosure of mortgage and credit-card loans.

- We have started the process of winding down Fannie Mae and Freddie Mac and reforming the overall mortgage market.

Additionally, many of the weakest parts of the system no longer exist or have been significantly restructured, said Neal Wolin in his testimony to the Senate Banking Committee on July 21, 2011.

- Of the 15 largest financial institutions in the United States before the crisis, only nine remain as independent entities.

- The 19 firms that were put through the stress tests have together increased common equity by more than $300 billion since 2008.

- The average level of common equity to risk weighted assets across these institutions is now 10 percent, much higher than before the crisis.

- The average level of total leverage in these institutions has fallen substantially – from $16 of assets for every dollar of common equity to $11.

- Debt maturing in one year or less at these institutions, as a share of total liabilities, has declined dramatically to roughly 40 percent of the pre-crisis level.

- Assets in the “shadow banking system” are roughly half the level seen in 2007.

- Funding through tri-party repurchase agreements has fallen 40 percent from its peak in 2007.

- Asset-backed commercial paper outstanding—which was often used to fund leveraged off-balance sheet vehicles—is a third of where it was in 2007.

Most of these changes are a direct result of DFA; however, some changes were made prior to reform, including increased capital and reduced leverage.

Another benefit is that the Congressional Budget Office (CBO) estimates that DFA will generate revenue for the U.S. government. CBO has said that Dodd-Frank will reduce deficits by $3.2 billion over the next ten years. The $37.8 billion of increased spending will be offset by substantial revenues stemming primarily from fees assessed on various financial institutions and market participants, the impact of which was discussed in Section 5.

Perhaps the most significant benefit of new rules (and underlying purpose for the DFA) is that the likelihood of another financial crisis could be reduced. For some, the benefits of preventing another crisis outweigh any of the potential cumulative costs listed in the earlier chapters.

In August 2010, the Basel Committee on Banking Supervision released an assessment of the long-term economic impact of stronger capital and liquidity requirements, in which they determined that “higher capital and liquidity requirements can significantly reduce the probability of banking crises.”

According to the Basel Committee, historical experience suggests that in any given country, banking crisis occur on average once every 20 to 25 years. The cumulative losses from a crisis can range from 20% of pre-crisis output to an excess of 100%, depending primarily on how long lasting the effects are estimated to be. So if good policy can reduce the annual probability of a crisis by 1 percentage point, this will yield an expected benefit per year equal to 0.6% of output.

As one would expect, the incremental benefits decline at the margin, reports the Basel Committee. They are relatively larger when increasing bank capital ratios from lower levels and they decline as standards are progressively tightened. For example, Basel suggests that that the decrease in the likelihood of crises is three times larger when capital is increased from 7% to 8% than when it is raised from 10% to 11%. This is important in light of capital levels for the largest banks nearing 13%.

Beyond capital and liquidity, more empirical research is needed to determine how each new rule actually increases the safety and soundness of our system, and if those benefits counteract when applied on a cumulative basis.

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