Can Cost Benefit Analysis Pass The Cost Benefit Test?

Marcus Stanley, Phd
Policy Director
Americans for Financial Reform

Considering Costs vs. CBA

- Consideration of costs and benefits is an essential part of any decision making process.
- Formal 'Cost Benefit Analysis' (CBA) is something else.
- Standards vary, but generally includes mix of--
  - Formal finding that benefits exceed costs (or reverse).
  - Quantifiable if at all possible.
  - Subject to judicial review.
  - 'Veto point' structure.

CBA In Financial Regulation

- Real-world political economy of formal CBA is likely to be a disaster in financial arena.
- Two key problems:
  1. Financial regulation: large and concentrated private costs, massive but diffuse public benefits.
  2. Enormous methodological issues with trying to actually measure costs and benefits.
- Actors are very aware of their private costs, public does not have the resources to oppose.
- An ‘expert’ process like CBA will be co-opted because of the limits of our knowledge.

Public Benefits, Private Costs

- Only true net benefits to society should be considered in cost benefit analysis.
- Transfers from one private actor to another should be disregarded, except in cases where equity/fairness concerns are involved.
- The more externalities and transfers are involved in policy, the more challenging this becomes analytically – and politically.

Public Benefits, Private Costs

- Excessive leverage
  - amplifies short run private profits but creates destructive externalities. Capital, derivatives, structured products.
- Market concentration in finance
  - change creates huge private costs, any public cost?
- Complexity and opacity
  - concealing risks from buy side and regulators
  - dark market externalities (Bolton, Santos, Scheinkman, 2012)
- Public subsidies create incentive problems
  - Not just TBTF guarantee, but bankruptcy and tax
- Endemic agency problems
  - Fiduciary responsibilities, short-term pay incentives

Measurement Uncertainty -- Leverage

- Modigliani-Miller insight: leverage restrictions have at most very limited social costs.
  - Many prominent economists argue for extremely low costs of leverage limits.
  - Industry disagrees: claims Basel capital requirements will cost $2 trillion in GDP, 7.5 million jobs by 2015.
- We are deep into a highly uncertain area, the macroeconomics of money and finance.
  - Stein (2011): “Monetary Policy As Financial-Stability Regulation”
- Macroeconomic impacts of financial crises can be catastrophic. Do we even know why?

Finance and the Macroeconomy – The Missing Link

"Needless to say, if you want to build a model where finance matters, so that there is a link between developments in the financial sector and those in the real sector, you will have to model the reason for finance existing in the first place."

"We clearly need macroeconomic models in which financial intermediaries play a significant role...by either ignoring banks or assuming that they are just like any other industrial firm, our models are clearly missing something essential….Putting financial intermediation into macroeconomic models is the first step."

"The prevailing macroeconomic paradigm requires a very strong form of rationality: agents make decisions in a fully optimising way, with complete knowledge of the underlying economic model….Casual (and not so casual) observation of past boom-bust episodes suggests an absence of rationality"

Cecchetti et. al. 2009 (BIS)

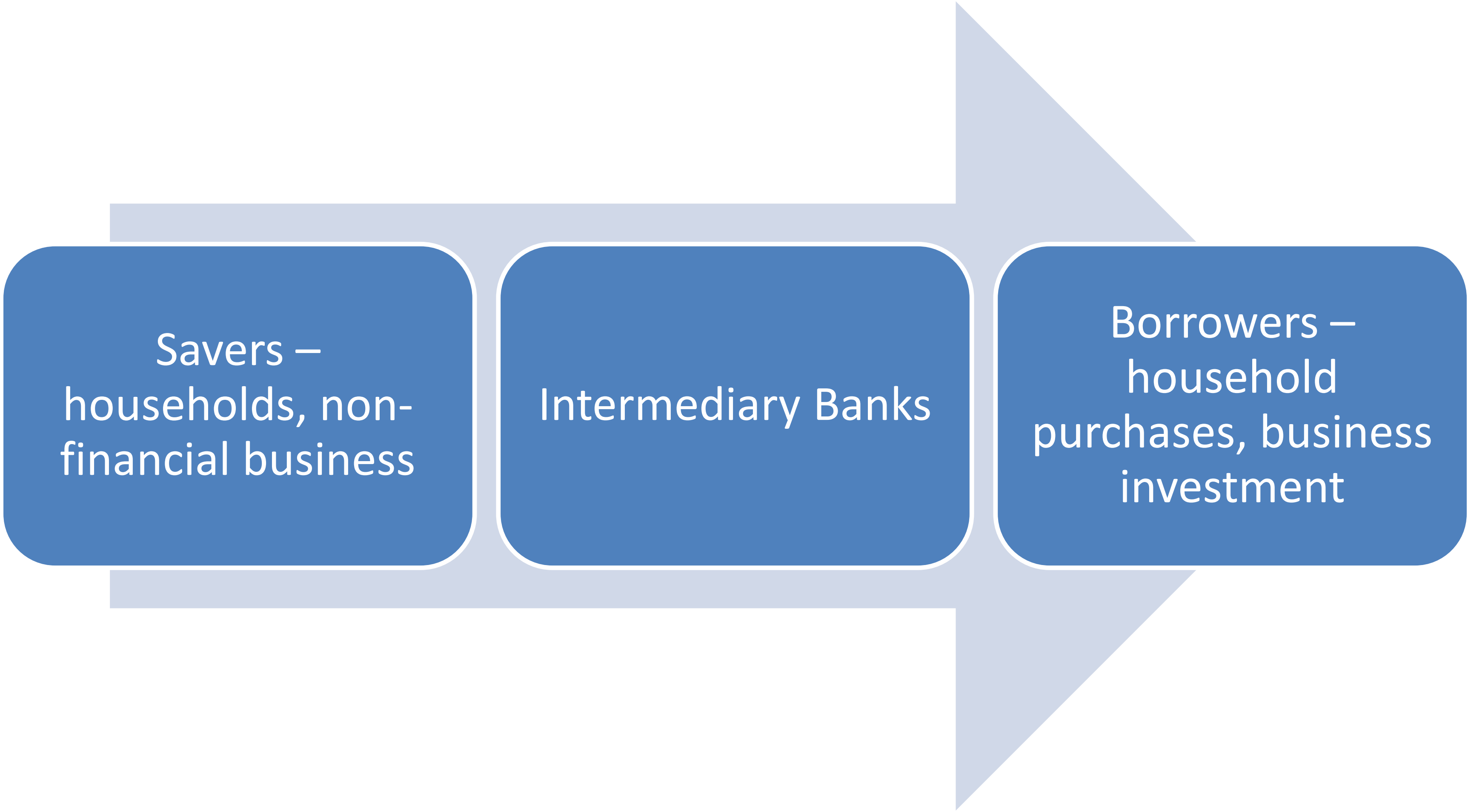
Measurement Uncertainty – Market Concentration

- Large ‘universal banking’ model:
  - attempt to increase monopoly power?
  - access to implicit government subsidies?
  - conceal risk?
  - take advantage of genuine economies of scale?
  - all of the above?
- Can economics clearly sort out these factors?
- No: after decades of work, no consensus on whether economies of scale exist for large banks
  - This is the literature that informed GLB.

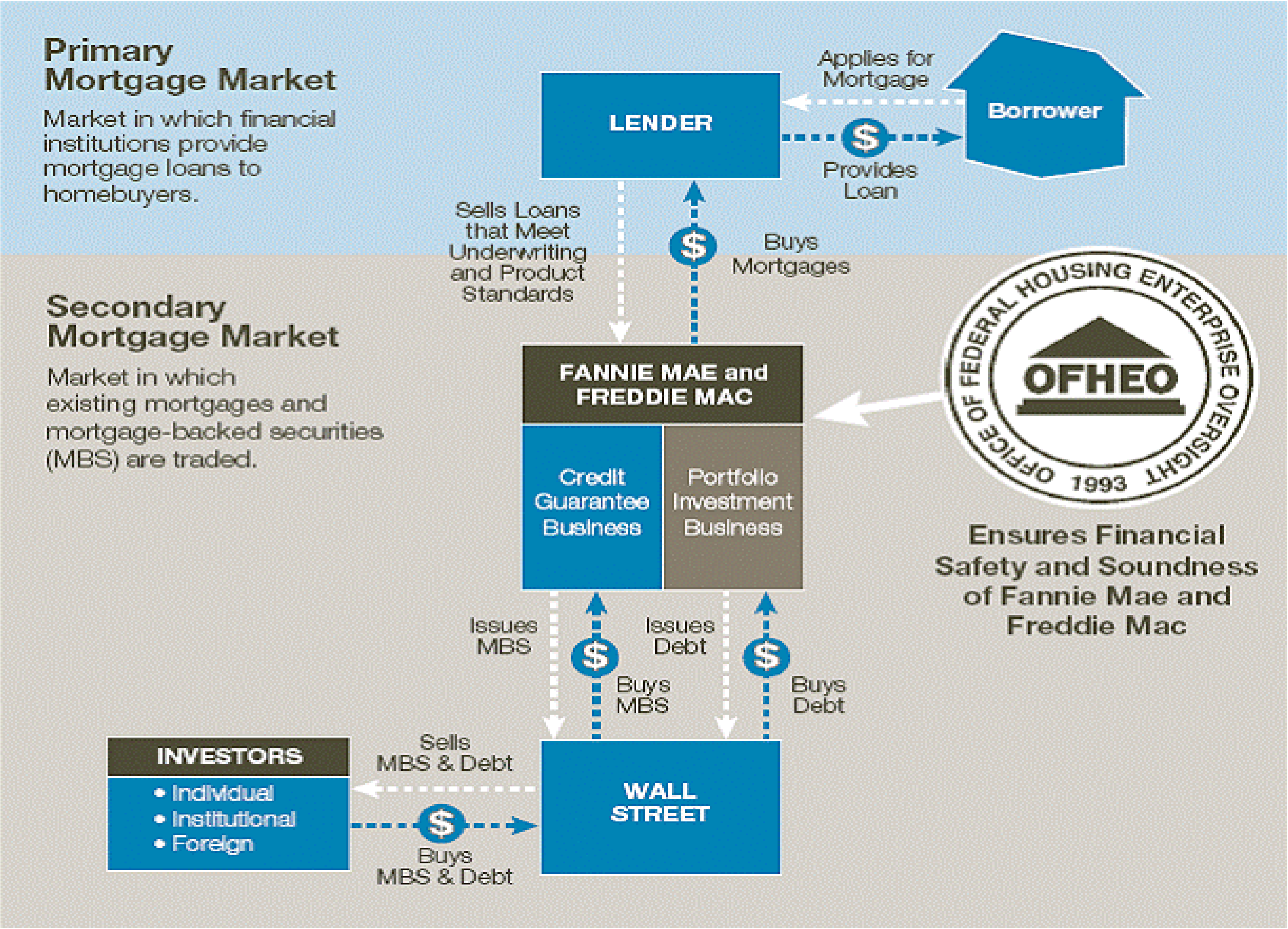
Measurement Uncertainty -- Complexity

- Increased complexity of market structure and instruments.
- Easier to hide risk, arbitrage regulations.
  - Acharaya et al. – ABCP conduits as fake risk transfer to arbitrage capital regulation.
  - Boaz, Barak, Brunnermeier – computational complexity and structured products, derivatives.

From this…

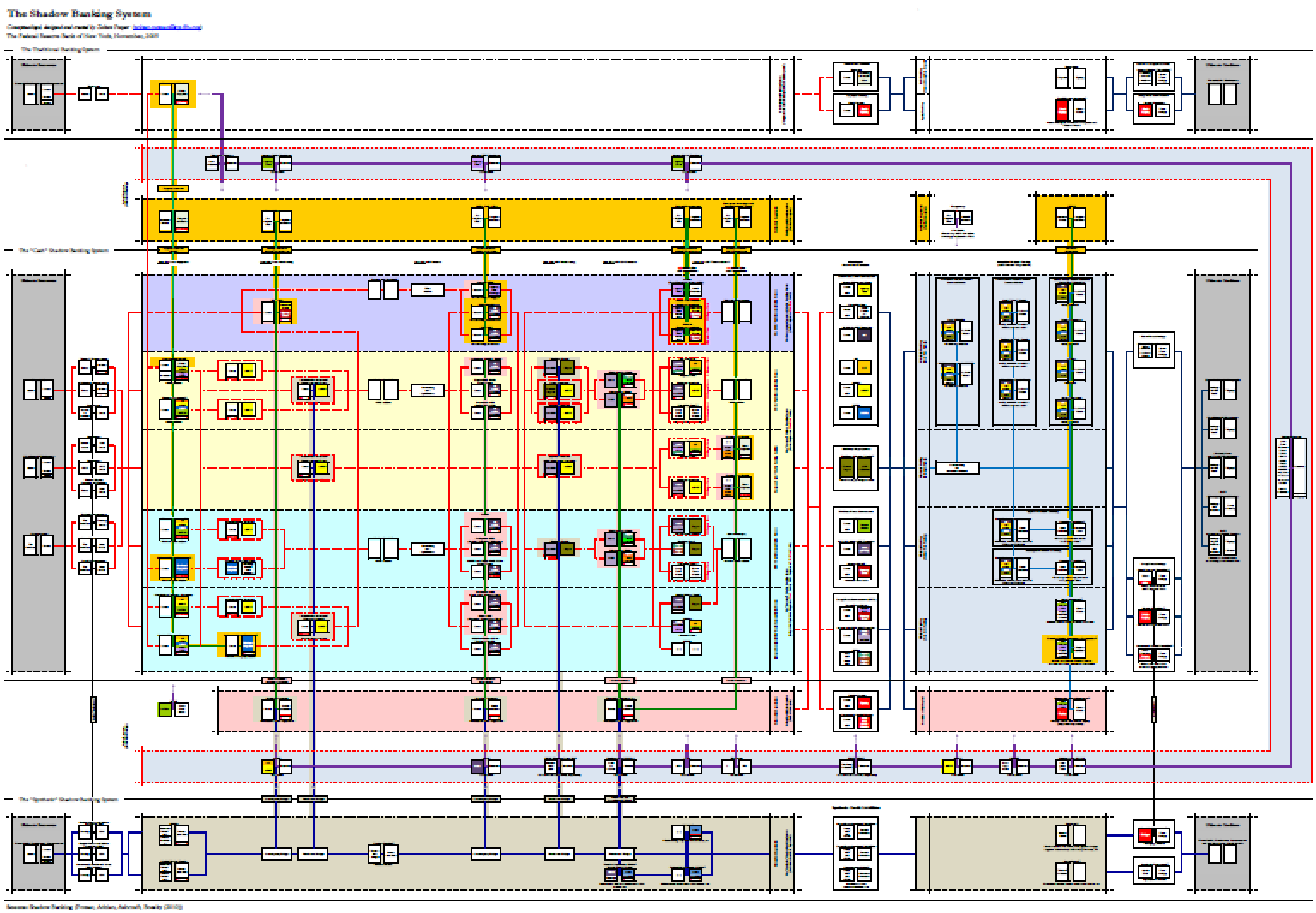

Savers – households, non-financial business
Intermediary Banks
Borrowers – household purchases, business investment

Or even this…



Primary Mortgage Market
Market in which financial institutions provide mortgage loans to homebuyers.
LENDER
Applies for Mortgage
Borrower
$
Provides Loan
Sells Loans that Meet Underwriting and Product Standards
$
Buys Mortgages
Secondary Mortgage Market
Market in which existing mortgages and mortgage-backed securities (MBS) are traded.
FANNIE MAE and FREDDIE MAC
Credit Guarantee Business
Portfolio Investment Business
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
OFHEO
1993
Ensures Financial Safety and Soundness of Fannie Mae and Freddie Mac
Issues MBS
$
Buys MBS
Issues Debt
$
Buys Debt
INVESTORS
• Individual
• Institutional
• Foreign
Sells MBS & Debt
$
Buys MBS & Debt
WALL STREET

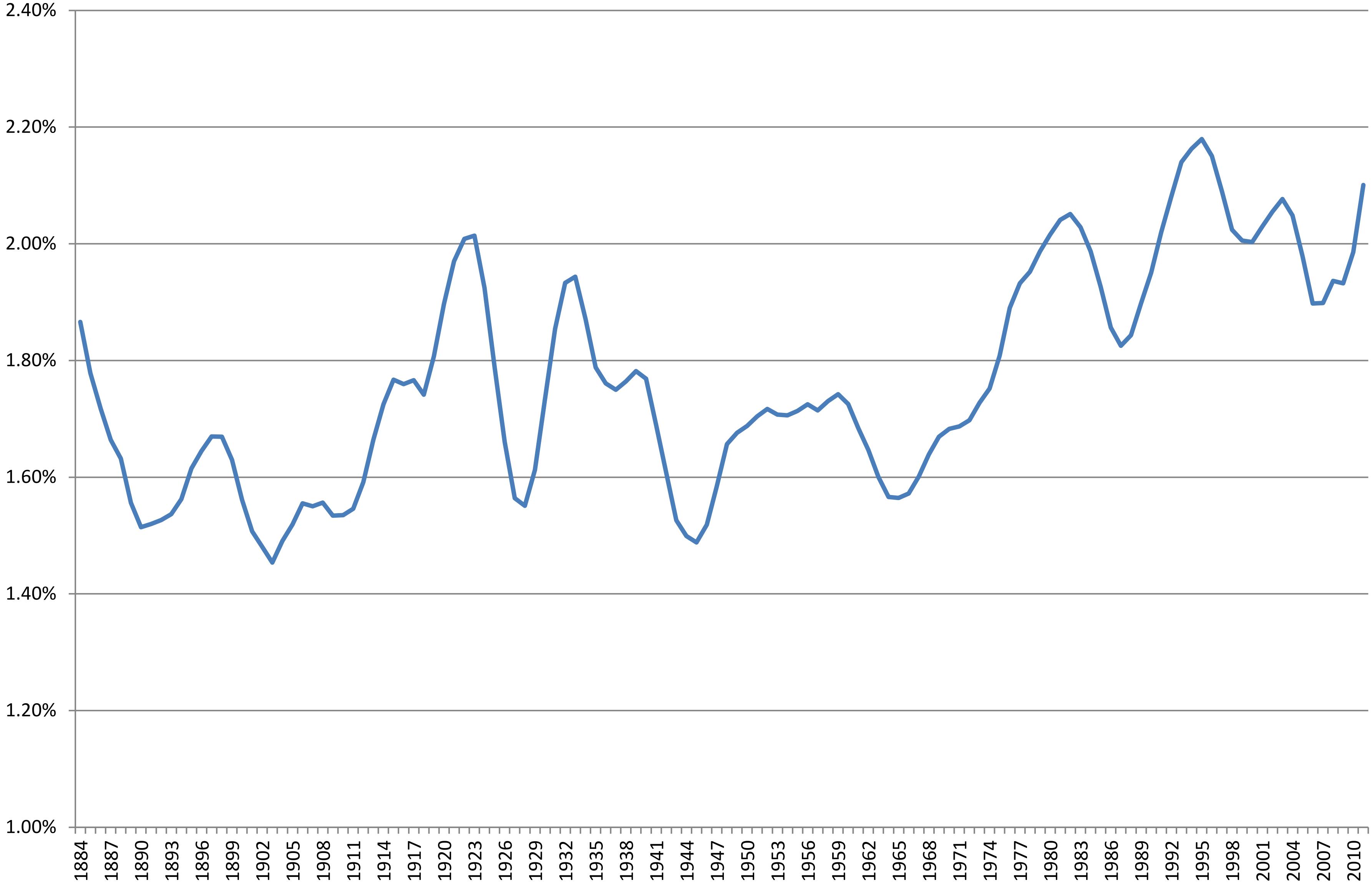
To this…



Measurement Uncertainty – Real Economy Connection

- Finance an intermediary sector.
- Has grown massively over past decades
  - 5% of economy in 1980 to over 8% today.
- But little evidence of real economy benefits.
- Phillipon (2012) – financial efficiency has not increased over the 20th century
  - Looks like law, medicine, education, not a sector where growth is productivity driven.

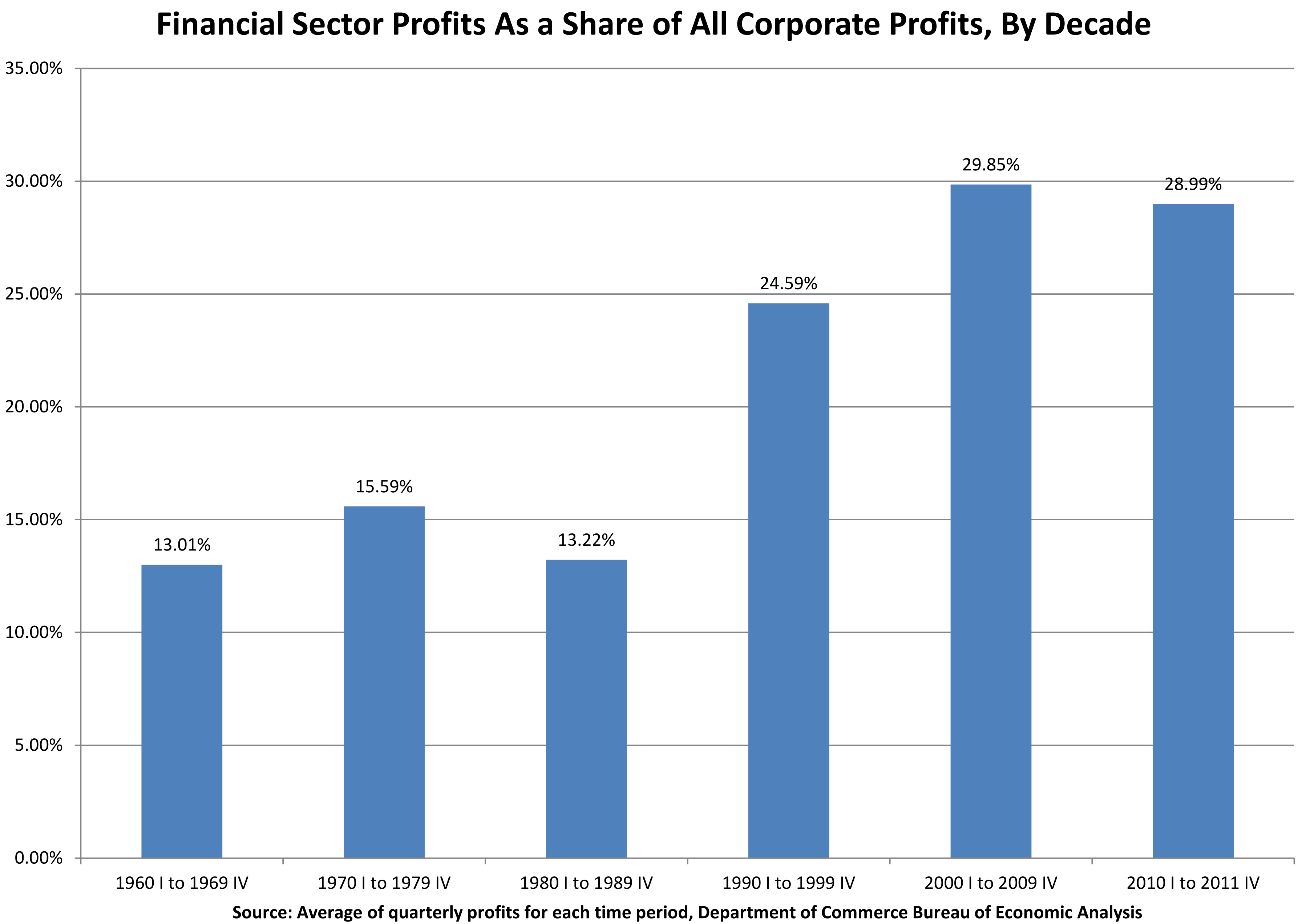
Quality-Adjusted Cost of Financial Intermediation, 1884-2010



SOURCE: Thomas Phillipon, "Has The U.S. Financial Services Industry Become Less Efficient?", Working Paper, May, 2012

Uncertainty, high stakes, insider power….

- Industry still has the best data access
  - Provides analysis supportive of preferred conclusion, resists regulatory requests for raw data
- Flood the process with shoddy ‘studies’.
  - E.g. NERA on swap dealer costs of margin – measures total margin at company marginal cost of capital
- Huge inputs into key veto points. Mobilize Congress
- Success in holding back regulation even where benefits are clear
  - AFR August 2011 letter: Basel Committee cooked their own cost benefit analysis in setting capital charges.


Financial Sector Profits As a Share of All Corporate Profits, By Decade
35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
13.01%
15.59%
13.22%
24.59%
29.85%
28.99%
1960 I to 1969 IV
1970 I to 1979 IV
1980 I to 1989 IV
1990 I to 1999 IV
2000 I to 2009 IV
2010 I to 2011 IV
Source: Average of quarterly profits for each time period, Department of Commerce Bureau of Economic Analysis