The Best of NERA 2011
Examining Economic Issues in Financial Regulation under Dodd-Frank
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SCOTT KIEFF: Good afternoon and welcome to The Best of NERA 2011, broadcast live on www.sechistorical.org, the virtual museum and archive of the history of financial regulation. I am Scott Kieff, Professor of Law, The George Washington University School of Law and moderator for today's program, the 8th in The Best of NERA series since its debut in 2004.

The Best of NERA is a joint program of the SEC Historical Society and NERA Economic Consulting. Through its virtual museum and archive, the society shares, preserves and advances knowledge of the history of financial regulation. Both the museum and the Society are independent of and separate from the U.S. Securities and Exchange Commission and receive no funding from the public sector. Today's program, along with the rest of the museum collection, is broadcast and will be preserved without any SEC oversight.

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It is my pleasure today to welcome three NERA experts to share their insights into economic issues that have resulted from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As regulatory agencies begin implementing the rules of Dodd-Frank, it is important to look at the economic risks and cost-benefits of this new regulation. Joining with me today are Dr. Robert Mackay, Senior Vice President of NERA Economic Consulting and Chair of NERA's Securities and Finance Practice, who will discuss quantification of systemic risk. Dr. Mackay also participated in the 2009 Best of NERA. Next we have Dr. Faten Sabry, who also presented in the 2006 Best of NERA and is a NERA Senior Vice President. She will look at the implications of the new risk retention rules on securitization. Third, we have Dr. James Overdahl, NERA Vice President, who will address the role of cost-benefit and impact analysis in regulatory rulemakings. We will begin the program with Dr. Robert Mackay kicking things off. Please.

DR. ROBERT MACKAY: Thank you, Scott. I want to turn to the topic that's really been driven in large part by the Dodd-Frank Act, with identifying systemically relevant financial institutions, or maybe more ambitiously put, quantifying systemic risk. For the last two years, we have been legislating and regulating in this area and certainly the regulatory part of this is guaranteed to proceed for quite a while. While later we will hear more about that in the next two talks but this effort of course is a response to the credit crisis of ’07 and ’08. As we start to think about how we will go about quantifying or identifying systemically relevant institutions, I think it is actually helpful to back up and put a little historical perspective on this question.

So as painful as it might be and we will take a few minutes and drag us through the credit crisis of ’07 and ’08, economic risks and cost-benefits one more time. And let me do it by sort of posing the discussion in terms of a question which is really, why didn’t the policy makers and others see this credit crisis coming? Certainly some economists and financial commentators had talked for years of a bubble in home prices that could eventually collapse and lead to losses in the housing sectors. Other economists and commentators however had argued that these rising home prices reflected economic fundamentals underlying the housing markets, and with 30 years of rising home prices in our history that argument had a certain power to it. Now with hindsight, of course, the bubble proponents may appear right but they shouldn’t blind us to the extent of disciplinary minimum experts both in the universities and in the government on this point prior to the bust. But even those that saw double comings saw in housing prices and saw the likelihood of busting did not see that this would lead to the freezing of the credit markets and ultimately a widespread contraction in the economic activity. For example, in the summer of ’07, Chairman Bernanke was quoted as saying that the problems in the sub-prime markets would be relatively contained and isolated and not spill over to the broader market. In just a moment of truthful confession here, at that same period, I was having lunch with a lawyer friend here in Washington who asked me, “What about all these sub-prime problems?” And I literally not quoting Bernanke but I basically said, “Oh, it will be contained to the housing market and the sub-prime sector.” We both were obviously wrong about that.

But most observers, including the financial market experts and regulators, did not fully understand how the effects of the national housing bust be magnified with several critical factors in the financial system. These features are that with the widespread use of complex securities for funding mortgages, the narrow equity cushions were highly levered balance sheets of some financial institutions and the heavy reliance on short term financing and the way they interacted to produce the freezing up of credit flows in the face of the housing bust and ultimately to produce contraction in real economic activity that as we now know many years later fed back to worsen the problems. We can talk about how they relate to systemic risk.

In the past two decades, in the ‘90s and 2000s, new and more complex creations on asset backed securities had been used excessively to facilitate mortgage finance and growth in home ownership. But the very complexity that was for the most part, at least in my view, necessary for these securities to successfully address the problems inherent in lending and lowered credit quality bars, made it incredibly difficult to know where the credit risk actually resided or how to price that risk appropriately. In the aftermath of the housing bust, the result was a major increase and concerns about counter party credit risk even between highly rated financial institutions. In addition, there was a shortage of capital, put it another way there was an excess of leverage in the system especially among the financial institutions as a whole. The capital cushions in major financial institutions had shrunk because of write-downs on these complex mortgage related instruments and because of credit losses associated with the delinquencies and foreclosures on real estate loans. The excess leverage was now equity cushions increased the risk of insolvency and the credit losses in the related write-downs. Finally, many of these highly levered financial institutions had come to rely extensively on short term financing after overnight loans to fund their operations making them even more vulnerable and prone to financial panics. As these individual firms struggled to increase their capital and delever, there were intend and unintended and widely unanticipated systemic consequences. The firms tightened their lending standards, reduced the volume of loans so fast, but the unanticipated systemic impact of so many firms attempting to delever simultaneously was to depress asset prices, producing additional losses, these depressed prices resulted in turn in further losses and additional saline and write-downs and eroded equity cushions into further virtually increasing leverage further.

The negative feedback cycle led outright liquidity in certain markets making it extremely difficult to value these assets in a limited ability using them as collateral. As the credit markets tightened, financial institutions became reluctant to lend even to one another. Firms began hoarding liquidity, uncertain about what liquidity demands it might face, and whether or not they could be met. The result was a systemic wide reduction in the flow of credit and the economy which in turn adversely impacted real economic activity and deepened and prolonged the recession as we now live through.

So with that brief history in mind let me turn to a question, if that is what we lived through and at least in my view those were the major causes of the credit crisis. What are the lessons there for either quantifying systemic risk or trying to identify systemically relevant financial institutions? Let me just say that there are three NERA white papers dealing with this topic that are co-authored and one of the co-authors, my other co-authors are Chris Laursen, who was a manager at the Federal Reserve Board, Sharon Brown-Hruska, who was a Commissioner of the Commodity Futures Trading Commission, and John Bovenzi who was Chief Operating Officer of the FDIC. But with that group we tried to address several issues related to the questions I have posed here.

The first one really had to do with the size alone is sufficient measure of systemic relevance. There was, at one point, proposals to build up a fund that would be available for future bail-outs so that the taxes will not have to be increased. I think and as we argue in one of papers, size alone is certainly not an adequate measure. And the story as I just related of the credit crisis, it wasn't just size, there were many other factors and surprises taking place there that contributed to the crisis. In fact, I think probably if you had to pick one word that would relate to systemic relevance. It's not size, it would be interconnectedness and that the concept of interconnectedness here is one that goes by other names, sometimes it is called contagion, spillovers. But we have tried to in a second working paper like what we mean by interconnectedness and in the context of the financial institutions we identified direct interconnectedness through contracts, contractual obligations. Indirect interconnectedness through some sense of behavioral interactions, asset prices had become correlated that typically aren't correlated. Investors that refinanced cash out on their mortgages, they basically reset the mortgages so that the thought now becomes much more common occurrence. And also funding interconnectedness, that result from freeze up in the market or liquidity. So as we take that perspective, in a third piece, we went on to try to say, is there a way in which you could use these concepts to try to rank the relative systemic risk of financial institutions. We identified nine factors and laid out a camel like rating system that could be used and this was done as a prototype and was tested and could be used. And when they just hit the nine factors some of them will sound familiar from the history I went through.

Number one was interconnectedness, number two was market concentration, either in products or geographic areas. Number three was implied product support, implicit support for instruments that they may not have been explicit, stay put options written on. Fourth is the cyclicality of the financial results. Fifth was transparency, sixth was liquidity, seventh was capitalization or turning around the degree of leverage. And then finally the combination of some of those factors, liquidity and interconnectedness or the other relationships or contracts that were there that might mitigate or amplify these. In our third paper in our series, we lay out a framework whereby those could be scored and then the scores could be advocated to try to develop that. The framework was really meant to be a prototype to help provoke the debate and the discussion and the rulemaking typically going on in this series. With that let me close and if people want more details I encourage them to follow up other papers.

SCOTT KIEFF: Wonderful. Thank you very much. Those remarks were from Dr. Robert Mackay and we turn next please if we could to Dr. Faten Sabry.

DR. FATEN SABRY: Thank you very much. Since the early stages of the credit crisis in 2007, securitization has been tagged as the villain. Many market participants including regulators, analysts and even some academics had made the argument and continue to make the argument that securitization was a main contributor to the $2 trillion of losses and write-downs that the world has experienced to-date. So it really comes as no surprise that the Dodd-Frank Act focus on various aspects of securitization in trying to regulate that. And in my talk today, we will not cover all aspects of the securitization, new rules, but I would like to focus and discuss in detail a key aspect related to risk retention. And I want to focus on this particular aspect because I believe that or I would like to make the argument that it really goes beyond regulating the process of issuing an asset backed securities. The risk retention rules, the proposed rules now, they regulate the core economics of issuing these types of products. So it goes beyond what I think we think of as regulation. So in the next few minutes what I will do is I will explain very quickly what I understand was the rationale for the risk retention rules and I will go very briefly as to the main highlights of these new proposed rules and then I will discuss what I think are the economic implications of risk retention.

As we all know securitization is the process of pooling a lot of illiquid assets like mortgages, credit cards, older loans into marketable securities. By design, securitization separates out the investors from originators and yes, there is an economic rationale for this separation. Separation was meant to free up capital and allow originators to have additional monies so they can’t go out and make additional credit. This separation point, to a lot of critics of securitization, is a problem. They say that because of the separation the firms involved in securitization no longer have skin in the game. And because they don’t have skin in the game, they have no incentive to properly underwrite the loans or to monitor the quality of the assets underlying these securities. And hence the Dodd-Frank Act came in to make sure that the securitizers have skin in the game. The Dodd-Frank Act requires seven agencies to write up these rules. We are talking about the Office of the Controller of Currency, the Treasury, the Board of Governors of the Federal Reserve System, the FDIC, the SEC, and as well as the Department of Housing. What these agencies collectively issued in the end of March 2001 are basically a proposed set of rules requiring securitizers of asset-backed securities to retain and unhinge economic interest in a portion of the credit risk for the assets that they put together for sale.

So very briefly, I will try and tell very briefly what the main highlights of these new proposed rules, which are not passed yet but they are what is on the table right now. Two main questions. Who is required to retain that risk? According to the proposed rule, it's the sponsor, generally the sponsor of the securitization and who is that? Well, what they mean by the sponsor, I believe is the entity that organize and initiate the securitization transaction by selling or transferring these assets. Do they also require depositors to retain interest risk? No. Do they require originators to retain risk? Not necessarily, no, the main focus in the proposed rule is to ask the sponsor to retain that risk. What are the acceptable forms of risk retention? Well, according to the proposed rules, the sponsor is required to retain an economic interest equal to at least 5% in business. There is no clear intuition for why 5%. But that is the rule of the aggregate credit risk of these pools of assets and the proposed rules basically lays out various ways you can retain that risk. One way you can is you can… the sponsor should retain, could retain a vertical interest in the securitization, so you hold a 5% of each class and they issue ABS. You can also do a horizontal first loss interest and that option would expose the sponsor to the first loss position with respect to the entire asset pool. Another is what they call the L-shaped retention option which would allow the securitizer or the sponsor to use a combination of a vertical and a horizontal. There are other alternatives too that were placed there, one is that the sponsor would take an interest in the representative sample. But again as long as it is 5% and as long as the sponsor can show that it is a representative sample, remaining are other ways, there are other forms. And the reason why they are, I believe, they are putting forth many different alternatives is because there are many different forms of securitizations and if it is not really realistic to expect that one form would… one size would fit all, there are exemptions of course. Who is exempted from those two requirements? Well, Fannie and Freddie, of course. As long as they are under the conservatorship of the FHFA they are not required to retain interest, as well as another exemption, important exemption is what the proposed rule call can qualify residential mortgages.

So the rules define the qualified residential mortgages by setting certain minimum underwriting standards. They are very strict standards. For example, you can be a qualified residential mortgage if you put 20% down, the loan to value ration cannot be more than 75%. The borrower could not have been more than 60 days late, for example, on any debt obligation for the last 24 or so. So very strict rules and this would be qualified as the other exemption. Its very important to remember that there is the prohibition on hedging. According to the rule which is very important and that goes to how costly the rules will be once the sponsor starts to apply them. The sponsor may not sell or transfer any interest or assets that he is required to retain on under these rules. So that is very important to the sponsors of who are going to affected by these rules.

I have very quick comments on the possible implications of these rules and before I say so I would like to recognize that it was a very difficult task for the agencies to try and put together a rule that will align in centers of the different parties of securitization. Having said that,I have a couple of comments. One, there are various mechanisms of risk retention that already exists that have actually functioned quite well even during the credit crisis that the rules are completely ignoring them. For example, excess spread particular to credit card securitizations, cash flow diversion mechanisms, letters of credits from banks and other mechanisms. They do exist but the rules are meant to apply on top of these credit methods. Another interesting observation here is that these proposed rules do not pay much attention to controlling originators directly, right? When you think about securitization, risks from securitization you think of two types of risks, economic risks, this has to do with the risk of housing prices, unemployment rates and so on. But when you think of origination risks and what the rules are trying to do is they are trying to limit the amount of economic risk that the sponsor can shed. But they completely ignore origination risk directly or they don't address it directly. And that's something, an observation and I am not quite sure why that is if the goal is to align in the centers. The rules don't cover synthetics and they don't seem to allow retention to be reduced over time. Finally, I have to rethink this is where economic analysis could be very valuable to the process is, that the important question that was left unanswered here even by the studies that were done by the Treasury and by the Financial Stability Council is, what is the impact of these new rules on the ability of securitization to provide credit to consumers and businesses and the cost of that credit? So, the academic literature economists from the Bank of International Settlements as well as the IMF have looked into the issue of optimal retention scheme and it does seem to… one of their main conclusions is that it really depends on a variety of factors including quality of funds and the economic conditions expected during the lifetime of the transaction.

So to conclude, it would be great to have a retention scheme that promote a greater attention to risk, as long as it does not introduce restrictions so burdensome that it would eliminate securitization altogether. Thank you.

SCOTT KIEFF: Thank you very much. We have just been hearing from Dr. Faten Sabry. And we turn now to Dr. James Overdahl.

DR. JAMES OVERDAHL: Thank you for the invitation today to offer my perspective of the role of economic analysis and more specifically "cost-benefit analysis" or "regulatory impact analysis" in the Dodd-Frank rulemaking process. This process is currently underway at several federal regulatory agencies including the SEC, who are now engaged in nearly one hundred Dodd-Frank Rulemakings. The importance and timeliness of this topic was highlighted this past Friday when the D.C. Circuit vacated the SEC's proxy access rule citing the Commission's failure to adequately consider the rule's economic effects. The Court's decision was significant because the proxy access rule is the first rule finalized as part of the implementation of the Dodd-Frank Act. The case is one of several court challenges to SEC rules in the past six years where the outcomes have turned on the adequacy of the economic support considered by the Commission when adopting new rules.

My goal today is to describe the role of economic analysis in the federal rulemaking process and to also describe how interested parties, in response to recent court challenges, are devoting more attention to the quality of their economic arguments when engaging in the public comment process. My comments apply generally to the federal rulemaking process and are not specific to the Dodd-Frank rulemakings, however the sheer number of Dodd-Frank rulemakings and the magnitude of their potential economic consequences have increased the public's attention paid to the role of the economic analysis in these rulemakings.

At the SEC there are no formal requirements for the Commission to conduct cost-benefit analysis in their rulemaking aside from the cost-benefit requirements of the Paperwork Reduction Act and these apply only to the rule's paperwork burden. Although there are no formal requirements to conduct economic analysis at the SEC, indirect requirements come from two main sources. First, the Administrative Procedure Act, or APA, which requires that federal regulatory agencies like the SEC adequately justify their exercise of rulemaking authority. Although the APA does not specifically require economic analysis, it does require that the federal rulemakings have a reasoned basis and not be, "arbitrary, capricious, an abuse od discretion, or otherwise not with accordance with the law,"

Second, individual statutes such as the Securities Exchange Act of 1934, may also require regulators to consider specific economic effects such as whether a regulatory action will promote efficiency, competition, and capital formation.

Recent court decisions regarding challenges to SEC rules have turned on the adequacy of the economic analysis considered by the Commission when adopting new rules. These court decisions have shown that failure to adequately consider the economic effects of a proposed rule can demonstrate a lack of a reasoned basis for adopting a rule and render its adoption "arbitrary and capricious." In the recent proxy access case, the D.C. Circuit found that the SEC, "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."

The message from the courts in this case and similar cases over the past six years has been that regulators' economic arguments need to be adequately supported and that vigorous assertion is not a substitute for rigorous economic analysis.

It is worth noting that even the specific instruction from Congress for the SEC to promulgate proxy access rules before a set deadline did not relieve the Commission of its duty to adopt rules fully in accordance with the APA and the Commission's governing statute-- without cutting any corners.

As a result of recent court challenges, parties affected by proposed rules now regard the notice and comment rulemaking process as if they were part of a legal proceeding. Affected parties are placing on the public record factual information about likely compliance costs and offering studies and analysis to help inform regulators. Because of the potential for litigation, parties are directing their comments not only to the members of the regulatory commission involved in adopting rules, but also to the judges who maybe reviewing the public record if rules are challenged in court.

Because commenters have become more sophisticated, the goal posts for the SEC have moved. The court is now scrutinizing the quality of the economic analysis itself and is no longer confined (as they were in the past) to scrutinizing whether any economic analysis was used to support the commission's assertions about economic effects. In last week's decision, the D.C. Circuit found that the SEC "failed to respond to substantial problems raised by commenters" citing a study co-authored by NERA economist Elaine Buckberg and Yale professor Jonathan Macey as one example. This study had been placed on the record by the Business Roundtable, one of the parties that ended up challenging the SEC proxy access rule.

In the end, the use of economic analysis is for more than simply satisfying procedural and court requirements. It can help improve regulatory decision making. I have found from my experience at the SEC, that Commissioners welcome rigorous data-driven economic analysis. It helps them sort out common sense from common nonsense. Such analysis enhances the ability of Commissioners to ask better questions, better understand trade-offs and consequences associated with a proposed rule and make more informed decisions.

In my view, economic analysis captures more than what is typically called “cost- benefit analysis” or “regulatory impact analysis.” Under my interpretation, economic analysis goes beyond what is readily quantifiable, such as out-of-pocket compliance costs and includes consideration of the trade offs, potential effects, and unintended consequences of regulatory actions--including identifying potential changes in behavior by market participants. It can also be helpful at the very early stages of the rulemaking process by helping the Commission frame the problem that is being addressed by a proposed regulatory action.

Perhaps the most important contribution of economic analysis to the rulemaking process is that it helps enhance the overall transparency and accountability of the process. There is no obligation, of course, for commissioners to abide by the results of the economic analysis, only that this analysis be responsibly considered. But discounting the economic analysis requires explanation, and this is where the accountability is injected into the process.

Although it has been the SEC that has faced the most scrutiny from the courts with respect to the use of economic analysis, scholars have observed a broader issue across other so called “independent regulatory commissions.” These are commissions, like the SEC, that are not part of the executive branch and not subject to oversight by the Office of Information and Regulatory Affairs (or OIRA), nor are they subject to executive orders on federal rulemaking. One recent study found that: “in many instances the independent regulatory commission appeared to be issuing major regulations without reporting any quantitative information on benefits and costs--apart from the paperwork burden. Instead there is only a qualitative discussion of the benefits and costs. The independent regulatory commissions present this discussion without any formal review of alternatives. Their analyses generally do not consider behavioral change. They also do not estimate possible unintended effects. And perhaps most importantly, with the exceptions of the paperwork burden…their analyses of economic effects are not prepared to comply with any identifiable standards to such analysis.”

Because of court challenges based on the economic analysis and the general concerns such as those that I just cited about independent regulatory commissions, Congress has recently held a series of hearings on the topic. One thing that has emerged from these hearings is that there is general support for process reforms aimed at bolstering the economic analysis conducted by independent regulatory commissions. One proposal is to establish third party review of the economic analysis, in the same way that executive branch agencies have their analyses reviewed by OIRA. Although separation of powers concerns have been raised, the recent congressional hearings have outlined a path that would preserve the independence of regulatory commissions but include third party review. In one proposal, OIRA would review the economic analysis but the commission would retain veto authority over any objections they raise. There also have been proposals for post-enactment review and greater use of pilot programs to improve the analysis associated with federal rulemakings. These again are general to all federal rulemakings but have been given heightened importance recently because of the scale and magnitude of the Dodd-Frank rulemakings. And I will stop there.

SCOTT KIEFF: Thank you very much, Dr. Overdahl, and thank you also to our two other speakers Drs. Mackay and Sabry. If we could open things up for a conversation among the group. Let me just reflect back that I notice that the one theme that ran through each of the presentations was some effort to identify risk and yet there are in a sense different types of risk that seem to be discussed there, there is systemic risk, for example, a special form of risk of some type and yet absent from the conversation was a risk that as Dr. Sabry pointed out was is explicitly exempted from the proposed rules. The risk that is ordinary risk built into mortgages that are backed by the government sponsored entities, Fannie and Freddie. And this of course was a risk that was purposefully taken off the table for the lead up to the problem because of a desire to focus on something other than what Dr. Overdahl's been talking about, cost benefit analysis. It was a desire to focus on a different agenda, an important agenda we probably all support, a social agenda totally unrelated to risk. Are there ways to pay attention to that basic underlying credit risk without fundamentally frustrating that social policy agenda?

DR. ROBERT MACKAY: Let me take a first shot at that. Certainly there are ways and in my list of factors that would go into determining the systemic relevance to the financial situation, the extent of its credit exposure that is just the sheer size of it, the concentration of that credit exposure, the extent to which credit exposures are correlated across different assets at home. Those are all an important part of what could we look at and what should be looked at. So of course credit risk is a critical part of what we are talking about here and it's a critical factor that the firms themselves have processes and procedures and qualifications that is in place for attempting to deal with that. It is also something that has to be a part of this systemic risk consideration. I am turning over to Dr. Sabry.

DR. FATEN SABRY: Right. I will echo what Robert said that yes, there are ways to address that risk. But it does seem to me that with the Dodd-Frank deal is, once the rules are applied, I don't see how it would not limit the private label securitization and implicitly continue to subsidize government sponsored enterprises whether they are in conservatorship or even if they find a way to get out of it. With the regulators, I guess, they will want only prime borrowers to have access to credit and they are going to shut the door on anybody who has less than stellar credit. This is the optimal policy, but it's not clear to me why it is. But that is what a few of us independently upgrading to what the act is going to do.

DR. ROBERT MACKAY: Just pick up one point. Surely part of the credit crisis was encouraged by the government, where homeownership became a goal in itself, the extension of homeowners very broadly, obviously it was pushing down on the credit ranking, that was a good part of that. One thing that surprised me was the actual extent to which the banks retained credit. I was surprised to see the large numbers come out when they came out and it turns out mortgage related exposure that I thought the business models in some sense and you pass it on.

DR. FATEN SABRY: The IMF had done a study recently and looked at over 10,000 securitizations. They found that the banks, the sponsors of securitization, have increasingly been retaining risk over time especially for the more complex structures. And part of that could be they were trying to hedge their other positions. But the thing is, just to echo, there is actual quantitative evidence to show that the banks were retaining a lot of that risk, even though the lower tranches of all these securitizations.

DR. ROBERT MACKAY: Quantitative evidence is the loss having showed up on the balance sheets.

DR. FATEN SABRY: Yes.

SCOTT KIEFF: Is it possible that part of the reason they did that was to manage political risk so that they could say that they were actively supporting the social policy agenda by credibly saying, "Look, we are loaning to people who don't need modest goals for being as in individual family or credit risk? We are lending to them nonetheless because you, the oversight committees have told Fannie and Freddie that they should tell us that we are good guys if we do that and bad guys if we don't. So we want to show our political bona fides by being good guys and by playing in that space."

DR. JAMES OVERDAHL: Well, I am not sure that I am prepared to answer that question right at the moment. But clearly Freddie and Fannie are the elephants in the room and it is one of the glaring holes in the entire response to the crisis. And I think probably the most reasonable explanation is that nobody could figure out what to do, at least not within the timetable that they were working on. So I think we are seeing that process play out now. We are seeing more discussions on the Treasury proposal out the last few months. So I think attention is being turned to that now but it may have been just was too complicated and controversial to handle during the timeframe that was before Congress when they responded to the crisis.

SCOTT KIEFF: Maybe to start with you, Jim, on this round of questions opened up to everybody. You mentioned the importance of existing mechanisms within the government apparatus to engage in a community conversation about cost-benefit analysis. You highlighted the difference between agencies that go through OIRA review and agencies that don't. Is it your sense that generally speaking we see better, at least today cost benefit analysis being conducted by those that go through that process?

DR. JAMES OVERDAHL: Well, it is an interesting question and I am aware of some scholars who have looked at that issue and I know that there are scholars at Resources For The Future who have looked at that and one of the things that they found, I am not sure that is a formal finding but I know that it's been shared anecdotally, is that when there is review by someone, some third party review, doesn't really matter who, that the quality of the work improves. And as long as people know there is going to be somebody scrutinizing their work that generally the quality of the work rises as a result. And perhaps I would say that now the D.C. Circuit is performing this function for financial market regulators as a result of the decisions relating to the SEC over the last few years. The regulators are certainly responding because they know that D.C. Circuit may be reviewing their work. But there could be a process in place that would make the process more standardized so that it would not be something that would have to go through court proceedings to get reviewed.

DR. ROBERT MACKAY: Just some certain question on the experience here. In the '80s I spent several years associated with the Federal Trade Commission and I was a chairman there and that is an agency that has a very strong economic culture, always has by the nature of it will. And there in my experience the cost benefit analysis that was done, the regulatory impact analysis that was done asking the factors, did the funeral role actually affect funeral pricing, funeral services. It was quite rigorous, there are other agencies and I would lump the SEC into that, that don't have that same strong economic culture as the FTC or the CFTC have. I think my experience of that agency was a much stronger economic culture there than at say the SEC. So my guess is that it varies by agency.

DR. JAMES OVERDAHL: I think you are right it does, but I also think it requires more than good intentions. I think based on my experience from 21 years with the federal government I have seen many fits and starts, I have seen many different chairmen at many different agencies come in with ambitions about improving the quality of the analysis. And it may last during that chairman's tenure but then you know it will be forgotten about. And so I think there needs to be some structure to this, it has to be something more than just good intentions.

DR. FATEN SABRY: Well, I was going to say given the scope and size of the Dodd-Frank and its impact on various national institutions, I think and I hope that regulators will take time to actually think about economic impact studies properly because this is very serious, the economic implications of curtailing credit even more than what it is today because of these new rules is very real.

SCOTT KIEFF: Well, maybe if nothing else than the records getting built in response to the notice in common period might provide perhaps informal focal point coordination vehicle for the type of review mechanism even if there is no formal organization task for that activity.

DR. JAMES OVERDAHL: It can be a substitute but it is not the best. However, it does have a couple of virtues. One is that when outside commenters place on the record economic analysis it forces the commission to engage more fully their own economic staff to respond and bring in the economic analysis that way. But I don't think you want commissions relying fully on outside commenters and I think we have seen also that sometimes commenters are constrained on what they can offer on the public record because it may actually be information that they don't want to show and there needs to be some confidential mechanism for information to flow. I know when I was at the SEC and CFTC we would oftentimes be frustrated by public comments because they would not share with us their expectations on compliance costs and other factors. And we had no method of surveying firms confidentially because other constraints, such as the Paperwork Reduction Act, for example, prohibited us from asking the same question to more than nine people.

SCOTT KIEFF: Right.

DR. JAMES OVERDAHL: So there are constraints on gathering information that could result in better decision making as well as business concerns that would prevent firms from offering on the record information that regulators would like to have.

SCOTT KIEFF: Even the so-called Sunshine Act sometimes ends up being the opposite in its effect in that way. Maybe just a flag I guess for us all to revisit in the future to see whether this plays out. It might be interesting to ask later whether the searching cost-benefit analysis that one hopes will occur will end up being an effective in the kind of post modern sense just a fig leaf for something that is actually not good. But to which somebody can respond and say, "Oh, when I ran my cost-benefit analysis, the cost-benefit analysis may not be good but having run it, I have now satisfied my APA requirement that I have run it." You see in different parts of the space of that game being played.

DR. JAMES OVERDAHL: I think that is a concern that you don't want this to become just a go-through-the-motions exercise. I think it is important when you said "effective" that we know what we mean by "effective." In one sense we want the process to produce better rules but I think also the goals are broader than that. We want transparency in the process and accountability. What I mean by accountability is that if commissioners and regulators want to disregard the economic analysis they have to put their reasons on the record and they have to be accountable for that decision.

SCOTT KIEFF: Isn't there a bit of tension here between the so-called economist who desire to get it right, if you will, and the political scientist's desire to think about a different market that gets made. So if I am a political actor and I find out that a particular activity will cost or save x amount of dollars or jobs, hasn't that fact just made a market for me politically? Because if I can then hold that up to some interest group who can then lobby me and explain to me that their view on that issue will get the same outcome plus one or minus one depending whether it is good or bad, then I can become a focal point for political power or contributions from both of those groups. I have now made a market and I have become an auctioneer in that market. And doesn't modern political science teach us that any self-interested government actor who has to be democratic so some of these agencies are further down the work chart. But those that are more democratic, more open to being elected or democratic power, the more responsive they are to that. Doesn't this really, doesn't this open up to them the rational self-interest to worry, in fact about social or political game rather than economic efficiency?

DR. JAMES OVERDAHL: Well, I am not sure economic analysis can solve that problem. As I see it, the role of economic analysis in these types of rulemaking decisions is to inform the process, make sure that the commissioners have the type of information they need to make a reasoned decision. But we have to remember that the people who are in these positions are political appointees who have a lot of considerations to factor in to a decision and that they are there to exercise their judgment but you hope that when they exercise that judgment that it is a fully-informed judgment. And of course these factors that you mentioned can play out, but I am sure they also play out in the absence of that information as well.

DR. ROBERT MACKAY: That information may now actually be on the record as opposed to in the background.

DR. JAMES OVERDAHL: That's what I think adds the accountability to the process.

SCOTT KIEFF: So then as we come near the hour, if we could maybe take a moment with each of you to just ask an open ended question? There probably are people out there who are staff in a legislative body or they are staff in the administrative body. And they are thinking to themselves, what could I do differently? What advice, targeted advice would you give somebody in one of those settings or a different setting? What one or two pearls of wisdom or request for mindfulness, what would you ask them in the future to be just a little bit more attentive to?

DR. ROBERT MACKAY: Well, let me answer that in relation to the topic I was asked to address. In designing regulations that are meant to deal with systemic risk, that to deal with the problems that the financial problems we went through in 2007 and '08, it seems to me that its critical to first get the understanding of what happened right, to have a solid understanding of the causes before one starts designing the fixes. And that in many cases without that analysis of the causes, I think some of the problems we illustrated can actually make things worse. Deep studying of the causes should precede the implication of brief words of wisdom.

DR. FATEN SABRY: I would completely agree with what Robert said particularly in the context of the risk retention rules. I would have loved to see if I was asked to think about this risk retention scheme what is the optimum way to do it is to actually think seriously about real data, use serious data on defaults on losses and address that as the economists do because it really is an economic question, not a legal issue, not a political issue either.

DR. JAMES OVERDAHL: If I was addressing a legislative assistant, I would remind them that the reason the federal rulemaking process exists at all is because Congress has delegated certain tasks to regulators to figure out, and oftentimes they have delegated the most difficult tasks, the things that are hardest to figure out, to the regulators to figure out. But there is always the option of Congress filling in those blanks in the statute. And so the process exists because of the authority that the Congress has given the regulators to fill in the blanks that Congress has not filled in.

SCOTT KIEFF: Well, Jim, Faten and Bob, thank you for sharing your insights into this complex web of economic issues in the implementation of financial regulation. Your views have been stimulating and the issues raised significant debate on the impact of Dodd-Frank going forward.

Today's broadcast will be available in audio mp3 format soon and an edited transcript will be added later. The program will be accessible in both programs and The Best of NERA sections at www.sechistorical.org.

The museum's next broadcast will be Bingham Presents 2011 on September 13, looking at Enforcement after Dodd-Frank. The online broadcast will be free and accessible worldwide without prior registration. My colleague Professor Jeffrey Manns will moderate the program with presenters Robert Khuzami, SEC Director of Enforcement; David Meister, Director of Enforcement at the Commodity Futures Trading Commission; and Susan Merrill of Bingham McCutchen, LLP and former head of enforcement at FINRA. Please plan to join on www.sechistorical.org on Tuesday, September 13th at 5 pm Eastern Time for Bingham Presents 2011. Thank you for being with us today.