Discussion:
“Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications”
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Discussion by
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Disclosure

I work as a non-management director for an asset management company which manages global stock portfolios for large institutional investors. I have also worked as a consultant for government agencies (CFTC, SEC, DOJ) on topics related to finance issues. My government work has included consulting for the SEC’s Inspector General concerning the issue of how the SEC conducts cost-benefit analysis in Dodd-Frank rulemaking. My work for CFTC includes a paper with Andrei Kirilenko and others on high frequency trading and the flash crash. I advised Ph.D. students, some of whom have worked or may work at the SEC, CFTC, and Fed. I am not a lawyer.
Summary of Paper

- Precise, quantifiable, cost-benefit analysis is infeasible.
- Expert judgement remains an inevitable part of “gold-standard” quantified CBA.
- Judicial review leads to camouflaged discretionary choices, does not promote democracy or transparency.
- Courts should not micro-manage cost-benefit analysis process at independent agencies (SEC, CFTC); let them have more flexibility or discretion.
Case Studies

- Taylor Rule (Fed’s interest rate policy)
- Sarbannes-Oxley Disclosure (Enron, Worldcom, Tyco)
- Mutual fund governance reforms (late trading, market timing)
- Basel III capital requirements (bank failures)
- Volcker Rule (proprietary trading)
- SEC cross-border swap (AIG)
- FSA mortgage reforms (consumer financial distress)
Summary of My Idiosyncratic Comments

1. CBA (and court cases!) requires honest economic analysis, not legal posturing. Need more economists, fewer lawyers.

2. CBA requires identification of market failures.

3. Market Microstructure: market failures readily identified, quantifying costs and benefits difficult but not impossible (high frequency trading, tick size, market fragmentation, transparency).


5. Comments by interested parties are useful: Blackrock comments on OFR study of asset managers. Democracy works.
1. Lawyer Thinking versus Economist Thinking

- Economists: Ask 100 economists one yes-no question?
  - You get 200 different answers.
- Lawyers: Ask one lawyer 100 yes-no questions, where “yes” is the favorable answer to his client and “no” is unfavorable?
  - You get 100 “yes” answers.
1. How to Read Proxy Access Decision

- Court sensed that SEC had looked at 100 issues and discovered a “yes” answer that favored SEC regulatory proposal 100 consecutive times.

- Court thought that analysis and framing were intellectually dishonest.

- If SEC had looked at 100 equally important issues and reported that 60 favored its proposal and 40 did not, with “expert judgement” favoring their proposal, it would have been difficult for a court to overturn rule.

- Court overturned proxy access rule because it detected posturing which camouflaged actual thinking of SEC.

- You can read proxy access case as discouraging posturing and camouflage, encouraging expert judgement, exactly the opposite conclusion as reached by the paper.
2. Market Failures

- Cost-benefit analysis should begin with market failures, discuss how proposed regulations correct inefficient incentives.
- Market failures include monopoly pricing, externalities, and endogenous private information.
- I think standard moral hazard problems (unobservable actions) are not market failures.
- Paper’s analysis mentioned the term “externalities” but not explain why alleged externalities are really externalities.
2a. Sarbannes-Oxley

Simple fraud (Worldcom, Enron) is not an externality.

- Insects eating a farmer’s crop have similar economic effects to thieves stealing the crop.
  - No obvious externality with insects or thieves.

Externality in enforcement arises when insects or thieves move from one farm to another. Then each farmer has insufficient incentives to tackle insects or thieves.

- That is why we have centralized enforcement (criminal law, SEC enforcement).

- Solution is not to impose regulations on insects and thieves, requiring them to hire consultants to prove they are something else.

- Solution may regulating farmers to prevent insects from moving to neighbors fields; USDA inspections are important.

- Sarbannes-Oxley rules encourage future Fastows to move to private equity, do not prevent externalities from spillovers.
2b. Mutual Fund Governance

- Solution to oversight of asset managers on behalf of clients is transparency of behavior, made possible with full disclosure of asset managers’ trading, with appropriate lags to prevent front-running of active positions.

- Market timing and late trading are easily detected, by regulators, investors, or plaintiffs’ lawyers’ consultants’ economists, given availability of data.

- Similarly, insider trading, leaking market moving trades, other bad investment practices are easily detected.

- How can good governance be imposed by regulation, when investors in funds have little incentive to monitor for themselves?
2c. Basel III Capital Requirements

- Problem is government failure, not market failure.
- Government cannot commit to let failing banks fail.
- Living wills would address the issue if living wills could be implemented in a credible manner. So far, it has not happened.
- Problem is that capital requirements are too low, not that capital regulation is not complicated enough.
- Evidence of low capital requirements is that marginal benefit of evading them is high.
2d. Volcker Rule

- If proprietary trading is moved off the balance sheet of banks, where does it go?
  - To hedge funds.

- Who are the prime brokers to hedge funds?
  - The banks which used to do proprietary trading, but now regard prime brokerage as a new growth area (like a new type of carry trade).

- How does forcing banks to give away the upside of proprietary trading while keeping the downside limit bank failures or systemic risk?
  - It does not.

- It is certainly not clear that the Volcker Rule addresses a market failure.
2e. Cross-Border Swaps (AIG)

- It is a cliche to say that swaps are complicated; swaps are not complicated. They are simple.
- Compare the mining activities of company with its hedging activities. Hedging is simple.
- Problem with AIG was, in my opinion, simple fraud.
- Company hid its liquidity risk associated with margin calls, both internally and externally.
- AIG wrote insurance (CDS on subprime derivatives) which it could not cover in the event the insured events ever happened.
- There is no systemic market failure here, but rather simple fraud (assuming fraud legislation is written correctly).
2f. FSA Mortgage Reforms

- Perhaps ordinary consumers are too financially disabled to manage their own financial affairs responsibly.
- Then an impartial hand-holding service may be needed.
- Government might provide a better hand-holding service than other alternatives (e.g., churches, non-profits, self-help organizations).
- Or maybe not.
2. How do you evaluate regulation if there is no market failure?

- You need to replicate what an efficient market would have done by itself, inside a government bureaucracy.
- I think this is impossible. Problem similar to how a socialist bureaucracy can “theoretically” discover a competitive equilibrium by processing all available information correctly.
- Consistent with analysis in the paper, but from opposite perspective.
- If there are no market failures, theoretical argument that unregulated outcome is efficient is compelling.
3. Market Microstructure: Numerous Externalities

- Exchanges have history of charging monopoly prices (Buttonwood Agreement)
- Network externalities or economies of scale in centralizing trading.
- Adverse selection due to private information.
- Each trader’s information about own trading is valuable to others. Therefore, positive externality from sharing information, even though privately costly (related to prompt price reporting)
- External value of information related to speed with which it is obtained (related to high frequency trading).
3. Market Microstructure: Lots of Data

- Public data feeds.
- Private data on messages and transactions at account level. Legal entity identifiers helpful here.
- Active area of research. My area!
- Ability of regulators to do controlled experiments (almost like clinical trials). Example: deregulating short-sale restrictions on subsets of stocks.
- “Natural experiments” occur too: relationship between stock price and effective tick size.
3. Market Microstructure: Good Quantified CBA Is Possible

- Removing short sales restrictions.
- Price reporting. Inequality and delays.
- Centralization of trading or fragmentation.
- Level playing field with high frequency traders (batch auctions, random time delays, minimum resting time, message costs).

- Judicious discussion of incentives (not exactly market failure).
- Lots of data. Quantification of different parts of market (not exactly CBA).
- Nuance judgements delivered in a seemingly honest manner.
- Document obviously took multiple man-years of economist research effort, by economists who already knew the area empirically.
- Conclusion: Good CBA requires a healthy economics culture, empirical capability, band-width, expertise in multiple narrow areas.
4. Taylor Rule

- Fed does not go through a formal, lawyer-driven process of cost-benefit analysis to justify its monetary policy decisions.
- Fed is organized around how economists make decisions.
- Have continuous process of seminars, working papers, discussions, academic literature. A great deal of this is public.
- Over the years, much of this has discussed the Taylor Rule.
- Decisions are made based on expert judgement, with confidentiality protecting key deliberations for a period of time.
- Does publishing minutes with a 5-year lag lead to posturing at meetings? Or does judicious editing of minutes make this unnecessary? Did Fed know about Jerome Kerviel’s rogue trades when in cut interest rates 75 basis points at an emergency meeting in January 2008?
5. Blackrock Comments on OFR Report on Systemic Risk in Asset Management Industry

- Contains useful collection of information about asset management industry: I assign it to my class on institutional asset management.
- Produced at no cost to government.
- The “bias” of Blackrock is readily apparent: Blackrock happy to have expensive regulations as long as imposed on all asset managers equally.
- It is obvious that this makes the largest asset manager more competitive since fixed costs are spread over more assets.
- This is exactly how comment letters play a useful role in democracies.

(OFR Report was not exactly a regulatory proposal, but market treated it as one.)
Conclusion: I disagree with much of paper.

- Proxy access case can be read in a helpful way.
- Most of case studies in paper are about regulatory proposals where there is no clear market failure.
- Process of proposals and comments can help regulation.
- Good CBA is possible, with some quantitative analysis and some expert judgement.
- Good CBA needs many, many economists.
- Good CBA need data on trades at granular level.
- Good CBA requires identification of market failures and adequate bandwidth of economists.
- A good CBA process might not resemble what agencies do now.