COMMUNITY AND CONSUMER ADVOCATES' PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

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COMMUNITY AND CONSUMER ADVOCATES' PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

Thursday, July 16, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Gutierrez, Watt, Meeks, Moore of Kansas, Clay, Baca, Miller of North Carolina, Scott, Green, Cleaver, Moore of Wisconsin, Ellison, Donnelly, Carson, Speier, Kosmas, Himes, Maffei; Royce, Manzullo, Jones, Biggert, Hensarling, Bachmann, McCarthy of California, Posey, Jenkins, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order.

We are here today for the second day of hearings on the Administration's proposal for a change in the regulatory structure, and in particular today, we have advocacy groups of various sorts that have focused on consumer civil rights and community economic concerns.

All of the issues that are embodied in this are before us. As was the case yesterday, I think we probably have some particular interest among many of the witnesses today in the proposed consumer agency, but, as I said, all of the various aspects of that are before us.

I will begin. We will have 10 minutes of opening statements on each side and then proceed with our panel.

The need for regulation seems clear, and I think we should understand that this is, to a great extent, part of a historical pattern. We have a private sector economy in which the private sector generates wealth, and we are all supportive of that. There is constant innovation in the private sector, as there should be. At certain points in history, the level of innovation reaches a point where there is almost a qualitative change in the way in which certain institutions function.

Now we should be very clear. None of these institutions, none of these new approaches, would survive if they did not add significant value in the society because they are voluntary. And if they did not add value, nobody would participate and provide any funds for them.

The problem comes when they innovate, provide a great deal of benefit, but precisely because they are innovative, occur in a regulatory vacuum. There are no rules, and the free market clearly needs rules to function well. Rules to give investors, the people who will be making the money available, some confidence. Rules to protect the great majority of people in the business who want to be honest and follow all the rules from those who don't.

We had a situation in the late 19th Century where the innovation was large industrial enterprises. If you looked at the structure of American enterprise in the 1880's and 1890's, it was very different than it was in the 1940's and 1950's. It was larger. Those large enterprises were good, because you could not have had the degree of industrialization and wealth creation that we have had without them. But they operated in a regulatory vacuum.

So after the creation of the large enterprises in the latter part of the 19th Century, you had Woodrow Wilson and Theodore Roosevelt, in reverse order, adopting rules, the Federal Trade Commission, the Federal Reserve system, antitrust acts to try to preserve the benefit of those large institutions without much of the harm.

That worked pretty well but it, in turn, led to another situation where the newest innovation in terms of its impact was the stock market, because with large enterprises, you could not have individually financed entities or family financed entities. You needed a stock market. The stock market, obviously, did a lot of good, but it caused a lot of problems because there were no regulations. So in the New Deal you saw regulations both in the banking industry and of the equity industry. That worked for a long period of time.

Beginning in the 1980's, into the 1990's, and culminating in this past decade, a new round of innovations came up. Banks became less important, because there were ways for people to aggregate the money and lend it out outside of banks. So bank regulation covered less and less of the activity.

Securitization came into being, which meant that the discipline that came from the lender/borrower relationship eroded. Derivatives were created without an adequate regulatory structure.

I think we are in the third of those periods that I just mentioned, where innovation that essentially does a lot of good outstripped regulation by definition. And our job is to try to fashion regulations with regard to derivatives; with regard to excessive leverage; with regard to loan originations by people who have no economic interest in their being repaid; with regard to the model in which so many mortgages—such a large part of the economy—are held in a split fashion, where there are those with ownership interest and those with the control of the instrument and they are not always able to work together.

And it is not that we have had innovations that are bad. It is that innovations by definition are unregulated. The lack of regulation I believe has caused serious problems. And our job is, as it was for Woodrow Wilson, Franklin Roosevelt, and Theodore Roosevelt, to come up with rules that minimize the damage while maximizing the benefit.

Now I know—let me say in closing—there were those who tell us we will be killing off the innovations by doing this. I can save them the time. They don't have to write these speeches. They can go back to 1902 and 1903 and dig out what people said about Theodore Roosevelt and then later about Woodrow Wilson, and they can go back to 1933 and 1934 and be right here in the Congressional Record, and they can get all the speeches about how regulation will inherently kill off these activities.

Yes, excessive regulation and incompetent regulation and foolish regulation can do that, but well-done regulation, as it did under Theodore Roosevelt and Woodrow Wilson and as it did under Franklin Roosevelt, can help, and that is what we intend to try to do today.

The gentleman from California is recognized for 4 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

We really do need regulation. And what happens when a regulator fails in his task to make certain that you don't have overleveraging in the financial institutions is something like what happened with AIG. You end up with overleveraging of 170 to 1.

Banks typically are regulated to make certain they don't overleverage more than 10 to 1. The consequences are catastrophic when a regulator misses something like that. The consequences also are catastrophic when, for example, GSEs were leveraged 100 to 1.

In this case, the regulators did catch it, but in this case we in Congress did not take the decisive action necessary to allow those regulators the power to deleverage Fannie Mae and Freddie Mac. And, likewise, you have a consequence there of an impact to the system, a shock to the system. And with that kind of overleveraging in a society, you end up also, of course, with a consequence of helping to create a boom or an expansion, an overexpansion in housing.

Now we're here today again talking about the regulatory reform proposal issued by the Administration, and, logically, the consumer financial products agency is going to be discussed here today, as it was yesterday.

We know what happens when you separate solvent protection from consumer protection. We saw it with the regulatory structure over Fannie and Freddie. OFHEO focused on safety and soundness and for years competed against HUD, who was enforcing the affordable housing goals, akin to mission oversight in that case so you had that competition. Those affordable housing goals pushed by one agency led to the build-up of junk loans in Fannie and Freddie, which ultimately led to their demise.

Going forward, it will be very difficult to create a separate regulatory entity, charge it with consumer protection oversight, and not expect similar politically driven mandates to come further down the road.

There is a reason why virtually every Federal safety and soundness regulator has expressed concern over this proposal that we are talking about today. And it isn't because they are trying to protect their regulatory turf. It is because it is a flawed idea.

Consumers benefit from a competitive market with adequately capitalized institutions that consumers know will be there down the road. In many ways, solvency protection is the most effective form of consumer protection. Instead of bifurcating the mission of the various regulators, we should ensure consumers throughout the financial system have the tools necessary to make sound, educated financial institutions.

What we are doing with the plan that is being put forward today, I am concerned, is you are going to eliminate choice by requiring government bureaucrats to define what are suitable financial products. And then it gives each State the ability to change those standards.

To avoid litigation, institutions will have no choice but to sell only one-size-fits-all products.

Also, the plan put forward here that we are discussing would add an additional layer of bureaucracy on top of the current regulatory patchwork, with broad, undefined, and arbitrary powers which would impose requirements that would likely conflict with those of other regulatory agencies. So the plan invites the kind of turf battles that will undermine rather than promote effective consumer protection.

And lastly, in terms of lawsuits, we know what the consequence is going to be of outlawing mandatory arbitration clauses. Creating subjective standards for what constitutes acceptable products and reasonable disclosures, that is inevitably going to lead to more lawsuits.

So the plan put forward here in this committee today I am afraid will impose new taxes and fees on consumer financial transactions, increase the cost of borrowing and create a government bureaucracy. And, frankly, what we should be doing is providing regulators with more investigative and enforcement tools, increasing civil penalties, and maximizing restitution of victims of fraud. That should be our focus here and we should streamline and consolidate regulations of financial institutions, including consumer protection, so that no institution can game the system.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from California, Ms. Speier, for 2½ minutes.

Ms. SPEIER. Thank you, Mr. Chairman, and thank you for having the backbone to continue this fight to make sure consumers in America have a choice.

The taxpayers have spent more than $2 trillion to turn around an economic crisis that had its foundation in the insatiable appetite of Wall Street for the high yields provided by mortgage-backed securities and the fees that went with them. We got liar loans and no-doc loans and pick-a-payment loans that had no relation to the borrower's ability to pay. It didn't matter, because the loans were cut up into pieces and bundled and rated triple A. Lots of people got rich, and the foundation of this economy crumbled.

Today, we are going to talk about what we can do for the consumers of America now that we have taken care of Wall Street. We heard yesterday from the banks, both big and small, about how they weren't responsible for the current financial crisis and consumer protection should be left with the existing regulators.

Well, the existing regulators have had 14 years, and what have they done in 14 years to fix the problem? Sixty percent of the subprime borrowers would have qualified for cheaper mortgages, but they didn't get them.

They talked about how the consumers must have choice and access to innovative financial products, about how a Consumer Financial Protection Agency is somehow going to shut down access to credit for consumers or drive the price of credit sky high, about how they will be subject to 50 standards. These arguments are scare tactics intended to delay action until the economy starts to recover, as it inevitably will, and the political will for bold reform will fade.

The choice and innovation argument only works when the parties involved are on an equal negotiating level. Furthermore, what is wrong with plain vanilla? Innovative products have equaled paying for the consumers and ripoffs to the taxpayers. You can't tell me that a kindergarten teacher buying her first home or a firefighter who has been offered a teaser rate to transfer a large balance from one credit card to another is on an even playing field with the phalanx of lawyers deployed by Citibank or Bank of America or Wells Fargo who write 30 pages of legalese in print so small that even triple-strength reading glasses aren't enough to reveal the real terms.

A Consumer Financial Protection Agency will not limit creative or innovative products. It will, however, limit the ability to run roughshod over the consumers. Terms will have to be clear and fully disclosed, and the consumer may have to opt in. And although opt in seems to be a dirty word to those in the financial industry, it simply means that the consumer will actually have to affirmatively agree to the terms.

I yield back.

The CHAIRMAN. The gentlewoman from Illinois for 3 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Our financial regulatory system is broken, and our job is to clean it up, making it more efficient and effective. However, as I expressed during yesterday's hearing, I fear that we are moving in the wrong direction when we strip from the banking regulators their mission to protect consumers.

Our country got into this financial mess because there were simply too many regulators who weren't doing their job and were not talking to one another. So the logical answer to this problem of too many regulators not doing their job should be to consolidate and require more efficient, frequent, and effective regulators.

Instead, H.R. 3126 in the Administration's proposal goes 180 degrees in the opposite direction by placing the responsibility to protect consumers with a new government bureaucracy, an agency that I think should be called the Credit Rationing and Pricing Agency.

And why do I say this? Because this new agency that tells consumers what they can and cannot do and businesses large and small what they can and cannot offer to consumers can only result in one or more of three things: First, many consumers who enjoy access to credit today will be denied credit in the future. Second, riskier consumers will have access to affordable products or plain vanilla products, but who will pay for that risk? That is the less risky consumer whose cost of credit will certainly increase. And, third, financial institutions will be told to offer certain products at a low cost to risky consumers, which will jeopardize the safety and soundness of the financial institution.

Secretary Geithner last week couldn't really answer the question: Would the safety and soundness banking regulator trump a new consumer if the consumer's regulatory policy would put the bank in an unsafe territory? Maybe some of our witnesses today can explain what would happen in that situation.

In addition, maybe some of our witnesses today can better explain why we should keep CRA with a prudential regulator but not the consumer protection regulation.

I am very skeptical that, for consumers, the answer is making government bigger and eliminating Federal preemption. I think it weakens the system and could very well be detrimental to consumers, businesses, and the U.S. economy at a time when we can least afford it. We must first do no harm, and we must find a balanced approach to financial regulation.

I think our Republican plan that puts all of the banking regulators and consumer protection functions under one roof is a better answer for the consumer and really gets to the heart of preventing another financial meltdown.

With that, I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from California, Ms. Waters, for 2½ minutes.

Ms. WATERS. Thank you very much, Mr. Chairman, and members.

I am still shaken from yesterday when we had the financial services community representatives, bankers, etc., come before us and take on the consumer financial agency with great opposition, giving us 101 reasons why we didn't need it, how it was going to cost the taxpayer more money, how it would interfere with safety and soundness, and on and on and on.

But I am even more shaken with what is happening in the underground with the huge amount of money that the bankers and financial services community representatives are going to spend to lobby Members of Congress. I understand they almost have hired a lobbyist for each one of us. I never expected, given the subprime meltdown and the number of foreclosures we have, that we would get that kind of opposition. How soon we forget. And I am more concerned that there are Members of Congress who are beginning to take on the arguments of the financial services industry about why a consumer financial agency is not necessary.

Many of the people who are before us today have been fighting as nonprofits against predatory lending, opposition to bank mergers, forcing mortgage disclosure. I remember being in the fight with some on redlining, fighting to create CRA, helping to create the Cooling Off Period, Truth in Lending. And they are forever chasing the very-well-heeled financial services community, trying to protect the consumers. And now we have an opportunity to really show that we want to protect the consumers with an agency that will have the word "consumer" in it, and we have people who are backing off.

I am even more shocked that, as this chairman has provided opportunities for us to interact with the financial services industry, it has basically been dishonored. Even yesterday, when we were engaged with consumer advocates, one member got up and left and went to a fundraiser with the banking community in the middle of all of that.

Well, all I have to say is I am hopeful that our advocates will be stronger than ever and that we will fight against this opposition. We will respect our consumers. We will not forget the still-growing number of foreclosures that are out there created by greedy loan initiators, and we will do a job for the consumers despite the lobbyists and the money and the opposition to this.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling, for 3 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Over the course of these last couple of hearings and listening to some of the opening statements, it is clear that we are witnessing a clash of principles, and there is much at stake. I think the question is, in a free society, how does the State best protect consumers rights? Clearly, the right and the left do not agree.

As I listen to my friends on the other side of the aisle, I am almost left with the impression that many of them believe that every consumer is a hapless fool incapable of discerning what is best for she and her family, that creditors are a powerful, monolithic evil in our society that only exist to victimize consumers.

The left seems to believe that if only we will empower some type of ruling enlightened elite, that only then can consumers hope for fairness and justice. But in order to receive all of this, somehow consumers are expected to yield their rights to the State in order to be protected.

Most of us on this side of the aisle believe something else. We believe that the best form of consumer protection comes from competitive markets, competitive markets that are vigorously policed for force and fraud. It is not business we believe in. It is competitive markets we believe in. And we believe in empowering consumers with effective and factual disclosure. And we believe fundamentally in the freedom to choose, the fundamental economic liberty of every American citizen to decide for himself what consumer financial products are best for he and his family.

And that is the difference. I simply cannot understand how you protect a consumer by assaulting consumer rights. I simply don't get it. I don't understand how passing legislation that ultimately will result in less competition empowers the consumer. I don't understand how passing legislation that will stifle innovation, perhaps the next ATM machine, the next frequent flyer mile offering on a credit card—how by stifling innovation are you somehow protecting the consumer? I don't get it.

And if we look at the turmoil, the economic turmoil that we find ourselves in today, it is the result of one and only one product, and that is subprime mortgages, more specifically, a subprime ARM. You know, Congress has acted.

And, besides that, some of the people who took out these loans took out loans that they knew any couldn't repay in the first place.

And so I hope that we are not taking advantage of the situation. It is more important that we get it done right than that we get it done quickly.

I yield back the balance of my time.

The CHAIRMAN. We will now begin with the panel, and we will begin with a man with whose work I am very familiar and of which I am very admiring, Joseph Flatley from the Mass Housing Investment Corporation.

Let me say at the outset, any additional material that anyone on the panel or on the committee wants to submit for the record will be accepted, if there is no objection, and I hear none. So the record is open for any submissions.

Mr. Flatley?

STATEMENT OF JOSEPH L. FLATLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MASSACHUSETTS HOUSING INVESTMENT CORPORATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF AFFORDABLE HOUSING LENDERS (NAAHL)

Mr. FLATLEY. Thank you, Mr. Chairman.

My name is Joe Flatley, and I am CEO—

The CHAIRMAN. You better pull the microphone closer, Joe. Move the papers. You are so faint.

Mr. FLATLEY. Again, my name is Joe Flatley, and I am president and CEO of—

Mr. MEEKS. It is not working.

Mr. FLATLEY. And I am also—

The CHAIRMAN. Wait, hold on, is the microphone not working as someone said?

Mr. FLATLEY. The green light is on.

The CHAIRMAN. Pull it very close to you. Just don't do it an inch at a time, Joe.

Mr. FLATLEY. It will be down my throat in a second.

Can you hear me now?

The CHAIRMAN. I will ask that we get the electricians in. This is not our first problem with the electrical equipment.

Are any of the microphones working? We will wait a minute until they are. Is somebody working on it? We will have to wait until they come.

Mr. Flatley, I don't think we have to look at you. We have to hear you. Please come take up the seat right up here and turn on the Member's mike and do it from here. I am not going to sit around waiting for the mikes.

I assume that people will forego looking at Mr. Flatley while he speaks, because hearing him is more important. And please sit down right there, turn on the mike, and start speaking.

If Members insist, we will get a staffer with a big mirror, but, until then, Mr. Flatley, please proceed. I am not going to hold this up.

Mr. FLATLEY. Good morning. My name is Joe Flatley, and I am president and CEO of the Massachusetts Housing Investment Corporation in Boston. I am also the former chairman and currently a board member of the National Association of Affordable Housing Lenders (NAAHL).

You have a copy of my written statement, so I just want to summarize and make a few general points.

First of all, NAAHL supports Chairman Frank's decision to preserve the bank regulators' role to enforce the Community Reinvestment Act (CRA). CRA is an enormous success story and big business, resulting in hundreds of billions of dollars each year invested in low- and moderate-income communities. It annually funds this money into investment in low- and moderate-income communities, financing affordable rental housing, home purchases, charter schools, day care facilities, and small business and micro enterprise loans.

Second, we believe that the regulators should revise the CRA regulations to update the rules so they do not discourage bank participation in community development activities that work to benefit low- and moderate-income communities.

Third, any statutory changes in CRA should be carefully considered, practical to implement, and should incentivize high-impact community development activities that may fall outside of a bank's normal course of business.

Fourth, the new Consumer Financial Protection Agency should have the authority needed to put an end to the problem of the dual-mortgage market that has contributed to mortgage meltdown.

If I could add a few general comments about CRA and the reason CRA has been such a tremendous success.

First of all, I think it is important to remember that the vast majority of lower-income households are renters, and CRA promotes lending and investing in rental housing and community development and not just in credit to consumers.

Second, CRA imposes an affirmative obligation on financial institutions and not just consumer protection on what they may or may not do.

Third, despite its flaws, CRA works, and it works in part due to the leverage of the bank regulatory agencies.

So if we are going to revise the CRA statute, we should do so very carefully so it would do no harm to a program that has been an enormous success.

I am prepared to take questions.

[The prepared statement of Mr. Flatley can be found on page 38 of the appendix.]

The CHAIRMAN. No, we will go to the next witness.

Mr. FLATLEY. Okay.

The CHAIRMAN. Is that mike working now?

Mr. IRELAND. Does this mike work?

The CHAIRMAN. Yes, it does. We can resume the regular seating order. Mr. Ireland?

STATEMENT OF OLIVER I. IRELAND, PARTNER, MORRISON & FOERSTER LLP

Mr. IRELAND. Good morning, Chairman Frank, Mr. Hensarling, and members of the committee.

I am a partner in the financial services practice in the Washington, D.C., office of Morrison & Foerster. I previously spent 26 years with the Federal Reserve System, 15 years as an Associate General Counsel at the Board in Washington. I am pleased to be here today to address the Administration's financial regulatory reform proposals and, in particular, the consumer protection aspects of the proposals.

The current recession was sparked by problems in subprime and Alt-A residential mortgages. As a result, investors lost confidence in subprime and Alt-A mortgage-backed securities. The loss in confidence spread to other mortgage-backed securities, disrupting the flow of funds for mortgage credit and leading to a downward spiral in housing prices and a panoply of new government programs and extraordinary actions by Federal regulators.

Clearly, these events warrant a rethinking of what has worked, what has not worked, and why, in financial regulation. The Administration has proposed to create a new stand-alone Consumer Financial Protection Agency to protect consumers of financial products and services.

Although I strongly support the goal of consumer protection, I believe that creating a separate stand-alone agency for this purpose ignores the increasingly vertically integrated nature of the market for consumer financial services.

A primary reason for regulating consumer financial services is that we believe these services are beneficial for consumers.

Leading up to the current crisis, excess demand for mortgage-backed securities encouraged mortgage origination practices that later triggered the panic in the secondary market. The relationship between these steps and the mortgage lending process was interactive, and neither is fully understood by looking at only one step in the process. In order to foster an efficient market for home mortgages, it is necessary to have an understanding of the entire market, from the consumer borrower to the ultimate investor, and the role of that market in the economy as a whole.

The oversight and regulation of each component of the market needs to take into consideration its effect on the other components. Bifurcating regulation of the market, as is contemplated by creation of a dedicated consumer protection agency, is likely to create conflicts between the agency and prudential supervisors. The expertise of each regulator will be less available to the others than under the current regulatory structure, making each of their jobs more difficult rather than easier and leading to a less efficient, rather than a more efficient, market for home mortgages.

These considerations weigh strongly against creation of a separate agency.

The countervailing argument is, of course, that the current system did not work to prevent the mortgage crisis and that changes are needed. The mortgage crisis has been a product of multiple failures at all levels, both in the public and private sectors. The fact that regulators may have made errors suggests that steps should be taken to prevent similar errors in the future.

However, my view, it does not mean the architecture of the regulatory system is the problem. There is a strong relationship between consumer issues, prudential supervision and, ultimately, monetary policy. In the end, these interests are not in conflict. Rather, they all seek the same goal, a healthy economy and a high standard of living for all Americans.

The goal of regulatory policy should be to ensure that prudential and consumer interest are harmonized, rather than that they are in conflict. The creation of a separate agency is a recipe for conflict, rather than harmonization.

Thank you for the opportunity to be here today to address this important issue, and I will be happy to answer questions.

[The prepared statement of Mr. Ireland can be found on page 45 of the appendix.]

The CHAIRMAN. Next, Mr. Mierzwinski.

STATEMENT OF EDMUND MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP (U.S. PIRG)

Mr. MIERZWINSKI. Thank you, Mr. Chairman, Congressman Hensarling, and members of the committee.

I am Ed Mierzwinski of U.S. PIRG, as are several of the witnesses here. U.S. PIRG is a founding member of Americans for Financial Reform, ourfinancialsecurity.org, a coalition of civil society members across the spectrum supporting broad reform.

My written testimony goes into detail about a number of aspects of the Obama plan, including its new investor protections to provide for greater fiduciary responsibilities on broker dealers, its limits on executive pay, and tying risk to longer-term-pay incentives rather than the greedy, short-term incentives that have helped precipitate the crisis.

I also talk about the aspects of prudential regulation and the notion of a new systemic risk regulator. We point out that if it is to be the Fed, the Fed needs democratization and greater transparency.

First of all, I also want to mention that one area where we think the proposal is extremely deficient is in the area of credit rating agencies. There needs to be much more regulation of credit rating agencies. We also are disappointed that it doesn't include enough on solving the mortgage and homeowner and foreclosure crises.

I want to spend the bulk of my time talking about the centerpiece of the reform, and that is the Consumer Financial Protection Agency. We look at this as a game changer, as a critically important new solution to a failed regulatory system.

The system failed because the regulators had conflicts of interest, and the regulators did not impose the civil penalties that they had available to them. The regulators did not establish rules to protect consumers in the marketplace. Those rules could have helped prevent the mortgage crisis, as everyone knows.

Fourteen years after the Congress gave the Fed authority over the Homeownership and Equity Protection Act to create rules on predatory lending, didn't do anything until after the crisis had passed. Complaints about credit cards reached a fever pitch while the OCC slept, the overdraft loan problem. And so Congress had to step in and act under the leadership of Congresswoman Maloney and this committee.

The regulators finally created some rules on credit cards, but the Congress, fortunately, had already suggested the rules, and then the Congress went further and made the rules into a law.

The issue of overdraft fees, banks are now making the bulk of their income on an unfair business model, overdraft fees where the regulators have allowed them to trick consumers into using their debit cards even when they have no money in their accounts. And the regulators have allowed the banks to change the order that deposited checks and items are cleared so that consumers will face more overdraft charges at the end of the day.

We have a number of other problems that we describe in our testimony, in our written testimony, both this month and last month, where the regulators have simply failed to go after the banks. So the idea of a new regulator that has only one job, protecting consumers, is one of the best ideas this Congress has had. It will not have conflicts of interest. It will not have two jobs to do. It will focus on consumer protection.

But you cannot set the new regulator up to fail. You must keep it independent, and you must also do the other things that the Obama Administration has suggested and that your bill, Mr. Chairman, retains. You must keep the Federal law as a floor of consumer protection and allow the States to go higher. The States are nimbler. Often, they respond more quickly, and they provide good ideas to the Congress.

In my testimony, I outline how in the 2003 FACT Act, Congress allowed the States to continue to investigate identity theft. Forty-six States and the District of Columbia came up with a security freeze model that allows consumers to protect themselves. Giving the States the ability to go further is the best way that we can protect consumers from new threats, because the States can act more quickly.

And the idea that State attorneys general can enforce the law is not balkanization. Providing State attorneys general at the enforcement level the ability to enforce the law, that is an area where you want competition. You want many enforcers. You don't want many rule writers. You don't want many agencies where banks can choose to charter shop to avoid regulation, but you do want a lot of cops on the beat, and you do want to give consumers the right to enforce the laws.

We wish the bill went further on giving consumers a private right of action, but we are very pleased that the new agency will have the authority to ban unfair forced arbitration in consumer contracts.

Thank you.

[The prepared statement of Mr. Mierzwinski can be found on page 55 of the appendix.]

The CHAIRMAN. Ms. Murguia.

STATEMENT OF JANET MURGUIA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL COUNCIL OF LA RAZA (NCLR)

Ms. MURGUIA. Thank you. Good morning.

My name is Janet Murguia, and I am president and CEO of the National Council of La Raza (NCLR).

NCLR has been committed to improving the life opportunities of the Nation's 40 million Latinos for the last 4 decades, and I would just like to thank Chairman Frank and Ranking Member Bachus for inviting us to testify today.

Our Latino families are experiencing record high foreclosures and mounting credit card debt. These are clear symptoms of weak oversight and gaps in consumer protections.

Through our homeownership network, NCLR serves more than 38,000 home buyers and homeowners every year. But, these days, our counselors have shifted their focus from homeownership to foreclosure prevention. We are in the trenches every day fighting to save homes and build wealth in our community.

The fact is, though, that our national banking system is failing communities of color. All Americans need access to bank accounts and credit to move up the economic ladder. A well-functioning system will put families on a path of financial security, not unwieldy debt. It will build wealth that future generations can rely on.

I just want to make three points today. I want to highlight the major weaknesses in our current system, ways in which the Administration's proposal addresses those weaknesses, and just a couple of recommendations to strengthen the reforms.

In regards to the current system, there is overwhelming evidence showing that minority borrowers pay more to access credit than their White peers. For example, Hispanic borrowers are twice as likely to receive high-cost mortgages. Latino credit card users are twice as likely as White cardholders to have interest rates over 20 percent. This trend is repeated among auto loans, bank accounts, and other financial services.

This pattern of overpayment, abuse, and discrimination disrupts the financial stability of low-income and minority communities and impedes their improvement towards the middle class.

Specifically, there are four ways the market fails our families: shopping for credit is nearly impossible; borrowers are still steered toward expensive products, even when they have good credit and high incomes; creditors trap borrowers in cycles of debt; and fraud and scams are rampant.

NCLR applauds the broad reforms proposed by the Obama Administration. The market's breakdown has had a devastating impact that extends well beyond those initially harmed.

As the proposed reforms make their way through Congress, there are four areas of particular importance to all communities of color: The missions of promoting access to credit and protecting borrowers are housed in the same regulatory agency. We agree. NCLR supports an independent regulator that will evaluate new financial products. These evaluations must be completed in light of credit needs of diverse communities.

We want to make sure that we are holding all players in the market accountable. Deception, scams, and discrimination are present in all aspects of the market.

Emphasizing simple, straightforward banking and credit products. This is an important part of this proposal, and we want to make sure that it is included.

The fourth point is making enforcement a priority. The plan creates a meaningful way to analyze and respond to consumer complaints, protects private rights of action, and creates new tools for regulators to assess systemic risk.

The concepts for promoting greater access to credit and increasing protections are not in conflict. Across the country, credit unions, community banks, and nonprofits are leaders in this area. They are creating alternatives to payday loans, offering free checking accounts, and using nontraditional credit information to underwrite loans. They do it while upholding highest standards of safety and soundness and generally offer prime pricing.

I will just close with three recommendations to further strengthen the President's proposal.

We strongly believe that we ought to create an Office of Fair Lending Compliance and Enforcement within the CFPA. Civil rights must be prioritized as part of the agency's formal structure.

We ought to help consumers make smarter financial decisions. Go beyond the generic financial literacy and establish a federally funded financial counseling program.

Improve data collection. Publicly available data, such as those available under HMDA, are valuable tools for holding financial institutions accountable.

Communities of color were clearly targeted by lenders for inferior products, even when they had high incomes and good credit. Hispanic borrowers continue to face real barriers to accessing safe, fair, and affordable credit. We need strong regulators that allow borrowers fair and equal access to the banking system throughout their life cycle.

Thank you, and I look forward to your questions.

[The prepared statement of Ms. Murguia can be found on page 82 of the appendix.]

The CHAIRMAN. Next, Mr. Plunkett.

STATEMENT OF TRAVIS B. PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Thank you, Mr. Chairman, and Ranking Member Hensarling.

We have been asked to comment on the full range of regulatory restructuring proposals in the Administration's white papers, so I will offer comments on four key components of the plan.

First, we support the Administration's fairly strong set of proposals on derivatives as an essential first step but urge you to strengthen it further by driving as much as possible of the over-the-counter derivatives market onto regulated exchanges.

Second, the President's plan should offer much more robust reforms of credit rating regulations than it currently does. For example, reduce reliance on ratings by clarifying that using a credit rating does not afford a safe harbor. The investor, whether it is a pension fund, a bank, or a money market fund, must remain responsible for conducting their own evaluation to determine that the investment is appropriate.

Our second recommendation on credit rating agencies is to increase rating agency accountability by eliminating the exemption from liability provided to rating agencies in the Securities Act.

Our third recommendation for reform to the President's proposal on credit rating agencies is to strengthen oversight by providing either the SEC or an oversight board modeled on the Public Company Accounting Oversight Board the full complement of regulatory tools, including inspections, standard setting, and sanction authority. The regulators, however, should not pass judgment on rating methodologies.

The third major component of the President's plan we are commenting on is the excellent proposals to strengthen protections for retail investors, in particular to create a fiduciary duty to act in the best interest of clients for investment advisors by proposing an examination and reform of the compensation practices that encourage financial professionals to act in ways that do not benefit their clients.

We do have a recommendation here as well, though. We are concerned that the legislation as drafted leaves the SEC with too much leeway to adopt a watered-down fiduciary duty "light" that would deny vulnerable investors the protections they both need and deserve. The SEC has created this problem that has to be fixed, and so Congress is going to have to step in to tell them how to do this. Because, at least until now, they haven't been willing to do so on their own.

Finally, we very strongly support the Administration's proposal to create a Federal consumer protection agency focused on credit, banking, and payment products, because it targets the most significant underlying causes of the massive regulatory failures that have led to harm for millions of Americans.

Federal agencies did not make protecting consumers from lending abuses a priority, as you have heard repeatedly. They appeared to compete against each other to keep standards low and reduce oversight of financial institutions. They ignored many festering problems that grew worse over time. If agencies did act to protect consumers—and they often didn't—the process was cumbersome and time consuming. As a result, agencies did not act to stop some abusive lending practices until it was far too late.

In short, regulators were not truly independent of the influence of the financial institutions they regulate.

It is particularly important that the proposal would ensure that consumer protection oversight is no longer subjugated to safety and soundness regulation at regulatory agencies. Combining safety and soundness supervision with its focus on bank profitability in the same regulatory institutions as consumer protection magnified an ideological predisposition or anti-regulatory bias by Federal officials that led to unwillingness to rein in abusive lending before it triggered the housing and economic crisis.

For example, why curb abusive credit card or overdraft lending that may be harming millions of consumers if it is boosting the bottom lines of the banks you are regulating? This is the inherent conflict that the objections I am hearing from the banking industry to this proposal don't really address. Regulators viewed, often, safety and soundness regulation as in conflict with consumer protection. We now know that, had they taken the side of consumers, they would have better protected the financial institutions they were charged with and consumers as well.

Finally, let me just respond to some of the criticism we have heard by the financial industry. They are threatening broad-scale "Harry and Louise" type ads against this proposal. They have offered an elaborate defense of the status quo. They are minimizing the harm that the current regulatory regime has caused Americans, distorting specifics of the proposals and making the usual threats that improving consumer protection will increase costs and impede access to credit.

Let me finish by saying we are in a credit crunch right now. We are in an economic crisis right now. The deregulatory regime that these institutions championed helped create that, and a consumer regulator will help move us away from that.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Plunkett can be found on page 90 of the appendix.]

The CHAIRMAN. Mr. Taylor.

STATEMENT OF JOHN TAYLOR, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL COMMUNITY REINVESTMENT COALITION (NCRC)

Mr. TAYLOR. Good morning, Chairman Frank, Representative Waters, and other distinguished members of the Committee on Financial Services.

I am John Taylor, president and CEO of the National Community Reinvestment Coalition (NCRC). I am here representing 600 organizations from across the country, and my remarks reflect their views.

The current crisis demonstrates the need for comprehensive regulatory reform and the establishment of a Federal agency focused on consumer protection. If we had adequate protection against predatory lending, then we would have not have had the current foreclosure crisis.

The Administration asserts that consumer protection needs an independent seat at the table in our financial regulatory system and that the Consumer Financial Protection Agency, the CFPA, would be that independent seat. We couldn't agree more. NCRC strongly supports empowering the CFPA to administer and enforce all of the consumer protection and fair lending laws. In particular, we agree with the Administration that the CFPA must have jurisdiction over the Community Reinvestment Act. We urge the House Financial Services Committee to reinsert CRA under the CFPA in H.R. 1326.

Currently, the bank regulatory agencies charged with enforcing the CRA have shown a feeble interest in enforcing this important legislation. Weakened enforcement and less frequent and thorough exams have been the norm.

CRA grade inflation. Just so you understand, in 1990 to 1994, 8 percent of the financial institutions in this country failed the CRA exams, failed to accurately provide services and products to people of low- and moderate-income needs. That was between 1990 and 1994.

From 2002 to 2007, a period of which we had the absolute worst lending where we really needed these lenders in these communities offering safe and sound and quality products, the CRA grades given by these regulators went down from 8 percent to 1 percent.

Near absence of public hearings on mergers. We have had over the last 18 years all of 13 public hearings on mergers of CRA institutions. The opportunity for the public, for Members of Congress, for the press, and others to have a conversation about what this merger means for underserved communities, what the depositors and others who do business with the institutions need to see happen in the event these banks are merged, that process has been all but eliminated.

The bank regulatory agencies have sat idly as they have seen a systematic bank withdrawal from low-income and communities of color. I mean, why is it that the basic banking of choice in minority and low-income communities is payday lenders, check cashers, and pawn shops? Because all these regulators sat by and allowed all those banking institutions to close those branches one after one after one after the next.

By the way, in case you don't know this, we have gone from 15,000 financial institutions down to less than 10,000. In that same period of time, the number of branches has actually gone up but not in low-income and minority communities. And they were charged with enforcing that. Twenty-five percent of the CRA grade is supposed to be the servicing. What is the history of opening and closing branches? Where have the bank regulators been? Asleep at the helm.

Even the Fed's Consumer Advisory Council—this Congress passed a law that required them to have a Consumer Advisory Counsel to advise the Fed board Governors. I had the honor of serving on that Council, but it astounded me to watch all these bankers appointed to the Consumer Advisory Council and then would be in these debates inside the Federal Reserve with bankers to give what is supposed to be a consumer perspective. Hello.

And then, by the way, in case you don't know it, the Fed actually has a Bankers Council, made up of all bankers. Maybe one they will stop to invite consumers so that the banks will have to argue on them.

When better attempts are made to enforce CRA by one agency, such as under the OCC when Eugene Ludwig was the Comptroller of the Currency, he actually really began to really take seriously CRA and the fair lending laws and to really enforce them, what happened? One hundred and twenty national banks changed their charter and went over to the Federal Reserve.

So there is sort of this regulatory arbitrage. You don't like how they are enforcing law over here; go over here. OTS? Oh, gee, we will make a less frequent exam and we will go up to a billion dollars in assets, and we will say you don't really have to have the three exams. We will do a streamlined exam.

There is enough history here. We don't have to doubt it. CRA is a stepchild regulation in these regulatory agencies. We couldn't need more now an agency that really for the first time takes a look at consumer interest, the taxpayer's interest, and assures that their rights are protected and that the Community Reinvestment Act is enforced.

Let me—how am I doing for time? I still have some.

Let me jump ahead and say a couple of things.

We are very pleased that they have some enhanced data that I think will be very helpful to you, to us, and to others in looking at what banks do in underserved communities.

The CHAIRMAN. Ten seconds.

Mr. TAYLOR. Sorry, Mr. Chairman.

This is a letter from the U.S. Conference of Mayors, Mr. Chairman. Thank you for allowing us to put this into evidence.

These are—just in the last 2 days—hundreds of letters that are coming across the country endorsing CRA in this proposal. The

NAACP's National Conference, La Raza, all of these leading civil rights organizations are supporting CRA. It has to be enforced.

Thank you, sir.

[The prepared statement of Mr. Taylor can be found on page 142 of the appendix.]

The CHAIRMAN. Our final witness is Nancy Zirkin, on behalf of the Leadership Conference on Civil Rights.

STATEMENT OF NANCY ZIRKIN, EXECUTIVE VICE PRESIDENT, LEADERSHIP CONFERENCE ON CIVIL RIGHTS (LCCR)

Ms. ZIRKIN. Thank you, Mr. Chairman, and members of the committee.

I am Nancy Zirkin, executive vice president of the Leadership Conference on Civil Rights (LCCR), the oldest and largest human and civil rights organization in this country comprised of 200 national organizations. We are also a part of the Americans for Financial Reform.

LCCR supports a Consumer Financial Protection Agency because it is the key to protecting the civil rights of the communities that LCCR represents. Our interest ties into what has always been one of the key goals of the civil rights movement, homeownership, which is how most people build wealth and improve communities. LCCR and our member organizations have always worked to expand fair housing and also the credit that most people need to buy housing.

Despite the progress since the Fair Housing Act, predatory lending has been the latest obstacle standing in the way, and, of course, it is very much the root of the crisis that we find ourselves in today. For years, LCCR and our allies argued that the modern lending system was working against us.

Just to be clear, responsible subprime lending is a good thing. The problem is that the industry basically threw the responsible out of the window by giving countless numbers of people loans that weren't realistic or responsible. Even worse, many lenders were steering racial and ethnic minorities into these loans, even when they could have qualified for conventional loans.

So, for years, civil rights and consumer advocates have tried to get help from Federal banking regulators, but they ignored us and maintained the status quo. Seemingly, they were more persuaded by the industry's platitudes about access to credit than the growing evidence of what the credit was actually doing.

Since 1994, for example, the Fed has been able to ban predatory loans but waited until a year ago to actually start doing so, after most predatory lenders had already skipped down and left taxpayers holding the bag.

The OTS and OCC were no better, even when it came to enforcing civil rights laws like the Equal Credit Opportunity Act. During the housing bubble years, neither regulator referred cases to the Department of Justice. In one instance, DOJ had to go after an OTS thrift on its own, Mid-America Bank.

I have attached a new brief by the Center for Responsible Lending to my written statement which will be added to the record. The brief contains a lot of compelling horror stories about the lack of financial enforcement. And we all know about the Treasury Inspector General's report on IndyMac, which certainly shows what OTS did—or didn't do, I should say.

The problem with relying on Federal bank regulators to protect our communities is simple. Its structure is inherently designed to fail consumers. When regulators are financially dependent on the institutions that they police, consumer interest will always be squeezed out.

CFPA will break this pattern. In the same way that our Founders realized that sometimes you have to deliberately pick interests against each other in order to create a stable government, the interest of consumers and civil rights on the one hand and bank profitability on the other need to be pitted against each other.

It is obvious that the current system didn't serve either interest. That is why LCCR thinks your legislation, Mr. Chairman, is so important.

Speaking of details, my written testimony includes recommendations to the bill that we think are essential, and also LCCR's Fair Housing Task Force has a series of recommendations that we will be sharing.

Again, thank you for inviting LCCR here today; and I will be happy to answer any questions you might have. Thank you.

[The prepared statement of Ms. Zirkin can be found on page 170 of the appendix.]

The CHAIRMAN. Thank you.

I will begin.

Mr. Ireland, you were at the Fed. In 1994, this Congress passed a law, the Homeowners Equity Protection Act, giving the Fed the authority to take action restricting abusive mortgages, irresponsible mortgages. Nothing happened until Mr. Bernanke became chairman and this committee actually—after the current majority took over—began to act on it, was promulgated. Can you explain why for that period, from 1994 until 1995 to 2007, the Federal Reserve did not act on it? Do you recall any conversations about why that should or shouldn't happen?

Mr. IRELAND. I don't recall any conversations on that specific issue.

The CHAIRMAN. That is the specific issue I am asking about. So that is the answer. You are not aware of any conversations about whether or not to enforce that—what was your position at the Fed?

Mr. IRELAND. I was an Associate General Counsel in the Legal Division.

The CHAIRMAN. So if this was to be implemented, would that have come under your purview?

Mr. IRELAND. It would have come to the Board. We would have looked at it—

The CHAIRMAN. So, apparently, there was not even any interest in doing it.

And the question is, in general, is it your impression that consumer issues like this—Truth in Lending, the Homeowners Equity Protection Act, other areas that the Fed had—did they get equal attention at the Federal Reserve with other regulatory duties?

Mr. IRELAND. They got insufficient attention.

The CHAIRMAN. They got insufficient attention. Thank you.

And I would say this now: It is not simply ideological. Sure, there is an ideology. But there is both an ideology and an institutional role, and I do not think that it is purely personal that they got insufficient attention. When you give people a lot of responsibility, they can do some, but they can't do them all equally. I think it is very clear that that is the explanation, that they—as you acknowledge, and I appreciate—got insufficient attention because the primary mission was seen as other.

Now, I do want to address in this time what I think is an inaccurate analogy between the Fannie and Freddie situation and this one. People have said, well, after all, you had OFHEO and you had HUD and HUD overruled OFHEO.

By the way, I agree with that. In 2004, when Secretary Jackson in the Bush Administration ordered Fannie Mae and Freddie Mac to substantially increase the number of subprime mortgages they bought, I objected. I said at the time—quoted in Bloomberg—that it was a mistake. That was not a favor to these people to push them into these mortgages. My own view consistently was that we should have been doing more rental housing. I was frustrated that we couldn't get enough of that.

And, by the way, when you talk about the housing goals, it was the home purchases for people who couldn't afford it rather than rental housing that were the cause of these problems.

But here is the point. Everybody agreed by then that OFHEO was too weak a regulator. In fact, in 2005, this committee did recommend a change. Now, many of those critical of Fannie and Freddie opposed the change.

Mr. Oxley, looking down on us, put the bill through. There was then a dispute among the Republicans in the House, the Republicans in the Senate, and the President.

I must say I am flattered by those who think that I somehow was the arbiter of this intra-Republican dispute and that I was responsible for the outcome. Would that I was responsible for mediating Republican disputes. We wouldn't be in Iraq today. But that is another story.

In any case, what we had was, in 2007, the passage out of this committee and onto the Floor of the House a tough regulator. And, in fact, people have said, where is your regulation of Fannie and Freddie? Well, the fact is that we did pass the regulation. Unfortunately, in the United States Senate, it was bogged down. It didn't pass until 2008. But people have said, how can you do this without doing Fannie and Freddie?

Well, one of the key points that the Bush Administration wanted was to put it into conservatorship. We have done that. The Fannie and Freddie today is nothing like what it was before in part because too long had gone by without legislation and in part because of the legislation we adopted.

But the point is this: The weakness of OFHEO—in fact, people have said, well, see, you had a consumer regulator, HUD, and a safety and soundness regulator, OFHEO, and that caused the problem. But the very people making that argument are the ones who argued that OFHEO was too weak a safety and soundness regulator. They explicitly, in fact, disavowed the comparison between OFHEO and the OCC and the Fed.

In other words, it is not the case that we tried having a separate safety and soundness regulator and a separate consumer regulator. Those making the argument today argued correctly that OFHEO was not in the class of OCC, was not in the class. At first, I didn't think it had to be. I later changed my mind by 2005 and thought it should be because of these subprime mortgages.

But the argument that because we had an OFHEO and a HUD that means you can't do these together misses the point that the big problem was not that you had a separate consumer and safety and soundness regulator but that the safety and soundness regulator was too weak. And people who argued again that it was not comparable to the bank regulators can't use that now as an analogy. I think we have tough bank regulation, and I think we can have a system in which we also get tough consumer regulation.

The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

Clearly, the thrust of the Administration's plan and as illustrated by the chairman's bill is that financial service firms produce—I think the Administration used this phrase—plain vanilla products. Is everybody in favor of the concept that financial firms produce at least one plain vanilla product? Is that something—is anybody against that? I assume that means everybody supports it?

Ms. ZIRKIN. Well, if I could comment on that, Mr. Hensarling.

We are in favor of having transparency. We are in favor of having a menu of options. Alt-A mortgages were not a menu of options.

Mr. HENSARLING. So you are a Baskin-Robbins kind of—

Ms. ZIRKIN. We believe that it won't necessarily be only plain vanilla, but the consumers must have a choice.

Mr. HENSARLING. Well, if you end up essentially saying that you have a semi-safe harbor for a plain vanilla product and you don't for any other product—we had testimony here just yesterday of a number of banks, including our community banks, that you want to have step-up lending, saying they are not going to roll out new products because they fear that these products will be found unlawful. At least all the people who are in production of the ice cream, the financial ice cream, are saying, you know what? The incentive structure is we are going to produce plain vanilla.

So if the impact—I know how it may look to you on the drawing board, but if the impact is we end up with plain vanilla products after—assuming this legislation passes—would it change your mind about the legislation?

Mr. PLUNKETT. Mr. Hensarling, I don't think that will be the impact. The stated goal and the obvious goal is to encourage choice.

Mr. HENSARLING. I appreciate that. But, again, there is testimony that is different.

Then I would ask the question, what exactly is a plain vanilla product? I had my staff go online, and they pulled up hundreds and hundreds of recipes for plain vanilla ice cream, the first one being Thomas Jefferson's handwritten ice cream recipe. Apparently, the President didn't have terribly good penmanship. I have a hard time reading it.

I have one vanilla ice cream recipe calling for egg whites. I have another ice cream recipe calling for egg yolks. I have an ice cream recipe, vanilla ice cream, calling for whole milk. I have one calling for Eagle Brand milk. Here is one for half-and-half. One calls for vanilla extract, another for vanilla beans, and the list goes on.

My point is, number one, not even—not even can you define precisely what is a plain vanilla product. People are different in this Nation. And so now, because people have trouble with subprime mortgages, all of a sudden we are going to create this huge government leviathan which is going to have the opportunity to ban types of mortgage loan, personal loans, car loans. They will have the ability to now regulate loan servicing, check cashing, debt collection, and the list goes on and on.

Well, let me ask you this. Some people will say, okay, here is a plain vanilla product. Credit cards used to be plain vanilla products. Now they are very complicated entities. But when I look back at a plain vanilla credit card product 20, 30 years ago, it was one that charged an annual fee, 25, 35, 40 bucks. There was no cash back. There were no frequent flyer miles. Everybody paid the same high interest rates, far higher than today. Is that the kind of product that your members would like to have?

Mr. TAYLOR. Mr. Hensarling, if I may, I think your assumption is wrong, and your analogy to food is wrong. All that is being asked here is that you take the laws that Congress has passed and make sure that there is an agency that protects consumers and enforces those laws.

Mr. HENSARLING. Mr. Taylor, it is my time.

But, with all due respect, you are giving an agency the power to ban products, taking away consumer choice. How do you protect the consumer by taking away their choice? You may disagree, but others believe that you will squash innovation. We will not see the next ATM. We will not see the next set of frequent flyer miles. And so if you think that the members of your organizations are having trouble getting credit now, wait until this legislation is passed, and then you will see real problems.

I see my time is up. I yield back.

Ms. WATERS. [presiding] Thank you very much.

I will recognize myself for 5 minutes.

Yesterday, in talking with representatives of the banking community, we were admonished for not supporting adjustable rate mortgages. And basically what they said is, you guys don't understand adjustable rate mortgages and how they have helped so many people. It is the same argument we get a lot when people say we don't understand subprime lending. We have never said we are against subprime lending, but there are so many iterations on the subjects.

I would like to ask—perhaps you could help me, Mr. Mierzwinski—for a definition of these adjustable rate mortgages.

As I understand it, there are option ARMs, and there are products that could reset 6 months, 1 year, 2 years, and when the mortgage is negotiated—and many of these adjustable rate mortgages. They don't look at whether or not the homeowner will be able to afford the mortgage 1 year or 5 months or 5 years from the time that they sign on to these mortgages. And the formula for the increase possibly in interest rates allows something called a margin on top of the interest rates. So you could have an increase in interest rate, plus they can mark up this mortgage another 2, 3, 4 percent. Could you help us with a description of the harmful adjustable rate mortgages?

Mr. MIERZWINSKI. Well, Congresswoman, I would say you have exactly identified the problem, and the new agency would have the opportunity to hold hearings on and to regulate some of the most unfair aspects of these mortgages.

As you pointed out, people were qualified based on their ability to make the payments only in the first year, not after the option kicked in, the so-called 2/28s or the 3/27s, and the regulators looked the other way. We want a regulator that will look at the product, and we want a regulator who will then say certain aspects of this product, not the product itself necessarily, should be made illegal.

We regulate toasters to make sure they don't catch fire. We are not banning toasters with the Consumer Product Safety Commission, and we are not banning adjustable rate mortgages with the Consumer Financial Protection Agency. We are simply saying they have to be safe and we want the innovations to be within the circle of safe products.

Ms. WATERS. And, again, when many of these adjustable rate mortgages reset, this margin that they put on top of, what I understand, the existing interest rates could be flexible in terms of how much they charge. They could be 2 percent, 3 percent, 4 percent. Are you familiar with that?

Mr. MIERZWINSKI. Congresswoman, I am generally familiar with that, and I can say, again, that there may be unfair aspects as to the way that the margins reset, the way that they are disclosed to consumers and the calculation of what the consumer's interest rate and monthly payment will be and how often that they can change. And that is really something that the current regulators have not had been on top of. They just absolutely have not been on top of it. There is a Wild West out there, if you will, and that is why we are looking for a new agency to tame the Wild West.

Ms. WATERS. Mr. Ireland, you talked about the complications of creating such an agency and you talked about vertically integrated markets in harmonization, whatever that is. But I want to know about Alt-A loans, because I am very interested in regulation of these products that I think have been so harmful to our homeowners. Would you discuss for me Alt-A loans and why they must be regulated, what went wrong with them, and how they were misused?

Mr. IRELAND. The classic Alt-A loan is something called a no-doc loan, and it is a loan where you do not obtain the same kind of documentation as to income and ability to repay that you would on a conventional mortgage. And in a limited number of circumstances that may make sense because of the nature—somebody who is self-employed and the nature of the business that they are in.

The problem we had is that kind of loan was offered to a great many more people than it was appropriate for, and we had a proliferation of no-doc loans. My father-in-law got a no-doc loan, and he had no business with it. We eventually had to bail him out of his mortgage.

So I think you had a product with a limited use that was being misused by the lenders who were offering it.

Ms. WATERS. Did any of the regulators say anything about that product being misused?

Mr. IRELAND. There was regulatory guidance issued, and I think some of the Federal regulators have admitted somewhat late in the process about how to address Alt-A and other unconventional mortgage products. That probably should have been done sooner rather than the time it was introduced.

Ms. WATERS. And would you conclude that is typical of what regulators did not do?

Mr. IRELAND. I think regulators were behind the curve on a number of consumer issues, particularly the mortgage issue.

Ms. WATERS. And that is why we need some kind of consumer protection. Would you agree?

Mr. IRELAND. I would agree that we need to enhance consumer protection. I don't think this agency is the best way to do that.

Ms. WATERS. All right. Thank you very much.

Mr. PLUNKETT. Madam Chairwoman, on Alt-A loans, one thing we heard yesterday from the banks was a lot of finger pointing. They said, we didn't create these problems. But we do know that the national banks regulated by the Office of the Comptroller of the Currency did issue a lot of Alt-A loans that do have very high default rates.

Ms. WATERS. Thank you very much.

Mr. Posey?

Mr. POSEY. Thank you very much, Madam Chairwoman.

The far-reaching tentacles of the proposed Consumer Financial Protection Agency would appear to have almost completely unfettered jurisdiction over advertisement, marketing, solicitation, sale, disclosure, delivery or account maintenance or supervising of deposit taking activities, extension of credit, loan acquisition, brokering or servicing, real estate appraisal, title insurance, credit insurance, mortgage insurance, real estate insurance, services including title insurance, leasing of personnel or real property, acting as an agent, broker or advisor in such activity, credit reporting services, guaranteed check services, money transaction, business services, stored value instruments, i.e., debt cards, certain financial data processing, transmission of storage services, debt collection services, investment service not subject to SEC or CTFC regulations, financial advisory services, credit counseling or tax planning or preparation, financial management advice, financial custodial services, and numerous other financial activity related services specifically identified by some rule that they would develop, which my staff has not been able to ascertain yet because that remains unclear.

And so, to paraphrase in another context exactly what Congressman Hensarling said before, just what exactly is acceptable? Or do we want this agency to list every possible transaction in detail that is acceptable and then figure out every possible transaction and list it in detail as being unacceptable?

I mean, do we want to turn into omnipresent defenders of nonexistent problems not suffered by 90 percent of the people? I mean, can't we focus a little bit better on precisely maybe a standard of care that should be offered by somebody who is in these positions of fiduciary relationships with clients, rather than kind of turning the entire business world upside down to try and so broadly brush the choices that people have?

And I see all of you anxiously jumping for your buttons. Mr. Plunkett, if you could take a minute, and then we will give Mr. Taylor a minute.

Mr. PLUNKETT. Thank you.

For the most part, the new agency doesn't get new authority. They get new authority in one area, but this is an authority that exists under 17 existing laws or is very similar to unfair and deceptive acts and practices authority the Federal Trade Commission has or it is regulated at the State level. It is mostly a consolidation. It is a streamlining, actually. It is not a new layer of bureaucracy at all. And it is a minimum standard of the States, where necessary—and I think in many cases they won't find necessary—could exceed if there is a local problem.

Mr. POSEY. You don't anticipate any new rules being written?

Mr. PLUNKETT. Well, I think the idea is that, first and foremost, it will do research. It will be focused solely on consumer protection, and rules should follow good empirical knowledge of the marketplace. If we had had that on subprime loans, for example, we might have seen some rulemaking earlier on.

Mr. TAYLOR. I agree. I think all you are talking about is having a consumer protection agency that essentially enforces the laws that this Congress and various Congresses and Presidents have signed.

Yes, there will be rulemaking, as there is for any other agency, but this Congress as well will have an impact on that if you perceive that they go too far or not too far. I mean, that is the way the system works. This notion—

Mr. POSEY. Now, let me just say—the question that begs for an answer—back to Mr. Plunkett's response. Why do we expect a new agency of bureaucrats to do the exact same jobs he said that 17 agencies of bureaucrats have failed to do properly before? What is it about this new brand of bureaucrat that we are going to have that—instead of looking for a job description, they are going to actually do a job?

Mr. TAYLOR. Fair question. And I think the difference is you will actually have an agency whose primary focus is to ensure that the American taxpayer, the consumers, their interests are protected, as opposed to worrying about the bank or worrying about—

Mr. POSEY. So in the sake of streamlining, as Mr. Plunkett said, do you agree then that if we have this new agency with these all-inclusive powers, which are really just powers previously delegated to other agencies, we can now get rid of the other 17 agencies?

Mr. TAYLOR. No. They have other functions to serve. Obviously, the bank regulators, monetary policy, safety and soundness and other very important roles to play.

But, clearly, this has been the stepchild of legislation. That is why we had all this predatory and abusive lending, and that is what this is aimed to stop.

And I just want to, for Mr. Hensarling as well, none of us are opposed to competition. I think competition will remain robust. But we should have a free market that has a rule of law in it that ensures fairness and doesn't allow for a free market that is free to abuse and free to fraud and free to do things that hurt consumers, and I think that is what this agency gets at.

Mr. POSEY. And I think we agree, but somebody needs to define pure vanilla. And the agencies that have those authorities now—thank you for your indulgence, Madam Chairwoman—should be capable of doing that, we think.

Mr. TAYLOR. I wish that were true, sir.

Ms. WATERS. Thank you.

Mr. Mel Watt.

Mr. WATT. Thank you, Madam Chairwoman.

We were down here debating which one of us was more or less prepared. So let me start by commercializing a little bit to let all of the members of the committee know that this afternoon at 2:00 there is going to be another one of these hearings focused primarily on the consumer protection, financial protection agency as it relates to taking powers away from the Federal Reserve and transferring them to this new agency.

And while I don't normally do this, because I think this, obviously, will be part of the record in the subcommittee this afternoon, I did want to offer for the record a statement that has been prepared by Patricia A. McCoy, Director of the Insurance Law Center, and George and Helen England Professor of Law at the University of Connecticut School of Law, that more concisely than anyplace I have seen goes back and talks about the regulatory history in which we are operating, how we ended up with this race to the bottom, as opposed to having true regulation, the regulatory failure of the Federal Reserve, the OCC, and the OTS and how the race to the bottom kind of encouraged banks or other regulated institutions to seek the least common denominator and how this new consumer protection agency, financial protection agency would probably address this in the best way.

So if I can get unanimous consent to submit that for the record and encourage my colleagues to read it, it is one of the best summaries of this I think I have seen.

Ms. WATERS. Thank you very much, Mr. Watt. Without objection, it is so ordered.

Mr. WATT. Now, we had a hearing on this yesterday from the financial services industry perspective, and one thing I did come away convinced of was that, to the extent that you leave consumer protection in the existing regulatory agencies responsibility, any responsibility for it, and take part of the responsibility and give it to this new consumer protection agency, there is possibility for conflict between the existing regulators and the new agency.

Now, their solution to that was not to create the new agency. My solution to it is not to leave any of the responsibility over on the existing regulators' side or to be absolutely clear on what that relationship is.

So I would like, not here today, but for you all to go back and look at the interplay between what we are leaving over there on the consumer protection side in the existing regulatory agencies and what we are giving to this new agency so that we make sure that the possibility of conflicts that so many people have complained about don't exist in the consumer protection area. Do that outside the context of this hearing.

Mr. Ireland, the other thing I keep hearing is that there is this potential for conflict between consumer protection responsibilities and safety and soundness regulators, even if you separate these things. Give me one example of where there would be a conflict between the consumer protection person or agency and an existing regulator on safety and soundness.

Mr. IRELAND. Well, you can—

Mr. WATT. One concrete example. No theory. Just give me one example where you see that would happen.

Mr. IRELAND. I think the State of Georgia's predatory landing law—

Mr. WATT. I am talking about in our Federal structure. Give me one example where that would be a problem.

Mr. IRELAND. In our Federal structure today, those responsibilities are carried out in the same agencies, and they have—

Mr. WATT. I understand that, Mr. Ireland. That is not what I am asking. I am asking—I keep hearing that there is this potential for conflict between a consumer protection agency and the safety and soundness agency. And I don't understand that. Tell me one example where that would play itself out.

Mr. IRELAND. With all due respect, I can give you a hypothetical example you asked for.

Mr. WATT. No. I want a real example, because we are operating in the real world here.

Mr. IRELAND. I offered you a real example.

Mr. WATT. We have had all of these things operating in the same agencies and people keep telling me that there is this amazing conflict between consumer protection or a potential for conflict between a consumer protection agency and safety and soundness regulator. I don't see it. And I don't—I just want you to give me an example.

Mr. IRELAND. If I, as a consumer protection agency, create a mortgage that can't be securitized, I have a problem.

Ms. WATERS. I would love for you to have an opportunity to pursue this, Mr. Watt. The time is up. Give him time to think about it, and before this hearing is over, he can help you.

Mr. WATT. We are going to explore that issue at my hearing this afternoon.

Ms. WATERS. Mr. Paulsen?

Mr. PAULSEN. Thank you, Madam Chairwoman.

And maybe one of the areas we could discuss a little bit, you could certainly go into Freddie and Fannie a little bit if you want to talk about where there is some potential issues there that the gentleman was just talking about.

Let me ask you this, Mr. Ireland. The Fed has often been criticized for not acting or acting too slowly in missing or issuing, implementing regulations for consumer protection on credit cards, on mortgages, etc., etc. Warren Buffet once said that the troubles of the mortgage market that you mentioned, it is only when the tide goes out that you discover who is swimming naked. And is it reasonable to think that a Consumer Financial Protection Agency—is it really reasonable to think that they would be able to assess the future risks of consumer financial products any better than the Federal Reserve or any other present regulatory agency if there is to have that focus?

Mr. IRELAND. I think structurally the anticipation would be they would not do as good a job. They do not have access to the same kind of information.

Mr. PLUNKETT. It is not rocket science. There was evidence 10 years ago that subprime mortgages were defaulting at a higher rate than regular mortgages. If those agencies had bothered to look, do research that was available in the public realm, if it was a priority, they could have done it. That is why we need an agency focused just on consumer protection.

Mr. PAULSEN. Going back to what Mr. Posey had mentioned earlier, he talked about the 17 different commissions or agencies that were charged with this. And it is interesting as I talked to one of my banks back home—and I just have this one chart and it lists a number of the regulatory burdens and I am not going to read every one as he had gone through each of these agencies that they have to deal with. But it is extremely frustrating I think for a lot of these organizations, because we hear about the frustrating flow of credit that has to go to small businesses for job creation, which we don't see happening right now.

And this chart clearly shows and illustrates the burden that is posed on hundreds—or hundreds of these regulations that are posed and many of which are already dealing with consumer protection agencies. So I understand the goal of having it be smart, having it be strategic to make sure these consumers are protected, but I am not convinced that, at least given the details that have yet to emerge on this one, the devil is in the details, that we are going to be able actually fix this; and, if anything, I think we are going to be able to potentially make it worse.

If a bank is engaged in unscrupulous lending, we need to find them out. Safety and soundness, most critical, and that should be the focus I think of all regulation.

What I would like to do is actually yield my time to Mr. Hensarling, if I could, because I know he had one follow-up question.

Mr. HENSARLING. I thank the gentleman for yielding.

And the gentleman did cover one point when my colleague from North Carolina was searching for an example. I mean, nobody has to look past the fact that HUD had product approval, consumer protection for the GSEs. We had somebody else to serve as the safety and soundness regulator. Now we have the mother of all bailouts.

Mr. PLUNKETT. Mr. Hensarling, that example doesn't really work.

Mr. HENSARLING. Mr. Plunkett, you do not control the time here. Thank you very much. And I don't think anybody has asked you a question at the moment, but I am sure that someone else will give you an opportunity to speak.

So, with all due respect, I believe, as do many others, that, frankly, it is a perfect analogy and one why we think it is very harmful, very harmful inclusion in this legislation.

I thank the gentleman for yielding. I will ask another question, unless the gentleman wants his time back.

Ms., is it "Murguia?"

Ms. MURGUIA. Yes.

Mr. HENSARLING. I had a question for you.

In your testimony, I believe you spoke about the Hispanic community needing access to credit for economic upward mobility—I don't want to put words in your mouth. That is essentially, I believe, what you said—and that there is essentially a disparate overpayment by many racial minorities on certain credit products.

Under the legislation that is being proposed, the white paper—the White House says that, "the CFPA should be authorized to use a variety of measures to help ensure alternative mortgages were obtained only by consumers who understand the risk and can manage them."

Assuming that is the Obama Administration that wrote this paper who would end up appointing the five panel members, this seems to open the door to having one group of consumers being authorized to have one type of mortgage and another group of consumers being authorized to have another. Is that not a type of discrimination and does that not trouble you?

Ms. MURGUIA. I certainly didn't interpret it that way. I think what we are saying is that there are clearly disparities that data can support in the system today. We believe this agency will help bring more focus, and we are really looking at a commonsense standard here. And that is the system is very complicated and far too complex for even the savviest of consumers to navigate and many rely on professionals to help them navigate these systems and many still trust and have trusted their loan officers, brokers, and realtors. All we are asking for is that there be some standard of accountability, some standard of oversight, some standard of transparency to make sure that we can have equal enforcement here and lessen that disparity.

Mr. HENSARLING. Thank you. And I thank the gentleman for yielding.

Ms. WATERS. Thank you.

Mr. Gutierrez?

Mr. GUTIERREZ. Thank you so much.

First of all, I have a question for the entire panel, and I would like a simple yes or no, since I only have 5 minutes. I would like to ask you, would you support nonbank financial institutions being subjected to the Community Reinvestment Act after we establish the CFPA? Just a quick yes or no.

Ms. MURGUIA. Yes.

Mr. FLATLEY. Yes.

Mr. IRELAND. I don't know how you do that.

Mr. GUTIERREZ. Okay. You don't know how you do that.

Mr. FLATLEY. Yes.

Ms. MURGUIA. Yes.

Mr. PLUNKETT. Yes.

Mr. TAYLOR. Most definitely.

Ms. ZIRKIN. Yes.

Mr. GUTIERREZ. Well, thank you. I just wanted to—

And I want to say to my friend, Janet Murguia, as you know, we have been working for nearly a decade on the basic Federal consumer protections and disclosures for remittance consumers. I think with the CFPA, we have an opportunity to finally put those protections in place. And I just want to ask you, do you support the idea of giving the CFPA jurisdiction over consumer protection aspects of the remittance industry?

Ms. MURGUIA. Well, I think that we—we have never—I am trying to remember in terms of that.

Mr. GUTIERREZ. They don't have a Federal regulator right now.

Ms. MURGUIA. We need some oversight on remittances. We would like to see some ability to regulate that area, and we are very interested in making sure someone will take a look at that. So I think this would be a good place for that to happen.

Mr. GUTIERREZ. What I am going to try to do with the help of others is see if we can't, in the context of this bill, put those protections in so that they are already authorized to do that and to cover that. And they have a Federal—

I want to say to—I have so many friends up here. I want to say to my other friends, to Travis Plunkett and Mr. Mierzwinski, thank you. It is great working with both of you on the Credit Card Bill of Rights. I look forward to working with you on other successful consumer advocacy issues.

I want to make it clear for the record, you know, that we are friends, we are allies, that we work together. Disclosure is always the best policy, transparency.

So I want to ask you both, both of your organizations have indicated on several occasions that anything short of a 36 percent usury cap on all loan products would be ineffective; and many times representatives from the CFA have touted President Obama's support of a 36 percent rate cap. But, unfortunately, the language the White House sent to Congress explicitly prohibits the CFPA from implementing usury caps without legislation requiring such caps. So, contrary to all our hopes and expectations, the Administration essentially has handed the issue back to Congress.

Do you both agree with that basic statement? Do both of you, Mr. Plunkett and Mr. Mierzwinski?

Mr. PLUNKETT. Yes.

Mr. MIERZWINSKI. That is correct.

Mr. GUTIERREZ. So we all know that to get it, it has to come from Congress. But aside from the 36 percent cap for pay loans for military families, which for the record started with my amendment in this very committee, Congress has not had an appetite for passing usury caps.

As an aside, I met yesterday—I had an opportunity to meet with an Australian senator who also serves as the assistant treasurer in the current government, and we discussed payday lending there at length. And he indicated to me that they have put caps of 48 percent, and the payday industry has somehow gotten around them. He indicated that rate caps alone have not adequately dealt with the payday industry in Australia, and so he says they just simply extend the terms of the loan. But what they will be doing soon is experimenting with an ability to pay standard in conjunction with a rate cap.

So I would like to ask both of you, do you think it is a good idea for the CFPA to look at and implement ability to pay standards for products such as this industry?

Mr. PLUNKETT. Thank you, Mr. Chairman. That is at the essence of what this agency should be doing.

Mr. GUTIERREZ. So you agree?

Mr. PLUNKETT. Yes, sir.

Mr. GUTIERREZ. I am sorry. Since this is only 5 minutes and I want to coordinate my work in 2 weeks during this 5 minutes right here—

Mr. PLUNKETT. I would just add, on a lot of different credit products.

Mr. GUTIERREZ. Agreed. On a lot of different credit that we should—this ability to pay issue is a really big one.

Let us just assume for a second that this fine committee and the House doesn't adopt the 36 percent cap, which doesn't say we are not. Maybe we will have the ability to do that and get members here to do what the Senate has failed to do. Do you think in terms of payday lending—I want to ask both of you, would you support a ban on rollovers for payday lenders, eliminate any rollovers for payday lenders?

Mr. PLUNKETT. We supported rollover bans and restrictions. That have just been—

Mr. GUTIERREZ. I am sorry. I just wanted—if I could just have 30 seconds? Just unanimous consent?

Mr. MIERZWINSKI. I would agree that the rollover bans have been evaded. But this agency might be able to figure out a way. Even if it is not given the usury cap right, unless Congress adds it in, this agency might be able to figure out a solution to that.

Mr. GUTIERREZ. So I just wanted—because it is 30 seconds. You see how 5 minutes goes. When you try to help consumers, 5 minutes are less than 5 minutes, and they go fast. Anyway, so I have 30 seconds.

So I want to say, so I would like you guys to, please, if you can put in writing yes or no, maybe we should extend the payment plan from 2 weeks to 3 or 4 months instead of 2 weeks back. Maybe we should set a national registry so you can only have one payday loan at a time and you can't have two, and we can start—and a database to enforce that.

So that, in essence, if we cannot get this 36 percent, which I know is the standard, which both of your organizations have established but that we know the President hasn't promoted here, isn't in his bill, but we are going to see if we can get—I want to see what other things we can do in the interim period to help consumers.

Ms. WATERS. Thank you.

Mr. Royce?

Mr. ROYCE. Thank you, Madam Chairwoman.

I think if we reflect for a minute, it was in 1992 that the GSE Act was passed by the Democrat side of this institution, and that GSE Act started the affordable housing goals. That was the legislation that basically set up a system and HUD did the mission enforcement on this in which Fannie and Freddie went out and bought subprime loans and Alt-A loans in order—in order to meet that requirement.

Now, we all know that OFHEO was a weak regulator, but I don't think that is the point. I mean, HUD was a strong regulator here, and HUD was enforcing this mission, and in point of fact when we tried to do something about it—and I specifically carried legislation on the House Floor in 2005 to try to allow OFHEO to become a stronger regulator, to allow them to do what the Fed wanted them to do, which was to deleverage these portfolios. Because, at the time, they said, this is a systemic risk to the entire financial system globally because of what is happening with the GSEs being leveraged over 100 to 1.

So this was the desire by the regulators who saw the problem. But HUD did not see that problem, and our colleagues didn't see that problem. The GSE example highlights the inherent conflict of interest that arises when you bifurcate these regulatory responsibilities as they were bifurcated between HUD on one side and OFHEO on the other; and this is why all of our safety and soundness regulators, every one of them, have expressed concern over the idea being put forward in this legislation.

The altruistic yet misguided affordable housing goals put Fannie and Freddie at risk; and, yes, indeed, as the Fed said, it put the financial system at risk by 2005 because of the political interference in this process that pushed those downpayments down to 3 percent, to zero percent. You had 30 percent of the loans that year being people who were flipping homes, never taking possession of those homes, pushing that market up, up, up, ballooning that market up, up, up.

And, yes, the Fed saw that coming, and we weren't able to do anything about it because of the political pressure to prevent an effective regulator from taking the action necessary. And this wasn't realized I think by the general public until after the mortgage meltdown.

You task a separate agency with this mission, then you have to expect that altruistic policies, seemingly altruistic policies that they put in place are going to lead to unintended consequences because the market isn't deciding these factors anymore. This is being decided by political pull. This is being decided by political interference in the market, which is exactly what happened.

Now, Mr. Ireland, we have the commentary of Sheila Bair, head of the FDIC, against this approach of this separate agency. John Dugan, head of the OCC, against it. James Lockhart, FHFA, he is against this step. Donald Kohn, the Fed's Vice Chairman, strongly against this step. They have all expressed concern over this idea. Why do you think that is?

Mr. IRELAND. Well, I think that, as I said in my testimony, the issues of safety and soundness and the issues of consumer protection are not separate issues. You are trying to deliver good products, and by separating the functions you tend to frustrate that.

Mr. Watt asked for an example. If you go back to the 1970's, fixed rate mortgages and a rising interest rate environment were a very dangerous product for the safety and soundness of financial institutions. And if you have an agency, a consumer protection agency that creates a preference for fixed-rate 30-year mortgages, you have a safety and soundness problem if interest rates rise over time and institutions have to fund themselves at higher rates than they are earning on those mortgages.

Mr. ROYCE. Now let me raise another concern I have here, and that is, with the legal liability exposure for businesses, that really would be on a massive scale. Right now, we have 95 percent of the lawsuits worldwide filed here. Maybe we can get it up to 99 percent. Maybe we could.

Mr. Ireland, here are some of the highlights?

It applies a new and high reasonableness standard for the sale of financial products to consumers.

It leaves open the potential for an increase in statutory damages for existing private rights of action.

It applies a duty of care for financial products. Is it good for the buyer, in other words.

It recommends the elimination of mandatory arbitrary provisions in consumer financial products and broker/dealer investment contracts.

Do you share any of my concerns with the amount of litigation that is going to come out of this?

Mr. IRELAND. I think that the people who are most likely to benefit from this law as originally drafted are the lawyers.

Mr. MIERZWINSKI. Madam Chairwoman, can I quickly respond? I just want to say that the mandatory arbitration—the Attorney General of Minnesota filed a lawsuit against an arbitration mill this week where she alleged all kinds of violations of the existing consumer laws and that the company was essentially in bed with the banks and tricking consumers into signing forced arbitration contracts.

The mandatory—the statutory damages in current law were written in 1968 and have been exceeded by inflation by about 5 times. This is not going to benefit the lawyers. This is going to benefit the public.

Ms. WATERS. Thank you.

Mr. Meeks?

Mr. MEEKS. Thank you, Madam Chairwoman.

First of all, I want to agree with Ms. Zirkin, who stated in her statement that I am not against subprime loans that are responsible. Those kinds of loans can help individuals own a home, which I still believe is the greatest opportunity for wealth creation that we have and will lower the gap between those who own and don't have, particularly in regards to African Americans, Latinos, etc.

The problem comes in is where the responsibility leaves, and we get into areas of predatory loans. And I think for a long period of time many individuals, on this side of the aisle, at any rate, were yelling and screaming that we should ban predatory lending because predatory lending put many of the individuals in the situations that they are currently in.

Now, if it is someone who is flipping homes, that is a whole different person. We are talking about individuals who bought these homes, trying to participate in the great American dream of homeownership so they can raise their kids for a long period of time. And, to me, what we are simply trying to do here is to say, yes, we have to have safety and soundness regulations, but we also have to have someplace to go where there may be some predatory lending going on. This consumer regulatory agency can overlook and can oversee what is going on so we can make sure that the product is not having a negative impact overall.

For example, there is a debate that is going on as to whether or not—you know, yield spread premiums. From my idea, we should ban yield spread premiums, because I don't see what the utilization of them are except for costing individuals more money.

Now, it would seem to me that we could debate that. Because on one side, if you just leave it to the bankers and the financial institutions who—they are—part of their role is to try to make as much money as they can. But we need someone else whose role is to try to make sure that we are not doing it at the backs or at the expense of other individuals. And I think what the President's plan is simply trying to do is say, let us lay it out.

And what I would think that—I had hoped yesterday and what I may comment to those who testified yesterday is, as opposed to people lining up dead set against something, I think it helps them. It would help their image if they came with some recommendations on how we could make sure consumers are also protected. Because one of the biggest problems in America right now is it is us against them, and we need to find a way to bridge that gap. And, to me, it makes sense that this is an avenue to bridge that gap so Main Street doesn't think that Wall Street is against them.

But if anytime you talk about something of that nature without saying, well, here is my recommendations, how we can work it again, then it looks like Wall Street is against Main Street. And we have to figure out how we bridge that.

I thought that Ms. Zirkin's testimony was right on the money in that regard. I think that is the direction we need to go in.

I think that the conversation that we also need to have is—because I heard some say it needs to be an independent agency. And it gets to the question of how do we pay for it. Should it be a situation where there is a direct appropriation from Congress? Should it be by fee? Who—I hadn't heard that. Let me just throw that out. Anyone have any recommendation of how we should pay for it?

Mr. PLUNKETT. It is a really crucial question, Congressman.

What the Administration has proposed is a good start. First, they allow congressional appropriations but say that the main business of the agency should be funded by industry assessments. What they see happening is that those assessments which are now going to the other banking regulators would then be applied to this agency and so there would not be additional costs. The consumer groups thinks there needs to be a mix of funding so that the agency is not reliant on any one source, So it is stable and adequate.

Mr. MEEKS. Everybody agrees with that?

Mr. MIERZWINSKI. I would say, Congressman, we totally agree.

For example, just to be clear, OCC and OTS are virtually 100 percent funded by industry assessments, and that is part of the corruption and conflict of interest in the system, because banks can charter shop, move around. We think that this agency, because you couldn't move around, would not face that conflict of interest. But diversifying the funding, not putting all the eggs in one basket is the way to go to protect it against political or industry interference.

Ms. WATERS. Thank you very much.

Just one correction before we break and recess for the next seven votes. Mr. Royce said that Sheila Bair was opposed to this agency. She is not opposed to this agency. She has suggested that their primary focus should be on the nonbanks that have not been regulated and it should serve as a backup to what they are doing in the other regulatory agencies. So it may not—many may not agree with that, but that is a difference between her being against the establishment of this agency and her deciding that it should do something else.

Mr. HENSARLING. Parliamentary inquiry, Madam Chairwoman. Whose time is this coming out of?

Ms. WATERS. The Chair yields itself adequate time.

Therefore, we will stand in recess until we complete the 7th vote and we will return. Thank you.

[recess]

Mr. WATT. [presiding] I do need to officially adjourn the last hearing that never got officially adjourned. There was a full committee hearing in this room, and we got called for votes, and it never came back together to officially adjourn that hearing. So let me just do that first.

The full committee hearing from this morning is officially adjourned.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

A P P E N D I X

July 16, 2009

Statement

of

Joseph L. Flatley
President and CEO
Massachusetts Housing Investment Corporation

On Behalf of the National Association of Affordable Housing Lenders on Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

House Committee on Financial Services
U.S. House of Representatives

July 16, 2009

®

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SUMMARY

1. NAAHL supports Chairman Barney Frank's decision to preserve the bank regulators' role to enforce the Community Reinvestment Act (CRA). CRA is a success story and a big business. It annually funnels hundreds of billions of dollars in loans and investments to low- and moderate-income communities, financing affordable rental housing, home purchases, charter schools, daycare facilities, and small business and microenterprise loans.

2. The regulators should revise the CRA regulation to update rules that discourage bank participation in important community development work that benefits low-and moderate-income (LMI) communities.

3. Any statutory changes to CRA should be carefully considered, practical to implement, and incentivize high-impact community development activities that may fall outside of banks' normal course of business.

4. A new consumer financial protection agency should have the authority needed to put an end to the problem of the "dual mortgage market" that contributed to the mortgage meltdown.

INTRODUCTION

My name is Joseph Flatley, and I am the President and CEO of the Massachusetts Housing Investment Corporation (MHIC) in Boston. I am also a former chairman of the National Association of Affordable Housing Lenders' (NAAHL) Board of Directors. Thank you for the opportunity to testify.

MHIC is a private non-profit whose mission is to finance affordable housing and community development. Since 1990, MHIC has invested over $1.3 billion in 320 projects – for the creation of more than 13,300 units of affordable housing and more than one million square feet of commercial space. MHIC has also been a leader in the creative utilization of the New Markets Tax Credit program to finance community development projects, and has been awarded five allocations of New Markets Tax Credits totaling $364 million.

NAAHL represents America's leaders in moving private capital to those in need, 100 organizations committed to increasing lending and investing private capital in LMI communities. This "who's who" of private sector lenders and investors includes major banks, blue-chip, non-profit lender CDFIs, and others in the vanguard of affordable housing.

NAAHL's mission is to increase responsible, private capital lending and investing to low (under 50% of area median) and moderate (under 80%) income persons and areas. Over the past decade we have worked with Congress to thwart attempts to gut CRA regulations, believing that CRA has provided important incentives for insured depository institutions to increase access to LMI persons and areas, consistent with the institutions' "safety and soundness".

NAAHL strongly supports House Financial Services Committee Chairman Barney Frank's decision not to transfer statutory responsibility for the Community Reinvestment Act (CRA) away from the prudential bank regulators, a recommendation NAAHL made before the Administration released its proposal. NAAHL is committed to community investment; let me explain why we support the current oversight structure.

The Administration's proposals suggest they listened carefully to the concerns of NAAHL and other affordable housing advocates about the urgent need for enhanced regulatory focus on Community Development (CD), and appropriate credit for high impact CD activities. But since the Administration released its proposal to transfer CRA to a new Consumer Financial Protection Agency (CFPA):

- NAAHL non-profits have expressed concerns about how the "emerging market" business of innovative, high impact, CD lending and investing, including commercial real estate transactions, would fare in a consumer-product-focused compliance culture such as the CFPA.

- NAAHL bankers have raised concerns about splitting the "Siamese twins" of CRA evaluation (going to CFPA) and the diminished influence of CRA in the regulatory application approval process (retained with the banking regulatory agencies).

- All raised concerns about the possibilities of dueling regulators (CFPA versus bank regulators) disagreeing about banks' CRA credit risks, resulting in a shift in CRA focus away from innovation and high impact CD lending and investing.

- Former OTS Director Ellen Seidman testified recently before this committee about the three important reasons she is not convinced that the CFPA is the best place to locate CRA.

CONSUMER FINANCIAL PROTECTION AGENCY (CFPA)

The Administration's proposed CFPA contemplates a massive, unprecedented shift in oversight of Federal laws involving consumer protection. Ideally, the CFPA will have the authority needed to put an end to the problem of the "dual mortgage market" that contributed to the meltdown, as unregulated, unexamined mortgage market participants were left free to abuse their customers. But CRA was not part of that problem, and CD lending and investing is now more important than ever before to rebuilding in LMI communities.

CRA's success has been well-documented by public and private studies. Bank regulators appointed in the Bush Administration confirmed that CRA credited loans have benefited both consumers and the bank originators. Home Mortgage Disclosure Act (HMDA) reporting documents that CRA has provided a regulatory incentive for funneling to underserved communities literally hundreds of billions in LMI loans in each of the past 5 years. This infusion of private capital leverages public subsidy for affordable rental housing as much as 10-25 times, and also finances LMI community services and economic development activities such as charter schools, day care facilities, small business and microenterprise lending.

SUCCESSFUL COMMUNITY REINVESTMENT

We believe that the CRA has been, and will continue to be critical to the preservation and expansion of rental housing affordable to LMI communities because it encourages private capital lending and investing in community development projects.

The private-public partnership fostered by CRA has evolved and matured over the past 30 years. For-profit and non-profit lenders and investors, developers, community leaders, and government at all levels, have all learned to collaborate as partners in devising new solutions and creative strategies for financing affordable housing and other community development activities.

We know how to do it right: how to build affordable rental housing and homeownership properties that people are proud to call home, with a mix of incomes, built with the discipline of the private market, using government resources responsibly. These homes are of high quality and lasting value, and remain affordable over the long run. Attached to this statement are pictures of two typical examples, in Alabama and Massachusetts.

TAKING THE ROUGH EDGES OFF OF CAPITALISM

Since it was enacted in 1977, CRA has provided regulatory incentives for funneling more than a trillion dollars into LMI communities. Former Federal Reserve Board Chairman Paul Volcker has characterized CRA as "taking the rough edges off of capitalism."

Every academic study of CRA has confirmed that the law has been enormously successful in incentivizing insured depository institutions' involvement in underserved areas. But updates to CRA regulations are long overdue, and some advocate changes to the law. NAAHL proposes two guiding principles for revitalizing CRA, and makes several policy recommendations.

NAAHL PRINCIPLES FOR REVITALIZING COMMUNITY REINVESTMENT

First, and most important, address the weaknesses in the current regulatory structure that discourage bank participation in important community development work that benefits LMI communities. Restore meaningful regulatory incentives for undertaking high-impact activities that reflect best practices in community development.

Policy Recommendations

- Reward high-impact, innovative, high-quality, often costly community development lending, services and investments that respond to a local government/community's needs assessment.
- Ensure that the regulations are sufficiently flexible to align with local policies, new markets, and financial instruments.
- Eliminate unrealistic bank "benchmarks" that have caused some market distortions by requiring specific market shares regardless of profitability or responsiveness to community needs.
- Provide meaningful incentives for an Outstanding rating under CRA.
- Reform regulatory techniques for evaluating performance. Increasing emphasis on the quantitative versus the qualitative impacts of CRA activities has discouraged risk-taking and innovation, and undercuts support for Community Development

Financial Institutions (CDFIs). Provide more flexibility to encourage banks and others with affirmative obligations to reach deeply into underserved areas.

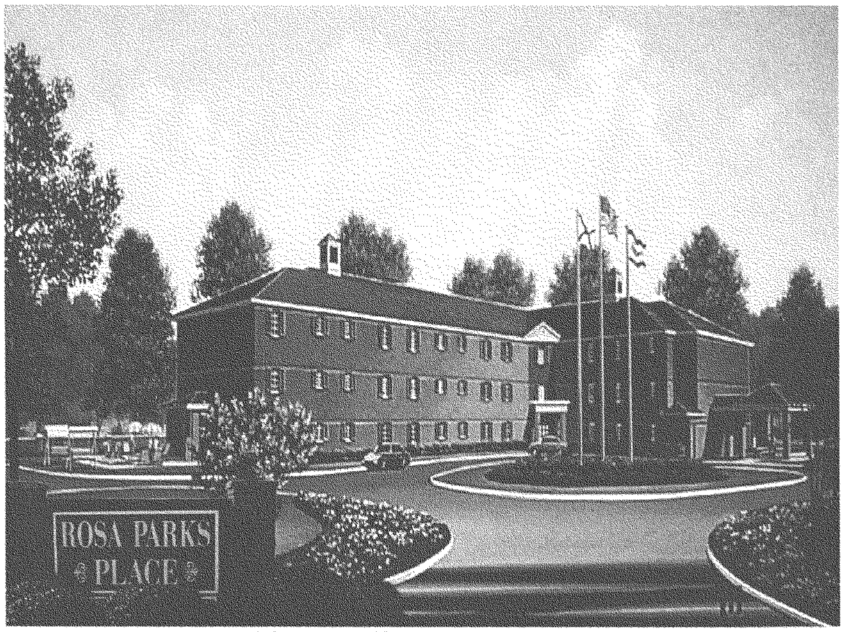
Second, do no harm. For more than 30 years CRA has encouraged insured depositories to help meet the credit needs of their communities. Any changes to the law should be carefully considered, practical to implement, and incentivize banks to engage in high-impact community development activities that fall outside of their normal course of business.

Policy Recommendations

- Maintain the focus of CRA on LMI borrowers and neighborhoods in local markets where financial institutions have a physical presence and staff. Broadening CRA's objectives to address a wide range of social and economic problems and expanding the geographic reach beyond where banks can effectively engage in CRA activities risks diluting the positive impacts of the law for community development.
- Permit limited purpose and wholesale depositories that lack "on the ground presence" to have nationwide assessment areas.
- Level the regulatory playing field and address the dual mortgage market problem by expanding CRA's affirmative obligations, safety and soundness, and consumer protection laws, including examinations and enforcement, to all primary and secondary market lenders.
- Maintain the combined oversight of safety and soundness, and the efforts to meet LMI credit needs.
- Maintain the integrity of separate laws. CRA has been effective because of a continuing focus on expanding capital and banking services to LMI households and neighborhoods. If existing consumer protection laws, regulations, examination practices, and enforcement are inadequate they should be enhanced to achieve the appropriate scope.

Thank you again for the opportunity to testify, and I will be pleased to answer any questions.


Massachusetts
Housing
Investment
Corporation



Alabama Multifamily Loan Consortium

WRITTEN STATEMENT

OF

OLIVER I. IRELAND

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

COMMUNITY AND CONSUMER ADVOCATES' PERSPECTIVES

ON

THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

July 16, 2009

Mr. Chairman and members of the Committee, my name is Oliver Ireland and I am a partner in the financial services practice in the Washington D.C. office of Morrison & Foerster LLP. Before joining Morrison & Foerster, I spent 26 years with the Federal Reserve System, the last 15 years as an Associate General Counsel. During my tenure with the Federal Reserve System, I worked on a wide range of issues, including consumer protection regulations, the lead mechanics of monetary policy and resolving troubled banks. I am pleased to be here today to address the Obama Administration's Financial Regulatory Reform Proposals and, in particular, the consumer protection aspects of the Proposals.

The current recession, while probably reflecting the confluence of a number of different trends in the world economy, both within the United States and abroad, was sparked by problems in residential mortgages; these problems themselves reflected a confluence of economic and regulatory events. A rapid rise in housing prices across the country, fueled at least in part by low interest rates, combined with lax mortgage underwriting practices, resulted in high levels of defaults on mortgage loans when interest rates started to rise and housing prices started to decline. Falling housing prices and low loan to value ratios on mortgages, some of which contained repricing features that abruptly increased monthly payments to levels that borrowers could not meet, coupled with borrowers' inability to refinance or sell their homes as prices declined, led to defaults. The effects of these defaults were absorbed by investors in mortgage backed securities, particularly securities backed by subprime and Alt-A mortgages, rather than be absorbed on the balance sheets of lending financial institutions, as had been the case in past housing bubbles that eventually burst. As investors lost confidence in these mortgage backed securities, the flow of funds to make new housing loans, particularly to subprime borrowers, also dried up. Constraints on the availability of credit further reduced housing demand, leading to further declines in housing prices and further defaults. The loss of confidence in subprime and Alt-A mortgage backed securities spread to other mortgage and asset backed securities turning a housing bubble into what in the past would have been referred to as a "panic" in the market for mortgages, and other asset backed securities and collateralized debt obligations. This "panic" in turn further disrupted the flow of funds available for mortgage credit for all classes of borrowers leading to further declines in housing prices, creating a downward spiral that is only now being arrested through a panoply of new government programs and extraordinary actions by financial services regulators.

Clearly these events warrant a rethinking of what has worked, what has not worked and why in our system of financial regulation. In this context, the Administration has proposed to create a new stand-alone consumer financial protection agency to protect consumers from inappropriate financial practices in providing consumer financial products and services. This Proposal, in effect, recognizes the role that retail financial transactions had in triggering the current crisis and seeks to avoid similar problems in the future by increasing the level of consumer protection in financial services more broadly. Although I believe that these goals are appropriate and that changes in the way that consumer financial transactions are regulated are required, I believe that creating a separate stand-alone agency for this purpose ignores the increasingly vertically integrated nature of the market for retail financial services and the role that retail financial transactions play in the overall economy of the United States.

A primary reason for regulating consumer financial products and services is that we believe that these products can be beneficial to consumers. If we did not believe that these services can be beneficial, we would simply make them illegal as some states have done for gambling transactions. For example, consumer mortgages finance home ownership thereby contributing to stable communities and to quality of life. The availability of home mortgages on reasonable terms requires that each step in the process for supplying home mortgages, from the raising of funds in the money markets or through deposits to the payment to the seller, must operate efficiently and in coordination with other steps.

As a starting point, in order to have adequate availability of funds for home mortgage loans, a sufficient volume of investors must view instruments, whether they are deposits, mortgage backed securities, covered bonds or some other investment vehicle, to be sufficiently attractive in order to induce the funding of mortgage lending. In the past we have seen that interest rate restrictions on deposits at regulated depository institutions can adversely affect the availability of funds for home mortgages. Similarly, in the current crisis we have seen that a loss of confidence in securitization vehicles can dry up funds for mortgage lending. Conversely, too much demand for these instruments can also create problems. Part of the problem in the terms and underwriting standards for individual home mortgages that we have seen in the current crisis may have been influenced by the strong demand for mortgage backed securities. As traders identified market demand for securities with particular characteristics, that created a demand for securities that would meet those characteristics. This demand led to orders for mortgages with those characteristics from mortgage brokers and mortgage originators. These orders were filled at the retail level by mortgage originators and brokers who saw an immediate secondary market for these loans, and little or no risk to themselves in originating these loans.

Second, in order to use market sources to fund the supply of mortgage credit, financial intermediaries must not only be able to access funds at reasonable costs, but also use them to extend mortgage credit at reasonable cost. Although the vehicles for carrying out this process can range from securitization trusts to regulated insured depository institutions, overly stringent requirements or inefficient operating conditions at financial intermediaries will raise the cost of funds to the borrowers, ultimately making mortgage credit less available to average Americans. For example, the bank capital levels, in excess of 30 percent, that prevailed in the early part of the nineteenth century would make home mortgages available only to a select, narrow group of borrowers able to afford the high rates necessary to cover the cost of capital but unable or unwilling to pay cash for their homes. On the other hand, insufficient capital levels would leave financial intermediaries unable to absorb losses and without the ability to continue to perform their functions. As we have seen, widespread failures of financial intermediaries can have devastating effects, on the availability of credit, as well as on their customers and on the economy as a whole. Conversely, financial intermediaries with no responsibility or incentive for originating home mortgage loans that will be repaid will have little incentive to originate loans that will provide the funding market with long term confidence.

Finally, in order for financial intermediaries to originate or arrange home mortgages that have a high likelihood of being repaid, the terms of these mortgage loans to consumers have to be fair and reasonable. While almost any underwriting standards and credit terms may seem adequate in a market where home prices are appreciating rapidly and a troubled loan can be refinanced or paid off by selling the home at a profit, in a more stable or a falling housing market, the terms of the loan and the underwriting standards must ensure that the vast majority of loans can be repaid according to their terms. This is necessary in order to minimize the personal tragedies caused by foreclosures, to maintain access to home mortgage credit for those who are willing and able to repay, and ultimately to avoid the downward spiral in home values brought on by foreclosures and ever tightening credit.

Moreover, in the current crisis we have seen that problems even in relatively small segments of the market for mortgage loans can spill over and have adverse consequences for the economy as a whole. For these reasons, the need for reasonable terms in individual mortgage transactions with consumers is an issue of concern not only for purposes of consumer protection and for the purposes of prudential supervision of financial institutions, but also for the Federal Reserve in its role in carrying out monetary policy and fostering economic stability, as well as for any systemic risk regulator that may be established. In this regard, a better understanding of what was happening in the market for home mortgages might have led to a more gradual rate of interest rate increases and the potential for a more gradual deflation of the housing bubble. Further, if the Federal Reserve had made a market in prime private mortgage backed securities in 2007, it might have been able to mitigate the spread of the loss in confidence in subprime from Alt-A mortgage backed securities to higher quality securities, and the Federal Reserve might have been able to mitigate the downward spiral that ensued from the spreading loss in confidence. A high degree of understanding of the details of consumer mortgage transactions would have been vital in either case, both in terms of understanding how fragile these transactions would be when the housing bubble burst and in distinguishing good mortgage backed securities from bad mortgage backed securities for the purposes of market making. A detailed understanding of these transactions would also be crucial to any program of loan modifications whether designed only to help troubled homeowners or to help to put a floor under the housing market.

In other words, in order to foster an efficient market for home mortgages, it is necessary to have an understanding of the entire market, from the consumer borrower to the ultimate investor, and the role of that market in the economy as a whole. The oversight and regulation of each component of the market needs to take into consideration its effect on the other components. However, bifurcating regulation of the market as is contemplated by the creation of a dedicated agency that focuses only on the consumer protection aspects of the mortgage lending process, at a minimum, is likely to create conflicts with prudential supervisors. The narrow focus of the consumer protection agency and prudential supervisors will lead both regulators to increasingly think of themselves as fostering competing interests, when in reality their ultimate goal is the same. Further, the expertise of each regulator will be less available to the other, making each of their jobs more difficult rather than easier and leading to a less efficient, rather than a more efficient, market for home mortgages. While the foregoing discussion on the mortgage transactions that led to the current financial crisis, its principles are equally applicable to other consumer financial services.

These considerations weigh strongly against the creation of a separate agency to assume sole responsibility for consumer protection in financial services. The countervailing argument is, of course, that the current system did not work to prevent the mortgage crisis and that changes are needed. It cannot be denied that the mortgage crisis has been a product of multiple failures, both on the part of private sector participants in their failure to recognize their own long term interests and on regulators in their failure to identify and respond to problems in a timely manner. Investors in mortgage backed securities failed to carefully evaluate their investments and placed undue reliance on rating agencies and the system that produced those securities. In some cases, the regulators of these investors, both in the United States and abroad, failed to recognize this failure in regulated entities. Rating agencies failed to recognize the significance of changes in the composition of mortgage pools that they were rating. Lenders failed to use careful underwriting standards and to limit specialized loans, such as "no doc" loans, to the few cases where they were appropriate. In some cases, regulators of these lenders failed to recognize the failures of these lenders. Finally, home buyers failed to make sure that they understood and could afford the mortgages that they were entering into and regulators failed to take steps to make sure that consumers were reasonably able to understand the mortgage transactions that they were entering into. In addition, the Federal Reserve's interest rate policy has been criticized by some as having contributed to the crisis by keeping rates too low for too long and then by raising them too rapidly. These types of, and other similar, failures are not unique to the current crisis or events and have contributed to past bubbles and panics.

The fact that regulators may have made errors suggests that steps should be taken to prevent similar errors in the future; however, in my view it does not mean that the architecture of the regulatory system is the problem. There is a strong relationship between consumer issues, prudential supervision issues and ultimately monetary policy and overall economic stability. In the end, these interests are not in conflict, rather they all seek the same goal—a healthy economy and a high standard of living for all Americans. The goal of regulatory policy should be to insure that these factors are harmonized, rather than that they conflict. Creating a separate consumer regulatory agency is more likely to foster conflict than harmonization.

In the current regulatory structure in which financial institution regulators are responsible for both prudential supervision and consumer rules, the economic and transactional analysis of consumer transactions that is part of the consumer oversight process both benefits from an understanding of prudential concerns and informs prudential supervisors. This two-way flow of information creates synergies that will be difficult, if not impossible, to replicate in an independent consumer regulatory agency. Nevertheless, in my view, historically the prudential supervisors have, in some cases, paid insufficient attention, and devoted insufficient resources to, consumer regulatory issues. Although regulatory actions in the area of home mortgages and credit cards in the recent past strongly suggest that the Federal Reserve Board has increased its attention to these areas, more could be done and steps could be taken to ensure that it is.

For example, a coupling of a Humphrey-Hawkins like procedure under which (1) the Chairman of the Federal Reserve Board, or potentially the head of a new agency responsible for overall supervision of regulated financial institutions, would report to the Congress annually on the state of consumer financial services, and actions and plans for the supervision and regulation of consumer financial services, with (2) a biennial survey process, including public comment, to evaluate current and developing practices in consumer financial services, as well as the effects of past regulatory initiatives and the need for further regulatory initiatives, would provide a strong oversight process to ensure adequate attention to these important issues. Such a process would enhance the synergies inherent in the current regulatory structure while minimizing the potential for conflicts between monetary policy, prudential supervision and the protection of consumers.

Finally, the proposed legislation to create a new consumer financial protection agency includes broad new regulatory and examination authorities. These Proposals should be evaluated on their own merits. Clearly, there have been problems in the area of mortgage origination outside of the insured depository institution regulatory structure that may benefit from centralized federal oversight. Other areas of consumer financial services may also benefit from additional federal oversight. These responsibilities can be housed within the existing regulatory structure or, in a new agency, consistent with recognition of the close relationship between prudential and consumer interests. However these issues are resolved, it should be done in a way that the resolution recognizes the vertical integration of our financial markets and the common goals of regulatory policies rather than fostering conflicts between them.

Thank you for the opportunity to be here to today and to share my views on this important issue. I would be happy to answer any questions.

Testimony of

Edmund Mierzwinski,
Consumer Program Director
U.S. Public Interest Research Group

Before the Committee on Financial Services
U.S. House of Representatives
The Honorable Barney Frank, Chairman

Hearing on

Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

16 July 2009

SUMMARY

Thank you, Chairman Frank, Rep. Bachus and members of the committee. I am Edmund Mierzwinski, Consumer Program Director for the U.S. Public Interest Research Group, the federation of state PIRGs. I am pleased to be able to offer the views of U.S. PIRG at the hearing on Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals. U.S. PIRG is a founding member of Americans for Financial Reform, a coalition of nearly 200 national, state and local consumer, employee, investor, community and civil rights organizations spearheading a campaign for real reform in our banking and financial system.[1]

We are generally quite pleased with the Obama Administration's legislative proposals as presented last month to the nation,[2] although not all have yet been presented to date in legislative language. In particular, we strongly support the establishment of a Consumer Financial Protection Agency. Among its critical concepts are its independence, its recognition that federal law should always serve as a floor of protection not a ceiling, and its shared enforcement with states.

The remainder of the plan addresses all of the elements of reform we believe are necessary to reform our collapsed financial system and inoculate it against further catastrophic events. It closes the so-called shadow market gaps in regulation, it strengthens existing prudential regulation and it provides for systemic risk amelioration.

Its proposed new investor protections in the form of greater fiduciary responsibilities for broker-dealers were released last Friday in legislative language. If improved, these will be important reforms. The administration's proposed limits on and greater transparency for executive pay and bonuses are also important. Executive compensation policies should be fair to investors and should provide incentives to keep corporate leaders from making decisions that are detrimental to the safety and soundness of our financial system.

The Administration's proposal establishes a Financial Services Oversight Council and also vests the Federal Reserve with many new powers aimed at controlling system-wide risk. If the Congress and the public are to accept the Federal Reserve as a systemic regulator, strong measures must be added to ensure the Federal Reserve is truly independent, transparent and responsive to the public. We must open up and democratize the Federal Reserve so that it is publicly accountable.

There are some additional areas where the aforementioned Obama proposals could be perfected. We discuss these in the testimony. There are others where it is lacking. In particular, we find that the proposed regulation of Credit Rating Agencies is insufficient to police those firms and solve the problems they caused. We also find that the proposal is missing adequate provisions on mortgage foreclosure prevention and solving the home affordability crisis. Without more effective strategies to keep people in their homes, our nation will continue to face the catastrophe of millions of mortgage foreclosures.

[1] More information on Americans for Financial Reform is available at http://www.ourfinancialsecurity.org
[2] "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, June 17, 2009.

In summary, President Obama has taken a critical and in some ways a bold step toward restoring integrity and fairness to our financial system, but the battle for reform has only just begun. We look forward to working with the President and the Committee to move these proposals into law in the strongest form possible. We have no illusions about the difficulty of the fight to come. Our principles will only prevail if the voices of the public are heard over those of bankers, traders, mortgage brokers and their armies of lobbyists. We appreciate the opportunity to provide that voice today.

I. Comments on the President's Consumer Financial Protection Agency proposal

In our testimony in June before this committee,[3] we outlined the case for establishment of a robust, independent federal Consumer Financial Protection Agency to protect consumers from unfair credit, payment and debt management products, no matter what company or bank sells them and no matter what agency may serve as the prudential regulator for that company or bank. We described the many failures of the current federal financial regulators. We discussed the need for a return to a system where federal financial protection law serves as a floor not as a ceiling, and consumers are again protected by the three-legged stool of federal protection, state enforcement and private enforcement. We rebutted anticipated opposition to the proposal, and not a moment too soon. Since that hearing, the opposition from the vested interests who relied on that system to protect them from enforcement of the consumer laws has increased to a shrill level, despite its lack of substance. The companies and regulators that are part of the system that failed to protect us are both claiming that it wasn't their fault and that nothing needs to be done.

In that June testimony, we offered detailed suggestions to shape the development of the agency in the legislative process. We believe that, properly implemented, a Consumer Financial Protection Agency will encourage innovation by financial actors, increase competition in the marketplace and lead to better choices for consumers.

The idea of a federal consumer protection agency focused on credit and payment products has gained broad and high-profile support because it targets the most significant underlying causes of the massive regulatory failures that occurred. First, federal agencies did not make protecting consumers their top priority and, in fact, seemed to compete against each other to keep standards low, ignoring many festering problems that grew worse over time. If agencies did act to protect consumers (and they often did not), the process was cumbersome and time-consuming. As a result, agencies did not act to stop some abusive lending practices until it was too late. Finally, regulators were not truly independent of the influence of the financial institutions they regulated.

[3] Joint written testimony of Edmund Mierzwinski, U.S. PIRG and Travis Plunkett, Consumer Federation of America, on behalf of over a dozen groups, 24 June, 2009, Hearing of the U.S. House Financial Services Committee on "Regulatory Restructuring: Enhancing Consumer Financial Products Regulation," available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/mierzwinski_-_submitted_with_plunkett.pdf (last visited 14 July 2009).

In our earlier testimony, we provided extensive examples for the record of the failure of existing agencies to do their job, and in some cases, to focus instead on preventing state enforcers from doing theirs. We will not repeat all of that material here, but summarize much of it below.

In that previous testimony, we also outlined the reasons that the Obama Administration proposal has tremendous potential to solve the problems caused by the conflicts of interest, lack of will charter-shopping and other barriers to robust consumer protection that defeated our and Congressional efforts to force the existing regulators to fulfill their role of implementing Congressional intent in issuing rules to protect consumers, examining institutions for compliance with those rules and, finally, enforcing those rules when they did not.

Combining safety and soundness supervision – with its focus on bank profitability – in the same institution as consumer protection magnified an ideological predisposition or anti-regulatory bias by federal officials that led to unwillingness to rein in abusive lending before it triggered the housing and economic crises. Though we now know that consumer protection leads to effective safety and soundness, structural flaws in the federal regulatory system compromised the independence of banking regulators and encouraged them to overlook, ignore and minimize their mission to protect consumers. This created a dynamic in which regulatory agencies competed against each other to weaken standards and ultimately led to an oversight process that was cumbersome and ineffectual. These structural weaknesses threatened to undermine even the most diligent policies and intentions. They complicated enforcement and vitiated regulatory responsibility to the ultimate detriment of consumers.

Within agencies in which these functions are combined, regulators have often treated consumer protection as less important than their safety and soundness mission or even in conflict with that mission.[4] For example, after more than 6 years of effort by consumer organizations, federal regulators are just now contemplating incomplete rules to protect consumers from high-cost "overdraft" loans that financial institutions often extend without the knowledge of or permission from consumers. Given the longstanding inaction on this issue, it is reasonable to assume that regulators were either uninterested in consumer protection or viewed restrictions on overdraft loans as an unnecessary financial burden on banks that extend this form of credit, even if it is deceptively offered and financially harmful to consumers. In other words, because regulators apparently decided that their overriding mission was to ensure that the short-term balance sheets of the institutions they regulated were strong, they were less likely to perceive that questionable products or practices (like overdraft loans or mortgage pre-payment penalties) were harmful to consumers. Last week, USA Today explained the issue in powerful terms:

> Today, each of the nation's 10 largest banks allows consumers to overdraw with checks, debit cards or at ATMs, a 2009 USA TODAY survey reveals. Large banks also reserve the right to process large transactions first, triggering more overdraft fees by emptying the account more quickly. Some even charge consumers before they overdraw by

[4] Occasionally, safety and soundness concerns have led regulators to propose consumer protections, as in the eventually successful efforts by federal banking agencies to prohibit "rent-a-charter" payday lending, in which payday loan companies partnered with national or out-of-state banks in an effort to skirt restrictive state laws. However, from a consumer protection point-of-view, this multi-year process took far too long. Moreover, the outcome could have been different if the agencies had concluded that payday lending would be profitable for banks and thus contribute to their soundness.

> deducting a purchase when it's made, rather than when it clears, pushing the account into the red sooner.[...] Meanwhile, the Federal Reserve is examining the fairness of certain overdraft practices. It's unclear whether those efforts will be enough to rein in overdrafts, now the single-largest driver of consumer fee income for banks. In 2009, banks are expected to reap a record $38.5 billion from overdraft fees, nearly twice the $20.5 billion they stand to collect from credit card penalties such as late and over-limit fees.[5]

Two other examples of agency failures discussed in detail in the previous testimony are the Federal Reserve's failure to implement Home Ownership and Equity Protection Act (HOEPA) rules for fourteen years as the mortgage crisis grew and the Office of the Comptroller of the Currency's (OCC) focus on eviscerating state consumer protections while enforcing no consumer laws itself:

The Federal Reserve Board was granted sweeping anti-predatory mortgage regulatory authority by the 1994 HOEPA. Final regulations were issued on 30 July 2008 only after the world economy had collapsed due to the collapse of the U.S. housing market triggered by predatory lending.[6]

Meanwhile, in interpretation letters, amicus briefs and other filings, the OCC preempted state laws and local ordinances requiring lifeline banking (NJ 1992, NY, 1994), prohibiting fees to cash "on-us" checks (par value requirements) (TX, 1995), banning ATM surcharges (San Francisco, Santa Monica and Ohio and Connecticut, 1998-2000), requiring credit card disclosures (CA, 2003) and opposing predatory lending and ordinances (numerous states and cities).[7] Throughout, OCC ignored Congressional requirements accompanying the 1994 Riegle-Neal Act not to preempt without going through a detailed preemption notice and comment procedure, as the Congress had found many OCC actions "inappropriately aggressive."[8]

In 2000-2004, the OCC worked with increasing aggressiveness to prevent the states from enforcing state laws and stronger state consumer protection standards against national banks and their operating subsidiaries, from investigating or monitoring national banks and their operating subsidiaries, and from seeking relief for consumers from national banks and subsidiaries.

These efforts began with interpretative letters stopping state enforcement and state standards in the period up to 2004, followed by OCC's wide-ranging preemption regulations in 2004 purporting to interpret the National Bank Act, plus briefs in court cases supporting national banks' efforts to block state consumer protections.

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[5] Kathy Chu, "Banks' 'courtesy' loans at soaring rates irk consumers," USA Today, 8 July 2009, available at http://www.usatoday.com/money/perfi/credit/2009-07-08-banks-overdraft-fees_N.htm (last visited 14 July 2009).

[6] 73 FR 147, Page 44522, Final HOEPA Rule, 30 July 2008

[7] "Role of the Office of Thrift Supervision and Office of the Comptroller of the Currency in the Preemption of State Law," USGAO, prepared for Financial Services Committee Chairman James Leach, 7 February 2000, available at http://www.gao.gov/corresp/ggd-00-51r.pdf (last visited 21 June 2009).

[8] [Statement of managers filed with the conference report on H.R. 3841, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Congressional Record Page S10532, 3 August 1994

Meanwhile, OCC's only two meaningful consumer protection actions since 1995 followed earlier actions against the same wrongdoers by other, smaller agencies.[9] Essentially, the agency was shamed into a few pro-consumer activities.

While some might argue that the Federal Reserve Board does deserve some credit for leading regulators (after Rep. Carolyn Maloney of this committee showed them the way) in enacting credit card protections in 2008, [10] that action is the exception that proves the rule. Congress, led by Maloney, ultimately passed a stronger law, the 2009 Credit Card Accountability, Responsibility and Disclosure Act (CARD Act).[11]

The Fed's abject failure to heed years of warnings on the mortgage crisis, its actions (with other regulators) encouraging the above-explained overdraft fees and its disdain for the Federal Trade Commission's efforts since 2003 to complete a concurrent rulemaking to improve consumer rights in the Fair Credit Reporting Act are more typical of its point of view. In many ways, the inactions of the one agency that did not embrace the credit card rules, the OCC, likely led to the final action by Congress this year. The OCC's failure to act on rising credit card complaints at the largest national banks triggered Congress to investigate, resulting in passage of the law.

Although a Consumer Financial Protection Agency (CFPA) would not be a panacea for all current regulatory ills, it would correct many of the most significant structural flaws that exist, realigning the regulatory architecture to reflect the unfortunate lessons that have been learned in the current financial crisis and sharply increasing the chances that regulators will succeed in protecting consumers in the future. As proposed by the President, the CFPA is designed to achieve the regulatory goals of elevating the importance of consumer protection, prompting action to prevent harm, ending regulatory arbitrage, and guaranteeing regulatory independence.

The CFPA, as proposed by President Obama, is granted broad authority to assure a marketplace that promotes fair treatment, fair competition, and the marketing of asset-building financial products. In particular, it provides broad, generic authority to address unfair, deceptive and abusive practices beyond those identified in existing substantive statutes and beyond disclosures. It is given authority to address arbitration abuses. It places all consumer protection statutes together in one place for holistic protection. It is granted authority to set standards for products that are deserving of and that warrant public trust and reliance.

A. The structure of the CFPA as proposed by President Obama has several other critical components that must not be weakened.

1) The CFPA gets a full set of examination, supervision, and data collection tools.
2) The proposal recognizes the need for stable, diversified funding (although its funding sources need specificity).

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[9] [9] Testimony of Arthur E. Wilmarth, Jr., Professor Of Law, George Washington University Law School, Hearing On "Credit Card Practices: Current Consumer And Regulatory Issues" On April 26, 2007, Before The Subcommittee On Financial Institutions And Consumer Credit Of The Committee On Financial Services, available at http://financialservices.house.gov/hearing110/htwilmarth042607.pdf (last visited 14 July 2009).

[10] The final rule was published in the Federal Register a month later. 74 FR 18, page 5498 Thursday, January 29, 2009

[11] HR 627 became Public Law No. 111-24 on 22 May 2009.

3) The commissioners are independent (although the bill could be improved by requiring stronger consumer protection qualifications and a revolving door ban.)

In its work to protect consumers and the marketplace from abuses, the CFPA as envisioned by the Administration would have a full set of enforcement and analytical tools. The first tool would be that the CFPA could gather information about the marketplace so that the agency itself could understand the impact of emerging practices in the marketplace. The agency could use this information to improve the information that financial services companies must offer to customers about products, features or practices or to offer advice to consumers directly about the risk of a variety of products on the market.

For some of these products, features or practices, the agency might determine that no regulatory intervention is warranted. For others, this information about the market will inform what tools are used. A second tool would be to address and rein in deceptive marketing practices or require improved disclosure of terms. The third tool would be the identification and regulatory facilitation of "plain vanilla," low risk products that should be widely offered. The fourth tool would be to restrict or ban specific product features or terms that are harmful or not suitable in some circumstances, or that don't meet ordinary consumer expectations. Finally, the CFPA would also have the ability to prohibit dangerous financial products. We can only wonder how much less pain would have been caused for our economy if a regulatory agency had been actively exercising the latter two powers during the run up to the mortgage crisis.
Under the Administration proposal, the agency will have broad rule-making authority to effectuate its purposes, including the flexibility to set standards that are adequate to address rapid evolution and changes in the marketplace. Such authority is not a threat to innovation, but rather levels the playing field and protects honest competition, as well as consumers and the economy.

The Administration's plan also provides rule-making authority for the existing consumer protection laws related to the provision of credit would be transferred to this agency, including the Truth in Lending Act (TILA), Truth in Savings Act (TISA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Protection Act (RESPA), Fair Credit Reporting Act (FCRA), Electronic Fund Transfer Act (EFTA), and Fair Debt Collection Practices Act (FDCPA). Current rule-writing authority for nearly 20 existing laws is spread out among at least seven agencies. Some authority is exclusive, some joint, and some is concurrent. However, this hodge-podge of statutory authority has led to fractured and often ineffectual enforcement of these laws. It has also led to a situation where federal rule-writing agencies may be looking at just part of a credit transaction when writing a rule, without considering how the various rules for different parts of the transaction effect the marketplace and the whole transaction. The CFPA with expertise, jurisdiction and oversight that cuts across all segments of the financial products marketplace, will be better able to see inconsistencies, unnecessary redundancies, and ineffective regulations. As a market-wide regulator, it would also ensure that critical rules and regulations are not evaded or weakened as agencies compete for advantage for the entities they regulate.

Additionally the agency would have exclusive "organic" federal rule-writing authority within its general jurisdiction to deem products, features, or practices unfair, deceptive, abusive or unsustainable, and otherwise to fulfill its mission and mandate. The rules may range from placing prohibitions, restrictions or conditions on practices, products or features to creating standards, and requiring special monitoring, reporting and impact review of certain products, features or practices.

A critical element of a new consumer protection framework is ensuring that consumer protection laws are consistently and effectively enforced. As mentioned above, the current crisis occurred not only because of gaps and weakness in the law, but primarily because the consumer protection laws that we do have were not always enforced. For regulatory reform to be successful, it must encourage compliance by ensuring that wrongdoers are held accountable.

B. A new CFPA will best achieve accountability by relying on a three-legged stool: enforcement by the agency, by states, and by consumers themselves.

First, the CFPA itself will have the tools, the mission and the focus necessary to enforce its mandate. The CFPA will have a range of enforcement tools under the Administration proposal. The Administration, for example, would give the agency examination and primary compliance authority over consumer protection matters. This will allow the CFPA to look out for problems and address them in its supervisory capacity. But unlike the banking agencies, whose mission of looking out for safety and soundness led to an exclusive reliance on supervision, the CFPA will have no conflict of interest that prevents it from using its enforcement authority when appropriate. Under the Administration proposal, the agency will have the full range of enforcement powers, including subpoena authority; independent authority to enforce violations of the statues it administers; and civil penalty authority.

Second, both proposals allow states to enforce federal consumer protection laws and the CFPA's rules. As stated in detail below, states are often closer to emerging threats to consumers and the marketplace. They routinely receive consumer complaints and monitor local practices which will permit state financial regulators to see violations first, spot local trends, and augment the CFPA's resources. The CFPA will have the authority to intervene in actions brought by states, but it can conserve its resources when appropriate. As we have seen in this crisis, states were often the first to act.

C. In particular, the bill proposes to reverse decades of rollbacks and restrictions on state innovation and enforcement. These provisions must not be weakened.

1) The CFPA rules establish federal law as a floor of protection, not a ceiling against further state action.
2) The CFPA rules are enforceable by state attorneys general.
3) The bill rolls back the OCC's and other banking agencies' wrongheaded preemption of state laws.

A key principle of federalism is the role of the states as laboratories for the development of law.[12] State and federal consumer protection laws can develop in tandem. After one or a few states legislate in an area, the record and the solutions developed in those states provide important information for Congress to use in deciding whether to adopt a national law, how to craft such a law, and whether or not any new national law should displace state law.

[12] *New State Ice Co. v. Leibman*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

Consumers need state laws to prevent and solve consumer problems. State legislators generally have smaller districts than members of Congress do. State legislators are closer to the needs of their constituents than members of Congress. States often act sooner than Congress on new consumer problems. Unlike Congress, a state legislature may act before a harmful practice becomes entrenched nationwide. In a September 22, 2003 speech to the American Bankers Association in Hawaii, Comptroller John D. Hawke admitted that consumer protection activities "are virtually always responsive to real abuses." He continued by pointing out that Congress moves slowly. Comptroller Hawke said, "It is generally quite unusual for Congress to move quickly on regulatory legislation – the Gramm-Leach-Bliley privacy provisions being a major exception. Most often they respond only when there is evidence of some persistent abuse in the marketplace over a long period of time." U.S. consumers should not have to wait for a persistent, nationwide abuse by banks before a remedy or a preventative law can be passed and enforced by a state to protect them.

States can and do act more quickly than Congress, and states can and do respond to emerging practices that can harm consumers while those practices are still regional, before they spread nationwide. These examples extend far beyond the financial services marketplace.

States and even local jurisdictions have long been the laboratories for innovative public policy, particularly in the realm of environmental and consumer protection. The federal Clean Air Act grew out of a growing state and municipal movement to enact air pollution control measures. The national organic labeling law, enacted in October 2002, was passed only after several states, including Oregon, Washington, Texas, Idaho, California, and Colorado, passed their own laws. In 1982, Arizona enacted the first "Motor Voter" law to allow citizens to register to vote when applying for or renewing drivers' licenses; Colorado placed the issue on the ballot, passing its Motor Voter law in 1984. National legislation followed suit in 1993. Cities and counties have long led the smoke-free indoor air movement, prompting states to begin acting, while Congress, until this month, proved itself virtually incapable of adequately regulating the tobacco industry. A recent and highly successful FTC program—the National Do Not Call Registry to which fifty-eight million consumers have added their names in one year—had already been enacted in forty states.

But in the area of financial services, where state preemption has arguably been the harshest and most sweeping, examples of innovative state activity are still numerous. In the past five years, since the OCC's preemption regulations have blocked most state consumer protections from application to national banks, one area illustrating the power of state innovation has been in identity theft, where the states have developed important new consumer protections that are not directed primarily at banking. In the area of identity theft, states are taking actions based on a non-preemptive section of the Fair Credit Reporting Act, where they still have the authority to act against other actors than national banks or their subsidiaries.

There are seven to ten million victims of identity theft in the U.S. every year, yet Congress did not enact modest protections such as a security alert and a consumer block on credit report information generated by a thief until passage of the Fair and Accurate Credit Transactions Act (FACT Act or FACTA) in 2003. That law adopted just some of the identity theft protections that had already been enacted in states such as California, Connecticut, Louisiana, Texas, and Virginia.[13]

Additionally FACTA's centerpiece protection against both inaccuracies and identity theft, access to a free credit report annually on request, had already been adopted by seven states: Colorado, Georgia, Maine, Maryland, Massachusetts, New Jersey and Vermont. Further, California in 2000, following a joint campaign by consumer groups and realtors, became the first state to prohibit contractual restrictions on realtors showing consumers their credit scores, ending a decade of stalling by Congress and the FTC.[14] The FACT act extended this provision nationwide.

Yet, despite these provisions, advocates knew that the 2003 federal FACTA law would not solve all identity theft problems. Following strenuous opposition by consumer advocates to the blanket preemption routinely sought by industry as a condition of all remedial federal financial legislation, the final 2003 FACT Act continued to allow states to take additional actions to prevent identity theft. The results have been significant.

Since its passage, fully 47 states and the District of Columbia have granted consumers the right to prevent access to their credit reports by identity thieves through a security freeze. Indeed, even the credit bureaus, longtime opponents of the freeze, then adopted the freeze nationwide.[15]

Efficient federal public policy is one that is balanced at the point where even though the states have the authority to act, they feel no need to do so. Since we cannot guarantee that we are ever at that optimum, setting federal law as a floor of protection as the default—without also preempting the states—allows us to retain the safety net of state-federal competition to guarantee the best public policy.[16]

[13] See California Civil Code §§ 1785.11.1, 1785.11.2, 1785,16.1; Conn. SB 688 §9(d), (e), Conn. Gen. Stats. § 36a-699; IL Re. Stat. Ch. 505 § 2MM; LA Rev. Stat. §§ 9:3568B.1, 9:3568C, 9:3568D, 9:3571.1 (H)-(L); Tex. Bus. & Comm. Code §§ 20.01(7), 20.031, 20.034-039, 20.04; VA Code §§ 18.2-186.31:E.

[14] See 2000 Cal. Legis. Serv. 978 (West). This session law was authored by State Senator Liz Figueroa. "An act to amend Sections 1785.10, 1785.15, and 1785.16 of, and to add Sections 1785.15.1, 1785.15.2, and 1785.20.2 to the Civil Code, relating to consumer credit."

[15] Consumers Union, U.S. PIRG and AARP cooperated on a model state security freeze proposal that helped ensure that the state laws were not balkanized, but converged toward a common standard. More information on the state security freeze laws is available at http://www.consumersunion.org/campaigns/learn_more/003484indiv.html (last visited 21 June 2009).

[16] For further discussion, see Edmund Mierzwinski, "Preemption Of State Consumer Laws: Federal Interference Is A Market Failure," Government, Law and Policy Journal of the New York State Bar Association Spring 2004 (Vol. 6, No. 1, pgs. 6-12).

C. Additional Suggestions to Improve the President's proposal[17] on the Consumer Financial Protection Agency

1. Provide consumers with a private right of action to enforce its organic rules

The bill lacks any mechanism for holding wrongdoers accountable to individual consumers for violating rules or giving consumers remedies for harm when rules are violated. While it is important to have both strong federal and state enforcement, strong consumer enforcement also helps guarantee compliance.

Consumers themselves are an essential, in some ways the most essential, element of an enforcement regime. Recourse for individual consumers must, of course, be a key goal of a new consumer protection system. The Administration's plan appropriately states that the private enforcement provisions of existing statutes will not be disturbed. However, the Administration's plan does not address the enforceability of new CFPA rules, but it is equally critical that the consumers who are harmed by violations of these rules be allowed to protect themselves. Its predecessor, H.R. 1705, as introduced by Reps. Delahunt and Brad Miller, provided such a right of action for consumers to enforce these rules.

Consumers must have the ability to hold those who harm them accountable for numerous reasons:

- No matter how vigorous and how fully funded a new CFPA is, it will not be able to directly redress the vast majority of violations against individuals. The CFPA will likely have thousands of institutions within its jurisdiction. It cannot possibly examine, supervise or enforce compliance by all of them.
- Individuals have much more complete information about the affect of products and practices, and are in the best position to identify violations of laws, take action, and redress the harm they suffer. An agency on the outside looking in often will not have sufficient details to detect abusive behavior or to bring an enforcement action.
- Individuals are an early warning system that can alert states and the CFPA of problems when they first arise, before they become a national problem requiring the attention of a federal agency. The CFPA can monitor individual actions and determine when it is necessary to step in.
- Bolstering public enforcement with private enforcement conserves public resources. A federal agency cannot and should not go after every individual violation.

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[17] Last week, Chairman Frank and over a dozen co-sponsors introduced HR 3126, to establish a Consumer Financial Protection Agency. Our comments generally apply to both the President's language[17] and the Chairman's language unless noted.

- Consumer enforcement is a safety net that ensures compliance and accountability after this crisis has passed, when good times return, and when it becomes more tempting for regulators to think that all is well and to take a lighter approach.

- The Administration's plan rightly identifies mandatory arbitration clauses as a barrier to fair adjudication and effective redress. We strongly agree -- but it is also critically important to access to justice that consumers have the right to enforce a rule.

Private enforcement is the norm and has worked well as a complement to public enforcement in the vast majority of the consumer protection statutes that will be consolidated under the CFPA, including TILA, HOEPA, FDCPA, FCRA, EFTA and others. While consumers, under the administration proposal, would retain their existing rights to enforce violations of these statutes, they also should gain the right to enforce CFPA rules.

2. Strengthen its authority over civil rights enforcement

We concur with the detailed testimony today of the Leadership Conference on Civil Rights that systemic discriminatory and abusive lending practices were major contributors to the current financial crisis. Any attempt to protect consumers from unscrupulous financial products must therefore also seek to prevent and remedy illegal discrimination. As proposed, the Consumer Financial Protection Agency will significantly enhance protections for American consumers.

Racial minorities have received a disproportionately high number of high-cost subprime mortgages, and African Americans and Latinos will lose at least $213 billion dollars in wealth as a result of the current economic downturn. A robust Consumer Financial Protection Agency will be aware of these disparities and proactively work to reduce them.

Among the changes that should be made are the following, as recommended by the Leadership Conference on Civil Rights. Civil rights must be part of the agency's stated mission; fair lending compliance and enforcement must be built into the agency's formal structure; enforcement authority under the Fair Housing Act currently held by HUD and the Department of Justice should not be diminished; and all agencies engaged in regulating financial institutions or enforcing civil rights and fair lending statutes must cooperate and openly share information. Further, we concur that CFPA rules should be enforceable by individuals and those who violate CFPA rules must be accountable to the individuals they harm. More specifically, the bill should include a private right of action by consumers; that CFPA must have clear authority to impose mandates/sanctions on institutions found to be out of compliance with fair lending statutes; and, that the CFPA Consumer Advisory Council should include persons with fair lending and civil rights expertise.

3. Add greater consumer representation and empowerment provisions

The CFPA should have the authority to grant intervener funding to consumer organizations to fund expert participation in its stakeholder activities. The model has been used successfully to fund consumer group participation in state utility ratemaking. Second, a government chartered consumer organization should be created by Congress to represent consumers' financial services interests before regulatory, legislative, and judicial bodies, including before the CFPA. This organization could be financed through voluntary user fees such as a consumer check-off included in the monthly statements financial firms send to their customers. It would be charged with giving consumers, depositors, small investors and taxpayers their own financial reform organization to counter the power of the financial sector, and to participate fully in rulemakings, adjudications, and lobbying and other activities now dominated by the financial lobby.[18]

Rather than simply expanding or complicating regulation, government-chartered citizen groups can balance the power of regulated entities and keep their regulators from being captured. Government-chartered consumer organizations and intervener-funding and other citizenship strategies address the same broad problem: the imbalance between the concentrated power of affected industries and the diffuse power of ordinary people. By designing regulation so that it engages and informs citizens, facilitates organizing, and puts citizens into direct encounters with the industry as well as with regulators, these policies energize citizenship, and they begin to redress the structural power imbalance.[19]

4. The Proposal's Consumer Arbitration Provisions Are a Work In Progress

We strongly commend the administration for giving the CFPA the power to eliminate forced arbitration in consumer contracts. We have provided the committee staff with perfecting language to ensure that the provision achieves its goals.

This week, Minnesota Attorney General Lori Swanson filed an important lawsuit against one of the largest arbitration companies.[20] The lawsuit will shed important light on this system of private justice. Just the first few sentences of her complaint document the problem:

> 1. Just about every American has a credit card. The credit card companies often require—deep in the fine print of the consumer agreement—that the consumer forfeit his or her right to have any dispute resolved by a judge or jury. Instead, the agreements often require that any disputes be resolved exclusively through a private system of binding arbitration—and frequently through the National Arbitration Forum. The Forum represents to the public, the courts, and consumers that it is independent, operates like an impartial court system, and is not affiliated with any party. The consumer does not know that the Forum works alongside creditors behind the scenes—against the interests of consumers—to convince creditors to place mandatory pre-dispute arbitration clauses in their customer agreements and to appoint the Forum as the arbitrator of any disputes that

[18] As his last legislative activity, in October 2002, Senator Paul Wellstone proposed establishment of such an organization, the Consumer and Shareholder Protection Association, S 3143.
[19] For a more detailed treatment, see Edmund Mierzwinski, "Regulation as Civic Empowerment," pages A11-A14, the American Prospect, July-August 2009, Special Report On The Credit Crisis and Working America, available online at http://www.prospect.org/cs/articles?article=regulation_as_civic_empowerment (last visited 14 July 2009).
[20] News release, "Attorney General Swanson sues national arbitration company for deceptive practices," 14 July 2009 available at http://www.ag.state.mn.us/Consumer/PressRelease/090714NationalArbitration.asp (last visited 14 July 2009). The civil complaint is on file with the author. Also see Kathy Chu and Taylor McGraw, "Minnesota lawsuit claims credit card arbitration firm has ties to industry," USA Today, 15 July 2009, available at http://www.usatoday.com/money/perfi/credit/2009-07-14-credit-card-arbitration-firm-lawsuit_N.htm (last visited 15 July 2009).

may arise in the future. The Forum does this so that creditors will file arbitration claims against consumers in the Forum, thereby generating revenue for it.

2. The consumer also does not know—and the Forum hides from the public—that the Forum is financially affiliated with a New York hedge fund group that owns one of the country's major debt collection enterprises.

5. Clarify Its Independence and Limit Its Exposure To Cost-Benefit Requirements Under OMB

In recent Congressional testimony, Professor Rachel Barkow stated:

> Finally, my last major point is to raise the issue of the relationship between the CFPA and the President. It is unclear from the Act as it is currently written whether the CFPA will be subject to presidential directives and oversight, including review by the Office of Information and Regulatory Affairs (OIRA) in the President's Office of Management and Budget (OMB). I take no position on whether or not the agency should be subject to this type of review.[21]

Our position is that a truly independent agency should not be subject to this type of review and that the proposal's references to onerous cost-benefit rules, which are generally under purview of OIRA, should be deleted to better allow the agency to conduct its mission.

6. Additional Suggestions To Improve the CFPA

We have provided committee staff with a number of perfecting amendments to clarify various parts of the legislative language to meet its legislative intent. For example, its laudable provision on whistleblower protection must be upgraded from a modest grievance process to a full set of due process rights for workers, as Congress has established in several recent laws in other sectors. Its provisions on state enforcement and establishment of a federal floor of protection should be fine-tuned to avoid potential misinterpretation.[22] We also concur with the National Community Reinvestment Coalition that the Community Reinvestment Act (CRA) should be transferred to the new agency.[23]

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[21] Professor Rachel Barkow, 8 July 2009, Hearing of the Consumer Protection Subcommittee of the Energy and Commerce Committee, "The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC," available at http://energycommerce.house.gov/Press_111/20090708/testimony_barkow.pdf (last visited 15 July 2009).

[22] In addition to points we have made to staff, Professor Prentiss Cox makes a number of useful points on clarifying state preemption and attorney general enforcement terms of the bill, 8 July 2009, Hearing of the Consumer Protection Subcommittee of the Energy and Commerce Committee, "The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC," available at http://energycommerce.house.gov/Press_111/20090708/testimony_cox.pdf (last visited 15 July 2009).

[23] Legitimate questions have been raised about the continuing role of CRA protests in merger proposals, which will continue to be under prudential regulators as well as about non-consumer aspects of the CRA including community development lending. These provisions all need to be worked out, but we believe the issues are not insurmountable. (Note, HR 3126 does not include the transfer of the CRA.)

II. Comments on the President's Proposal To Reform Executive Pay and Bonuses and Additional Recommendations on Whistleblowers and Frontline Worker Incentives

We will seek to better align compensation practices with the interests of shareholders and the stability of firms and the financial system through the following five principles. First, compensation plans should properly measure and reward performance. Second, compensation should be structured to account for the time horizon of risks. Third, compensation practices should be aligned with sound risk management. Fourth, golden parachutes and supplemental retirement packages should be reexamined to determine whether they align the interests of executives and shareholders. Finally, transparency and accountability should be promoted in the process of setting compensation.
"Financial Regulatory Reform, A New Foundation," 17 June 2009, Treasury Department, at 29

A system that rewards failure and short-term gains with catastrophic risk undoubtedly contributed to the collapse of the big banks, AIG and the entire financial system. Failed leadership and the outright ignorance of facts by the executives and staff on the highest levels made their multi-billion dollar compensation packages and bonuses incredibly hard to comprehend for those of us stuck with the bill of bailing them out. Executive compensation policies should be fair to investors and should provide incentives to keep corporate leaders from making decisions that are detrimental to the safety and soundness of our financial system.

The Wall Street Journal reported that "from 2002 to 2008, the five biggest Wall Street securities firms paid an estimated $190 billion in bonuses. Those companies churned out $76 billion in combined profits during the same period. Last year, the companies had a combined net loss of $25.3 billion, yet paid bonuses of roughly $26 billion." Ninety percent of institutional investors think the current compensation system has overpaid executives, while 75% support giving shareholders "say on pay."[24]

To begin to address this issue, the Administration proposes a number of changes to the current system. Within these proposals are some common sense solutions that simply work to better align a corporation's decisions and investments with what's best for the real owners – the shareholders. And now that taxpayers are the reluctant shareholders in large banks, the insurance and auto industries – we're owners too.

There are two key elements to the proposed reforms:

- Shedding light on the process of determining executive compensation and including shareholders in the process
- Aligning performance and reward incentives with long-term performance and the recognition of risk, not short-term gains

[24] Statistical source: Americans For Financial Reform "Executive Compensation" white paper, available at http://ourfinancialsecurity.org/2009/07/executive-compensation/ (last visited 4 July 2009).

A. Shedding light on the process of determining executive compensation and including shareholders in the process

Compensation committees can easily consist of individuals in the same industries who want to keep their friends in the money, and often do. There is little to no independence or requirement to act in the interest of shareholders when it comes to compensation.

The Administration recommends that public companies "facilitate greater communication between shareholders and management over executive compensation" and should "include on their proxies a nonbinding shareholder vote on executive compensation." Studies have found that this practice, widely known as "say on pay," has been effective in several other countries in terms of producing shareholder value and compensation and retirement packages that are more in line with performance.[25]

Critics will say that the shareholders do not understand the complexities of compensation and therefore would not add value. The bank executives repeatedly – in many times and within many aspects of the financial crisis – used the complexity argument to scare people from asking tough questions. That needs to end. If they language is oblique and terms are from the inside, then these institutions need to make it a more clear and transparent communication. And there isn't one shareholder who does not understand that bringing a company and the financial system to a collapse calls for new leadership.

B. Aligning performance and reward incentives with long-term performance and the recognition of risk, not short-term gains

Executives and employees have the incentive to "bet the house" because in many cases they are not playing with their own money. They are paid based on what they bring in – not necessarily on what they risked to get there. And as long the money poured in, no one rocked the boat.

The common sense approach is to align to align compensation with long-term performance and not short-term or immediate financial gain.

A responsible executive compensation program should not pay out short term bonuses unless performance is maintained a period of time, to avoid the possibility of rewarding executives just prior to a collapse in performance. Short-term incentive plans, if not designed with effective safeguards, could inappropriately encourage senior executives to manage for the short term and take on excessive risk. Evidence indicates that the current financial crisis was exacerbated by executives being rewarded for short-term financial performance without regard to whether that level of performance was sustainable.

Short term bonus payments to top executives of failed financial institutions have renewed interest in finding more efficient methods of compensation. Tens of millions of dollars in bonus payments were made to firms such as Bear Sterns, AIG and Lehman Brothers.

[25] Sudhakar Balachandran, Fabrizio Ferri & David Maber, *Solving the Executive Compensation Problem through Stockholder Votes? Evidence from the U.K.*, 2007 Nov.; Jie Cai & Ralph Walking, *Stockholders Say on Pay: Does it Create Value?* 2008 Dec.

In 2007, the Committee for Economic Development, a distinguished panel of business and academic leaders, found that "[d]ecision making based primarily on short-term considerations damages the ability of public companies, and therefore, of the U.S. economy to sustain superior long-term performance."

Goldman Sachs Chairman and CEO Lloyd Blankfein agreed, stating that "an individual's performance should be evaluated over time so as to avoid excessive risk taking and allow for a 'clawback' effect. To ensure this, all equity awards should be subject to future delivery and/or deferred exercise over at least a three-year period." [26] This week, Goldman announced a return to profitability and a return to large bonuses.

> "I find this disconcerting," said Lucian A. Bebchuk, a Harvard law professor. "My main concern is that it seems to be a return to some of the flawed short-term compensation structures that played an important role in the run-up to the financial crisis."[27]

C. Improving incentives and protections for frontline workers

Executive pay reforms should also be accompanied by fixing frontline worker incentives so that they are not forced to sell wealth-depleting products to consumers to meet work goals and requirements and to maintain their pay levels above-minimum wage. In the bank pay pyramid, the fewer highly-compensated employees make greater bonuses when their work culture compels low-paid frontline workers to pile high-cost credit cards, overdraft accounts and other profitable but unfair products onto unsuspecting consumers.

Perversely, an incentive system similar to one at the top is at work at the street level of the biggest banks, although the street level workers can't actually win. In the tens of thousands of bank branches and call centers of our biggest banks, employees-including bank tellers earning an average of $11.32 an hour-are forced to meet sales goals to keep their jobs and earn bonuses. Many goals for employees selling high-fee and high-interest products like credit cards and checking accounts have actually gone up as the economy has gone down.

Risk-taking in the industry will quickly outpace regulatory coverage unless financial sector employees can challenge bad practices as they develop and direct regulators to problems. Whistleblowers are critical to combating fraud and other institutional misconduct. The federal government needs to hear from and protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare. If we previously had more protections for whistleblowers, we would have had more warning of the eventual collapse of Wall Street. We commend the administration for including employee protection in its reform, but urge that it be strengthened.

Since 2000, Congress has enacted or strengthened whistleblower protections in six laws. They include consumer product manufacturing and retail commerce, railroads, the trucking industry, metropolitan transit systems, defense contractors, and all entities receiving stimulus funds. All of these laws provide more incentives and protections for disclosure of wrongdoing than does the

[26] Both CED and Blankfein quoted in Americans For Financial Reform "Executive Compensation" white paper, available at http://ourfinancialsecurity.org/2009/07/executive-compensation/ (last visited 4 July 2009).
[27] Graham Bowley, "With Big Profit, Goldman Sees Big Payday Ahead," the New York Times, 15 July 2009.

current proposal from the administration. For example, it does not protect disclosures made to an employer, which is often the first action taken by loyal, concerned employees, and the impetus for retaliation. Also conspicuously absent are administrative procedures and remedies that include best practices for fair and adequate consideration of claims by employees.

We recommend the following improvements in any reform legislation before the committee.

Whistleblower protections. Innovation in the industry will quickly outpace regulatory coverage unless bank branch, call-center, and other financial sector employees can challenge bad practices as they develop and direct regulators to problems. The federal government needs to hear from and provide best practice whistleblower rights consistent with those in the stimulus and five laws passed or strengthened last Congress to protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare.

Fair compensation. New rules need to restructure pay and incentives for front-line finance sector employees away from the current 'sell-anything' culture. The hundreds of thousands of front-line workers who work under pressure of sales goals need to be able to negotiate sensible compensation policies that reward service and sound banking over short-term sales.

III. Comments on Administration plan to provide greater protection for investors

A. New Fiduciary Responsibilities a Critical Step

The critically-important section 913 of the proposed Investor Protection Act of 2009[28] empowers the SEC to impose a fiduciary duty on dealer-brokers in order to harmonize the regulation of these professionals with that of investment advisors. This heightened standard of care is a positive step towards ensuring that investors have the protection needed to engage in sound and beneficial investments. By folding broker-dealers in with investment advisors, this legislation deals with the reality of these professions: those who act as advisers should be regulated as advisers. While the thrust of this amendment is commendable, it is critical that Congress take steps to ensure that the legislative language used to empower the SEC is drawn as narrowly as possible to meet legislative intent.

We agree with the position of the Consumer Federation of America that any "watered down" language that provides less than the most robust protection for investors in adviser/investor relationships does not go far enough to right the wrongs of previous practices. In particular, the language of Sec. 913 subsections (k) and (f), the sections that may be used to impose a fiduciary duty on brokers, dealers, and investment advisers, is permissive, "...the Securities and Exchange Commission **may** promulgate rules...." Instead we join the North American Securities Administrators Association[29] and the CFA to urge that the legislative language mandate that the SEC adopt the highest standard of care in order to avoid overly broad standards and that broker-

[28] Legislative language is available at http://www.treas.gov/press/releases/docs/tg205071009.pdf (last visited 14 July 2009).

[29] Testimony of Fred J. Joseph, Colorado Securities Commissioner and President, North American Securities Administrators Association Before the United States Senate Committee on Banking, Housing, and Urban Affairs, "Enhancing Investor Protection and the Regulation of Securities Markets," March 26, 2009.

dealers not be able to escape that higher standard of protection. Roper goes further and argues that there should not be an artificial delineation allowing broker-dealers to escape their fiduciary duties between offering advice and selling.

As the Consumer Federation of America has noted on numerous occasions, over the past two decades, in response to competition from both financial planners and discount brokers, full service brokers have transformed their business model into one that is, or at least appears to be, largely advice-driven. They have taken to calling their sales representatives "financial advisers," offered investment planning services, and marketed their services based on the advice offered. The SEC permitted this transformation without requiring brokers to comply with the Investment Advisers Act provisions designed to govern such conduct. Instead, each time the SEC has had to make a choice between protecting investors and protecting the broker-dealer business model, it has chosen the latter. The President's plan attempts to reverse that trend, by ensuring that all those who offer advisory services are subject to the appropriate fiduciary standard of care and loyalty and by improving the quality of pre-engagement disclosure investors receive about these obligations.

The Administration also proposes a study of the use of mandatory arbitration clauses in investor contracts and, based on that study, very commendably recommends "legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers." We believe that the study will show that the SEC should and must use that authority to prohibit forced arbitration in investor contracts, just as we believe that the CFPA should ban them in credit and deposit accounts. It is a myth that forced arbitration lowers the costs of dispute settlements. This may be true among equivalent business players; it is rarely true between small investors and big securities firms and more rarely, if ever, true in any standard consumer contract, between, for example, a credit card company and a consumer, a hospital or cell phone company or car dealer and a consumer, or, worse, between a nursing home and a bed-ridden, aged consumer.[30]

B. Other Improvements Needed To Protect Small Investors

While Congress needs to hold the SEC accountable; it must also preserve its independence. Congress also needs to fully fund the SEC, including its consumer and investor protection and enforcement divisions. Given demonstrated weaknesses in the agency's oversight revealed by both the current crisis and the Bernie Madoff scandal, Congress should assess the funding needs of the SEC and then take steps to bring the agency as quickly as possible to the point that it can fully carry out its mission of oversight of the markets and financial professionals. In addition, the SEC should be authorized to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action. Too often, the Department of Justice passes on securities-related cases because of its own resource constraints and competing priorities.

Finally, although we commend the administration for its proposals in the Investor Protection Act of 2009 to improve and clarify its own aiding and abetting liability, it regrettably does not propose to reinstate investor rights to enforce aiding and abetting liability under Section 10(b) of

[30] For more information and studies on these matters, see the U.S. PIRG-supported coalition Fair Arbitration Now! website at http://www.fairarbitrationnow.org/ (last visited 14 July 2009).

the Securities Exchange Act of 1934 and SEC Rule 10b-5, as largely eliminated by the Supreme Court in *Central Bank*[31] in 1994 and even more harshly limited in *Stoneridge* in 2008.

Even when individuals' claims are small, the costs to society and the economy of a fraud may be in the hundreds of millions or billions of dollars. Yet, absent the ability to proceed collectively, individuals have no means of redress because – as the wrongdoers know – it is frequently economically impossible for victims to pursue claims on an individual basis. Private investors form a key front-line defense against financial fraud and abuse as they are in the unique position to identify and take action against unlawful conduct. The ability of investors to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Legislation should ensure that all individuals have the right to access federal courts individually or as a member of a class action.
As we told the Supreme Court in our 2008 friend of the court brief in *Stoneridge*:[32]

> Few, if any, of the major corporate frauds of the last decade have been perpetrated by corporate securities issuers (including their officers, directors, managers, and other insiders) acting alone. Outside actors have played significant roles in nearly every one – in some instances by making false statements calculated to deceive investors about the issuer's financial condition and in others by participating in deceptive financial transactions calculated to achieve the same result. [...] The victims of several of the most notorious recent frauds have achieved a substantial measure of recovery (though in each case far from all of their losses) only because courts allowed them to proceed against culpable outside actors.

Further, the administration regrettably does not propose to reduce unduly high pleading requirements and other barriers to justice for small investors established by the so-called Private Securities Litigation Reform Act of 1995.[33]

IV. Comments on Administration plan to reform prudential regulation[34]

For the last three decades, financial regulators, Congress and the executive branch have steadily eliminated core pieces of the regulatory system that had restrained the financial sector from acting on its own worst tendencies. The post-Depression regulatory system aimed to force disclosure of publicly relevant financial information; established limits on the use of leverage; drew bright lines between different kinds of financial activity and protected regulated commercial banking from investment bank-style risk taking; enforced meaningful limits on economic concentration, especially in the banking sector; provided meaningful consumer protections (including restrictions on usurious interest rates); and contained the financial sector so that it remained subordinate to the real economy.

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[31] U.S. PIRG joined Trial Lawyers for Public Justice (now Public Justice) in an unsuccessful amicus in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).
[32] *Stoneridge Investment Partners, LLP v. Scientific-Atlanta, et al.*, Brief of AARP, Consumer Federation of America, and U.S. PIRG as *amici curiae* in support of petitioner, available at http://www.uspirg.org/html/consumer/archives/stoneridgeamicus-aarp.pdf (last visited 14 July 2009).
[33] Public Law 104-67.
[34] Parts of this section come from the Americans for Financial Reform white paper "Restoring Prudential Financial System Regulation" I co-authored, available at http://ourfinancialsecurity.org/afr/pdfs/restoring_prudential_regulation.pdf (last visited 14 July 2009).

This regulatory system was highly imperfect, of course, but it was not the imperfections that led to the system's erosion and collapse. Instead, it was a concerted effort by Wall Street, which gaining momentum steadily until it reached fever pitch in the late 1990s that continued through the first half of 2008.

One of the key flaws in that system was a lack of prudential supervision by the financial regulators themselves. They failed to use their broad powers. Bank regulators were supposed to hold banks to adequate capital standards, prevent unsafe and unsound lending and maintain an adequate deposit insurance base. With too little congressional oversight, regulators became too cozy with the banks. Worse, the Congress acceded to industry demands to reduce deposit insurance premiums and to even base them on weak "risk" standards. As a result, many banks avoided making adequate payments into the funds even as the level of risk they placed on the system grew. This worsened moral hazard.

Further, the bank regulatory system has remained largely outside of congressional purview because bank regulators are not paid out of congressional appropriations. Instead, regulators receive regulatory dues assessments from banks and largely control their own budgets.

We need a simpler and more transparent financial system that is far less vulnerable to speculative abuse and systemic risk, as well as a reliable policing mechanism in order to restore the financial markets to their proper role as facilitators of the real economy. A core principle of both efforts is that any institution that creates credit (and hence risk) must be subject to prudential regulation. It does not matter whether the institution calls itself a commercial bank, an investment bank, a mortgage broker, a hedge fund or a private equity firm. There must be no category of institution that escapes supervision. As candidate Barack Obama astutely stated in an important campaign speech on March 27, 2008, at Cooper Union in New York: "We need to regulate institutions for what they do, not for what they are."

As the Administration has correctly proposed, a variety of actions must be taken to improve capital standards, reduce leverage, require real "skin in the game" in securitizations, and bring off-balance sheet entities onto balance sheets.

The administration has also proposed a modest consolidation-- between the two most problematic regulators, the Office of the Comptroller of the Currency and the Office of Thrift Supervision. "Competition" between the OCC and OTS for "memberships" in the form of regulatory dues assessments created a regulatory race to the bottom, in which banks sought the least attentive regulator that would grant them the most powers. This and other proposed reforms will greatly reduce the charter-shopping that is a hallmark of the failed system.

We also believe that the deposit insurance system should be reviewed and reforms should be considered after its degradation over the years as banks requested more and more exceptions from paying adequate premiums. Further, imposition of significantly higher premiums on larger banks will both fairly price the cost of their risks and, as a bonus, temper their size organically, thereby reducing the number of institutions that may become too-big-to-fail.

Congress should also consider giving the FDIC more authority over holding companies, not only in winding down situations. The administration has instead proposed "a new authority" like the

FDIC. But as FDIC Chair Sheila Bair has testified,[35] "Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level." This means that the FDIC needs greater authority over the actions of an entire holding company, not just a failing bank, to limit risk caused by the holding company's actions.

Additional Suggestions: Each prudential regulator should issue an annual report on emerging risks so that the public will know what trends the regulators are observing. The data included in public Call Reports, or statements of condition, of institutions under federal regulation should be broadened and subject to more detailed public disclosure so that the public and the Congress can better evaluate where institutions obtain their income and where their risks are changing over time. Each regulator should also implement an effective complaint system that actually assists consumers and complements the efforts of the Consumer Financial Protection Agency.

V. Comments on Administration plan to improve systemic risk regulation and reform the Federal Reserve

We join others in the bedrock belief that requiring financial firms to sell safer, less risky products in the first place, by establishing a CFPA, will help reduce the potential for overall risk in the system. Second, a revitalization of the prudential regulators further limits risk. Third, greater accountability and quicker responses through information sharing, such as among the members of the proposed Financial Services Oversight Council, which would have the ability to gather information from any financial firm, ensures a broader scope of oversight. Nevertheless, the role of the interconnectedness of the system in the recent economic collapse demonstrates that greater attention to systemic risk response is needed.

The most important step in addressing systemic risk is to ensure the safety and soundness, fairness, transparency, and accountability of financial markets, participants, and products. If regulatory agencies perform those functions properly, then systemic risk will be far less of a problem. Congress must close loopholes in the regulatory structure to ensure that all financial products and activities are subject to appropriate oversight, provide agencies with sufficient resources to do their jobs, and hold them accountable to do so. Finally, regulators must regulate. Policy makers should not permit the question of a new systemic risk regulator to eclipse the tasks of strengthening other forms of oversight and accountability; nor should they over-assume the existence of systemic risk. Nevertheless they should also understand that systemic risk can derive from a variety of different practices, and not just from the very biggest players.

U.S. PIRG remains agnostic on whether the Federal Reserve Board or some other agency instead should become the systemic risk regulator. If it is to be the Federal Reserve, a series of democratization and transparency steps must be taken first. At a minimum, the Fed's governance must be reformed substantially before it could be considered as an appropriate systemic risk regulator, for example by removing bank representatives from the governance of the regional

[35] Statement of Sheila C. Bair Chairman, Federal Deposit Insurance Corporation on Regulating and Resolving Institutions Considered "Too Big To Fail"; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 6, 2009, available at http://www.fdic.gov/news/news/speeches/chairman/spmay0609.html (last visited 14 July 2009).

Reserve Banks. Further, as an example of the banking industry's untoward sway over monetary policy, under current rules, the Federal Open Market Committee is composed of the 7 Fed governors, plus the presidents of the Regional Federal Reserve Banks (whose voting rights rotate). Yet each of these presidents is chosen by a non-democratic system dominated by the banks. Past reforms designed to place public and labor representatives on these boards have not been adequately implemented and deserve greater scrutiny and improvements. Earlier and more public access to Fed deliberations is a critical transparency step.

The Administration has proposed a variety of important systemic risk actions and responses. One that is most problematic, however, is its proposal to identify "systemically significant" institutions up-front and subject them to higher standards and more regulatory scrutiny. Essentially, large parts of the administration's paper are devoted to creating a regulatory system under the Fed for institutions that we would call too-big-to-fail, and are designated in the paper as Tier 1 FHCs (Financial Holding Companies) or "any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed."[36]

We agree with the Consumer Federation of America that such riskier firms should be subject to heightened regulation, but that "heightened standards should ratchet up along a continuum rather than turn on or off according to a determination that a particular institution poses a systemic threat."

We are also concerned that the prominent identification of firms as "TBTF" by some automatic criterion vastly increases their own moral hazard. If you know you are too-big-to-fail, you'll take more risks, and increase your impact on systemic risk.

As the Nobelist Joe Stiglitz has testified, we don't necessarily want too many of these firms:

> Being too big to fail creates perverse incentives for excessive risk taking. The taxpayer bears the loss, while the bondholders, shareholders, and managers get the reward. [...] The only justification for allowing these huge institutions to continue is that there are significant economies of scope or scale that otherwise would be lost. I have seen no evidence to that effect. [...] In short, we have little to lose, and much to gain, by breaking up these behemoths, which are not just too big to fail but also too big to save and too big to manage.[37]

VI. Comments on Administration plan to cover the shadow markets

Financial oversight has failed to keep up with the realities of the marketplace, characterized by globalization, innovation, and the convergence of lending and investing activities.[38] This has allowed institutions to structure complex transactions and take on risky exposures without

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[36] Page 22, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, June 17, 2009.

[37] See testimony of Professor Joseph Stiglitz at a hearing of the Joint Economic Committee entitled "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions," 21 April 2009, for further discussion.

[38] Parts of this section are based on the Americans for Financial Reform white paper "Regulating the Shadow Markets," prepared by Heather Slavkin of the AFL-CIO and a committee including the author of this testimony, available at http://ourfinancialsecurity.org/afr/pdfs/regulating_shadow_markets.pdf (last visited 14 July 2009).

fulfilling the regulatory requirements Congress deemed necessary to prevent a systemic financial crisis after the Great Depression. These unregulated and under-regulated activities and institutions, the "shadow financial system," were permitted to become so intertwined with the real economy that the government has chosen to use taxpayers' money to bail them out when they failed.

Again, as President Obama said during the campaign, "We need to regulate institutions for what they do, not what they are." This means that hedge funds, private equity funds, derivatives, off-balance sheet lending vehicles, structured credit products, industrial loan companies and other shadow markets actors and products must be subject to transparency, capital requirements, and fiduciary duties befitting their activities and risks.

Shadow market institutions and products must be subject to comprehensive oversight. We need to return to the broad, flexible jurisdiction originally provided in federal securities regulation, which allowed regulators to follow activities in the financial markets. This means ensuring that all institutions that are active in the shadow financial markets provide regular information to regulators and the public about their activities and their counterparty relationships, requiring derivatives to be traded on regulated exchanges that are transparent and impose meaningful margin requirements, and requiring money managers to provide comprehensive disclosures and to act as fiduciaries for their investors.

U.S. PIRG has long supported these reforms as well as supported closing existing loopholes that others have sought to expand or exploit. For example, the administration proposal takes important steps in closing Industrial Loan Company loopholes that not only allow commercial firms to intrude into the banking sphere but to do so in an under-regulated way, where their regulators do not have full ability to examine and regulate the ILC's parent holding company. As we testified in 2006 before the FDIC in opposition to Wal-Mart's application for deposit insurance coverage for an industrial bank chartered in Utah:[39]

> Oversight of the holding company is the key to protecting the safety and soundness of the banking system. It is immaterial whether the owner of the bank is a financial or a commercial entity. Holding company regulation is essential to ensuring that financial weaknesses, conflicts of interest, malfeasance or incompetent leadership at the parent company will not endanger the taxpayer-insured deposits at the bank.
>
> Years of experience and bank failures have shown this to be true. For example, recent accounting scandals at Sunbeam, Enron, Worldcom, Tyco, Adelphia and many others involved deliberate deception about the financial health of the companies involved. If these companies had owned banks, not only would employees, investors and the economy have suffered, but taxpayers as well.
>
> Moreover, allowing a Wal-Mart-owned industrial bank to enter the FDIC system would further widen the ILC loophole to the BHCA, which should instead be closed. It is time to shut down this parallel banking system, not allow its further expansion.

[39] See 28 March 2006 testimony of U.S. PIRG before the FDIC available at http://static.uspirg.org/consumer/archives/PIRGWalmarttestimony.pdf (last visited 14 July 2009).

Some have suggested that certain aspects of the shadow financial markets, particularly hedge funds and derivatives such as credit default swaps, should be overseen only by a systemic risk regulator instead of being subject to comprehensive regulation. This would be a terrible mistake. The shadow financial markets must be subject to comprehensive, routine oversight appropriate to the activities involved. Systemic risk regulation should function as an addition to this oversight, not a replacement for it, focusing on problems that arise from interactions among institutions regulated by different regulatory bodies or emerging risks not fully addressed by the other regulators.

We concur with the Consumer Federation of America[40] that the President's plan attempts to address both problems associated with unregulated shadow markets: the ability of risks to grow undetected and the potential for abuse. It addresses the former problem both through its approach to systemic risk regulation, and through its requirement that all financial firms be subject to functional regulation by the appropriate regulatory authority. Hedge fund advisers, for example, would not only be required to register with the SEC; they would also be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability, provide confidential reports to regulators on their holdings, and submit to SEC compliance inspections.

We concur with the Consumer Federation of America's detailed analysis that the proposed plan on derivatives represents significant improvement over the current situation. Whether investors and the markets reap the full benefits of this regulatory proposal will depend on several key factors, including how rigorous the capital and margin requirements for dealers turn out to be and how vigorously regulators enforce the business conduct rules and other rules to prevent market abuse. More fundamental factors that will determine success are: 1) how effective regulators are in preventing dealers from evading the central clearing and requirement through the use of customized contracts and 2) how forcefully they push to move as much as possible of the standardized markets onto regulated exchanges.

Among the most important of the plan's other provisions on derivatives include whether its emphasis on exchange, not clearinghouse, trading is maintained. Because of the potential benefits exchange trading offers not only for price transparency and competition, but also for effective risk reduction and fraud prevention, we join the CFA in urging Congress to ignore the self-interested arguments of derivatives dealers and ensure that, as legislation is drafted to implement the administration plan, it includes the strongest possible provisions to require exchange trading of standardized derivatives as soon as that is feasible, with a strong preference against unnecessary customization.

[40] For a more detailed treatment, see testimony of Travis Plunkett, Consumer Federation of America, 16 July 2009, at this same hearing before the Committee on Financial Services, U.S. House of Representatives on "Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals."

VII: Comments on the Administration Plan To Regulate Credit Rating Agencies[41]

One disappointing area of the administration's proposal is its failure to propose robust reforms of the Credit Rating Agencies – including Standard and Poor's, Moody's and Fitch's.

With Wall Street combining mortgage loans into pools of securitized assets and then slicing them up into tranches, the resultant financial instruments were attractive to many buyers because they promised high returns. But legal and internal rules prohibit many pension and government funds and other investors from investing in financial instruments unless they are highly rated by credit ratings agencies. The credit rating firms enabled these investors to join the speculative frenzy, by attaching top ratings to securities that actually were high risk—as subsequent events have revealed.

The credit ratings firms have a bias to offering favorable ratings to new instruments—and have a long record of failure including enthusiastic ratings for Enron debt—because of their complex relationships and conflicts of interest with securities issuers, and their desire to maintain and obtain other business dealings with issuers and investment banks.

This institutional failure and conflict of interest might and should have been forestalled by the SEC, but the Credit Rating Agencies Reform Act of 2006 gave the SEC insufficient oversight authority. In fact, the SEC must give an approval rating to credit ratings agencies if they are adhering to their own standards—even if the SEC knows those standards to be flawed.[42] The SEC itself has documented substantial credit ratings firm failures over the last decade, including conflicts of interest and an inability of the firms to manage the proliferation of complex instruments.[43]

Despite these manifold problems and their well-document massive impact on the economic collapse, the administration proposal merely proposes some minimal changes. We support these efforts, but they are not sufficient.

One option to address the failure of the credit ratings firms would be to increase the regulatory controls over their operations, such as authority to monitor credit rating firm performance and to oversee and regulate the process by which the firms derive their ratings. Due to structural conflicts of interest, this approach may also not be sufficient. Additionally, Congress should

[41] Americans for Financial Reform will soon be issuing a detailed white paper on Credit Rating Agency issues, prepared by Robert Weissman of Essential Action and a committee including the author of this testimony.
[42] Available at http://www.sec.gov/news/testimony/2007/ts092607cc.htm.
[43] See "The Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," Securities Exchange Commission, July 2008, available at http://www.sec.gov/news/ press/2008/2008-135.htm.
[44] See for example, S. 1073, introduced May 19, 2009 by Senator Jack Reed (important features of S. 1073 include: SEC review of credit rating firm methodologies and transparency rules for methodologies; strong conflict of interest prohibitions or at least disclosures; and development of scorecards to reveal credit rating firm performance over time); Testimony of Robert F. Auwaerter, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, May 19, 2009, available at http://www.house.gov/apps/list/ hearing/financialsvcs_dem/hrcm051209.shtml.

consider establishing civil liability for credit ratings firms that are grossly negligent or worse, giving parties that relied on improper credit ratings the right to recover damages.[45]

A more transformative solution would be to establish a public credit ratings agency, as Essential Action has proposed.[46] This agency, which could be funded by a small financial transactions tax,[47] would provide ratings for all financial instruments, as a condition of the securities being legally trade-able. On some occasions, the public agency may conclude that an instrument is "not ratable," because it is too complex to provide an accurate risk appraisal. Private ratings firms could continue to operate, and they could offer their own judgments about the riskiness of financial instruments. However, financial regulations that rely on an independent assessment of risk would be required to use the ratings of the public agency. Establishing a public credit ratings agency would eliminate existing conflicts of interest and the corrupting complex relationship between private ratings firms and issuers. It would treat credit ratings as a public good, and align the government-mandated use of credit ratings with independent and publicly generated risk assessments.

Conclusion

We appreciate the opportunity to work with both the President and the Committee to seek enactment of the strongest possible reforms following the unfortunate collapse of our financial system that has had a severe effect on our members and other consumers. We believe that the President and the Committee are correct to prioritize the establishment of strong consumer protections while re-establishing federal law as a floor not a ceiling. We look forward to working with you to first establish a fully empowered Consumer Financial Protection Agency and then to ensure that comprehensive reforms covering the entire financial system are enacted. Mr. Chairman, please have any members of the committee contact us with any questions.

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[45] According to Robert Weissman of Essential Action, some First Amendment issues could be avoided by attaching liability not to the voicing of an opinion but by requiring entities performing statutorily specified gatekeeper functions to agree to accept liability as a condition of certification to perform the gatekeeper role. See Testimony of Eugene Volokh, before the Financial Services Committee, U.S. House of Representatives, May 5, 2009, available at: http://www.house.gov/apps/list/hearing/ financialsvcs_dem/hrcm051209.shtml

[46] M. Ahmed Diomande, James Heintz and Robert Pollin, "Why U.S. Financial Markets Need a Public Credit Rating Agency," Washington, DC: Essential Action (forthcoming).

[47] "A financial transactions tax (FTT) can be an important force for constraining the financial sector.[...] An FTT could raise an enormous amount of money. It could easily raise an amount equal to 1 percent of GDP, currently $150 billion a year or more than $1.8 trillion over the course of a decade." See the Americans for Financial Reform white paper on "Financial Transactions Taxes" as prepared by Dean Baker, Center for Economic Policy Research, available at http://ourfinancialsecurity.org/2009/07/financial-transactions-taxes/ (last visited 14 July 2009).

NCLR

NATIONAL COUNCIL OF LA RAZA

Laying the Foundation for Improved Access to Credit for Hispanic Families

Presented at:

"Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

Submitted to:

U.S. House of Representatives Committee on Financial Services

Submitted by:

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July 16, 2009

Good morning. My name is Janet Murguía. I am the President and CEO of NCLR (the National Council of La Raza)—the largest national Hispanic[1] civil rights and advocacy organization in the United States. For the last four decades, NCLR has been committed to improving opportunities for the nation's 47 million Latinos. To this end, NCLR conducts research, policy analysis, and advocacy on a variety of financial services issues that impact the ability of Latinos to build and maintain assets and wealth. I would like to thank Chairman Frank and Ranking Member Bachus for inviting me to participate in this timely and important hearing.

NCLR is deeply concerned that a generation of Latino wealth will be lost as a result of widespread failures of the banking systems and insufficient policy responses. Latinos have been historically marginalized from mainstream financial services, such as basic banking and checking accounts. Despite the many barriers, Latinos are entering the financial services market in record numbers. Unfortunately, these same barriers leave Hispanic borrowers vulnerable to abuse. As a leading voice for Latino consumers, NCLR has been warning corporations and governments for years that the financial markets do not serve Latino consumers well. Unprecedented foreclosures on homes and rising household debt from burdensome credit cards and car loans have exposed the system's weaknesses. We and our national network of Affiliates have been doing our part to ensure that potential Latino homeowners have access to safe and affordable credit and home loans, as well as high-quality financial advice. As a housing counseling intermediary, NCLR serves more than 38,000 homebuyers and homeowners every year. The NCLR Homeownership Network (NHN) has expanded beyond its traditional work in homeownership counseling to include foreclosure prevention, rental assistance, and financial planning. We understand what it takes to build sustainable wealth in Latino communities and have executed a successful strategy to do so.

Our national banking system is failing communities of color. Latino families are routinely steered toward inferior financial products designed to profit front-end originators, often resulting in default or burdensome debt. In contrast, a well-functioning system would put families on a path to financial security, building wealth for future generations. We applaud the administration and Congress, especially members of this committee, for taking on a bold regulatory reform agenda. We urge Congress and regulators to move swiftly to create a regulatory environment that promotes financial security for all communities, rather than quick profits for a few.

In my testimony today, I will discuss critical weaknesses in our banking system that have led to a two-tier financial system in which communities of color and other underserved populations routinely pay more for financial services and credit. I will also offer our analysis on the ways in which the administration's proposed overhaul addresses our concerns. I will close with a series of recommendations on how the proposed reforms can be strengthened.

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[1] The terms "Hispanic" and "Latino" are used interchangeably by the U.S. Census Bureau and throughout this document to identify persons of Mexican, Puerto Rican, Cuban, Central and South American, Dominican, Spanish, and other Hispanic descent; they may be of any race.

Banking System Shortfalls

All Americans rely on financial products to help them buy homes and otherwise build wealth and financial security. Access to safe and affordable credit is an important means to this end for Latinos as they more fully integrate into the mainstream financial system and work to gain access to the American middle class. Yet, clear disparities exist between the quantity and quality of credit and banking products made available to low-income and minority consumers. These disparities perpetuate the wealth gap between minority and White households. Our banking oversight and regulatory systems are outdated, leaving consumers, investors, and even banking institutions themselves vulnerable to the consequences of failure. Congress must take this opportunity to modernize our banking oversight infrastructure with the goal of improving the quality and quantity of credit available to marginalized communities while also protecting consumers and investors.

Hispanic families are entering financial markets at a rapid rate, demonstrating a clear and growing demand for services. With their purchasing power to exceed 1.2 trillion by 2012,[2] it is no wonder that many financial institutions are looking for ways to capture the Hispanic market. However, the industry has taken few steps to develop or tailor products that meet their needs. Predatory lenders have been quick to fill the gaps between the needs and demands of consumers and the offerings available at banks and credit options. As a result, families waste hard-earned income on fees and high interest rates, rather than saving or paying down principal, and are at high risk for burdensome debt, foreclosure, and bankruptcy. There are numerous examples:

- **Lending:** Hispanic mortgage borrowers are more likely to have nontraditional profiles, resulting in rejection by automated underwriting. Even though the technology and business models exist to serve such a profile, originators often choose the more profitable route of steering families into subprime and exotic loans, even when their credit and income justify a prime product. As a result, Latino borrowers are more than twice as likely to receive a subprime home loan and are overrepresented among interest-only and negatively amortizing products.[3] In the case of auto lending, research has shown that Latino borrowers are more likely than White borrowers to receive an unnecessary markup in their interest rate, and the markup is typically higher for Latinos than Whites.[4]

- **Credit:** Hispanic families are less likely than others to have a credit card. Selective marketing tactics ensure that they only receive offers from the most expensive cards, which are characterized by terms and conditions that pile on fees and interest rate hikes. Latinos are nearly twice as likely as Whites to have a credit card interest rate over 20%.[5]

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[2] "Hispanics Are the Largest Minority in the U.S. with Purchasing Power Projected to Exceed...," *Reuters.com*, March 31, 2008, http://www.reuters.com/article/pressRelease/idUS124765+31-Mar-2008+BW20080331 (accessed January 9, 2009).

[3] Robert B. Avery, Kenneth P. Brevoort, and Glen Canner, "The 2007 HMDA Data," *Federal Reserve Bulletin* 94 (December 23, 2008).

[4] Mark A. Cohen, "Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation," Vanderbilt Law and Economics Research Paper no. 07-01 (December 14, 2006).

[5] Jennifer Wheary and Tamara Draut, *Who Pays? The Winners and Losers of Credit Card Deregulation* (New York, NY: Demos, 2007).

- **Banking:** Nearly one in six Latinos does not have a basic bank account. Two of the most commonly cited reasons for not having a transaction account by all those without one is that they do not like dealing with banks or the service fees are too high. When traditional banks do not meet their needs, consumers are driven to fringe financial providers that often charge high fees and do not encourage long-term savings.[6]

There is overwhelming evidence demonstrating that minority borrowers pay more to access credit than similarly situated White borrowers. This pattern of overpayment, abuse, and discrimination disrupts the financial stability of low-income and minority communities, and impedes their movement toward the middle class. There are four fundamental issues that characterize how the banking and financial services markets drain wealth rather than build it.

- **Shopping for credit is nearly impossible.** Many credit offers are not transparent. Credit card, auto loan, and mortgage borrowers are often unaware of the hidden costs included in their loans. Few shopping tools exist that can help borrowers create true apples-to-apples cost comparisons. As a result, some borrowers forgo shopping altogether while others rely on intermediaries, such as mortgage brokers or auto dealers, to shop on their behalf. Numerous studies and reports showing deception and hidden costs through these delivery channels demonstrate that brokers and dealers cannot be trusted consistently to operate in a manner that truly benefits the borrower. Furthermore, issuers of credit aggressively shop for their borrowers by trolling credit profiles and sending offers to their selected profile. This system guarantees opportunities for some and makes easy targets for high-cost products out of others.

- **Borrowers are steered toward expensive products regardless of creditworthiness.** Many low-income and minority borrowers have unique borrower profiles—such as thin credit files, multiple co-borrowers, or multiple sources of income—that are not easily processed through automated underwriting. Rather than taking the time to match these consumers with existing products that accurately measure their true risk, lenders err on the side of higher-risk and steer borrowers toward products that are easier to originate and highly profitable. Low-income and minority borrowers are more likely than similarly situated White borrowers to receive high-cost mortgage loans, even after controlling for income, co-applicant, and credit. The scenario is the same for credit cards and auto loans—Hispanic and African American borrowers are more likely than their White peers to get higher markups or pay higher interest rates. In fact, in auto and mortgage lending, brokers and dealers are paid kickbacks (known as Yield Spread Premiums in mortgage loans) for putting consumers in loans with higher interest rates than their credit warrants.

- **Creditors trap borrowers in cycles of debt.** For some subprime borrowers, excessive fees, high interest rates, and mounting debt effectively trap them in the subprime market. For example, many credit card customers find relief from a high interest rate card by transferring their balance to a credit card with a lower interest rate. Transferring balances from one card to another is not an option for consumers who carry high interest rates and

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[6] Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 95 (February 12, 2009).

who are often rejected for credit. In the case of home loans, the pervasive use of loose underwriting criteria led to the origination of loans that homeowners could never afford to repay. The mortgage industry wagers that the value of home prices would continue to climb and clients would refinance if their mortgage product became too expensive. This practice led many families into a downward spiral of wealth-draining refinances that has contributed heavily to the current mortgage crisis.

- **Fraud and scams are rampant.** Compounding the impact of predatory lending and the gaps in consumer protections is the rise of fraud and scams targeting victims of burdensome debt and foreclosure. Research conducted by the Federal Trade Commission (FTC) shows that 14.3% of Hispanics are victims of fraud, compared to 6.4% of non-Hispanic Whites.[7] From fake credit cards claiming to help families build credit to foreclosure rescue scams claiming to help families save their home, fraud is on the rise. In fact, scammers are taking advantage of the industry's slow response to the administration's Making Home Affordable program by marketing quick access to loan modifications. Families are paying thousands of dollars in desperate attempts to reach their servicer and save their home.

Examining Proposed Reform

NCLR applauds the bold reforms proposed by the Obama administration. The market's breakdown in its service to communities of color, low-income families, the elderly, and other traditionally underserved populations has had a devastating impact that extends well beyond those initially harmed. Though we have not taken formal positions on every aspect of the proposed reforms, NCLR is actively engaged in Americans for Financial Reform (AFR), which has established positions on each segment of the administration's proposal.[8] In addition to offering general support, there are four areas of the proposed reforms that are of particular importance to communities of color and must be maintained as the proposal moves through the legislative process:

- **Housing the missions of promoting access to credit and protecting borrowers in the same regulatory agency.** In some cases, the failure of banks to serve the community has gone beyond poor service to include active disengagement from certain communities or populations and discrimination. In the meantime, some community banks, credit unions, and Community Development Financial Institutions (CDFIs) offer safe and fair credit and banking products, but are often beat in the marketplace by bigger banks or predators with large marketing budgets. For these reasons, we see the value of an independent agency to evaluate, test, and track the performance of financial products. Such evaluations must be conducted in light of the credit needs of diverse communities. Communities of color have long been cut off from mainstream banking institutions, often because banks do not offer products that meet their needs and borrower profiles. The proposed Consumer Financial Protection Agency (CFPA) would place value on promoting positive innovations in the market and limitations on new practices and products that would drain wealth and increase debt.

[7] "Consumer Fraud in the United States: An FTC Survey," Federal Trade Commission Staff Report (August 2004).
[8] For more information, visit Americans for Financial Reform at http://ourfinancialsecurity.org.

- **Holding all players in the market accountable.** Players throughout the banking system, from originators, brokers, and credit issuers to Wall Street investment firms, had a hand in manipulating a weak regulatory system to maximize short-term profit gains, leading to our current foreclosure crisis. Mortgage brokers earned profits at the closing table with no investment in the long-term performance of a home loan. Banks and mortgage finance companies routinely packaged and sold their loans within hours of the transaction. Investment firms heavily influenced the terms and types of credit cards, car loans, and mortgages available for consumers by establishing risk tolerances and directing capital to certain products. The proposed reforms would hold all of these players accountable for their role in extending credit by requiring banks to retain a portion of the credit risk on loans they originate and closing loopholes that allowed some finance companies and bank affiliates to evade compliance with more prudent state and federal laws.

- **Emphasizing simple, straightforward banking and credit products.** All too often, standard, safe mortgage and credit products were beat in the marketplace by those that were high risk and, thus, highly profitable. Compensation schemes guaranteed that brokers, originators, and card issuers would put forward their most expensive products first, wherever possible, and seek to further maximize profit by attaching expensive add-ons and kickbacks, such as Yield Spread Premiums. These compensation structures are at the root of predatory lending and steering. The Obama proposal promotes the creation and advancement of straightforward financial products that emphasize consumer safety and affordability, such as a classic 30-year fixed rate mortgage and automatic enrollment in employer-sponsored retirement accounts. NCLR encourages Congress to take this concept a step further by making the offering of such products the default option for originators before moving to more expensive and risky products.

- **Making enforcement a priority.** Much of the current foreclosure and household debt problem is attributable to gaps in consumer protections and an unwillingness to enforce current law. For example, despite widespread evidence of racial and ethnic steering and other violations of civil rights laws, bank regulatory agencies refused to take enforcement action against lenders. Individual borrowers struggled to make their case against brokers or financial institutions when their rights were violated. Legal resources for modest-income families are scarce and consumer complaints often go without a response. The administration's proposed reforms put an emphasis on enforcement by creating a meaningful system for analyzing consumer complaints, protecting private rights of action, and creating new tools for regulators to assess systemic risk.

It should also be noted that the concepts of promoting greater access to the financial mainstream and increasing protections for vulnerable consumers are not in conflict, though at times a healthy tension may exist. Financial industry lobbyists often attempt to paint commonsense regulation as cutting off access to credit for minority families. This is a false argument and a scare tactic. Throughout the country, credit unions, community banks, and nonprofit lenders are serving the community well by creating alternatives to payday loans, offering free checking accounts, and using nontraditional credit information to underwrite loans. They do it while holding to the highest standards of safety and soundness, and generally offer prime pricing. NCLR strongly urges Congress and the CFPA to look to market leaders for innovative ways to expand all forms of credit and banking products to underserved communities, without sacrificing consumer protections.

Recommendations

NCLR welcomes the bold vision of the administration and many others who have contributed to the ideas and concepts within the proposal. Our current regulatory system has not kept pace with our expanding and dynamic financial markets. We need a regulatory system that is nimble and strong, and can respond to the complex demands of a global market as well as the individual circumstances of the consumers who make up one of their fundamental constituencies. In that spirit, we offer three recommendations for further strengthening the proposal.

- **Create an Office of Fair Lending Compliance and Enforcement within the CFPA.** Civil rights must be prioritized as a part of the agency's formal structure by establishing an office dedicated to promoting and enforcing fair housing and lending laws. This office should ensure that the CFPA itself operates in a manner that affirmatively furthers fair housing and that financial market players comply with fair lending statutes. It must have sufficient authority and resources to conduct fair lending examinations, engage in compliance activities, and write rules, and should be headed by a senior position who reports directly to the director of the CFPA.

- **Help consumers make smarter financial decisions.** The administration rightly proposes that the CFPA streamline disclosures and create standards that will simplify consumer shopping. However, these reforms stop short of improving borrowers' decision-making options. To achieve this, NCLR recommends that Congress go beyond general financial literacy and create a federally funded financial counseling program. Under such a program, nonprofits could provide objective, tailored advice to modest-income families to help them manage their personal finances, build credit, avoid unmanageable debt, plan for retirement, and spot scams.[9] In fact, this is the mainstream approach taken by families with the means to do so—they seek the advice of a professional financial planner or investment advisor. The CFPA can help give this same opportunity to lower-income families.

- **Improve data collection.** Publicly available data, such as those available under the Home Mortgage Disclosure Act (HMDA), have been valuable tools for holding financial institutions accountable. The administration's plan is unclear on the extent to which it would increase data collection and make data publicly available. NCLR recommends that data be collected, and publicly disseminated, on small business lending, credit cards, auto loans, and insurance products.

Conclusion

Communities of color have clearly been targeted by lenders for inferior products, even when they have high incomes and good credit. Hispanic borrowers continue to face real barriers to

[9] For a longer discussion on the creation of a community-based financial counseling program see House Committee on Financial Services Subcommittee on Financial Institutions, *Empowering Latino Consumers Through Financial Counseling*, 111th Cong., 1 sess., 2009.

accessing safe, fair, and affordable credit. Most of these families will not be able to move firmly into the middle class and achieve financial sustainability without access to credit and safe banking products. We need a strong regulatory system that will promote a well-functioning marketplace that allows borrowers fair and equal access to the banking system throughout their lifecycle. We look forward to working with Congress and the administration toward this end.

Consumer Federation of America

Testimony of

Travis Plunkett
Legislative Director
Consumer Federation of America

Before the

Committee on Financial Services
United States House of Representatives

Regarding

Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

July 16, 2009

Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education. I greatly appreciate the opportunity to appear before you today to testify about the President's Plan for Financial Regulatory Reform.

The President's regulatory reform plan offers a sound foundation on which to build strong, comprehensive legislation to restore the integrity and stability of our nation's badly damaged financial system. Although there are gaps that will need to be filled and provisions that will need to be strengthened, the plan correctly identifies the necessary component parts of a comprehensive reform package. First and foremost, it recognizes the paramount importance of closing gaps in our financial regulatory system, ensuring that all aspects of the financial system are subject to an appropriate level of oversight. It seeks to strengthen regulations in areas where weak laws contributed to the near collapse of the financial system. It recognizes the important roles that consumer and investor protection play in ensuring not only the fairness but also the stability of the financial markets. And it seeks to reduce systemic risk through a combination of measures designed to better alert regulators to looming threats, improve the ability of financial institutions to survive periods of economic stress, and create a mechanism to allow for the orderly failure of non-bank financial institutions.

Despite its many positives, there are aspects of the plan that will require substantial work as the legislation to implement it takes shape in Congress over the coming months. The plan's provisions on credit rating agencies, in particular, are weak considering the central roles these agencies played in causing the current crisis. Also largely missing is a broad agenda of corporate governance reforms needed to restore effective board oversight and accountability at our public companies and financial institutions. Moreover, as the legislation is drafted to implement the Administration's derivatives plan, care will need to be taken to ensure that as much of the market as possible is traded on regulated exchanges and that dealers cannot easily evade the requirements for central clearing and exchange trading. Finally, if Congress pursues the Administration's plan of designating the Federal Reserve as the lead systemic risk regulator, it will need to address concerns that have been raised about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks, the agency's closed culture, and its lack of public accountability.

CFA has previously testified before this Committee in strong support of the President's proposal to create a new Consumer Financial Protection Agency and on the need for improved systemic risk oversight. Although this testimony will touch on both those topics, its primary focus will be on other aspects of the President's Plan, including provisions:

- to close gaps in the regulatory structure, in particular by regulating the over-the-counter derivatives market;
- to strengthen weak laws that contributed to the financial crisis, including by reforming credit rating agency practices; and

- to strengthen the protections investors receive in their interactions with the investment professionals they rely on for investment recommendations.

It will also address in greater detail than we have previously provided the reasons why credit-related insurance products should be regulated by the new CFPA.

Closing Gaps in the Regulatory System

One of the greatest strengths of the President's plan is its commitment to ensuring that all aspects of our financial system are subject to appropriate regulatory oversight. Moreover, the administration has recognized that it is not enough to provide systemic risk oversight of previously unregulated markets and institutions. Under the plan, all aspects of the financial system would be subject to some level of functional regulation based on basic principles of transparency and fair dealing. The most important and ambitious of the administration's proposals in this regard is its proposal for regulating the over-the-counter (OTC) derivatives markets. But the plan includes a variety of additional measures to close regulatory loopholes, including provisions to: require advisers to hedge funds and other private pools of capital to register with the Securities and Exchange Commission under the Investment Advisers Act; subject off-balance-sheet activities of banks to regulatory oversight; and give the SEC clear authority to oversee all aspects of the market in asset-backed securities.

To Be Effective, Regulatory Reform Legislation Must Close Existing Loopholes

The current crisis has provided a textbook illustration of why it is not only unwise, but irresponsible to allow regulated and unregulated systems to operate side-by-side, performing many of the same basic functions. First, allowing essential financial functions to be performed out of view of regulators allows risks to grow unnoticed until they reach a point where they spill over into the broader economy and threaten the entire financial system. Because of the opacity of the over-the-counter derivatives markets, for example, financial institutions developed complex webs of inter-connection through credit default swaps without either regulators' or market participants' fully grasping, until it was too late, the degree to which the entire system was vulnerable to the failure of a single institution. The ability of major banks to hold risky assets in off-balance-sheet special purpose entities blinded both the market and regulators to the degree of risk to which these institutions were exposed.

Another problem with the unregulated markets is that they lend themselves to manipulation and abuse. Specifically, unregulated markets allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. Evident since the earliest days of the derivatives markets, this problem took on a new dimension in the current crisis. Investment banks, for example, were able to sell subprime-related CDOs to pension funds and other institutional investors in private placements free from disclosure and other obligations of the regulated marketplace. And European banks used derivatives, often sold by AIG, to evade regulatory capital requirements. In fact, it has been suggested that the credit default swaps sold by AIG were, in many cases at least, simply a new version of the reinsurance-with-side-letters practices that had previously landed certain insurers in regulatory hot water, sold with "no correlation between 'fees' paid and the risk assumed" and with an eye toward allowing financial institutions and public companies that purchased the swaps to "falsify [their] balance sheets and income statements."[1] Meanwhile, the lack of regulatory scrutiny of hedge funds left them vulnerable to accusations that they had manipulated the downfall of Bear Stearns and Lehman Brothers and left regulators unable to either prove or disprove those allegations or act thoughtfully in response.

The basic reasoning that has been used to justify the existence of an unregulated market is that sophisticated investors do not require the protection that regulation affords. According to this line of reasoning, these investors are capable both of protecting their own interests and of absorbing any losses should they fail to do so. That myth should have been dispelled back in the early 1990s, when Bankers Trust took "sophisticated" investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex formulas that the companies clearly didn't understand. Or when Orange County, California lost $1.7 billion, and ultimately went bankrupt, buying structured notes with borrowed money in what essentially amounted to a $20 billion bet that interest rates would remain low indefinitely. Or when a once-respected, conservative government bond fund, Piper Jaffray Institutional Government Income Portfolio, lost 28 percent of its value in less than a year betting on collateralized mortgage obligations that involved "risks that required advanced mathematical training to understand."[2]

All of these deals, and many others like them, had several characteristics in common. In each case, the brokers and bankers who structured and sold the deal made millions while the customers lost fortunes. The deals were all carried out outside the regulated securities markets. As a result, brokers were free of the suitability obligation in their dealings with institutional clients that, despite their best lobbying efforts throughout much of the 1990s, still applied in the regulated markets. Once the deals blew up, efforts to recover losses were almost entirely unsuccessful. And, in many of cases, strong evidence suggests that the brokers and bankers knowingly played on these "sophisticated" investors' lack of sophistication. In his 2003 book *Infectious Greed*, author Frank Partnoy offers the following illustration of the culture at Bankers Trust:

> As one former managing director put it, "Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, 'I can get [this customer] for all these points.' The senior guys would say, 'Yeah, ream him.'"[3]

More recent accounts suggest that little has changed in the intervening years. As *Washington Post* reporter Jill Drew described in a story detailing the sale of subprime CDOs:

> The CDO alchemy involved extensive computer modeling, and those who wanted to wade into the details quickly found that they needed a PhD in mathematics.

[1] The Institutional Risk Analyst, *AIG: Before Credit Default Swaps, There Was Reinsurance*, April 2, 2009.
[2] Frank Partnoy, *Infectious Greed, How Deceit and Risk Corrupted the Financial Markets*, Henry Holt and Company (New York), 2003, p. 123.
[3] Partnoy, p. 55, citing Brett D. Fromson, "Guess What? The Loss is Now ... $20 Million: How Bankers Trust Sold Gibson Greetings a Disaster," *Washington Post*, June 11, 1995, p. A1.

> But the team understood the goal, said one trader who spoke on condition of anonymity to protect her job: Sell as many as possible and get paid the most for every bond sold. She said her firm's salespeople littered their pitches to clients with technical terms. They didn't know whether their pitches made sense or whether the clients understood.[4]

The sophisticated investor myth survived earlier scandals thanks to Wall Street lobbying and the fact that the damage from these earlier scandals was largely self-contained. What's different this time around is the harm that victimization of "sophisticated" investors has done to the broader economy. Much as they had in the past, "sophisticated" institutional investors have once again loaded up on toxic assets – in this case primarily mortgage-backed securities and collateralized debt obligations – without understanding the risks of those investments. In an added twist this time around, many financial institutions also remained exposed to the risk of these assets, either because they made a conscious decision to retain a portion of the investments, confident that they had fully hedged their risks, or because they couldn't sell off their inventory after the market collapsed. As events of the last year have shown, the damage this time is not self-contained; it led to a 50 percent drop in the stock market, a freezing of credit markets, and a severe global recession.

The President's Plan Includes Effective Measures to Plug Regulatory Gaps

The President's plan attempts to address both problems associated with unregulated markets: the ability of risks to grow undetected and the potential for abuse. It addresses the former problem both through its approach to systemic risk regulation, which gives a newly formed Financial Services Oversight Council authority to gather information from any financial firm, and through its requirement that all financial firms be subject to functional regulation by the appropriate regulatory authority. Hedge fund advisers, for example, would not only be required to register with the SEC; they would also be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability, provide confidential reports to regulators on their holdings, and submit to SEC compliance inspections. Originators of asset-backed securities would also have to provide more information regarding their securities' risk characteristics and the credit quality of the assets underlying the security over the life of the transaction. While this is intended to help investors and credit rating agencies better understand those risks, it should also prove beneficial to prudential regulators seeking to assess the safety and soundness of financial institutions that hold such securities.

Transparency, reporting, and record-keeping requirements are also essential tools for regulators seeking to rein in abusive conduct. For example, regulators seeking to determine whether hedge funds played a role in engineering the downfall of Bear Stearns and Lehman Brothers through a strategy based on naked short-selling or naked credit default swaps would benefit from the kind of reporting that would be required under the President's plan. Prudential regulators seeking to determine whether financial institutions under their jurisdiction were attempting to evade regulatory capital requirements would benefit from the new ability they would have under the President's plan to examine financial institutions on a consolidated basis, including their off-balance-sheet activities. Closing the many loopholes that have kept non-bank

[4] Jill Drew, "Frenzy," *Washington Post*, December 16, 2008, p. A1.

banks, such as Industrial Loan Companies, outside the financial regulatory system would have a similar effect.

For these reasons, CFA believes the comprehensive approach the President's plan takes to closing regulatory loopholes is an essential component of the plan that must be preserved in any final regulatory package.

Care Needed To Ensure Dealers Can't Undermine Derivatives Plan

As noted above, the most important of the plan's provisions to close regulatory loopholes is its proposal to regulate the OTC derivatives market. As described in the plan itself, and in somewhat greater detail in testimony from Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler and Securities and Exchange Commission (SEC) Chairman Mary Schapiro, the plan takes a two-pronged approach to regulating this market:

- all "standardized" derivatives would be required to be cleared through a regulated central clearinghouse and eventually to trade on regulated exchanges or regulated electronic trading systems;

- all derivatives dealers and major participants in the OTC derivatives market would be subject to a "robust" regulatory regime that includes registration and recordkeeping requirements, as well as "conservative" capital requirements, margin requirements, reporting obligations, and business conduct standards.

This two-pronged approach is designed to ensure that the plan covers "all dealers and all derivatives, no matter what type of derivative is traded or marketed."[5]

CFTC and SEC would share oversight authority under the plan. Although not all of the details have yet been worked out, it appears that the SEC would take the lead in regulating securities-based derivatives and the CFTC would take the lead in all other areas of the derivatives markets. The agencies would be given "clear, unimpeded" authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives. Again, it is essential that the regulatory authority provided includes the full complement of traditional regulatory tools to allow these agencies to effectively police both the market and market participants.

Finally, we are pleased that the plan gives some recognition to the problem described above: that the complexity of modern financial products has made old notions of investor sophistication obsolete. The plan directs the SEC and CFTC to strengthen limits on who can participate in the derivatives market or to better protect participants through additional disclosure requirements or standards of care. In recent testimony before the Senate Banking Committee, Chairman Schapiro provided greater detail on what the agencies are considering:

[5] Statement of Gary Gensler, Chairman, Commodity Futures Trading Commission, before the Senate Banking Subcommittee on Securities, Insurance, and Investment, June 22, 2009.

> "The SEC and CFTC staff, together with other financial regulators, currently are considering a tiered approach to regulation, with scaling that could be based in the first instance on indicia of sophistication and financial thresholds, with requirements for additional disclosure and standards of care with respect to the marketing of derivatives to less sophisticated counterparties."[6]

We believe reconsideration along these lines is badly needed, and we urge Congress to give the agencies the authority they need to put any such changes into effect. This reconsideration should not stop with derivatives markets, however. Rather, Congress should direct the agencies to conduct a similar evaluation of all areas where the laws deny supposedly "sophisticated" investors the protections available in the regulated markets.

CFA believes the proposed plan on derivatives represents a dramatic improvement over the current situation. Whether investors and the markets reap the full benefits of this regulatory proposal will depend on several key factors, including how rigorous the capital and margin requirements for dealers turn out to be and how vigorously regulators enforce the business conduct rules and other rules to prevent market abuse. More fundamental factors that will determine success are: 1) how effective regulators are in preventing dealers from evading the central clearing and requirement through the use of customized contracts and 2) how forcefully they push to move as much as possible of the standardized markets onto regulated exchanges.

Regulating Standardized Derivatives Contracts: As Chairman Gensler recently stated in testimony before the Senate Securities Subcommittee, a major goal of the administration plan is to ensure that "all derivatives that can be moved into central clearing ... be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems."[7] Currently, although most experts agree that the vast majority of the derivatives market either has been or could be standardized;[8] most derivatives consist of bilateral transactions between individual buyers and sellers that are not centrally cleared. As a result, the parties to the contract are at risk if the counterparty should default. Central clearing would reduce this risk, since the central clearinghouse would stand between the two parties and guarantee the performance of the trade.

To protect themselves, central clearinghouses use a variety of techniques to reduce risks, including setting initial margin requirements, marking transactions to market on a daily basis, and requiring daily posting of margin to cover any changes in value of positions. In essence, the central clearinghouses would centralize the risk that is now spread throughout the financial system in a complex web of interconnections between financial institutions. This, of course, makes the clearinghouses themselves a locus of systemic risk. To address this risk, the administration plan would require both systemic risk and prudential oversight of these institutions. Among other things, they would be required to establish and maintain "robust

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[6] Testimony Concerning Regulation of Over-the-Counter Derivatives by Mary Schapiro, Chairman, U.S. Securities and Exchange Commission, before the Senate Subcommittee on Securities, Insurance, and Investment, June 22, 2009.

[7] Ibid.

[8] See, for example, the June 4, 2009 testimony of Richard Bookstaber before the Senate Agriculture Committee on "Regulatory Reform and the Derivatives Markets."

margin standards and other necessary risk controls and measures."[9] Toward that end, Chairman Gensler has proposed strengthening the standards that currently apply to clearinghouses under the Commodity Exchange Act. Ensuring that these standards are truly "robust" will be essential if this plan is to be genuinely effective in reducing risks.

The Need for Exchange Trading: Some have argued that central clearing alone is sufficient to reduce risks in the system. In a speech delivered more than a decade ago, then CFTC Chairperson Brooksley Born emphasized the important role that the increased transparency that comes with exchange trading plays in reducing risks and combating abusive conduct. "Lack of price transparency may aggravate problems arising from volatile markets because traders may be unable accurately to judge the value of their positions or the amount owed to them by their counterparties," she said. "Lack of price transparency also may contribute to fraud and sales practice abuses, allowing OTC derivatives market participants to be misled as to the value of their interests."[10] This latter point helps to explain the vehemence of industry objections to the exchange-trading proposal, as it threatens what self-described conservative libertarian Christopher Whalen has called the "deliberate inefficiency of the OTC derivatives market."[11] After all, derivatives dealers who are able to earn several hundred basis points on an OTC contract may earn only a couple of points if the same contract is traded on an exchange.

Richard Bookstaber, a derivatives pioneer and author of the prescient book, *A Demon of Our Own Design – Markets, Hedge Funds, and the Perils of Financial Innovation,* summed up the argument in favor of exchange trading this way in recent testimony before the Senate Agriculture Committee:

> The proposal for a centralized clearing corporation, while a welcome step, is not sufficient ... It may reduce counterparty concerns, but it will not provide the necessary level of standardization, transparency, price discovery and liquidity. To do all that, we need to have standardized derivative products, and have those products traded on an exchange. Standardization will address the complexity of derivatives. Exchange trading will be a major improvement in the transparency and efficiency, and will foster liquidity by drawing in a wider range of speculators and liquidity suppliers. These steps will shore up the market against the structural flaws that derivative-induced complexity has created.

Moreover, moving to exchange trading of most derivatives need not pose insurmountable difficulties. As Whalen noted in his Senate testimony: "Since many OTC contracts for currencies, interest rates or energy, for example, have observable cash markets upon which to base their pricing, moving these contracts to an exchange-traded format is a relatively easy matter that does not pose significant hurdles for the Congress, investors or regulators. Indeed, most market participants would welcome and benefit from such change."[12]

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[9] Gensler.
[10] Brooksley Born, CFTC Chairperson, "Regulatory Responses to Risks in the OTC Derivatives Market," before the ABA Committee on Federal Regulation of Securities, November 13, 1998.
[11] Statement of Christopher Whalen before the Senate Subcommittee on Securities, Insurance, and Investment, June 22, 2009.
[12] Ibid.

Because of the potential benefits exchange trading offers not only for price transparency and competition, but also for effective risk reduction and fraud prevention, we urge Congress to ignore the self-interested arguments of derivatives dealers and ensure that, as legislation is drafted to implement the administration plan, it includes the strongest possible provisions to require exchange trading of standardized derivatives as soon as that is feasible.

Restricting Unnecessary Customization: Even if Congress succeeds in adopting legislation requiring central clearing and exchange trading of all standardized derivatives, OTC derivatives dealers can be expected to try to evade these requirements through the use of "customized" contracts. While some have argued that the OTC market should be eliminated entirely, we are persuaded by the arguments of those, like Born and Bookstaber, who see a continued use for a customized market, but subject to tight constraints. As Bookstaber has argued, these restrictions should be designed to ensure that customization is used for a legitimate economic purpose and not just to game the system.

The administration has acknowledged the need to constrain unnecessary customization "to ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems."[13] Toward that end, Chairman Gensler has proposed establishing "objective criteria" that regulators could use "to determine whether, in fact, a swap is standardized."[14] Acceptance for trading by one regulated clearinghouse, for example, would create a presumption that the contract is standardized and must be centrally cleared. Other possible criteria include: the volume of transactions in the contract, the similarity of the terms of the contract to the terms in standardized contracts, whether any differences in terms from a standardized contract are of economic significance, and the extent to which any of the terms of the contract, including price, are disseminated to third parties.[15] Customized contracts would also carry higher capital and margin requirements to account for their greater risks.

While this is an excellent start, we believe additional constraints could and should be adopted to restrict the inappropriate use of customized contracts. For example, their use could be limited to highly sophisticated and knowledgeable parties, with at least one of those parties required to certify and able to demonstrate that it is entering the contract to hedge a legitimate business risk. In a similar vein, Bookstaber has proposed that investors who use non-standardized derivatives be required to disclose their holdings in such derivatives and to demonstrate both how they are being used and why they are being used in place of the standard instruments. Dealers in customized contracts could face heightened disclosure obligations, including an obligation to fully disclose risks and costs. Indeed, customization could carry a heightened standard of care to reflect both the advisory nature of that customization and the degree of reliance that exists in the relationship. These latter proposals should be taken up as part of the SEC and CFTC's reexamination of the criteria for participation in derivatives markets.

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[13] Gensler testimony.
[14] Ibid.
[15] Ibid.

Other measures, such as banning certain abusive products or practices, deserve serious consideration. Whalen, for example, has argued that certain OTC products, including many CDS and CDOs, are inherently fraudulent. "If an OTC derivative contract lacks a clear cash basis and cannot be valued by both parties to the transaction with the same degree of facility and transparency as cash market instruments, then the OTC contract should be treated as fraudulent and banned as a matter of law and regulation," he said.[16] Others have argued that only investors with a direct interest in the underlying debt instrument should be permitted to purchase credit default swaps, or at least that those institutions that are backed by U.S. taxpayers should face such a limitation. Making a distinction between using swaps to allocate "genuine losses of wealth" and using them to bet on whether a particular company will fail, Benjamin Friedman explained in a recent article in *The New York Review of Books* how the latter practice can actually create huge economic losses that would not otherwise exist. "If those firms that bet incorrectly fail to pay what they owe – as would have happened if the government had not bailed out the insurance company AIG – the consequences might impose billions of dollars' worth of economic costs that would not have occurred otherwise," he wrote.[17] We believe proposals such as these deserve to receive a serious hearing as Congress considers the best way to regulate the OTC derivatives markets.

Finally, as it always does when faced with potentially effective regulation, the industry has threatened to take its business overseas if it faces tough regulation at home. One way to try to prevent that from happening is to work cooperatively with other countries to ensure a universally high level of regulation. As former CFTC Chairperson Born said more than ten years ago: "Global cooperation is essential to avoid a race to the bottom, in which individual regulatory authorities are afraid to enact even modest regulatory protections for fear of placing their domestic markets at a competitive disadvantage." Beyond global cooperation, however, we would urge Congress and the administration to consider whether there are additional restrictions that they can impose to prevent companies that are either located in the United States or wish to do business here from evading our regulatory requirements.

Self-Serving Industry Arguments Must Be Ignored: Industry has already begun to mount an all-out campaign to beat back the most important of these regulatory reforms. Perhaps sensing that derivatives users' arguments may be less suspect, derivatives dealers have recruited corporations to join them in making the case against "excessive regulation." Their argument boils down to this: too much regulation, and particularly limits on customization, would hurt market participants by restricting their ability or driving up their costs to hedge risks.

In assessing these arguments, however, members of Congress should be aware that, like derivatives dealers, some users of derivatives have strong incentives to retain a complex and opaque OTC market. Once again, Bookstaber has explained it best. Although customized derivatives can serve beneficial purposes, they have also come to be used "for less lofty purposes," he notes. In particular, "derivatives have been used to solve various non-economic problems, basically helping institutions game the system in order to:

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[16] Whalen testimony.

[17] Benjamin M. Friedman, "The Failure of the Economy and the Economists," The New York Review of Books, May 28, 2009.

- Avoid taxes. For example, investors use total return swaps to take positions in UK stocks in order to avoid transactions taxes.

- Take exposures that are not permitted in a particular investment charter. For example, index amortizing swaps were used by insurance companies to take mortgage risk.

- Speculate. For example, the main use of credit default swaps is to allow traders to take short positions on corporate bonds and place bets on the failure of a company.

- Hide risk-taking activity. For example, derivatives provide a means for obtaining a leveraged position without explicit financing or capital outlay and for taking risk off-balance sheet, where it is not as readily observed and monitored. Derivatives also can be used to structure complex risk-return tradeoffs that are difficult to dissect.

These non-economic objectives are best accomplished by designing derivatives that are complex and opaque, so that the gaming of the system is not readily apparent."[18]

Later Bookstaber adds, "For the bank, the more complex and custom-made the instrument, the greater the chance the bank can price in a profit, for the simple reason that investors will not be able to readily determine its fair value. And if the bank creates a customized product, then it can also charge a higher spread when an investor comes back to trade out of the product. For the trader, the more complex the instrument, the more leeway he has in his operation, because it will be harder for the bank to measure his risk and price his book. And for the buyer, the more complex the instrument, the easier it is to obfuscate everything from the risk and leverage of their positions to the non-economic objectives they might have in mind."[19]

Congress fell for these arguments once, when it adopted the Commodity Futures Modernization Act. That experience, and a clear eye for the self-interest behind industry's arguments, should prevent it from doing so again.

Strengthening Existing Market Regulations

In addition to closing regulatory gaps, the President's Plan includes several provisions to strengthen regulations in areas where weak laws contributed to the current crisis. Among these are measures to reduce the risk of unsound mortgage lending, improve transparency in the securitization market, address executive compensation practices that encourage excessive risk-taking, and reform credit rating agencies. Leaving aside the mortgage lending issue for the moment, which is addressed in the following section on the CFPA, each of these provisions falls short to a greater or lesser degree. The measures to reform credit rating agencies are particularly weak, especially when considered in proportion to the central role credit ratings played in causing the current crisis.

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[18] Bookstaber testimony.
[19] Ibid.

Asset-Backed Securities Should Not Be Sold Through Shelf-Registration

The plan's provisions to strengthen regulation of the securitization market include measures to dramatically improve the transparency of these instruments, which we strongly support. However, we believe more could and should be done in this area by prohibiting the sale of asset-backed securities through the shelf-registration process or, at the very least, reforming that process with regard to sales of asset-backed securities. Requiring such securities to be sold from a prospectus made available at least 24 hours before the sale would accomplish three important goals: it would improve the ability of investors to make an informed decision, reduce their need to rely on credit ratings to assess the risk of the securities, and require more meaningful due diligence on the part of underwriters. We believe all would be extremely beneficial.

Broader Corporate Governance Reforms Should Be Adopted

Among the many failures that contributed to the current crisis, one was a failure of board oversight that echoes similar failures at Enron and other public companies in an earlier round of scandals. Unfortunately, with a variety of higher profile issues on the table, momentum for reform in the wake of the Enron-WorldCom scandals ran out of steam before a robust agenda of corporate governance reforms could be adopted. A similar phenomenon appears to be at work in the President's plan, which includes only two proposals on corporate governance: one directing financial regulators to adopt rules on executive pay for financial institutions to reduce incentives to take excessive risks and better align managers' interests with those of long-term shareholders and a second requiring all public companies to allow a non-binding vote on executive pay.

While CFA supports both these measures, we believe it would be a grave error to miss yet another opportunity to adopt more far-reaching reforms. Among the top priorities should be legislation giving the SEC clear authority to reform the proxy access rules to make it easier for shareowners to nominate directors. Although the SEC has already taken up rules in this area, industry groups have made no secret of their intent to challenge any such rules in court. By clarifying the agency's authority to act, Congress could avoid the wasteful costs and pointless delays of litigation. Another important priority designed to make directors more accountable to shareholders is requiring majority votes in uncontested board elections. To supplement the administration's proposal on executive pay at financial institutions, Congress should also strengthen claw-back provisions on executive pay. These and other corporate governance reform proposals supported by CFA are described more fully in the agenda of ShareOwners.org included in Appendix A of this testimony.

Credit Rating Agency Reform Proposals Must Be Strengthened

Perhaps the weakest single aspect of the President's Plan is its failure to propose the kind of comprehensive reform of credit rating agencies that their repeated failures and central role in the financial system warrant. Instead, the plan proposes a handful of beneficial but modest changes: reducing reliance on ratings in regulations and supervisory practices, providing clearer differentiation between ratings on structured and other credit products, and requiring strengthened policies and procedures to manage and disclose conflicts of interest. While we certainly support these proposals, we believe they stop well short of the steps needed to improve the reliability of ratings and the accountability of ratings agencies.

If complex derivatives and mortgage-backed securities were the poison that contaminated the financial system, it was their ability to attract high credit ratings that allowed them to penetrate every corner of the markets. Over the years, the number of financial regulations and other practices tied to credit ratings has grown rapidly. For example, money market mutual funds, bank capital standards, and pension fund investment policies all rely on credit ratings to one degree or another. As Jerome S. Fons and Frank Partnoy wrote in a recent *New York Times* op ed: "Over time, ratings became valuable ... because they "unlock" markets; that is, they are a sort of regulatory license that allows money to flow."[20] This growing reliance on credit ratings has come about despite their abysmal record of under-estimating risks, particularly the risks of arcane derivatives and structured finance deals. Although there is ample historical precedent, never was that more evident than in the current crisis, when thousands of ultimately toxic subprime-related mortgage-backed securities and CDOs were awarded the AAA ratings that made them eligible for purchase by even the most conservative of investors.

Looking back, many have asked what would possess a rating agency to slap a AAA rating on, for example, a CDO composed of the lowest-rated tranches of a subprime mortgage-backed security. (Some, like economists Joshua Rosner and Joseph Mason, pointed out the flaws in these ratings much earlier, at a time when, if regulators had heeded their warning, they might have acted to address the risks that were lurking on financial institutions' balance sheets.)[21] Money is the obvious answer. Rating structured finance deals pays generous fees, and ratings agencies' profitability has grown increasingly dependent in recent years on their ability to win market share in this line of business. Within a business model where rating agencies are paid by issuers, the perception at least is that they too often win business by showing flexibility in their ratings. Another possibility, no more attractive, is that the agencies simply weren't competent to rate the highly complex deals being thrown together by Wall Street at a breakneck pace, but did so anyway. One Moody's managing director reportedly summed up the dilemma this way in an anonymous response to an internal survey: "These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both."[22]

The SEC found support for both explanations in its July 2008 study of the major ratings agencies.[23] That study documented both lapses in controls over conflicts of interest and evidence of under-staffing and shoddy practices: assigning ratings despite unresolved issues, deviating from models in assigning ratings, a lack of due diligence regarding information on which ratings are based, inadequate internal audit functions, and poor surveillance of ratings for continued accuracy once issued. Moreover, in addition to the basic conflict inherent in the issuer-paid model, credit rating agencies can be under extreme pressure from issuers, investors, and occasionally even regulators to avoid downgrading a company or its debt. With credit rating

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[20] Jerome S. Fons and Frank Partnoy, "Rated F for Failure," *New York Times*, March 16, 2009.

[21] Joseph R. Mason and Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?* (preliminary paper presented at Hudson Institute) February 15, 2007.

[22] Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" *New York Times*, December 7, 2008.

[23] U.S. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008.

triggers embedded in AIG's credit default swaps agreements, for example, a small reduction in rating exposed the company to billions in obligations and threatened to disrupt the CDS market. This fact clearly influenced regulators' decision to shore up the company finances in order to avoid such an outcome.

It is tempting to conclude, as many have done, that the answer to this problem is simply to remove all references to credit ratings from our financial regulations. This is the recommendation that Fons and Partnoy arrive at in their *Times* op ed. "Regulators and investors should return to the tool they used to assess credit risk before they began delegating responsibility to the credit rating agencies," they conclude. "That tool is called judgment." Unfortunately, Fons and Partnoy may have identified the only thing less reliable than credit ratings on which to base our investor protections. After all, even many institutional investors lack the sophistication to evaluate today's complex financial products. And it is difficult to see how simply eliminating existing ratings-based restrictions on their investment options will make these investors any more cautious, particularly in an environment in which they are under extreme pressure to boost returns.

The other frequently suggested solution is to abandon the issuer-paid business model on the grounds that it creates a massive conflict of interest. Simply moving to an investor-paid model suffers from two serious short-comings, however. First, it is not as free from conflicts as it may on the surface appear. While investors generally have an interest in receiving objective information before they purchase a security – unless they are seeking to evade standards they view as excessively restrictive – they may be no more interested than issuers in seeing a security downgraded once they hold it in their portfolio. Moreover, we stand to lose ratings transparency under a traditional investor-paid model, since investors who purchase the rating are unlikely to want to share that information with the rest of the world on a timely basis. SEC Chairman Schapiro indicated in her confirmation hearing before the Senate Banking Committee that she is interested in exploring other payment models designed to get around these problems. We believe Congress should encourage such a review as part of a comprehensive solution to the credit rating problem.

While it is easier to diagnose problems with the credit rating agencies than it is to prescribe a cure, we believe the important gatekeeper function ratings play in our financial system and the conflict of interest at the heart of their business model call for a far more robust program of regulatory oversight and accountability than either our current laws or the President's plan afford. The best approach, in our view, can be found in simultaneously reducing reliance on ratings, increasing accountability of ratings agencies, and improving regulatory oversight.

Reducing Reliance on Ratings: Without removing references to ratings from our legal requirements entirely, Congress and financial regulators could reduce reliance on ratings by clarifying, in each place where ratings are referenced, that reliance on ratings does not substitute for due diligence. Rather than identifying a set of investments in which institutions are free to invest, ratings should be viewed instead as identifying those investments that are out of bounds. The investor – whether a bank, a money market fund, or a pension manager – would still be responsible and accountable for conducting meaningful due diligence to determine that any investment they proposed to purchase met appropriate risk standards. Under such an approach, no safe harbor should be accorded those who rely on a rating in making an investment selection. Although it is short on details, the Administration's plan appears to support such an approach, with its recommendation that reliance on ratings in regulations and supervisory practices should be reduced wherever possible. Moreover, its further recommendation that any such standards distinguish between ratings for structured products and ratings on more traditional debt instruments would be a useful supplement to this approach.

Increasing Rating Agency Accountability: The President's plan seeks to increase rating agency accountability by requiring more complete disclosures, including disclosure of performance measures for structured credit products "in a manner that facilitates comparisons across products and ratings." While we believe such disclosures can be useful in identifying agencies whose ratings for various types of credit products have been more or less reliable, we do not believe they can provide an adequate counter-balance to the massive conflict of interest at the heart of the rating agency business model. In our view, increased liability is the only factor with the potential to provide that counterweight. The goal should be to provide the incentive ratings agencies need to be rigorous in their ratings procedures and more willing to refuse to rate products whose risks they do not understand or cannot reasonably predict. It seems reasonable to assume, for example, that ratings agencies would have been less tolerant of the shoddy practices uncovered both in the SEC study and in congressional hearings if they had known that investors who relied on those ratings could hold them accountable in court for their failure to follow appropriate procedures or to conduct adequate due diligence.

Toward that end, Congress should eliminate the exemption from liability provided to rating agencies in Section 11 of the Securities Act and should further clarify that ratings are liable to the same degree as other gatekeepers, such as auditors of public companies, when they are reckless in failing to conduct an adequate investigation on which to base a rating. In addition, the SEC should be given additional authority to impose tough sanctions on ratings agencies for such failures.

Improving Regulatory Oversight of Ratings Agencies: Finally, while we appreciate the steps Congress took in 2006 to enhance SEC oversight of rating agencies, that legislation stopped far short of the comprehensive reform that we believe is needed in light of recent events. That earlier legislation was extremely useful in enabling the SEC study that identified short-comings in rating agency practices. However, new legislation is needed to give the agency greater authority to respond to those problems. Specifically, new legislation should authorize either the SEC or an independent regulatory body modeled on the Public Company Accounting Oversight Board to:

- review credit rating agency policies, practices, methodologies and procedures to ensure rating agency compliance with appropriate controls for determining credit ratings;

- require rating agencies to maintain records and make those records available to the SEC for review, including through review of individual ratings engagements, in order to ensure compliance;

- set standards in areas such as due diligence practices and post-rating surveillance and to ensure that conflict of interest and compliance practices are effective; and

- impose fines and other sanctions for violations.

To be clear, we are not proposing that regulators be given authority to specify or approve actual ratings methodologies. Rather, their authority should extend to the procedures rating agencies follow in applying those methodologies, such as obtaining sufficient data to support a rating or taking reasonable steps to verify that data. Furthermore, either the SEC or any new oversight body Congress should establish for this purpose must have sufficient funding to enable it to hire competent staff and carry out these functions effectively.

Strengthening these provisions of the President's Plan should be among Congress's top priorities as it fashions comprehensive legislation to reform financial regulation.

Enhancing Consumer and Investor Protections

One of the clear lessons of the current crisis is that failure to provide basic consumer and investor protections – in this case with regard to mortgage lending – can have a devastating effect on the safety and soundness of the financial system as a whole. Put another way, had regulators acted to rein in predatory and unsound mortgage lending when problems first began to emerge, the worst of the current crisis could likely have been avoided. One of the major strengths of the President's Plan is its clear recognition of this fact and the strong set of measures it proposes to strengthen consumer and investor protections going forward. In fact, the strongest and most crucial aspect of the entire regulatory reform plan may be its proposal to create a new Consumer Financial Protection Agency. However, the plan also includes much needed provisions to enhance investor protections, particularly when dealing with the financial intermediaries investors rely on for recommendations.

<u>CFPA Must Be Adopted Without Weakening Amendments</u>

We have testified before in strong support of the administration's proposal to create a new Consumer Financial Protection Agency (CFPA). Our July 14, 2009 testimony before the Senate Banking, Housing and Urban Affairs Committee provides greater details on why we support the Consumer Financial Protection Agency, how the agency should be structured and funded, the abuses that the CFPA would rectify, and rebuttals to arguments opposing the enactment of the CFPA (A link to the testimony is <u>here</u>: <u>http://www.consumerfed.org/pdfs/Travis_Plunkett_Testimony_CFPA_Senate_Banking_07-14-09.pdf</u>.) Since then there have been several developments:

- Chairman Frank has introduced strong legislation to implement the administration's plan;

- the industry has made clear that they intend to pull out all the stops in opposing this legislation, including through a campaign of misinformation; and

- new evidence has emerged showing the need for this agency.

Consumers and the Economy Need the Consumer Financial Protection Agency

Although the CFPA would not be a panacea for all current regulatory ills, it would correct many of the most significant structural flaws that exist, realigning the regulatory architecture to reflect the unfortunate lessons that have been learned in the current financial crisis and sharply increasing the chances that regulators will succeed in protecting consumers in the future. The CFPA would be designed to achieve the regulatory goals of elevating the importance of consumer protection, prompting action to prevent harm, ending regulatory arbitrage, and guaranteeing regulatory independence.

The CFPA Would Be THE Agency Looking Out for Financial Consumers

The CFPA would have as its sole mission the development and effective implementation of standards that ensure that all credit products offered to borrowers are safe and not discriminatory. The agency would then enforce these standards for the same types of products in a transparent, uniform manner. Ensuring the safety and fairness of credit products would mean that the CFPA would not allow loans with terms that are discriminatory, deceptive or fraudulent. The agency should also be designed to ensure that credit products are offered in a fair and sustainable manner. In fact, a core mission of the CFPA would be to ensure the suitability of classes of borrowers for various credit products, based on borrowers' ability to repay the loans they are offered – especially if the cost of loans suddenly or sharply increase, and the terms of the loans do not impose financial penalties on borrowers who try to pay them off. As we've learned in the current crisis, focusing exclusively on consumer and civil rights protection would often be positive for lenders' stability and soundness over the long term. However, the agency would be compelled to act in the best interest of consumers even if measures to restrict certain types of loans would have a negative short-term financial impact on financial institutions.

The CFPA Would Stop Regulatory Arbitrage

The present regulatory system is institution-centered, rather than consumer-centered. It is structured according to increasingly irrelevant distinctions between the type of financial services company that is lending money, rather than the type of product being offered to consumers. Right now, financial institutions are allowed (and have frequently exercised their right) to choose the regulatory body that oversees them and to switch freely between regulatory charters at the federal level and between state and federal charters. Many financial institutions have switched charters in recent years seeking regulation that is less stringent. At the federal level, where major agencies are funded by the institutions they oversee, this ability to "charter shop," has undeniably led regulators like the OTS to compete to attract financial institutions by keeping regulatory standards weak. It has also encouraged the OTS and OCC to expand their preemptive authority and stymie efforts by the states to curb predatory and high-cost lending.

The "charter shopping" problem would be directly addressed through the creation of a single CFPA with regulatory authority over all forms of credit. Federal agencies would no longer compete to attract institutions based on weak consumer protection standards or anemic enforcement of consumer rules. The CFPA would be required to focus on the safety of credit products, features and practices, no matter what kind of lender offered them.

The CFPA Would Set the Floor for National Consumer Protection Standards

As for regulatory competition with states, it would only exist to improve the quality of consumer protection. Therefore, the CFPA should be allowed to set minimum national credit standards, which states (as well as victimized consumers) could then enforce. States would be allowed to exceed these standards if local conditions require them to do so. If the CFPA sets "minimum" standards that are sufficiently strong, a high degree of regulatory uniformity is likely to result. With strong national minimum standards in place, states are most likely to act only when new problems develop first in one region or submarket. States would then serve as an early warning system, identifying problems as they develop and testing policy solutions, which could then be adopted nationwide by the CFPA if merited. Moreover, the agency would have a clear incentive to stay abreast of market developments and to act in a timely fashion to rein in abusive lending because it will be held responsible for developments in the credit market that harm consumers.

The CFPA Must Be Independent

The leadership of a CFPA would be held to account based on its ability to inform consumers and help protect them from unsafe products. In order to function effectively, the leadership would need to show expertise in and commitment to consumer protection. Crucial to the success of the agency would be to ensure that its funding is adequate, consistent, and does not compromise this mission. Congress could also ensure that the method of agency funding that is used does not compromise the CFPA's mission by building accountability mechanisms into the authorizing statute and exercising effective oversight of the agency's operations.

The CFPA Is Needed to Stop Inaction on Consumer Financial Protections

Current regulators may already have some of the powers that the new agency would be given, but they haven't used them. Conflicts of interest and a lack of regulatory will work against consumer enforcement. In our previous testimony, we detailed numerous actions and inactions by the federal banking regulators that have led to or encouraged unfair practices, higher prices for consumers, and less competition. That list has been updated and expanded and is included below.

- The Federal Reserve Board ignored the growing mortgage crisis for years after receiving Congressional authority to enact anti-predatory mortgage lending rules in 1994.

- The Office of the Comptroller of the Currency engaged in an escalating pattern of preemption of state laws that were designed to protect consumers from a variety of unfair bank practices and to quell the growing predatory mortgage crisis, culminating in its 2004 rules preempting both state laws and state enforcement of laws over national banks and their subsidiaries.

- As unfair credit card practices increased over the years, these agencies took little action except to propose greater disclosures, until Congress stepped in.

- The Federal Reserve has allowed Debit Card Cash Advances ("Overdraft Loans") without consent, contract, cost disclosure or fair repayment terms.

- The Fed has allowed a shadow banking system (Prepaid Cards) outside of consumer protection laws to develop and target the unbanked and immigrants. The OTS is allowing bank payday loans (which preempt state laws) on prepaid cards.

- Despite advances in technology, the Federal Reserve has refused to speed up availability of deposits to consumers.

- The Federal Reserve has supported the position of payday lenders and telemarketing fraud artists by permitting remotely created checks (demand drafts) to subvert consumer rights under the Electronic Funds Transfer Act.

- The Federal Reserve has taken no action to safeguard bank accounts from Internet payday lenders.

- The Banking agencies have failed to stop banks from imposing unlawful freezes on accounts containing Social Security and other funds exempt from garnishment.

- The Comptroller of the Currency permits banks to manipulate payment order to extract maximum bounced check and overdraft fees, even when overdrafts are permitted.

- The regulators have failed to enforce the Truth In Savings Act requirement that banks provide account disclosures to prospective customers.

- The Federal Reserve actively campaigned to eliminate a Congressional requirement that it publish an annual survey of bank account fees.

Modest Changes Are Needed to Strengthen the Administration's Proposal

Consumer Representation: The CFPA should have the authority to grant intervener funding to consumer organizations to fund expert participation in its stakeholder activities. The model has been used successfully to fund consumer group participation in state utility ratemaking. Second, a government chartered consumer organization should be created by Congress to represent consumers' financial services interests before regulatory, legislative, and judicial bodies, including before the CFPA. This organization could be financed through voluntary user fees such as a consumer check-off included in the monthly statements financial firms send to their customers. It would be charged with giving consumers, depositors, small investors and taxpayers their own financial reform organization to counter the power of the financial sector, and to participate fully in rulemakings, adjudications, and lobbying and other activities now dominated by the financial lobby.[24]

Compensation Incentives: We recommend that the Administration's proposal deal more explicitly with incentives that are paid to employees working in the credit sector. An incentive system similar to one at the top is at work at the street level of the biggest banks. In the tens of thousands of bank branches and call centers of our biggest banks, employees - including bank tellers earning an average of $11.32 an hour - are forced to meet sales goals to keep their jobs and earn bonuses. Many goals for employees selling high-fee and high-interest products like credit cards and checking accounts have actually gone up as the economy has gone down. New rules need to restructure pay and incentives for front-line finance sector employees away from the current 'sell-anything' culture. The hundreds of thousands of front-line workers who work under pressure of sales goals need to be able to negotiate sensible compensation policies that reward service and sound banking over short-term sales.

Whistleblower protections: Risk-taking in the industry will quickly outpace regulatory coverage unless financial sector employees can challenge bad practices as they develop and direct regulators to problems. Whistleblowers are critical to combating fraud and other institutional misconduct. If we had previously had more protections for whistleblowers, we would have had more warning of the eventual collapse of Wall Street. The federal government needs to hear from and provide best practice whistleblower rights (consistent with those in the stimulus and five laws passed or strengthened last Congress) to protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare.

In addition, the following provisions of the legislation need to be fixed:

- The bill lacks any mechanism for holding wrongdoers accountable to individual consumers for violating rules or giving consumers remedies for harm when rules are violated.

- The bill gives the agency too much authority to decide that its rules or another federal statute preempts state laws.

- The ability to limit forced arbitration does not extend to state consumer protection laws. Because of preemption, only Congress can address arbitration abuses involving state claims.

- The prohibition on a usury cap could be read to limit the Agency's authority over high cost loans.

- Requiring cost/benefit analysis could tip the scales in industry's favor and invite litigation challenges to Agency rules. Disclosures that purport to help a consumer weigh risks could be used against consumers.

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[24] As his last legislative activity, in October 2002, Senator Paul Wellstone proposed establishment of such an organization, the Consumer and Shareholder Protection Association, S. 3143.

- The Agency should not have authority to create exemptions to the existing enumerated statutes beyond what is already in those statutes. Much narrower authority – for example, to alter requirements if necessary to simplify and create more understandable disclosures for pilot projects - might be appropriate.

The CFPA Should Have Jurisdiction Over Credit-related Insurance Products

The CFPA legislation proposed by the Administration and introduced by Chairman Frank would give the new agency jurisdiction over four credit-related insurance products: credit insurance, title insurance, mortgage insurance, and mortgage guarantee insurance (also known as private mortgage insurance since it is a form of credit insurance). (See Appendix B for a description of the various types of credit insurance.) All of these products are sold in connection with a credit transaction and are intertwined with loans. For this reason, we believe the CFPA should have the same authority over these products that it has over other credit-related financial products.

Under the legislation, the agency would not have jurisdiction over either investment-type products, such as annuities, or other personal insurance products, such as personal auto, residential property, and other consumer property and casualty insurance products. In general, CFA believes this is the appropriate division of responsibility, with three exceptions:

- We believe forced place insurance, which is also a form of credit-related insurance, should be covered by the CFPA.

- To prevent regulatory arbitrage, we believe products that are similar to credit insurance such as debt cancellation contracts sold by banks, should also be regulated by the CFPA. From a consumer's perspective, they are equivalent products, but they are regulated differently because federal banking regulators have declared them to be banking products. (For additional information on these products, see Appendix C.)

- We believe the CFPA should have the authority to advocate for and represent consumers of personal insurance products (such as auto or homeowners and other property insurance) before the state insurance regulators. Some have said that this consumer advocacy authority might rest with the proposed new Insurance Office within the Department of Treasury, but CFA believes consumer advocacy is better placed in CFPA, an agency whose mission is to protect consumers.

Problems for Consumers Buying Insurance Products Related to Lending Transactions

Reverse Competition Hurts Consumers: The dominant characteristic of insurance markets related to credit transactions throughout the country is *reverse competition.* The consumer who pays for the product does not select the insurer; rather, the parties receiving compensation for the insurance select the insurer. For example, an insurer might sell a credit insurance group policy to a lender. The lender then sells the credit insurance to the borrower on behalf of the credit insurer and issues a certificate of insurance under the group policy to the borrower. This market structure leads insurers to bid for the lender's business by providing higher commissions and other compensation to the lender. As a result, greater competition for the lender's business leads to higher, often unfair prices of credit insurance to the borrower. In fact, CFA's Director of Insurance, J. Robert Hunter, was once at a credit insurance hearing in Virginia at which Prudential was asked why they wrote so little credit insurance in the state. The Prudential witness said they were non-competitive because their rates were "too low." The same sort of system holds in title insurance and mortgage guarantee insurance, which are covered under the President's plan, and forced-place insurance, which is not.

In addition to raising prices, reverse competition also harms consumers by limiting consumer choice, often to products that offer little real value to consumers. This results from the fact that, in a reverse-competitive market, the consumer is unable to effectively exert normal competitive pressure on the original seller of the product. In credit insurance, mortgage guarantee insurance, title and forced place insurance (but not mortgage insurance), the lender is almost always involved in the selection of the insurer, while the ultimate consumer – the borrower – is effectively limited to accepting or rejecting the package offered. If a consumer purchases a product and finances the purchase at one store or auto dealer, he or she cannot decide to go elsewhere to purchase the credit-related insurance for that loan. There is no marketplace for the insurance separate from the lender financing the purchase. As a result, lenders are able to dictate the terms of the credit insurance sale, determining what coverages will be offered, for example. Because the credit-related insurance transaction is typically a minor aspect (to the borrower) of a larger transaction – the loan to purchase a car, jewelry or furniture – consumers are willing to go along, particularly if they believe they must purchase the credit-related insurance to get the financing to buy the product they want.

As a result of this market dynamic, lenders rather than borrowers are the primary beneficiaries of credit-related insurance sales. First, the lender's loan is protected against events that impair the borrower's ability to repay. With credit-related insurance in place, the lender need not incur any costs to force payment from the surviving spouse or relative of a deceased borrower or from a borrower who has become disabled or unemployed. Second, the lender often gets substantial commission and other revenue from the insurance premium. Commissions and other compensation are typically 40 percent or more of the premium.

Consumers, on the other hand, often obtain little if any benefit. The best measure of overall value of credit insurance to consumers is the loss ratio – the ratio of benefits paid on behalf of the consumer to the premiums paid by consumers. Consumer groups have advocated regulation to ensure that consumers receive a loss ratio of at least 60 percent, meaning that, on average, at least 60 percent of the premiums paid by borrowers should be ultimately paid out in claim benefits on behalf of borrowers.

While the vast majority of states regulate credit insurance rates, most have done a poor job. The nationwide average loss ratio has been under 50 percent for credit life (46 percent in 2007[25]), in the mid 30s for credit disability, was 37 percent in 2007[26] for credit health insurance, under 30 percent for forced-place insurance, and in the single digits for credit unemployment and

[25] Life Insurers Fact Book 2008, American Council of Life Insurance
[26] Ibid

near zero for credit family leave insurance. For many years, mortgage guaranty products had a very low loss ratio, less than 25 percent, until the ratio rose to 135 percent in 2007 in the midst of the current mortgage crisis. Similarly, title insurance loss ratios have been under 10 percent for many years. One study found, for example, that between 1995 and 2004, title insurance loss ratios averaged 4.6 percent and the loss ratio was below five percent eight out of ten years.[27] In 2008, the loss ratio "jumped" to 11.7 percent.[28]

In short, all of these products represent remarkably poor value for consumers. State regulators have, with a handful of exceptions,[29] utterly failed to rein in reverse competition and end the wholesale consumer abuse the practice represents. The special interest determination to hold off reform at any cost has proven highly effective. For these reasons, we believe America's consumers need CPFA to cover credit-related insurance products.

The agency should study credit-related insurance products to determine exactly what actions are needed to protect consumers from the ravages of reverse competition. The agency should, for example, be involved in the process of rate regulation by the states, advocating before the states for minimum loss ratios consistent with fair consumer value. The agency should also be advocating for states to develop real (as opposed to reverse) competition in these lines of insurance and should develop ideas for accomplishing this. Possible approaches might include: educating consumers about their rights to shop for alternative sources of coverage; breaking up the cartel-like control over information about who needs such insurance so that other providers of coverage could contact consumers in time to compete for the sale; and abolishing the kickback arrangements that leave low-priced competitors unable to sell their products.

The agency should seek to learn from those firms that are struggling to break down the walls with lower prices, but who are thwarted by the cartel relationships and big kickbacks, and from other agencies that have been successful in adopting reforms. Iowa, for example, succeeded in reforming the market for title insurance, and other nations have also apparently broken the cartel-like arrangements. These examples, and systems such as Torrens[30] rather than title insurance, should be reviewed for possible use in this country.

Plan Proposes Long-Sought Investor Protection Reforms

As a complement to its proposal to create a Consumer Financial Protection Agency, the President's plan authorizes and directs the Securities and Exchange Commission to strengthen investor protections in a number of ways long sought by investor advocates. Just last week, the administration sent Congress legislation designed to enact those reforms. CFA strongly urges quick passage of that legislation, once potentially serious weaknesses in the section on fiduciary

[27] "Title Insurance Cost and Competition," Testimony of J. Robert Hunter, Director of Insurance, Before House Committee on Financial Services, Subcommittee on Housing and Community Opportunity, April 26, 2006.
[28] Missouri Department of Insurance, Financial Institutions and Professional Regulation, at http://www.insurance.mo.gov/reports/lossratio
[29] Examples include Iowa, which has successfully reformed title insurance, and New York and Maine, which have gotten considerable control of credit insurance costs through effective and reasonable maximum loss ratio regulation.
[30] Torrens is a system of registration of land titles that makes title insurance unnecessary.

duty are fixed. By helping to ensure that investors get the most out of their often scant investment dollars, this proposal should contribute to their individual well-being and retirement preparedness, which has been badly damaged by the recent crisis. By raising the standards that brokers must meet in dealing with clients and attacking conflicts of interest that encourage abuses, it would also improve the overall integrity of the capital markets.

Fiduciary Duty for Investment Advice: A centerpiece of the administration's plan to enhance investor protections is its language advocating a fiduciary duty for brokers who provide investment advice that is comparable to the duty investment advisers must abide by. This has long been a priority for CFA. Over the past two decades, in response to competition from both financial planners and discount brokers, full service brokers have transformed their business model into one that is, or at least appears to be, largely advice-driven. They have taken to calling their sales reps "financial advisers," offered investment planning services, and marketed their services based on the advice offered. The SEC permitted this transformation without requiring brokers to comply with the Investment Advisers Act provisions designed to govern such conduct. Instead, each time the SEC has had to make a choice between protecting investors and protecting the broker-dealer business model, it has chosen the latter. The President's plan attempts to reverse that trend, by ensuring that all those who offer advisory services are subject to the appropriate fiduciary standard of care and loyalty and by improving the quality of pre-engagement disclosure investors receive about these obligations.

The legislation risks undermining that goal by delegating to the SEC the job of writing rules to implement the fiduciary duty requirement and giving it broad leeway in doing so. While this may seem to be a logical approach, for investors to receive the full benefits of the President's plan, the SEC will have to get right the very issues it has mishandled for at least two decades. After all, the investor confusion this legislation is designed to address is not the inevitable result of industry changes; rather, it is the direct result of anti-investor policy decisions by the SEC over many years. We are encouraged by the commitment Chairman Schapiro has made to change that direction, and by the strong leadership Commissioner Aguilar has shown on the fiduciary duty issue.

However, to better ensure that the legislation delivers on the administration plan's promise of a full scale fiduciary duty for all investment advice, and not the "fiduciary duty lite" some in the brokerage industry have sought, some revision of the legislative language appears necessary. Specifically, the words fiduciary duty of care and loyalty that are referenced in the President's plan should be included in the legislative language itself, so that the fiduciary duty exists in law and not simply through the adoption of SEC rules. The "in substance" language in the legislation, which could be used to justify watering down that standard, should be removed. In addition, the SEC should be required, not simply authorized, to adopt the appropriate standards. Finally, Congress should clarify, preferably through the legislation itself but if not through accompanying report language, that: 1) the intent is to ensure no weakening of the fiduciary duty that currently applies to advisers and 2) that a fiduciary duty, once entered into, cannot easily be abandoned; brokers who are covered by a fiduciary duty when giving advice cannot escape that requirement when selling the products to implement that advice.

Compensation Reform: The President's plan backs up its provision on fiduciary duty for investment advice with a requirement that the SEC study industry sales practices and prohibit those compensation practices and conflicts of interest that it determines are not in investors' best interests. The securities industry is riddled with such conflicts, and the resulting damage to investors is significant. Conflict-laden compensation practices are behind the myriad sales abuse scandals that have constantly dogged the industry over the years, whether the instrument of choice was limited partnerships or mutual fund B shares, high-cost annuities or out-of-state 529 plans. These practices not only damage investors by increasing their costs and diverting often limited funds from their investment goals, they encourage a form of reverse competition in which investment products compete to be sold rather than bought, limiting the potential for market forces to discipline costs. Because investors typically rely heavily on the recommendations they receive, doing little if any additional research on such factors as costs and risks, they are particularly vulnerable to harm from these conflicts of interest. Like the provision on fiduciary duty, this provision of the legislation shows a welcome willingness to put investor interests over industry interests, even when it challenges industry's traditional way of doing business.

Improved Disclosure: One reason investors rely so heavily on the recommendations they receive from investment professionals is that the disclosures designed to aid them in understanding their investment options are neither timely nor well designed to convey the crucial information. The administration plan includes two important provisions to improve the quality of product disclosures that investors receive: first, it authorizes the Commission to conduct regular testing of disclosures to determine their effectiveness and second, it authorizes the Commission to require pre-sale disclosure for mutual funds. Based on the Commission's limited past experience with disclosure testing, we believe an expanded program to test both new and existing disclosures would be extremely illuminating both in revealing the limits of disclosure in conveying intended messages and in helping the Commission to develop more effective means of presenting information.

We also strongly support requiring pre-sale disclosure to assist mutual fund investors to make more informed investment decisions. While mutual funds are subject to more robust disclosure requirements than many competing investment products and services, the disclosures typically do not arrive until three days after the sale. This makes them essentially useless in helping investors to assess the risks and costs of the fund, as well as the uses for which it may be most appropriate. It should be obvious to anyone that, if we want investors to make informed decisions, they must receive the information they need to make that choice in a readable form and at a time when it can be factored in to the investment decision. We believe the ideal timing is at the point of recommendation; even point-of-sale disclosures may come too late to influence the investor. Moreover, today's information technology makes instant delivery of such information possible at virtually no cost, eliminating arguments the industry has previously used to oppose such requirements.

Although we strongly support the administration proposal on pre-sale disclosure for mutual funds, we are disappointed that it is so narrowly focused. While mutual funds are a logical place to start in adopting such reforms, given their wide use with average investors, reform should not stop there. We therefore encourage Congress to amend the administration legislation to require the SEC to study the feasibility of requiring pre-sale disclosures of key information for all products and services recommended by investment professionals.

Pre-dispute Binding Arbitration Agreements: Another pro-investor provision in the administration's investor protection legislation is its language authorizing the SEC to ban or limit the use of pre-dispute binding arbitration clauses in broker and advisory contracts. As the President's plan cogently argues, asking investors to give away their right to choose the most appropriate means of resolving a dispute before a dispute has even arisen is patently unfair. Moreover, the requirement typical of brokerage contracts that any dispute be resolved in an industry-run arbitration system undermines confidence in the fairness of that system. While we believe arbitration will remain the resolution mechanism of choice for most investors, giving investors a choice of dispute resolution mechanisms offers two important benefits: it will allow cases that involve complex questions of law and require the procedural protections afforded by a formal trial to be resolved in court where they belong, and it will provide an incentive for the arbitration system to be run in a way that ensures investors view it as a fair, affordable and effective means of resolving disputes.

Strengthening SEC Enforcement Powers: Finally, the legislation includes several provisions to strengthen SEC enforcement powers. It authorizes the agency to bar regulated individuals who violate the securities laws from all aspects of the industry. So, for example, a broker who committed a serious violation could be barred from acting as either a broker or an adviser. It also would strengthen whistleblower protections and allow the agency to reward whistleblowers for information that is instrumental in uncovering a fraud and convicting the perpetrators. Finally, it clarifies and expands the agency's authority to act against those who aid and abet securities fraud. It does so by extending this authority to violations of the Exchange Act and the Investment Advisers Act and by clarifying that the knowledge requirement for bringing an aiding and abetting complaint can be satisfied by recklessness.

CFA strongly supports these provisions. We regret, however, that the administration's plan does not address the long-standing need to restore aiding and abetting liability in private actions, and we urge Congress to rectify this important oversight. (For more on this issue, see Appendix A.)

Systemic Risk Regulation

As we have noted in previous testimony (attached in Appendix D), CFA believes the most important steps Congress and the administration can take to reduce risk in the financial system are to close regulatory loopholes and strengthen functional regulation. Nonetheless, we also support strengthened systemic risk oversight as a supplement to traditional functional regulation of financial markets, institutions, products and practices.

The President's plan includes a number of the key characteristics we have identified as essential to effective systemic risk regulation:

- the Financial Services Oversight Council it proposes to create would have the ability to gather information from any financial firm, ensuring a properly broad scope of oversight;

- the largest, most interconnected, and highly leveraged institutions would face stricter regulation, including higher capital requirements and more robust consolidated supervision, with a goal of forcing them to "internalize the costs that their failure could pose;"

- it looks beyond mere size when determining whether an institution poses out-sized risks to the financial system, to include such important factors as leverage, reliance on short-term funding, and importance to the overall economy;

- it attempts to address the conflicts of interest that exist within complex financial holding companies, both by imposing greater constraints on transactions between banks and their affiliates and by tightening supervision of conflicts posed by proprietary trading and the operation of hedge funds;

- it includes corrective action authority, which would enable regulators to act before risks spin out of control and threaten an institution's failure; and

- it creates a mechanism to allow for the orderly failure of non-bank financial institutions and holding companies.

One aspect of the administration's plan that we believe is particularly important is the effort it makes to address conflicts of interest and potential risks within complex financial holding companies. For years, CFA opposed the repeal of the Glass Steagall Act on the grounds, among other things, that it risked creating financial institutions that were both subject to vast conflicts of interest and were too complex to regulate effectively. The current crisis has led some eminent experts, such as former Federal Reserve Chairman Paul Volcker and MIT Professor Simon Johnson, to conclude that institutions that are too big or too complex to fail are too big and too complex to exist and should be broken up.

While the administration's plan stops short of breaking up such institutions, it deserves credit for attempting to take a much tougher, more comprehensive approach to regulation of these institutions than was proposed in the original Gramm-Leach-Bliley Act. Moreover, its proposal to raise capital and other standards in order to force these institutions to internalize the costs of being big and complex is theoretically sound. Effective implementation of these provisions is essential to reducing systemic threats. It will require regulators to be much tougher in standing up to industry pressure than they have traditionally been willing to be, however. Should their efforts fail, there will no longer be any credible answer to those who argue for the restoration of much simpler financial institutions.

The administration plan deviates from our suggested approach in one important respect; it proposes to identify "systemically significant" institutions up-front and subject them to higher standards and more regulatory scrutiny. As we discuss in more detail in the attached testimony (see Appendix D), we are concerned that this approach may not be either practical or effective. The administration's failure to recognize the systemic risk posed by the failure of Lehman Brothers, for example, should provide ample evidence of the fallibility of such an approach, particularly in light of the complex factors that contribute to systemic risk. While we agree that institutions that are larger, more inter-connected, more leveraged or otherwise engaged in riskier conduct should face higher capital standards, stricter risk management requirements, and enhanced regulatory oversight, we believe those heightened standards should ratchet up along a continuum rather than turn on or off according to a determination that a particular institution poses a systemic threat. Such an approach is in our view less susceptible to gaming, in which institutions attempt to manipulate risk factors to either avoid or trigger designation as a systemically significant institution based on their perception of the costs or benefits of such a designation.

Finally, CFA has not taken a position on what regulatory agency should have primary responsibility for systemic risk oversight. We have, however, identified concerns that we believe must be addressed if Congress chooses to go forward with the administration plan to make the Federal Reserve Board the chief systemic risk regulator. Chief among these are concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks, its closed culture and lack of public accountability, factors that, left unaddressed, are likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. The President's plan addresses this issue by requiring the Fed and Treasury Department, in consultation with outside experts, to suggest changes to better align the Fed's structure and governance with its authorities and responsibilities. Moreover, the plan puts that evaluation on a very tight time-frame, which should allow any proposed changes to be factored into the decision about whether and under what terms to delegate this new responsibility to the Fed.

Other concerns that need to be addressed include a potential conflict between the Fed's role setting monetary policy and the role of a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Moreover, combining these two functions within the same agency raises question about how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis). The evaluation recommended in the President's plan will need to directly address these issues of conflicting missions, and Congress will need to determine whether these potential conflicts are capable of being resolved.

Conclusion

A fundamental lesson of this crisis is that the basic regulatory philosophy that has dominated the past three decades was mistaken, that market forces cannot be relied on to rein in abuses, and that markets cannot be left to self-correct. The President's plan is based on a clear recognition of this lesson and responds by proposing a more comprehensive approach to regulation designed to address the market failures that make our system vulnerable to crisis.

Opponents of regulatory reform have argued that more regulation cannot solve a problem that poor regulation created. Taking that line, it is easy to poke holes in any single component of the overall regulatory plan and argue that, standing alone, it would not prevent a crisis similar to the one we now face. Moreover, all aspects of the plan are susceptible to the criticism that they require regulators to make exactly the sort of tough, responsible decisions that they failed to make in the lead-up to the current crisis. In truth, unless there is a renewed commitment to tough regulation at our regulatory agencies, we risk making that prediction a reality.

After all, it is completely predictable that, if these proposals are adopted, financial institutions will soon be heard complaining to regulators, to Congress, and to members of the media that regulators are over-reacting, that restrictions are unreasonable, and that they are stifling innovation and undermining the institutions' ability to compete globally. This is the same litany of complaints that financial services firms have used successfully over the years to stave off effective regulation, and it is their success in advancing those arguments before Congress and the regulatory agencies that has brought our financial system to the brink of collapse. Unless Congress and regulators are willing to resist that industry pressure, the result is likely to be weak implementation of crucial aspects of the plan designed to promote the safety and soundness of the financial system.

The answer, however, is not to throw up our hands in defeat. On the contrary, this susceptibility of the regulatory system to industry influence highlights the need to enact the administration's *entire* regulatory plan intact, to fill in the gaps that need filling, and to strengthen those aspects of the plan that need strengthening. Only the most comprehensive, toughest plan has a chance of overcoming the weakness in implementation that will inevitably undermine the effectiveness of individual components of the plan.

Moreover, the more focus we place on regulating effectively early in the process – by banning harmful and risky credit practices, by providing effective day-to-day oversight of markets and institutions – the less reliant we will be on those aspects of the plan that are most vulnerable to industry influence, including the proposals for higher capital standards, for more rigorous risk management practices, and for systemic risk regulation. Thus, it is absolutely essential that Congress adopt the strongest possible legislation to provide that up-front regulation, particularly by creating a new Consumer Financial Protection Agency to rein in unsound lending practices, by adopting a comprehensive and effective system of regulation for OTC derivatives, and by reforming the credit rating agencies.

Industry opposition is certain to be fierce, particularly to those aspects of the plan that are most likely to force them to change long-standing practices or to loosen their grip on the regulatory apparatus. Already, they have fired up their lobbying operations using their tried and true anti-regulation arguments and misinformation practices. The administration has for the most part resisted those arguments and presented a plan for regulatory reform that, while imperfect, is both comprehensive in scope and thoughtful in many of its details. We urge Congress to take up that challenge and shepherd the bill to passage, filling in gaps and strengthening certain key provisions, while avoiding weakening amendments.

Appendix A:

SHAREOWNERS.ORG:

A SHAREOWNER AGENDA FOR RESTORING CORPORATE ACCOUNTABILITY

We seek to create better protections for the average American investor in the financial marketplace. The severe losses suffered by tens of millions of Americans in their portfolios, 401(k)s, mutual funds and traditional pension plans all point to the need for a new emphasis on shareowner rights and meaningful regulation in order to ensure the financial security of American families.

America has tried going down the road of financial deregulation and reduced corporate accountability. That path has proven to be a dead end that is now imperiling the financial well being of millions of long-term shareowners. Unfortunately, shareholders in America's corporations -- who actually should more correctly be thought of as "shareowners" -- have limited options today when it comes to protecting themselves from weak and ineffectual boards dominated by management, misinformation peddled as fact, accounting manipulation, and other abuses.

Under the disastrous sway of deregulation and lack of accountability, corporate boards and executives either caused or allowed corporations to undertake unreasonable risks in the pursuit of short-term financial goals that were devoid of real economic substance or any long-term benefits. In most cases, it is long-term shareowners -- not the deregulators and the speculators -- that are paying the price for the breakdown in the system.

It is time for America to get back on the road of prudent financial regulatory oversight and increased corporate accountability. ShareOwners.org recognizes the devastating impact that a lack of appropriate regulation and accountability has had on our economy. In order to restore the confidence of investors in our capital markets, it is now necessary to take the following steps:

I. **Strengthen the <u>regulation of the markets</u>.** Key reforms needed to protect the interests of shareowners include the following:

   Beef up the Securities and Exchange Commission (SEC). Congress should assess the funding needs of the SEC and take steps to bring the agency as quickly as possible to the point that it can fully carry out its mission of oversight of the markets and financial professionals in order to protect and advocate for investors. Among other priorities, the SEC should impose requirements for the disclosure of long and short positions, enhance disclosures for private equity firms bidding for public companies, and require both the registration of hedge fund advisors with the Commission as investment advisors and additional disclosures of the underlying hedge fund. Following the request of the Administration, the SEC should be given additional authority to create a full-fledged fiduciary standard for broker dealers, so that the interests of clients who purchase investment products comes before the self interest of the broker. The SEC Division of Enforcement should be unshackled to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action.

Clear the way for forfeiture of compensation and bonuses earned by management in a deceptive fashion. Legislation should be adopted to allow for the "clawing back" of incentive compensation and bonuses paid to corporate executives based on fraudulent corporate results, and should provide for enforcement through a private right of action. There is no reason why directors and executives should not give back ill-gotten gains when innocent shareowners are victimized by crippling losses. The outrageous bonuses at AIG, Morgan Stanley and other banks responsible for our financial meltdown were not deserved and should not be allowed to stand. If they know their compensation is on the line, corporate managers and directors will be less likely to engage in, or turn a blind eye toward, fraud and other wrongdoing.

Strengthen state-level shareowner rights. Corporation structures and charters are regulated under state law. The corporate law in most states has not clarified the rights, responsibilities and powers of shareholders and directors or ways that they should communicate outside of annual general meetings. If regulation to strengthen shareholder rights does not occur at the federal level, it will be up to the states to move forward. State corporate law should require proxy access, majority voting and the reimbursement of solicitation expenses in a board challenge. We would encourage robust competition among states for corporate charters based on a race to the top for improved shareowner rights. If necessary, federal law should be changed to allow for shareholders to call a special meeting to reincorporate in another state by majority vote, in order to avoid being shackled by the corporate state laws that put the interests of management ahead of shareowners.

Protect whistleblowers and confidential sources who expose financial fraud and other corporate misconduct. Confidential informants -- sometimes called "whistleblowers" -- are of immeasurable value in discovering and redressing corporate wrongdoing. The information provided by these individuals may be crucial to victims' ability to prove their claims. Often, these individuals only come forward because they believe their anonymity will be preserved. If their identities were known, they would be open to retaliation from their employers and/or others with an interest in covering up the wrongdoing. Whistleblowers might lose their job or suffer other harm. Legislation is needed to clearly state that the corporate whistleblowers and other confidential informants will be protected when they step forward.

II. **Increase the <u>accountability of boards and corporate executives</u>.** Key reforms needed to protect the interests of shareowners include the following:

Allow shareowners to vote on the pay of CEOs and other top executives. Corporate compensation policies that encourage short-term risk-taking at the expense of long-term corporate health and reward executives regardless of corporate performance have contributed to our current economic crisis. Shareowners should have the opportunity to vote for or against senior executive compensation packages in order to ensure managers have an interest in long-term growth and in helping build real economic prosperity. The recently enacted stimulus bill requires all companies receiving TARP bail-out funds, nearly 400 companies, to include a "say on pay" vote at their 2009 annual meetings and as long as they hold TARP funds. It is now time for Congress to implement Treasury Secretary Geithner's plan for compensation reform by passing "say on pay" legislation for <u>all</u> companies and to make it permanent as the center piece of needed reforms to encourage executive accountability.

Empower shareowners to more easily nominate directors for election on corporate boards. (This is often referred to as "proxy access.") The process for nominating directors at American corporations is dominated today by incumbent boards and corporate management. This is because corporate boards control the content of the materials that companies send to shareholders to solicit votes (or "proxies") for director elections, including the identification of the candidates who are to be considered for election. The result is that corporate directors often are selected based on their allegiance to the policies of the incumbent board, instead of their responsiveness to shareowner concerns. Unless they can afford to launch an expensive independent proxy solicitation, shareowners have little or no say in selecting the directors who are supposed to represent their interests. The solution is to enable shareowners, under certain circumstances, to require corporate boards to include information about candidates nominated by shareowners in the company's proxy materials.

Require majority election of all members of corporate boards at American companies. Corporate directors are the elected representatives of shareowners who are responsible for overseeing management. Under the default rule applicable to virtually every corporation in the United States, however, corporate directors can be elected with just a single affirmative vote, even if that director's candidacy is opposed by the overwhelming majority of shareowners. While a few corporations have adopted policies that would require a director to receive support of the majority of shareowners in order to be elected, most corporations -- particularly those not in the S&P 500 -- have not. True majority voting should be mandatory in every uncontested director election at all publicly traded corporations.

Split the roles of chairman of the board and CEO in any company (1) receiving federal taxpayer funds or (2) operating under federal financial regulations. It already is the practice in most of the world to divide these two key positions so that an independent chairman can serve as a check on potential CEO abuses. Separation of the CEO and board chair roles helps to ensure good board governance and fosters independent oversight to protect the long-term interests of private shareowners, pension funds and institutional investors. A strong independent chair can help to address legitimate concerns raised by shareowners in a company. Splitting these roles and then requiring a prior shareowner vote to reintegrate them would be in the best interests of investors.

Stop the practice of brokers casting votes for shareowners in board elections. Brokers should no longer be allowed to vote on behalf of their clients in board of director elections. Stockbrokers who hold shares in their own name for their client investors have no real economic interest in the underlying corporation. Nevertheless, such brokers are permitted to vote these shares held in "street name" to elect corporate directors. Such brokers frequently can determine the leadership of corporate boards, even though they have no direct economic interest in the corporations. Moreover, brokers almost universally vote for managements' nominees and proposals and, in effect, interfere with shareowner supervision of the corporations they own.

Allow shareowners to call special meetings. Shareowners should be allowed to call a special meeting. Shareowners who own 5 percent or more of the stock of a company should be permitted, as they are in other countries, to call for a special meeting of all shareowners. They also should be given the right to call for a vote on reincorporation when management and corporate boards unduly use state laws detrimental to shareowner interests to entrench themselves further.

III. **Improve financial transparency.** Key reforms needed to protect the interests of shareowners include the following:

Crackdown on corporate disclosure abuses that are used to manipulate stock prices. Shareowners in securities fraud cases have always had the burden of proving that defendants' fraud caused the shareowners' losses. When corporate wrongdoers lie to shareowners and inflate the value of publicly traded stock through fraudulent and misleading accounting statements and other chicanery, those culpable parties should be held responsible for the damage wrought on the investing public that is caused by their fraud. Defendants should not be allowed to escape accountability to their shareowners for fraudulent conduct simply by cleverly timing the release of information affecting a company's stock price.

Improve corporate disclosures so that shareowners can better understand long-term risks. To rebuild shareowner confidence regulators should emphasize transparency by creating more mechanisms for comprehensive corporate disclosure. The SEC should devote particular attention to the adequacy of disclosures concerning such key factors as credit risk, financial opacity, energy and climate risk and those reflecting the financial challenges to the economy as identified by the transition team and the new administration. The SEC should develop internal expertise on issues such as environmental, social, and governance factors that pose material financial risks to corporations and shareowners, and also to require disclosure of these types of risks.

Protect U.S. shareowners by promoting new international accounting standards. Our current financial crisis extends far beyond the borders of the US and has affected financial markets and investors across the globe. Part of the problem has been a race to the bottom in favor of a more flexible international accounting standard that would decrease disclosure protection for the average investor. The current crisis makes a compelling case for why we need to slow down the movement towards the use of international accounting standards that could provide another back door route to financial deregulation and further erode confidence in corporate book keeping. A slower time frame is necessary to protect shareowners and allow the administration to reach out to other governments that share a commitment to high accounting and transparency standards.

IV. **Protect the <u>legal rights of defrauded shareowners</u>.** Key reforms needed to protect the rights of shareowners include the following:

Preserve the right of investors to go to court to get justice. Corporate and financial wrongdoers in recent years have effectively denied compensation to victims of fraud by requiring customers to sign away their rights to access federal courts as individuals and participate with other victims in class actions when their individual claims are small. Absent the ability to proceed collectively, individuals have no means of redress because -- as the wrongdoers know -- it is frequently economically impossible for victims to pursue claims on an individual basis. The ability of shareowners to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Shareowners should have the right to access federal courts individually or as a member of a class action.

Ensure that those who play a role in committing frauds bear their share of the cost for cleaning up the mess. What is known as private "aiding and abetting" liability is well established in criminal law, and private liability for engaging in an unlawful and fraudulent scheme is widely recognized in civil law. In cases of civil securities fraud, however, judicial decisions effectively have eliminated private liability of so-called "secondary actors" - even when they knowingly participated in fraud schemes.

Eliminating the private liability of such "secondary actors" as corporate accountants, lawyers and financial advisors has proven disastrous for shareowners and the economy. Most recently, in the sub-prime mortgage-backed securities debacle, bond rating agencies -- who were paid by the very investment bankers who created the securities they were asked to rate -- knowingly gave triple-A ratings to junk sub-prime debt instruments in order to generate more business from the junk marketers. The immunity from private liability that these culpable third parties currently enjoy should be eliminated.

Allow state courts to help protect investor rights. The previous decade saw the greatest shift in governmental authority away from the states and to the federal government in our history. The effect of this shift was to deny individuals their legal rights under state laws and to protect corporate defendants. Corporate interests and an administration devoted to the ideology of deregulation used the "doctrine of preemption" (that federal law supersedes state law) to bar action at the state level that could have stopped many of the abuses in sub-prime mortgage lending that are now at the heart of our economic crisis. Indeed, state attorneys general were blocked from prosecuting sub-prime lenders who violated state laws. The integrity of state law should be restored and both state officials and shareowners should be allowed to pursue remedies available under state law. Federal policy should make clear that state law exists coextensively with federal regulations, except where state law directly contradicts federal law.

Appendix B: Description of Consumer Credit Insurance Coverages

Credit insurance refers to a group of insurance products sold in conjunction with a loan or credit agreement. Credit insurance makes payments for the consumer to the lender for a specific loan or credit agreement in particular circumstances. The common types of credit insurance sold include:

- *Credit Life* pays off the consumer's remaining debt on a specific loan or credit card account if the borrower dies during the term of the coverage.
- *Credit Accident and Health,* also known as *Credit Disability,* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes disabled during the term of coverage.
- *Credit Involuntary Unemployment* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes involuntarily unemployed during the term of coverage.
- *Credit Personal Property* typically pays to repair or replace property that is serving as collateral for a loan.
- *Creditor-Placed Insurance* is auto or property insurance placed by a lender if the consumer fails to maintain the insurance required by the terms of the auto or home loan.
- *Credit Family Leave* makes monthly payments if the borrower goes on an approved family leave.
- *Credit GAP* pays the difference – or gap – between the amount owed on the auto loan and the amount paid by the insurance company on the auto insurance policy in the event there is an accident resulting in a total loss to the vehicle and the amount of insurance payoff is less than the amount owed on the loan. GAP is sometimes used as acronym for Guaranteed Auto Protection.
- *Non-Filing* pays the lender in the event loan documents have not been correctly filed.
- *Mortgage Guaranty* pays the lender in the event the borrower defaults on the mortgage loan.

Appendix C: Properly Regulating Insurance "Look Alike" Products

Many insurance products are perfect or near-perfect substitutes for financial products; it is logical for the CFPA to represent consumers on all substantively similar products.

Consumer credit insurance products are – from the consumer's perspective – equivalent to debt cancellation contracts and debt suspension agreements – products which federal banking regulators have declared to be banking products.

Debt Cancellation Contracts (DCCs) and related products like Debt Suspension Agreements (DSAs) are products sold in connection with a consumer loan and which promise to provide some debt relief to the consumer if certain events occur. The events triggering the benefit under the DCCs/DSAs are typically events that impair the borrower's income or place a financial burden on the borrower. DCCs/DSAs are part of the group of payment protection products that include credit insurance and which promise, among other things, to preserve the borrower's credit rating in adverse circumstances.

Since 2000, lenders have shifted their payment protection product offerings from credit insurance to DCCs/DSAs, initially in connection with credit cards and more recently in connection with closed-end loans. One of the earliest forms of DCC sold in connection with a closed-end loan was GAP Waiver sold in connection with auto loans.

To a consumer, DCCs and credit insurance are very similar – or even identical – products. For a one-time or monthly fee, DCC will cancel the debt or make monthly payments if certain events occur – just as credit insurance performs. For example, a credit card credit insurance program containing credit life, credit disability and credit involuntary unemployment coverages provides the identical benefits for a consumer as a DCC program for death, disability and involuntary unemployment.

The major difference between credit insurance and DCC is in regulatory oversight. Federal banking regulators have declared DCC to be a banking product and, consequently, not subject to state insurance regulation if sold by banks or credit unions with federal charters. Although state insurance regulators challenged these decisions, claiming that DCC was an insurance product, banks who sought the federal oversight of DCC and the federal agencies have prevailed in legal challenges. State regulation of DCCs offered by state-chartered financial institutions has generally followed the federal rules.

The rationale for not regulating DCC as an insurance product is that, unlike credit insurance, where a borrower, a lender and an insurance company are involved, there are only two parties involved with DCC – the borrower and the lender. The DCC is an addendum to the loan contract that states that, under certain circumstances, the lender will cancel the debt or the monthly payment. So, in theory, no insurance company need be involved.

In practice, DCC programs are administered in almost the same manner as credit insurance programs. Credit insurance companies provide the same administrative and sales services as with credit insurance. The lender purchases a contractual liability policy from the credit insurance company, and this policy pays any claims made under the DCC program offered by the lender. Credit insurance companies, including CUNA Mutual, now sell and administer DCC programs as well as credit insurance programs.

The difference in regulatory oversight of DCC versus credit insurance is dramatic. With credit insurance, the products (policy forms) must be approved by state insurance regulators prior to use and the rates subject to prima facie maximum rate regulation. A credit insurer wishing to offer a national program must obtain approvals in all states and comply with different rates in all states as well as variations in product requirements among the states. Under rules promulgated by the Office of the Comptroller of the Currency (OCC) and other federal financial regulators, lenders can offer a single DCC product nationally. Lenders have moved from credit insurance to DCC for several reasons:

- No oversight or limitations on fees charged
- Few limitations on product design and benefit provisions – no restrictions on bundling, flexibility in product design
- Ability to use one product nationally
- No agent licensing requirements
- No form or rate filing requirements
- No premium taxes

DCCs and DSAs generally provide much worse value to consumers than credit insurance – higher prices, fewer benefits and fewer consumer protections. In prior reports and testimony, CFA has estimated the loss ratio for DCCs and DSAs to be less than 5%. In addition to lower benefit payouts, the administrative costs for DCCs are lower than for credit insurance because of the ability to utilize a single program across the states, the absence of product filings and approvals, and the absence of a premium tax.

Failure to allow the CFPA to represent insurance consumers will lead to regulatory arbitrage – the shifting of banking products to insurance products.

When the federal banking regulators declared debt cancellation contracts to be banking products – and not subject to state insurance regulation – lenders started changing their products from credit insurance to debt cancellation or debt suspension to take advantage of the more favorable (to lenders) regulatory structure for the debt cancellation and debt suspension products. This is one example of regulatory arbitrage – regulated entities playing off competing regulators for the most advantageous – to the regulated entities – regulatory regime. Failure to include credit-related insurance products under the jurisdiction of the CFPA would reverse that trend, encouraging financial institutions to shift from use of regulated bank products to less regulated insurance products. Consumers would be the losers.

Appendix D:

Consumer Federation of America

Testimony of Travis Plunkett
Legislative Director
Consumer Federation of America

Hearing on "Systemic Risk"

Before the
Committee on Financial Services
U.S. House of Representatives

March 17, 2009

Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

I greatly appreciate the opportunity to appear before you today to testify about one of the most important issues Congress will need to address as it develops a comprehensive agenda to reform our nation's failed financial regulatory system – how to better protect the system as a whole and the broader economy from systemic risks. Recent experience has shown us that our current system was not up to the task, either of identifying significant risks, or of addressing those risks before they spun out of control, or of dealing efficiently and effectively with the situation once it reached crisis proportions. The effects of this failure on the markets and the economy have been devastating, rendering reform efforts aimed at protecting the system against systemic threats a top priority.

In order to design an effective regulatory response, it is necessary to understand why the system failed. It has been repeated so often in recent months that it has taken on the aura of gospel, but it is simply not the case that the systemic risks that have threatened the global financial markets and ushered in the most serious economic crisis since the Great Depression arose because regulators lacked either sufficient information or the tools necessary to protect the financial system as a whole against systemic risks. (Though it is true that, once the crisis struck, regulators lacked the tools needed to deal with it effectively.) On the contrary, the crisis resulted from regulators' refusal to heed overwhelming evidence and repeated warnings about growing threats to the system.

- Former Congressman Jim Leach and former CFTC Chairwoman Brooksley Born both identified the potential for systemic risk in the unregulated over-the-counter derivatives markets in the 1990s.

- Housing advocates have been warning the Federal Reserve since at least the early years of this decade that securitization had fundamentally changed the underwriting standards for mortgage lending, that the subprime mortgages being written in increasing numbers were unsustainable, that foreclosures were on the rise, and that this had the potential to create systemic risks.

- The SEC's risk examination of Bear Stearns had, according to the agency's Inspector General, identified several of the risks in that company's balance sheet, including its use of excessive leverage and an over-concentration in mortgage-backed securities.

Contrary to conventional wisdom, these examples and others like them provide clear and compelling evidence that, in the key areas that contributed to the current crisis – unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system – regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in Born's case, were denied the authority they needed to rein in those risks.

Regulatory intervention at any of those key points had the potential to prevent, or at least greatly reduce the severity of, the current financial crisis – either by preventing the unsound mortgages from being written that triggered the crisis, or by preventing investment banks and other financial institutions from taking on excessive leverage and loading up their balance sheet with risky assets, leaving them vulnerable to failure when the housing bubble burst, or by preventing complex networks of counterparty risk to develop among financial institutions that allowed the failure of one institution to threaten the failure of the system as a whole. This view is well-articulated in the report of the Congressional Oversight Panel, which correctly identifies a fundamental abandonment of traditional regulatory principles as the root cause of the current financial crisis and prescribes an appropriately comprehensive response.

So what is the lesson to be learned from that experience for Congress's current efforts to enhance systemic risk regulation? The lesson is emphatically not that there is no need to improve systemic risk regulation. On the contrary, this should be among the top priorities for financial regulatory reform. But there is a cautionary lesson here about the limitations inherent in trying to address problems of inadequate systemic risk regulation with a structural solution. In each of the above examples, and others like them, the key problem was not insufficient information or inadequate authority; it was an unwillingness on the part of regulators to use the authority they had to rein in risky practices. That lack of regulatory will had its roots in an irrational faith among members of both political parties in markets' ability to self-correct and industry's ability to self-police.

Until we abandon that failed regulatory philosophy and adopt in its place an approach to regulation that puts its faith in the ability and responsibility of government to serve as a check on industry excesses, whatever we do on systemic risk is likely to have little effect. Without that change in governing philosophy, we will simply end up with systemic risk regulation that exhibits the same unquestioning, market-fundamentalist approach that has characterized substantive financial regulation to a greater or lesser degree for the past three decades.

If the "negative" lesson from recent experience is that structural solutions to systemic risk regulation will have limited utility without a fundamental change in regulatory philosophy, there is also a positive corollary. Simply closing the loopholes in the current regulatory structure, reinvigorating federal regulators, and doing an effective job at the day-to-day tasks of routine safety and soundness and investor and consumer protection regulation would go a long way toward eliminating the greatest threats to the financial system.

The "Shadow" Banking System Represents the Greatest Systemic Threat

In keeping with that notion, the single most significant step Congress could and should take right now to decrease the potential for systemic risk is to shut down the shadow banking system completely and permanently. While important progress is apparently being made (however slowly) in moving credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, *Infectious Greed,* a primary use of the "shadow" banking system – and indeed the main reason for its existence – is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So banks used unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks sold Mezzanine CDOs to pension funds in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter market without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

The basic justification for allowing two systems to grow up side-by-side – one regulated and one not – is that sophisticated investors are capable of protecting their own interests and do not require the basic protections of the regulated market. That myth has been dispelled by the current crisis. Not only did "sophisticated" institutional investors load up on toxic mortgage-backed securities and collateralized debt obligations without understanding the risks of those investments, but financial institutions themselves either didn't understand or chose to ignore the risks they were exposing themselves to when they bought toxic assets with borrowed money or funded long-term obligations with short-term financing. By failing to protect their own interests, they damaged not only themselves and their shareholders, but also the financial markets and the global economy as a whole. This situation simply cannot be allowed to continue. Any proposal to address systemic risk must confront this issue head-on in order to be credible.

Other Risk-Related Priorities Should Also Be Addressed

There are other pressing regulatory issues that, while not expressly classified as systemic risk, are directly relevant to any discussion of how best to reduce systemic risk. Chairman Frank has appropriately raised the issue of executive compensation in this context, and CFA supports efforts to reduce compensation incentives that promote excessive risk-taking.

Similarly, improving the reliability of credit ratings while simultaneously reducing our reliance on those ratings is a necessary component of any comprehensive plan to reduce systemic risk. Ideally, some mechanism will be found to reduce the conflicts of interest associated with the agencies' issuer-paid compensation model. Whether or not that is the case, we believe credit rating agencies must face increased accountability for their ratings, the SEC must have increased authority to police their ratings activities to ensure that they follow appropriate due diligence standards in arriving at and maintaining those ratings, and laws and rules that reference the ratings must make clear that reliance on ratings alone does not satisfy due diligence obligations to ensure the appropriateness of the investment.

In addition, CFA believes one of the most important lessons that have been learned regarding the collapse of our financial system is that improved, up-front product-focused regulation will significantly reduce systemic risk. For example, if federal regulators had acted more quickly to prevent abusive sub-prime mortgage loans from flooding the market, it is likely that the current housing and economic crisis would not have been triggered. As a result, we have endorsed the concept advanced by COP Chair Elizabeth Warren and legislation introduced by Senator Richard Durbin and Representative William Delahunt to create an independent financial safety commission to ensure that financial products meet basic standards of consumer protection. Some opponents of this proposal have argued that it would stifle innovation. However, given the damage that recent "innovations" such as liar's loans and Mezzanine CDOs have done to the global economy, this hardly seems like a compelling argument. By distinguishing between beneficial and harmful innovations, such an approach could in our view play a key role in reducing systemic risks.

Congress Needs To Enhance the Quality of Systemic Risk Oversight

In addition to addressing those issues that currently create a significant potential for systemic risk, Congress also needs to enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of non-bank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain over the best way to accomplish that goal. The remainder of this testimony will address those key questions regarding such issues as who should regulate for systemic risk, who should be regulated, what that regulation should consist of, and how it should be funded. CFA has not yet reached firm conclusions on all of these issues, including on the central question of how systemic risk regulation should be structured. Where our position remains unresolved, we will discuss possible alternatives and the key issues we believe need to be resolved in order to arrive at a conclusion.

Should there be a central systemic risk regulator?

As discussed above, we believe all financial regulators should bear a responsibility to monitor for and mitigate potential systemic risks. Moreover, we believe a regulatory approach that both closes regulatory loopholes and reinvigorates traditional regulation for solvency and consumer and investor protection would go a long way toward accomplishing that goal. Nonetheless, we agree with those who argue that there is a benefit to having some central authority responsible and accountable for overseeing these efforts, if only to coordinate regulatory efforts related to systemic risk and to ensure that this remains a priority once the current crisis is past.

Perhaps the best reason to have one central authority responsible for monitoring systemic risk is that, properly implemented, such an approach offers the best assurance that financial institutions will not be able to exploit newly created gaps in the regulatory structure. Financial institutions have devoted enormous energy and creativity over the past several decades to finding, maintaining, and exploiting gaps in the regulatory structure. Even if Congress does all that we have urged to close the regulatory gaps that now exist, past experience suggests that financial institutions will immediately set out to find new ways to evade legal restrictions.

A central systemic risk regulatory authority could and should be given responsibility for quickly identifying any such activities and assigning them to their appropriate place within the regulatory system. Without such a central authority, regulators may miss activity that does not explicitly fall within their jurisdiction or disputes may arise over which regulator has authority to act. CFA believes designating a central authority responsible for systemic risk regulation offers the best hope of quickly identifying and addressing new risks that emerge that would otherwise be beyond the reach of existing regulations.

Who should it be?

Resolving who should regulate seems to be the most vexing problem in designing a system for improved systemic risk regulation. Three basic proposals have been put forward: 1) assign responsibility for systemic risk regulation to the Fed; 2) create a new market stability regulator; and 3) expand the President's Working Group on Financial Markets (PWG) and give it an explicit mandate to coordinate and oversee regulatory efforts to monitor and mitigate systemic threats. Each approach has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation.

The Federal Reserve Board – Many people believe the Federal Reserve Board (the "Fed") is the most logical body to serve as systemic risk overseer. Those who favor this approach argue that the Fed has the appropriate mission and expertise, an experienced staff, a long tradition of independence, and the necessary tools to serve in this capacity (e.g., the ability to act as lender of last resort and to provide emergency financial assistance during a financial crisis). Robert C. Pozen summed up this viewpoint succinctly when he testified before the Senate Committee on Homeland Security and Governmental Affairs. He said:

> "Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system ... If the Federal Reserve Board is going to bail out a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure."

Two other, more pragmatic arguments have been cited in favor of giving these responsibilities to the Fed: 1) its ability to obtain adequate resources without relying on the congressional budget process and 2) the relative speed and ease with which this expansion of authority could be accomplished, particularly in comparison with the challenges of establishing a new agency for this purpose.

Others are equally convinced that the Fed is the last agency that should be entrusted with responsibility for systemic risk regulation. Some cite concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks. Particularly when combined with the Board's closed culture and lack of public accountability, this conflict is seen as likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. Opponents of the Fed as systemic risk regulator also cite a conflict between its role setting monetary policy and its potential role as a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Another involves the question of how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis).

Others simply point to what they see as the Fed's long history of regulatory failure. This includes not only failures directly related to the current crisis – its failure to address unsound mortgage lending on a timely basis, for example, as well as its failure to prevent banks from holding risky assets in off-balance-sheet special purpose entities and its cheerleading of the rapid expansion of the shadow banking system – but also a perceived past willingness at the Fed to allow banks to hide their losses. According to this argument, Congress ultimately passed FDICIA in 1991 (requiring regulators to close financial institutions before all the capital or equity has been depleted) precisely because the Fed had been unwilling to do so absent that requirement.

Should Congress determine to give systemic risk responsibility to the Fed, we believe it is essential that you take meaningful steps to address what we believe are compelling concerns about this approach. Even some who have spoken in favor of the Fed in this capacity have acknowledged that it will require significant restructuring. As former Federal Reserve Chairman Paul Volcker noted in remarks before the Economic Club of New York last April:

> "If the Federal Reserve is also ... to have clear authority to carry effective 'umbrella' oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability ..., all backed by a stronger, larger, highly experienced and reasonably compensated professional staff."

CFA concurs that, if systemic risk regulation is to be housed at the Fed, systemic risk regulation must not be relegated to Cinderella status within the agency. Rather, it must be given a high priority within the organization, and significant additional staff dedicated to this task must be hired who have specific risk assessment expertise. Serious thought must also be given to 1) how to resolve disputes between these two potentially competing functions of setting monetary policy and mitigating systemic risks, and 2) how to ensure that systemic risk regulation is carried out with the full transparency and public accountability that it demands.

A New Systemic Risk Regulatory Agency – Some have advocated creation of an entirely new regulatory agency devoted to systemic risk regulation. The idea behind this approach is that it would allow a singular focus on issues of systemic risk, both providing clear accountability and allowing the hiring of specialized staff devoted to this task. Furthermore, such an agency could be structured to avoid the significant concerns associated with designating the Fed to perform this function, including the conflict between monetary policy and systemic risk regulation.

Although it has its advocates, this approach appears to trigger neither the broad support nor the impassioned opposition that the Fed proposal engenders. Those who favor this approach, including Brookings scholar Robert Litan, tend to do so only if it is part of a more radical regulatory restructuring. Adding such an agency to the existing regulatory structure would "add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions," Litan said in recent testimony before the Senate Committee on Homeland Security and Governmental Operations. Moreover, even its advocates tend to acknowledge that it would be a challenge, and possibly an insurmountable challenge, to get such an agency up and running in a timely fashion.

Expanded and Refocused President's Working Group – The other approach that enjoys significant support entails giving an expanded version of the President's Working Group for Financial Markets clear, statutory authority for systemic risk oversight. Its current membership would be expanded to include all the major federal financial regulators as well as representatives of state securities, insurance, and banking officials. By formalizing the PWG's authority through legislation, the group would be directly accountable to Congress, allowing for meaningful congressional oversight.

Among the key benefits of this approach: the council would have access to extensive information about and expertise in all aspects of financial markets. The regulatory bodies with primary day-to-day oversight responsibility would have a direct stake in the panel and its activities, maximizing the chance that they would be fully cooperative with its efforts. For those who believe the Fed must play a significant role in systemic risk regulation, this approach offers the benefit of extensive Fed involvement as a member of the PWG without the problems associated with exclusive Fed oversight of systemic risk.

This approach, while offering attractive benefits, is not without its short-comings. One is the absence of any single party who is solely accountable for regulatory efforts to mitigate systemic risks. Because it would have to act primarily through its member bodies, it could result in an inconsistent and even conflicting approach among regulators. It also raises the risk that systemic risk regulation will not be given adequate priority. In dismissing this approach, Litan acknowledges that it may be the most politically feasible but he maintains: "A college of regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing."

Despite the many attractions of this approach, this latter point is particularly compelling, in our view. Regulators have a long history of jurisdictional disputes. There is no reason to believe those problems would simply dissipate under this arrangement. Decisions about who has responsibility for newly emerging activities would likely be particularly contentious. If Congress were to decide to adopt this approach, it would need to set out some clear mechanism for resolving any such disputes. Alternatively, it could combine this approach with enhanced systemic risk authority for either the Fed or a new agency, as the Financial Services Roundtable has suggested, providing that agency with the benefit of the panel's broad expertise and improving coordination of regulatory efforts in this area.

FDIC – A major reason federal authorities were forced to improvise in managing the events of the past year is that we lack a mechanism for the orderly unwinding of non-bank financial institutions that is comparable to the authority that the FDIC has for banks. Most systemic risk plans seem to contemplate expanding FDIC authority to include non-bank financial institutions, although some would house this authority within a systemic risk regulator. CFA believes this is an essential component of a comprehensive plan for enhanced systemic risk regulation. While we have not worked out exactly how this should operate, we believe the FDIC, the systemic risk regulator, or the two agencies working together must also have authority to intervene when failure appears imminent to require corrective actions.

A Systemic Risk Advisory Panel – One of the key criticisms of making the Fed the systemic risk regulator is its dismal regulatory record. But if we limited our selections to those regulators with a credible record of identifying and addressing potential systemic risks while they are still at a manageable stage, we'd be forced to start from scratch in designing a new regulatory body. And there is no guarantee we would get it right this time.

A number of academics and others outside the regulatory system were far ahead of the regulators in recognizing the risks associated with unsound mortgage lending, unreliable ratings on mortgage-backed securities and CDOs, the build-up of excessive leverage, the questionable risk management practices of investment banks, etc. Regardless of what approach Congress chooses to adopt for systemic risk oversight, we believe it should also mandate creation of a high-level advisory panel on systemic risk. Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such a panel.

The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of regulators and reduce the risks of group-think and complacency. We urge you to include this as a component of your regulatory reform plan.

Who should be regulated?

The debate over who should be regulated for systemic risk basically boils down to two main points of view. Those who see systemic risk regulation as something that kicks in during or on the brink of a crisis, to deal with the potential failure of one or more financial institutions, tend to favor a narrower approach focused on a few large or otherwise "systemically important" institutions. In contrast, those who see systemic risk regulation as something that is designed, first and foremost, to prevent risks from reaching that degree of severity tend to favor a much more expansive approach. Recognizing that systemic risk can derive from a variety of different practices, proponents of this view argue that all forms of financial activity must be subject to systemic risk regulation and that the systemic risk regulator must have significant flexibility and authority to determine the extent of its reach.

CFA falls firmly into the latter camp. We are not alone; this expansive view of systemic risk jurisdiction has many supporters, at least when it comes to the regulator's authority to monitor the markets for systemic risk. The Government Accountability Office, for example, has said that such efforts "should cover all activities that pose risks or are otherwise important to meeting regulatory goals." Bartlett of the Financial Services Roundtable summed it up well in his testimony when he said that:

> "... authority to collect information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (e.g., transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk."

The case for giving a systemic risk regulator broad authority to monitor the markets for systemic risk is obvious, in our opinion. Failure to grant a regulator this broad authority risks allowing risks to grow up outside the clear jurisdiction of functional regulators, a situation financial institutions have shown themselves to be very creative at exploiting.

While the case for allowing the systemic risk regulator broad authority to monitor the financial system as a whole seems obvious, the issue of whether to also grant that regulator authority to constrain risky conduct wherever they find it is more complex. Those who favor a narrower approach argue that the proper focus of any such regulatory authority should be limited to those institutions whose failure would be likely to create a systemic risk. This view is based on the sentiment that, if an institution is too big to fail, it must be regulated. While CFA shares the view that those firms that are "too big to fail" must be regulated, we take that view one step further. As we have discussed above, we believe that the best way to reduce systemic risk is to ensure that all financial activity is regulated to ensure that it is conducted according to basic principles of transparency, fair dealing, and accountability.

Those like Litan who favor a narrower approach focused on "systemically important" institutions defend it against charges that it creates unacceptable moral hazard by arguing that it is essentially impossible to expand on the moral hazard that has already been created by recent federal bailouts simply by formally designating certain institutions as systemically significant. We agree that, based on recent events and unless the approach to systemic risk is changed, the market will assume that large firms will be rescued, just as the market rightly assumed for years, despite assurances to the contrary, that the government would stand behind the GSEs. Nonetheless, we do not believe it follows that the appropriate approach to systemic risk regulation is to focus exclusively on these institutions that are most likely to receive a bailout. Instead, we believe it is essential to attack risks more broadly, before institutions are threatened with failure and, to the degree possible, to eliminate the perception that large institutions will always be rescued. The latter goal could be addressed both by reducing the practices that make institutions systemically significant and by creating a mechanism to allow their orderly failure.

Ultimately, we believe a regulatory approach that relies on identifying institutions in advance that are systemically significant is simply unworkable. The fallibility of this approach was demonstrated conclusively in the wake of the government's determination that Lehman Brothers, unlike Bear Stearns, was not too big to fail. As Richard Baker, President and CEO of the Managed Funds Association, said in his testimony before the House Capital Markets Subcommittee, "There likely are entities that would be deemed systemically relevant ... whose failure would not threaten the broader financial system." We also agree with NAIC Chief Executive Officer Therese Vaughn, who said in testimony at the same hearing, "In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it."

The factors that might make an institution systemically important are complex – going well beyond asset size and even degree of leverage to include such considerations as nature and degree of interconnectivity to other financial institutions, risks of activities engaged in, nature of compensation practices, and degree of concentration of financial assets and activities, to name just a few. Trying to determine in advance where that risk is likely to arise would be all but impossible. And trying to maintain an accurate list of systemically important institutions going forward, considering the complex array of factors that are relevant to that determination, would require constant and detailed monitoring of institutions on the borderline, would be extremely time-consuming, and ultimately would almost certainly allow certain risky institutions and practices to fall through the cracks.

How should they regulate?

There are three key issues that must be addressed in determining the appropriate procedures for regulating to mitigate systemic risk:

- Should responsibility and authority to regulate for systemic risks kick in only in a crisis, or on the brink of a crisis, or should it be an on-going, day-to-day obligation of financial regulators?

- What regulatory tools should be available to a systemic risk regulator? For example, should a designated systemic risk regulator have authority to take corrective actions, or should it be required (or encouraged) to work through functional regulators?

- If a designated systemic risk regulator has authority to require corrective actions, should it apply generally to all financial institutions, products, and practices or should it be limited to a select population of systemically important institutions?

When the Treasury Department issued its Blueprint for regulatory reform a year ago, it proposed to give the Federal Reserve broad new authority to regulate systemic risk but only in a crisis. Despite the sweeping scope of its restructuring proposals, Treasury clearly envisioned a strictly limited role within systemic risk regulation for regulatory interventions exercised primarily through its role as lender of last resort. Although there are a few who continue to advocate a version of that viewpoint, we believe events since the Blueprint's release have conclusively proven the disadvantages of this approach. As Volcker stated in his New York Economic Club speech: "I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn." We share that skepticism, convinced like the authors of the COP Report that, "Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools."

As noted above, most parties appear to agree that a systemic risk regulator must have broad authority to survey all areas of financial markets and the flexibility to respond to emerging areas of potential risk. CFA shares this view, believing it would be both impractical and dangerous to require the regulator to go back to Congress each time it sought to extend its jurisdiction in response to changing market conditions. Others have described a robust set of additional tools that regulators should have to minimize systemic risks. As the Group of 30 noted in its report on regulatory reform: "... a legal regime should be established to provide regulators with authority to require early warnings, prompt corrective actions, and orderly closings" of certain financial institutions. The specific regulatory powers various parties have recommended as part of a comprehensive framework for systemic risk regulation include authority to:

- Set capital, liquidity, and other regulatory requirements directly related to risk management;

- Require firms to pay some form of premium, much like the premiums banks pay to support the federal deposit insurance fund, adjusted to reflect the bank's size, leverage, and concentration, as well as the risks associated with its activities;

- Directly supervise at least certain institutions;

- Act as lender of last resort with regard to institutions at risk of failure;

- Act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition;

- Require corrective actions at troubled institutions that are similar to those provided for in FDICIA;

- Make regular reports to Congress; and

- Take enforcement actions, with powers similar to what Federal Reserve currently has over bank holding companies.

Without evaluating each recommendation individually or in detail, CFA believes this presents an appropriately comprehensive view of the tools necessary for systemic risk regulation.

Most of those who have commented on this topic would give at least some of this responsibility and authority – such as demanding corrective actions to reduce risks – directly to a systemic risk regulator. Others would require in all but the most extreme circumstances that a systemic risk regulator exercise this authority only in cooperation with functional regulators. Both approaches have advantages and disadvantages. Giving a systemic risk regulator this authority would ensure consistent application of standards and establish a clear line of accountability for decision-making in this area. But it would also demand, perhaps unrealistically, that the regulator have a detailed understanding of how those standards would best be implemented in a vast variety of firms and situations. Relying on functional regulators to act avoids the latter problem but sets up a potential for jurisdictional conflicts as well as inconsistent and delayed implementation. If Congress decides to adopt the latter approach, it will need to make absolutely clear what authority the systemic risk regulator has to require its regulatory partners to take appropriate action. Without that clarification, disputes over jurisdiction are inevitable, and inconsistencies and conflicts are bound to emerge. It would also be doubly important under such an approach to ensure that gaps in the regulatory framework are closed and that all regulators share a responsibility for reducing systemic risk.

Many of those who would give a systemic risk regulator this direct authority to demand corrective actions would limit its application to a select population of systemically important institutions. The Securities Industry and Financial Markets Association has advocated, for example, that the resolution system for non-bank firms apply only to "the few organizations whose failure might reasonably be considered to pose a threat to the financial system." In testimony before the House Capital Markets Subcommittee, SIFMA President and CEO T. Timothy Ryan, Jr. also suggested that the systemic risk regulator should only directly supervise systemically important financial institutions.

Such an approach requires a systemic risk regulator to identify in advance those institutions that pose a systemic risk. Others express strong opposition to this approach. As former Congressman Baker of the MFA said in his recent House subcommittee testimony:

> "An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against failure."

Unfortunately, the recent actions the government was called on to take to rescue a series of non-bank financial institutions has already created that implied backing. Simply refraining from designating certain institutions as systemically significant will not be sufficient to dispel that expectation, and it would at least provide the opportunity to subject those firms to tougher standards and enhanced oversight. As discussed above, however, CFA believes this approach to be unworkable.

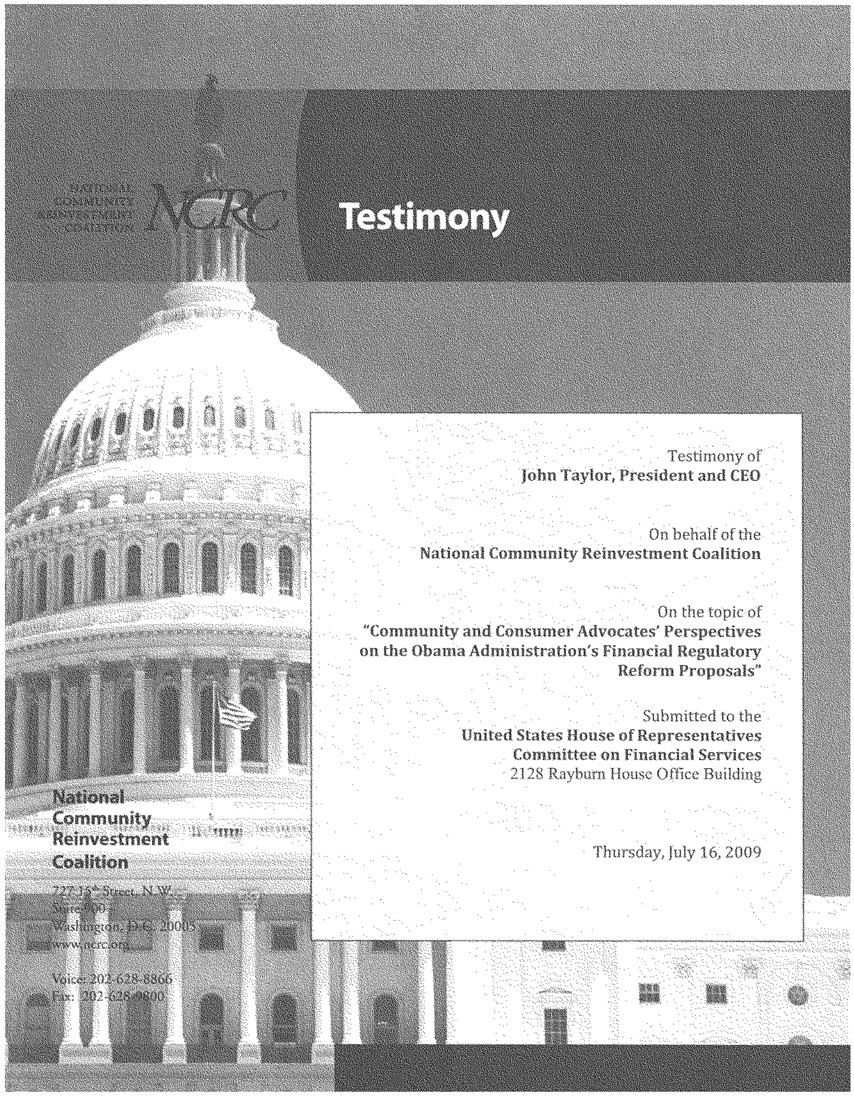
That is a key reason why we believe it is absolutely essential to provide for corrective action and resolution authority as part of a comprehensive plan for enhanced systemic risk regulation. As money manager Jonathan Tiemann argued in a recent article entitled "The Wall Street Vortex":

> "Some institutions are so large that their failure would imperil the financial system. As such, they enjoy an implicit guarantee,, which could ... force us to nationalize their losses. But we need for all financial firms that run the risk of failure to be able to do so without causing a widespread financial meltdown. The most interesting part of the debate should be on this point, whether we could break these firms into smaller pieces, limit their activities, or find a way to compartmentalize the risks that their various business units take."

CFA believes this is an issue that deserves more attention than it has garnered to date. One option is to try to maximize the incentives of private parties to avoid risks, for example by subjecting financial institutions to risk-based capital requirements and premium payments. To serve as a significant deterrent to risk, these requirements would have to ratchet up dramatically as institutions grew in size, took on risky assets, increased their level of leverage, or engaged in other activities deemed risky by regulators. It has been suggested, for example, that the Fed could have prevented the rapid growth in use of over-the-counter credit default swaps by financial institutions if it had adopted this approach. It could, for example, have imposed capital standards for use of OTC derivatives that were higher than the margin requirements associated with trading the same types of derivatives on a clearinghouse and designed to reflect the added risks associated with trading in the over-the-counter markets. In order to minimize the chances that institutions will avoid becoming too big or too inter-connected to fail, CFA urges you to include such incentives as a central component of your systemic risk regulation legislation.

Conclusion

Decades of Wall Street excess unchecked by reasonable and prudential regulation have left our markets vulnerable to systemic shock. The United States, and indeed the world, is still reeling from the effects of the latest and most severe of a long series of financial crises. Only a fundamental change in regulatory approach will turn this situation around. While structural changes are a part of that solution, they are by no means the most important aspect. Rather, returning to a regulatory approach that recognizes both the disastrous consequences of allowing markets to self-regulate and the necessity of strong and effective governmental controls to rein in excesses is absolutely essential to achieving this goal.



NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Testimony

Testimony of
John Taylor, President and CEO

On behalf of the
National Community Reinvestment Coalition

On the topic of
"Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals"

Submitted to the
United States House of Representatives
Committee on Financial Services
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I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus, and other distinguished members of the Committee. I am John Taylor, President of the National Community Reinvestment Coalition (NCRC), and I am honored to testify today before the House Financial Services Committee on behalf of NCRC on the topic of "Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals."

NCRC is an association of more than 600 community-based organizations that promotes access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families.

II. The Need for a Consumer Financial Protection Agency (CFPA) and CFPA Enforcement of the Community Reinvestment Act

The sharp economic decline resulting from the foreclosure crisis can be traced to out-dated consumer protection laws and failed regulatory oversight. Loopholes in the law and inadequate regulatory enforcement allowed abusive and problematic lending to flourish, which led to the destabilization of the US economy. The foreclosures that arose from predatory lending have not only severely undermined the financial stability of working families and communities but also are now weakening the credit markets and diminishing overall economic activity and performance. Massive foreclosures are spurring a self-reinforcing cycle of defaults, declines in home values, and rising unemployment.

The current crisis demonstrates the urgent need for comprehensive regulatory reform and the establishment of a federal agency focused exclusively on consumer protection. As the Obama Administration notes in its paper "Financial Regulatory Reform: A New Foundation," "Consumer protection is a critical foundation for our financial system. It gives the public confidence that the financial markets are fair and enables policy makers and regulators to maintain stability in regulation. Stable regulation, in turn, promotes growth, efficiency, and innovation over the long term." For these reasons, NCRC agrees strongly with the Administration that consumer protection needs an "independent seat at the table in our financial regulatory system" and that the CFPA would be that independent seat. For too long, consumer protection has played a marginal role in the U.S. regulatory system. In order to deter future foreclosure crises of this scale and magnitude, consumer protection must be elevated to one of the core priorities in the U.S. regulatory system through the establishment of a dedicated agency that gives consumer protection a principal role in federal oversight, regulatory reform, and fair lending enforcement.

When I was serving on the Federal Reserve Board's Consumer Advisory Council, I would hear Federal Reserve staff talk about serving their "clients." I initially thought clients meant the taxpayers but then I was shocked to learn that clients meant banks that were "members" of the Federal Reserve System. These semantics suggest that the agencies view their mission as primarily safeguarding the wellbeing of banks. While I agree that the wellbeing of banks is important, our country needs a new agency which sees its mission as safeguarding the interests of consumers.

A central element of consumer protection is the Community Reinvestment Act (CRA). CRA requires banks to meet the credit needs of communities, including low- and moderate-income communities, consistent with safety and soundness. As a result of CRA's prudent lending requirement, the Federal Reserve found that of all the high-cost loans issued in 2006, only 6 percent were considered on bank CRA exams and were made by banks to low- and moderate-income borrowers or neighborhoods.[1] The vast majority of the risky lending was issued by non-CRA covered mortgage companies over the years. Further research by the Federal Reserve documents that loans made by banks in geographical areas on CRA exams are about half as

[1] Randall Kroszner, former Federal Reserve Governor and currently at Booth School of Business, University of Chicago, *The Community Reinvestment Act and the Recent Mortgage Crisis*, in Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, http://www.frbsf.org/publications/community/cra/index.html

likely to end up in foreclosure as loans issued by independent mortgage companies.[2] Federal Reserve Chairman Ben Bernanke concludes, "Our own experience with CRA over more than 30 years and recent analysis of available data, including data on subprime loan performance, runs counter to the charge that CRA was at the root of, or otherwise contributed in a substantive way, to the current mortgage difficulties."[3]

Repeated assertions from some ideological pundits concerning CRA's contribution to the foreclosure crisis is a "big lie" strategy; yet loudly repeating this lie does not make it true. In fact, the reverse is true. If CRA's safety and soundness requirement had been applied broadly throughout the financial services industry, the U.S. economy would not be increasingly unhinged as a result of mounting foreclosures, widespread job loss, and a potentially steep and protracted recession.

Since CRA is a central component of consumer protection and CFPA will be the central agency to protect consumers, CFPA must be charged with enforcing CRA. NCRC strongly supports the Administration's proposal to place CRA under the jurisdiction of CFPA, and asks that the Chairman and the Committee amend H.R. 3126 (the Consumer Financial Protection Agency Act of 2009) to mandate that CRA be under the jurisdiction of CFPA. We understand that bank industry trade associations lobbied vigorously to retain the jurisdiction of the current bank agencies over CRA. The industry supports CRA in the existing bank agencies because the fragmented regulatory enforcement has resulted in inconsistent enforcement of CRA that too often accommodates the priorities of the industry at the expense of working communities. A lack of uniform and rigorous CRA enforcement means that CRA has not yet realized its full potential in terms of leveraging loans, investments, and services for families and communities. In fact, recent regulatory changes have reduced the amount of lending and investing in

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[2] Elizabeth Laderman and Carolina Reid, Federal Reserve Bank of San Francisco, "CRA Lending during the Subprime meltdown in Revisiting the CRA: Perspectives on the future of the Community Reinvestment Act," a Joint Publication of the federal Reserve Banks of Boston and San Francisco, February 2009, http://www.frbsf.org/publications/community/cra/cra_lending_during_subprime_meltdown.pdf

[3] Letter from Ben. S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System to Senator Robert Menendez, November 25, 2008.

communities. It is time to send the message that banks can no longer buy their way out of accountability.

III. The Shortcomings of Current CRA Enforcement

Four agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision) have been in charge of enforcing CRA and updating CRA regulations and examination procedures. As the Administration's white paper asserts, oversight of CRA and other fair lending laws has been fragmented among the four agencies, making the regulatory rulemaking process slow, creating opportunities for "regulatory arbitrage," and institutions shopping for a regulatory agency that is least restrictive. Because of this, CRA enforcement became inconsistent among the four agencies; specifically, the agencies were not able to update their regulations and examination procedures quickly enough to keep pace with changes in the industry, and enforcement ranged from mediocre to negligent.

The last time the agencies strengthened CRA regulations in any significant manner was in 1995 under a mandate from the Clinton Administration. Since that time, the agencies have weakened CRA regulations.

CRA Grade Inflation

One visible manifestation of the inadequacies of current CRA enforcement is grade inflation. Banks receive one of four ratings on their CRA exams: Outstanding, Satisfactory, Needs-to-Improve, and Substantial Non-Compliance. The last two ratings are considered failing ratings. As the table below shows, the current failure rate for banks has hovered between 1 to 2 percent in recent years. When ratings first became public in 1990, more than 10 percent of banks failed their CRA exams[4]. During the first five years of the public availability of CRA ratings, more

[4] See http://www.ffiec.gov/craratings/default.aspx for the database on CRA ratings.

than 5 percent of banks failed their CRA exams every year (over the five year time period, 7.6 percent of the banks failed).

Year	Outstanding		Satisfactory		Needs to Improve		Substantial Noncompliance		Total
	Count	Percent	Count	Percent	Count	Percent	Count	Percent	
1990	340	10.9%	2,474	79.5%	280	9.0%	19	0.6%	3,113
1991	407	8.3%	4,016	81.6%	453	9.2%	46	0.9%	4,922
1992	653	12.7%	4,067	78.9%	395	7.7%	40	0.8%	5,155
1993	941	14.7%	5,060	79.3%	355	5.6%	26	0.4%	6,382
1994	1,000	18.1%	4,249	76.7%	275	5.0%	15	0.3%	5,539
1995	1,363	24.3%	4,106	73.1%	138	2.5%	7	0.1%	5,614
1996	1,214	26.5%	3,275	71.5%	81	1.8%	11	0.2%	4,581
1997	829	22.4%	2,807	75.7%	59	1.6%	11	0.3%	3,706
1998	681	18.6%	2,915	79.6%	59	1.6%	7	0.2%	3,662
1999	679	18.6%	2,915	79.7%	55	1.5%	7	0.2%	3,656
2000	220	17.5%	1,001	79.6%	30	2.4%	7	0.6%	1,258
2001	132	10.6%	1,088	87.1%	23	1.8%	6	0.5%	1,249
2002	201	9.8%	1,820	89.0%	18	0.9%	5	0.2%	2,044
2003	283	10.1%	2,492	89.2%	17	0.6%	3	0.1%	2,795
2004	329	13.1%	2,170	86.1%	17	0.7%	3	0.1%	2,519
2005	247	16.0%	1,281	83.1%	10	0.6%	4	0.3%	1,542
2006	199	14.0%	1,194	84.0%	22	1.5%	6	0.4%	1,421
2007	212	11.9%	1,538	86.4%	26	1.5%	4	0.2%	1,780
2008	195	9.5%	1,823	88.9%	29	1.4%	4	0.2%	2,051
2009 to date	53	6.1%	805	92.6%	10	1.2%	1	0.1%	869
Total	**10,178**	15.9%	**51,096**	80.0%	**2,352**	3.7%	**232**	0.4%	**63,858**

Banks improved their CRA performance over the years as they bolstered their efforts to make loans, investments, and services in low- and moderate-income communities. Yet, the low failure rate in recent years appears to be implausible. A study conducted by the Center for Community Capitalism concluded that CRA service test scores are likely to be inflated when low scores on the lending test and investment test confront banks with the possibility of CRA exam failure.[5] In addition, Rick Marsico in his book *Democratizing Capital* reveals how quantitative criteria are applied in an inconsistent manner on CRA exams, suggesting that a number of CRA exams have ratings that cannot be justified.[6]

The inflated ratings reduce the incentives banks have to maintain and increase their responsible lending, investing, and services in low- and moderate-income communities. If banks conclude that they will receive passing ratings regardless of fluctuations in their lending, investing, and service levels, they will not be motivated to maximize their resources and attention to their CRA performance. The agencies have not significantly changed their ratings methodology or ratings scale in several years to bolster the meaning and value of passing ratings. At the very least, the agencies could have introduced more gradations among the passing ratings in order to reveal more accurately distinctions in bank performance, which would be useful for the general public, religious and nonprofit institutions, and state and local agencies as they determine which banks are excelling on their CRA exams and reward them by placing deposits at their branches. Thus, the meaning and value of CRA ratings as a mechanism for motivating bank lending, investment, and services has not realized its full potential due to the staid, unimaginative, and lackadaisical approaches of the agencies.

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[5] Michael A. Stegman, Kelly Thompson Cochran, and Robert Faris, Center for Community Capitalism, University of North Carolina, *Creating a Scorecard for the CRA Service Test: Strengthening Basic Banking Services under the Community Reinvestment Act*, 2001. Also see the Woodstock Institute, *Measuring the Provision of Banking Services for the Underbanked: Recommendations for a More Effective Community Reinvestment Act Service Test*, March 2007. Of the 14 banks in Woodstock's sample with the highest scores on the service test, eight had branch distributions in low- and moderate-income communities that were well below the averages for all lenders as a groupin the banks' assessment areas

[6] Richard D. Marsico, *Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act*, Carolina Academic Press, 2005.

OTS Leads in Weakening CRA, and Other Agencies Follow Suit

Instead of enhancing CRA, the slow regulatory changes to CRA over the last several years have weakened CRA. In 2001, the agencies announced an Advanced Notice of Proposed Rulemaking (ANPR) asking the general public, banks, and community groups if any changes should be made to CRA. After several years of enforcing CRA, the agencies were either not bold or creative enough to propose any changes, but merely asked stakeholders for their opinions. Several comments from NCRC and our 600 member organizations about improving the rigor of CRA were cast aside. After a three-year lapse, the agencies announced proposals in 2004 to weaken CRA by reducing data disclosure requirements and exam rigor for mid-size banks. Then, in the summer of 2004, a dramatic split occurred among the four agencies. Three of the agencies withdrew their proposal to reduce CRA requirements for mid-size banks, while the OTS further weakened CRA requirements.

On July 16, 2004, the Federal Reserve issued a press release that acknowledged the detrimental effects of the proposed regulatory laxity for mid-size banks. The Federal Reserve press release states, "While community banks strongly favor…(the proposal), it is uncertain that the cost savings to the average community bank of being "small" rather than "large" under the proposal would be significant. On the other side, the proposal's cost in the form of a potential reduction in community development capital in a significant number of rural communities is also uncertain, but potentially large in at least some communities. On balance, the Board does not believe that the cost savings of the proposal clearly justify the potential adverse effects on certain rural communities." The OCC and FDIC agreed with the Federal Reserve Board's assessment and also withdrew the proposed changes on the same day.

Unfortunately, the OTS not only proceeded with the change discarded by the other three agencies, the OTS made the change even worse. In its press release on July 16, 2004, the OTS announced that it would apply the reduced CRA exams for even larger category "small" institutions. The proposal discarded by the FDIC, OCC, and Federal Reserve had raised the asset range of small institutions to $500 million; the OTS raised the asset range to $1 billion and applied the reduced exams to these institutions.

The OTS continued to undermine CRA by implementing watered-down exams for thrifts with assets above $1 billion. For these thrifts, their lending test would count for at least 50 percent of their overall CRA rating, but their investment and service tests could count for any percentage the thrift chose. In contrast, the banks with assets above $1 billion under the FDIC, Federal Reserve, and OCC jurisdiction had CRA exams in which the lending test counted for 50 percent of the overall rating while the investment and service tests each counted for 25 percent. The discretion over changing weights lowered the thrifts community development financing. In a study of the OTS' new weighting model, NCRC and New York Law School found that large thrifts examined under the old and new schemes reduced their level of community development lending and investment from $6.2 million to $5.7 million. In addition, the ratio of the annualized median total dollar of community development lending and investment to asset level of the thrift decreased from .48 to .33. That is, the median percentage of a thrift's assets in the form of community development loans and investments dropped by nearly one-third. Yet, at the same time, the large thrift ratings became inflated. Before the new weighting scheme, 40 percent of the thrifts in the study's sample (of 25 thrifts) had Outstanding ratings. After the new weighting scheme, 60 percent of the thrifts had Outstanding ratings. The overall effect of the OTS's change was grade inflation coupled with less community development lending and investing.[7]

In the spring of 2007, a new and a more pragmatic OTS director reversed the OTS's changes to CRA regulation and aligned the OTS regulation and exam procedures to those of the other agencies. Yet, the other three agencies felt pressured by the OTS to also weaken their regulations because they were caught up in a "regulatory competition." They were afraid that if the OTS's CRA rules remained significantly more lenient for all sizes of institutions, they may lose financial institutions to the OTS. In response to this, the agencies returned to their proposal to weaken CRA exams for mid-size institutions. Though they removed some of the worst aspects of their original proposal, they nevertheless relaxed CRA exam and data reporting requirements for mid-size institutions with assets between $250 million to $1 billion.

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[7] Josh Silver, NCRC, and Rick Marsico, New York Law School, "An Analysis of the Implementation and Impact of the 2004-2005 Amendments to the Community Reinvestment Act Regulations: The Continuing Importance of the CRA Examination Process" in New York Law School Law Review, 2008-2009, Volume 53, Number 2.

One aspect of the laxity of CRA regulation was less attention to bank branches (though the exams were supposed to assess bank branches and services to low- and moderate-income communities). Before the changes to the mid-size exams, NCRC and New York Law School found that the 92 exams in our sample recorded the number of branches in low- and moderate-income neighborhoods 97 percent of the time. After the changes to the mid-size exams, the exams failed to record the number of branches in low- and moderate-income exams 32 percent of the time. In addition, 53 percent of the exams after the changes did not discuss the percentage or distribution of branches in low- and moderate-income neighborhoods. As payday lending and usurious fringe services have increased in low- and moderate-income neighborhoods, sensible public policy would be to increase emphasis on bank branches and the provision of affordable deposit and checking accounts in low- and moderate-income communities. Yet, a de-emphasis on branches is occurring in the case of mid-size banks, which are particularly important providers of services in smaller metropolitan areas and rural communities.

A final aspect of regulatory weakening was the deletion of small business and small farm loan data collection and reporting for the mid-size banks. In a report for the Appalachian Regional Commission, NCRC documents the important role of mid-size banks in providing small business loans, using the publicly available CRA small business loan data. Yet, we did not know when conducting the study that we were using the last year of the publicly available small business loan data for mid-size banks. It is likely that mid-size banks will not be as attentive to the credit needs of small businesses and small farms since the general public can no longer access their publicly available loan data showing how many loans they made to small businesses and farms in low- and moderate-income areas. In fact, the general public will never know for sure the impact of the deletion of the small business and farm reporting requirement since the deletion of the reporting requirement makes it impossible to compare lending trends of mid-size banks before and after the change.

The Case of Assessment Areas

NCRC believes that instead of diluting CRA exams and regulations, bank agencies could have taken constructive steps to bolster lending and investing by strengthening CRA exams and regulations. One of the most significant actions bank agencies could have taken was to reform the procedures regarding assessment areas or the geographical areas on CRA exams. The geographical coverage of CRA exams is critical because it determines the how much of the bank's lending and other financial activity is covered by CRA exams. The geographical locations covered by CRA exams generally consist of metropolitan areas or counties that contain bank branches. When Congress enacted CRA in 1977, banks received deposits and made loans through branches. While some banks still issue loans predominantly through branches, others make the majority of their loans through brokers and other non-branch means.

Though the CRA regulation stipulates that assessment areas include geographical regions containing bank branches, the regulation also states that assessment areas include other geographical regions in which the bank has originated or purchased a substantial portion of its loans.[8] Despite this regulatory clause, the federal agencies usually adopt a narrow definition of assessment areas for banks or thrifts that issue most of their loans through non-branch channels. For these banks, it is not unusual to encounter CRA exams that cover only the geographical area of the bank's headquarters.

In 2007, NCRC identified several lending institutions that engaged in questionable practices, including refusal to make loans under a minimum loan amount (usually $75,000 or $100,000), refusal to make loans to row homes, and failure to offer loans within entire cities. NCRC research revealed four banks engaged in these practices. In fact, only 11 percent to 13 percent of the loans investigated were in the banks' assessment areas.[9]

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[8] See Section 345.41 of the FDIC's CRA regulation available via http://www.fdic.gov/regulations/community/community/index.html

[9] Contact NCRC on 202-628-8866 for more information regarding our fair lending investigations.

Restricted assessment areas also motivate banks to locate their high-cost lending activities beyond assessment areas where they were not scrutinized by CRA exams. As previously stated, of all the high-cost loans issued in 2006, only 6 percent were made by banks to low- and moderate-income borrowers and neighborhoods in assessment areas and therefore considered on CRA exams. In contrast, 18 percent of all the high-cost loans were made by banks to low- and moderate-income borrowers and neighborhoods in geographical areas not on CRA exams. In other words, three times the amount of bank high-cost lending to low- and moderate-income borrowers and communities were in geographical areas not scrutinized by CRA exams than areas covered by CRA exams. If the geographical reach of CRA exams was extended, banks would likely make even fewer high-cost loans to low- and moderate-income borrowers.[10]

In addition to enabling problematic practices, narrow assessment areas defeat CRA's objective of banks responding to community needs. In one recent case, an NCRC member organization in Pennsylvania was concerned about the impact of a large bank merger on the bank's continued commitment to the organization's city. The newly merged institution would, in fact, be the largest lender (measured by number of home loans) in the city. Because the bank did not have a branch in the city and the city was not in a CRA assessment area, the bank declined to engage in substantive discussions about future collaboration or community development lending and investing. Although the bank had a major lending presence in the city, the bank was not encouraged by CRA exam procedures to see how it could meet credit needs beyond home lending in that area.

William Apgar and Ren Essene document the worrisome impacts of restricted assessment areas. They estimate that the share of home purchase and refinance lending covered by CRA exams fell from 40.6 percent in 1993 to 25.6 percent in 2006. Among CRA-covered banks, lending outside of assessment areas grew the fastest during this time period. For example, refinance lending by

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[10] Memo of November 21, 2008 to Sandra Braunstein, Director, Consumer and Community Affairs Division, from Glenn Canner and Neil Bhutta, subject Staff Analysis of the Relationship between CRA and the Subprime Crisis.

banks in their assessment areas increased by only 59 percent from 1993 to 2006 in contrast to a 334 percent increase by banks outside of their assessment areas.[11]

The response of the regulatory agencies to shrinking assessment area lending has been counterproductive. Although they engaged in a number of regulatory changes to CRA since 1995, they did not propose any adjustments to their assessment area procedures. Instead of rectifying assessment areas procedures, the agencies have increasingly proposed that certain bank community development activities outside of bank assessment receive favorable consideration on their CRA exams. This, however, is counterintuitive from a community development perspective since the prospects of community development succeeding in revitalizing communities is boosted when the community development is concentrated in geographical areas where banks lend and stimulate development in low- and moderate-income areas.

The OTS is the only agency that has taken marginal steps to address assessment areas since this agency oversees most of the non-traditional institutions lacking branch networks. OTS exams sometimes review lending trends in a sample of metropolitan areas outside of assessment areas, but these areas still constitute a minority of the non-traditional thrift lending.[12] Moreover, NCRC has not seen evidence of any significant consequences in the form of lower ratings when lending outside of assessment areas was not sufficient in reaching low- and moderate-income borrowers. Instead of the OTS half-measures, the agencies have had the authority to meaningfully expand assessment areas so that a majority of bank lending was considered on CRA exams. At the very least, the agencies could have emphatically raised this issue with Congress, but, to-date, have chosen not to do so.

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[11] Ren S. Essene and William C. Apgar, The 30th Anniversary of the Community Reinvestment Act: Restructuring the CRA to Address the Mortgage Finance Revolution in Revisiting the CRA: Perspectives on the future of the Community Reinvestment Act," a Joint Publication of the federal Reserve Banks of Boston and San Francisco, February 2009

[12] John Taylor and Josh Silver, "The Community Reinvestment Act at 30: Looking Back and Looking to the Future," in New York Law School Law Review, 2008-2009, Volume 53, Number 2.

The Agencies Fail to Adequately Utilize the Merger Application Process to Enforce CRA

In addition to a failure to adequately update CRA regulation, bank agencies have missed numerous opportunities to enforce CRA. The merger application process presents significant opportunities for federal agencies to enforce CRA. Yet, the enforcement of community reinvestment obligations through the merger application process has been lacking over the last several years.

In Congressional testimony in 2007, an official representing the Federal Reserve testified that the Federal Reserve has held only 13 public meetings on mergers since 1990. This is less than one meeting per year in an era in which consolidations have profoundly changed the banking industry. In addition, the Federal Reserve representative stated that since 1988, the Federal Reserve received 13,500 applications for the formation of banks or the merger of institutions involving bank holding companies or state-chartered banks that were members of the Federal Reserve System. Yet, only 25 of these applications were denied, with 8 of these denials involving consumer protection or community needs issues.[13] In addition, the Federal Reserve and the other agencies have had the authority to require specific improvements to CRA and fair lending performance when approving mergers. But the instances of the "conditional" approvals have declined significantly from the late 1990s; these conditional approvals occasionally occurred during the Clinton Administration but virtually disappeared during the Bush Administration.

The agencies also have not fully engaged the public in deliberations over mergers with profound impacts. In 2006, Wachovia acquired World Savings, the largest lender of exotic mortgages. However, there was no public hearing on this merger that posed significant fair lending and

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[13] See http://www.federalreserve.gov/newsevents/testimony/braunstein20070521a.htm for Ms. Braunstein's testimony.

safety and soundness issues. In 2006, Regions proposed to take over AmSouth Bank; although this merger involved two of the larger banks in the South, the Federal Reserve declined to hold a public hearing in spite of the clear ramifications for the recovery of the Gulf States after Hurricane Katrina. The Federal Reserve also declined to hold a hearing on the merger of Bank of New York and Mellon although the Bank of New York had received low ratings on two of the three tests on their two most recent CRA exams.[14]

Most recently, the agencies declined to solicit the public's input regarding the emergency mergers involving JP Morgan Chase/Washington Mutual and Wells Fargo/Wachovia. If the agencies believed that the usual application process and public comment period was not possible in these cases, they could have held post merger meetings and public hearings as requested by NCRC member organizations. These mergers had significant impacts on lending and investing. For example, community organizations in the Western part of the country were concerned about JP Morgan Chase's commitment to continue successful affordable housing and community development initiatives of Washington Mutual. By demonstrating the seriousness of the CRA issues, formal agency involvement in these post emergency discussions would have facilitated mutually acceptable arrangements regarding CRA bank activities.

Fair Lending Enforcement Lacking

Current federal fair lending enforcement efforts have been inadequate to protect the interests of minority consumers and other protected classes. In September of 2005, the Federal Reserve Board stated that it referred about 200 lending institutions to their primary federal regulatory agency for further investigations based upon the Federal Reserve's identification of significant

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[14] Bank of New York received a low satisfactory on its lending and service test from the Federal Reserve Bank of New York on both its 2005 and 2003 CRA exams. In other words, the bank was close to failing on two CRA exams in succession. Yet, no public hearing on the merger occurred.

pricing disparities in HMDA data.[15] An industry publication subsequently quoted a Federal Reserve official as stating that these lenders accounted for almost 50 percent of the HMDA-reportable loans issued in 2004.[16] In September of 2006, the Federal Reserve Board referred a larger number of lenders, 270, to their primary regulatory agencies for further investigations.[17]

Shockingly, not a single case of discrimination or civil rights violations have arisen from the roughly 470 Federal Reserve referrals. While the HMDA data analysis by itself cannot conclude which financial institutions were discriminating, it is inconceivable that Federal Reserve investigators could be so consistently inaccurate in their assessments about possible violations of fair lending laws during a time period of particularly abusive and usurious lending. When the HMDA data was not as detailed, the U.S. Department of Justice in the 1990s settled about a dozen cases alleging discrimination with major lenders, including Long Beach Mortgage and Huntington.[18] These settlements had industry-wide impacts, as lending institutions knew that the U.S. Department of Justice was serious about enforcing civil rights laws.

III. Rationale for Moving CRA to the CFPA

The current institutional structure has inhibited a fervent commitment to CRA and fair lending enforcement on the part of the agencies. Charter shopping, interagency conflict, competing regulatory priorities, and other institutional constraints have resulted in a CRA rulemaking and

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[15] Robert B. Avery, Glenn B. Canner, and Robert E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, Federal Reserve Bulletin, Summer 2005, http://www.federalreserve.gov/pubs/bulletin/2005/05summerbulletin.htm

[16] Inside Regulatory Strategies, November 14, 2005, p.2.

[17] Joe Adler, *Big Increase in Lenders with Suspect HMDA Data*, American Banker, September 11, 2006.

[18] There were a couple of cases in 2002 and 2004 (Mid America Bank, FSB, 2002; Fidelity Federal Bank, FSB, July 2002; First American Bank, July 2004), but these cases were before the new HMDA pricing information was available. The cases in the earlier years involved the Department of Justice versus Decatur Federal Savings and Loan, September 1992; Shawmut Mortgage Company, December 1993; BlackPipe State Bank, December 1993; Chevy Chase, FSB, August 1994; Huntington Mortgage Company, October 1995; Security State Bank of Pecos, October 1995; Northern Trust Company, 1995; First National Bank of Gordon, April 1996; Long Beach Mortgage Company, September 1996; First National Bank of Dona Ana County, January 1997; Albank, August 1997; Deposit Guaranty National Bank, September 1999.

enforcement record that ranges from lackluster to negligent. An objective analysis of the record does not produce compelling arguments for retaining CRA and fair lending enforcement with the current bank agencies. Instead, the same rationale for moving the enforcement and rulemaking for the other consumer protection and fair lending laws applies with the same vigor to placing CRA under the jurisdiction of the CFPA. The time is now to have an agency whose core mission is the protection of consumers and communities to oversee all of the consumer and fair lending laws.

Former Federal Reserve Governors testified last week that consumer protection and systemic risk should be overseen by separate regulatory agencies in order to most effectively utilize regulatory resources. "The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator," former Federal Reserve Governor Frederic Mishkin wrote in testimony for the House Financial Services Committee's Subcommittee on Domestic Monetary Policy. Mishkin continued, "A regulator charged with enforcing rules and managing systemic risk may end up devoting too much of its attention to rule enforcement."

Lawrence Meyer, another former Federal Reserve governor, said that "if something is to be given up (by the Federal Reserve System), the most obvious choice is consumer protection and community affairs (since)....These are not seen around the world as core responsibilities of central banks," he said.[19]

Placing all of the consumer protection and fair lending laws under the jurisdiction of the CFPA would maximize the ability of the CFPA to enforce the laws. The consumer protection and fair lending laws often reference each other, meaning that a violation of one of the laws is also a violation of another one of the consumer protection laws. If different regulatory agencies enforce these laws, opportunities will continue to be missed for effective enforcement since

[19] Steven Sloan, "Ex Fed Officials Back Paring Fed Role if It Gains Powers," Steven Sloan, Thursday, July 9, 2009.

different regulatory agencies have not regularly or routinely reported violation of laws to each other and thus have not jointly prosecuted practices that violate two or more laws.

Under CRA regulation, a violation of fair lending and anti-predatory law can also penalize a bank with a lower CRA rating if the violation of fair lending and anti-predatory lending law is widespread and substantial. Yet, if the current bank agencies retain the authority to conduct CRA exams, it is not guaranteed that the bank agencies will consult regularly with the CFPA to ascertain if any fair lending or anti-predatory violations have occurred that should impact on the CRA rating. If the bank agencies do not consult with the CFPA or conduct their own fair lending reviews, they will not develop a full understanding of the lending practices and patterns of the banks they are examining and thus will award ratings that will not fully reflect the banks' record of serving credit needs of all communities. The best way to avoid the possibility of inadequate consultation among agencies is to simply place both CRA and fair lending examination authority with the CFPA.

Arguments against Moving CRA to CFPA Are Not Convincing

Some stakeholders have recently testified before this Committee offering various arguments against moving CRA to the CFPA. These arguments involve the issues of safety and soundness, community development, and consumer protection. Each of these arguments is not convincing and can be easily addressed and rebutted.

<u>Safety and Soundness Argument a Red Herring:</u> Industry trade associations have asserted that placing CRA under the jurisdiction of the CFPA would divorce CRA enforcement from the examination of safety and soundness, which would remain with the federal bank agencies. The safety and soundness exams result in a CAMELS rating being issued to a bank, which is a rating from 1 to 5 of the overall condition of a bank. CAMELS is an acronym describing the exam elements: C- Capital Adequacy, A – Asset Management, M – Management, E- Earnings, L- Liquidity, and S – Sensitivity to Market Risks. Exams resulting in CAMELS ratings are

currently conducted separately from CRA exams and are confidential (the public does not see the rating which is shared between the regulatory agency and the bank).

CRA exams also consider safety and soundness issues but the consideration focuses on lending practices instead of the overall financial condition of the bank. If lending practices are abusive, illegal, and unsafe, the CRA exam is supposed to penalize a bank through a lower rating. An example of this is the FDIC's exam of CIT Bank of May 12, 2008. The FDIC failed this Utah-based industrial bank based on its purchases of predatory loans. Quoting from the FDIC's exam, "CIT Bank engaged in an unsafe and unsound practice by purchasing $3.1 billion in subprime nontraditional mortgage pools with predatory characteristics that resulted in a significant negative impact on the institution's overall CRA performance rating. The subprime nontraditional mortgage loans had undesirable characteristics including pre-payment penalties; stated income loans; and qualifying borrowers at a teaser rate, resulting in payment shock when scheduled resets ultimately occur. The characteristics of the underlying mortgage loans greatly increased the risk that the borrowers would default, or otherwise be in a worse financial position than they were previous to accepting the loan. CIT's purchase of the subprime mortgage pools was made in an unsafe and unsound manner that caused harm to consumers. In doing so, CIT failed in its responsibility to meet a basic tenet of CRA."[20]

As this example illustrates, transferring CRA, fair lending, and consumer protection oversight to CFPA would provide CFPA with the necessary examination tools to conduct similar analyses and ensure that CRA activities are conducted in a safe and sound manner. This skill set is distinct from those necessary to execute overall safety and soundness reviews that generate CAMELS ratings. In other words, these skill sets are significantly different and require separate

[20] FDIC CRA Exam of CIT Bank, May 12, 2008, Certificate Number 35575, available via http://www2.fdic.gov/crapes/2008/35575_080512.PDF, last accessed July 12, 2009. It is commendable that the FDIC took this action, but this is one of the few examples of adequate CRA enforcement by the agencies over the last eight years and occurred towards the tail end of the Bush Administration after the subprime lending crisis was in full bloom. It was also executed by an agency whose Chairman is one of the few examples of a regulatory leader over the last several years dedicated to consumer protection.

agencies to develop unique institutional expertise as recommended by former Governors Mishkin and Mayer.

Community Development Argument Specious: Ellen Seidman, former Office of Thrift Supervision Director during the Clinton Administration, the National Association of Affordable Lenders (an industry trade association), and a few other bank trade associations maintain that the CFPA should not oversee CRA because it would lack the expertise regarding community development. Community development refers to activities that revitalize the community as a whole such as financing affordable rental housing, community facilities such as health care clinics, and economic development including shopping centers. Seidman and others comment that since the CFPA would focus on the protection of consumers as individuals, that CFPA would not have the capacity to understand and encourage community development.

Seidman, however, undercuts her own argument by suggesting an institutional mechanism that would ensure that CFPA would acquire the necessary CRA and community development expertise. She recommends that should CRA be transferred to CFPA "there should be a statutory requirement for a separate division of the CFPA devoted explicitly to all parts of CRA, including in particular community economic development…" In fact, the Administration's proposal and H.R. 3126 take a step in this direction by creating a unit of community affairs that would provide guidance and technical assistance regarding the provision of financial products and "services to traditionally underserved consumers and communities." It is a straightforward matter to create the necessary divisions and institutional structures for establishing the expertise needed to conduct CRA exams and to motivate community development financing. Just as staff and expertise were shifted from the U.S. Department of Housing and Urban Development and the Office of Federal Housing Enterprise Oversight to the Federal Housing Finance Agency, the new regulatory agency overseeing Fannie Mae and Freddie Mac, so too can CRA-related staff be shifted from the federal bank agencies to CFPA.

False Dichotomy Between Consumer and Community Protection: Some have argued that since CFPA's mission will be to protect consumers, it is not well suited to enforce CRA, a law that requires that community credit needs be served. However, communities represent a collection of consumers so protecting and promoting responsible access to credit for communities is an extension of CFPA's mission to protect consumers. CRA requires that credit needs be met consistent with safety and soundness, which is consistent to the requirements of consumer protection laws against discriminatory or unfair and deceptive lending practices. Providing CFPA with jurisdiction to enforce both CRA and the other consumer protection laws would increase the effectiveness of the CFPA in enforcing all of these laws, which are complementary in nature.

Since the Bank Agencies Have Merger Approval Power, They Should Have CRA Responsibilities: While the Administration was correct in placing CRA under the jurisdiction of CFPA, its proposal was incomplete regarding merger applications. Because the Administration's proposal shifts CRA responsibility to CFPA but indicates that the bank agencies (such as Federal Reserve Board and the FDIC) must decide the outcome of merger applications, the bank agencies would be required to consider the CRA exams conducted by CFPA in their decisions on merger applications. Contrary to the Administration's proposal, Seidman suggests that since the existing agencies would decide merger applications, they should also conduct CRA exams. In contrast, NCRC recommends that bank agencies must be required to obtain the consent of CFPA before deciding the outcome of a merger application. Currently, these agencies have the authority to approve, deny, or require specific improvements to CRA and fair lending performance as part of a merger approval. The merger application process must also retain the same procedures for notifying the public when merger applications have been filed, which allows the public to obtain copies of the merger applications and provide comments to the regulatory agencies. NCRC recommends that CFPA issue a written opinion regarding the CRA and fair lending performance of banks as part of the merger application process, and that CFPA and the bank agencies hold public hearings and meetings with banks and those who have offered written comments on the merger application.

IV. CFPA's Effectiveness Would Be Bolstered If CRA Were Modernized

CFPA's effectiveness would be bolstered if CRA were updated as it was being shifted under CFPA's jurisdiction. CFPA would be more effective in leveraging increases in responsible loans and investments if CRA were strengthened as applied to banks, if CRA were applied to non-bank financial institutions, and if the publicly available data on financial institution lending, investing, and services were enhanced. Both the Administration's proposal and H.R. 3126 are particularly strong regarding enhancing data disclosure. The Administration's proposal and H.R. 3126 recognize that data enhancements are critical to promoting access to responsible credit and financial services, identifying business and community development opportunities, and promoting adherence to the fair lending and consumer protection laws.

Enhancements to Data Disclosure

The Administration's proposal and H.R. 3126 include the following critical enhancements to data disclosure:

Collection of Deposit Account Data

Banks and credit unions would be required to maintain and disseminate data on their branches, ATMs, and other depository facilities, as well as maintain and disseminate the census tract locations of their depository facilities. (Note: Deposit accounts include checking, savings, credit union share accounts and other types of account as defined by CFPA.) The number and dollar amount of deposit accounts for the residential and commercial customers for each deposit facility would also be collected. The place of residence/business of bank/credit union customers would be provided on a census tract basis, making it possible to analyze the income level and race/ethnicity percentage of the census tracts of these customers. These data should be used as part of CRA exam analysis as proposed by the Administration.

Small Business Loan Data Collection

Financial institutions would be required to collect Home Mortgage Disclosure Act (HMDA)-like data on small businesses to determine whether a business is minority- and/or women-owned. In addition to collecting race and gender data, the financial institution would be required to collect the type and purpose of the loan for which the business is applying, the type of action taken with respect to the application, the gross annual revenue of the small business, the census tract location of the business, and any other information CFPA deems appropriate.

Financial institutions that would be required to collect and report these data include any partnership, company, corporation, and cooperative organization. This requirement extends beyond banks that have a current obligation to report small business loan data under CRA. CFPA does, however, reserve the right to exempt any class of financial institutions from this reporting requirement.

The importance of this data cannot be understated. The addition of race and gender data in HMDA facilitated a dramatic expansion of prime lending to minorities and women in the 1990s before the explosion of subprime lending from 2003-2007. For example, home lending to African Americans and Hispanics increased 79.5 percent and 185.8 percent, respectively, compared to 51.4 for middle- and upper-income borrowers 1993 and 2002.[21] In contrast, a well-developed literature based on national surveys indicates the likely possibility of discrimination against women- and minority-owned small businesses.[22] A lack of publicly available data on small business lending by race and gender has inhibited lending to women- and minority-owned businesses by preventing stakeholders from identifying missed opportunities to serve minority- and women-owned businesses and by enabling discriminating lenders to remain undetected when violating the fair lending laws.

The Federal Reserve Board has inhibited rather than facilitated the promotion of additional data collection of small business lending. The Federal Reserve has prevented lenders from voluntarily collecting race and gender data for small business borrowers by failing to lift the

[21] See NCRC's CRA Toolbox via http://www.ncrc.org/images/stories/supportNCRC/ncrc_craoverview.pdf.
[22] NCRC report for the Appalachian Regional Commission, Access to Capital and Credit for Small Businesses in Appalachia, May 2007, http://www.ncrc.org/images/stories/mediaCenter_reports/ncrc%20study%20for%20arc.pdf

current prohibition in Regulation B (that implements the Equal Credit Opportunity Act) against collecting this data. In addition, the Federal Reserve discontinued the periodic national survey that enabled researchers to document disparities and likely discrimination in small business lending. In total, the Federal Reserve's actions discouraged debate and discussion on small business data disclosure, which is inconsistent for an agency that has been responsible for enforcing CRA and the fair lending laws. This is yet another reason to shift CRA enforcement to CFPA.

Enhancements to Home Mortgage Disclosure Act (HMDA) Data

In addition to the demographic characteristics they already collect in HMDA data, financial institutions would be required to collect the age of the borrower under the Administration's proposal and H.R. 3126. NCRC and others have found that elderly borrowers experience lending disparities; this additional data element will allow for a more systematic investigation of these disparities. Several loan terms and conditions would also be collected, including total points and fees, the difference between the annual percentage rate and a benchmark rate for all loans, prepayment penalties, the value of the real property pledged as collateral, whether the loan is a hybrid loan with a lower teaser rate, whether the loan is a negative amortization loan, whether the application was received by a broker or other retail channel, and the credit score of the borrower.

NCRC Recommendations for Expanding and Modernizing CRA

H.R. 3126 and the Obama Administration's legislative draft for the CFPA are particularly strong regarding disclosure data requirements. Yet, the other major elements of CRA modernization including strengthening CRA as applied to banks and expanding CRA to non-bank financial institutions is absent from the Administration's proposal and H.R. 3126.

The following is a description of the critical elements of CRA modernization that are not in the Administration's plan. The Community Reinvestment Modernization Act of 2009 (H.R. 1479) contains critical elements for expanding and modernizing CRA.

Strengthen CRA as Applied to Banks

CRA should be updated so that the great majority of loans that banks make are scrutinized by CRA exams. Currently CRA examines banks in geographical areas where they have branches but not in other areas where they lend through brokers. Consequently, CRA exams of many large banks only scrutinize a minority of the banks' loans. In addition, a bank has the option of including its affiliated mortgage company on its exam. NCRC has found that mortgage company affiliates not included on bank exams engaged in redlining, such as refusing to lend to row homes. Existing loopholes (primarily examining loans made through branches and optional inclusion of mortgage companies) lead to inconsistent enforcement that fails to detect and eliminate abusive practices. While the assessment area issue could probably be remedied by a regulatory agency dedicated to CRA enforcement, the surest fix is statutory language such as that in H.R. 1479. Moreover, statutory authority is necessary regarding applying CRA to mortgage company affiliates of banks.

Expand CRA to Non-bank Financial Institutions

CRA should be expanded to cover non-bank financial institutions. Independent mortgage companies, investment banks, and other non-bank institutions engaged in high volumes of risky lending that ended up in foreclosure and led to the financial collapse. Had CRA been applied broadly throughout the financial services industry, the foreclosure crisis could have been averted, as CRA mandates responsible lending and investing.

Mandate Additional Enforcement Mechanisms beyond Merger Applications

NCRC believes that CRA needs additional enforcement mechanisms beyond the merger application process. One enforcement mechanism involves requiring banks to submit improvement plans subject to public comment and federal agency approval if a bank has a low CRA rating in any geographical areas on their CRA exams. H.R. 1479 would expand the number of geographical areas receiving ratings to include metropolitan areas and rural areas (currently ratings are assigned on a state-wide level and for multi-state metropolitan areas that cross state borders). H.R. 1479 would also increase the number of possible ratings so as to make ratings more meaningful as discussed above. By increasing the number of geographical areas that are graded and requiring improvement plans for any area receiving a low rating, H.R. 1479 would increase bank attention to and therefore bolster bank CRA performance in medium-sized cities and rural areas, as well as their larger markets.

In extending CRA to insurance companies and mortgage companies, H.R. 1479 prevents loans from being sold to Fannie Mae and Freddie Mac if the insurance company and mortgage company involved with the loans failed its CRA exam and then did not submit a satisfactory improvement plan. This requirement should also be extended to banks.

NCRC recommends that Congress consider establishing a private right of action to enforce CRA. Community organizations and individuals would have a right to bring actions to a court of law if they could prove that CFPA and prudential regulatory agencies failed to adequately examine a bank under CRA, or adequately consider consumer protection and CRA factors in a merger application (Note: This is not a current provision of H.R. 1479).

Race as a Factor on CRA Exams

As beneficial as CRA has been to communities over the years, its coverage is incomplete. Specifically, the CRA regulation requires examiners to measure lending, investing, and services to low- and moderate-income communities and borrowers, but not to minorities and minority communities. If CRA explicitly considered lending to minorities, prime or market-rate lending to minorities would increase since banks are primarily prime lenders. Banks would be motivated to increase their responsible lending to minorities since their CRA exams would now assess their performance in serving minorities and communities of color. Product choice would also increase in minority neighborhoods and racial disparities in lending would be reduced.[23] H.R. 1479 would require CRA exams to explicitly scrutinize lending, investing, and branching/bank services to minorities and communities of color. H.R. 1479 also strengthens the sanction of lower CRA ratings for making or financing abusive loans that exhibit steering.

[23] For additional information on racial disparities in lending, see NCRC "Income Is No Shield, Part III: Assessing the Double Burden: Examining Racial and Gender Disparities in Lending," June 2009.

Additional Data Elements

H.R. 1479 requires the creation of a loan performance database that tracks delinquencies, foreclosures, and loan modifications (the Administration's proposal does not have this requirement). In addition, NCRC recommends that the Administration and Congress consider augmenting the CRA data on community development to include the census tract location of community development loan data and require a similar disclosure for community investment data. The purpose of community development lending and investment (such as affordable housing or small business development) should also be disclosed. NCRC also recommends that the enhancements that the Administration proposed regarding race, gender, and other data elements also be extended to small farm loan disclosure (Note: The recommendations about community development and small farm data are not in H.R. 1479).

V. Conclusion

The strongest consumer protection laws still do not amount to much if they are not vigorously enforced. Instead of a sheriff, the existing bank agencies are more like the Keystone cops, occasionally flailing their nightsticks but not coming close to capturing the predatory actors. The bank agencies have not displayed a sustained commitment to CRA enforcement nor have they been timely in updating CRA as the industry has changed. Their CRA enforcement record has fluctuated from mediocre to dismal. It is time that CRA enforcement is transferred to a new agency dedicated to protecting consumers and communities.

The placement of CRA in CFPA establishes a solid foundation for CRA modernization. As CRA is applied to different types of non-bank financial institutions, it would make more sense for one agency to conduct CRA exams than spreading this responsibility to even more agencies. CFPA could apply and adapt its experience in enforcing CRA for banks to other types of financial institutions. Institutional knowledge of the most effective ways to apply CRA is most effectively accumulated in one agency as CRA is applied to additional institutions.

Further, placing CRA under the jurisdiction of CFPA is the most effective means to utilize synergies among consumer protection laws. CRA enforcement also depends on the enforcement of fair lending and anti-predatory lending laws. One agency devoted to consumer protection can most effectively utilize all these laws for holding financial institutions accountable for serving communities in a responsible manner than several agencies with competing missions and priorities.

NCRC urges this Committee to reinstate CRA oversight with CFPA, to preserve and strengthen the data disclosure enhancements in H.R. 3126, and to graft H.R. 1479 (the Community Reinvestment Modernization Act of 2009) onto H.R. 3126. If the Congress adopts this course, our communities will benefit from an exponential increase in responsible lending and investing, recovery from the current recession will be expedited, and a looming foreclosure crisis will be averted. The time to act boldly is now.

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STATEMENT OF
NANCY ZIRKIN, EXECUTIVE VICE PRESIDENT
LEADERSHIP CONFERENCE ON CIVIL RIGHTS

HEARING ON
COMMUNITY AND CONSUMER ADVOCATES' PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

JULY 16, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee: I am Nancy Zirkin, Executive Vice President of the Leadership Conference on Civil Rights (LCCR). Thank you for inviting LCCR to become a part of your Committee's incredibly important discussion on improving consumer protections in the financial services industry.

LCCR is the nation's oldest and most diverse coalition of civil and human rights organizations. Founded in 1950 by Arnold Aronson, A. Philip Randolph, and Roy Wilkins, LCCR seeks to further the goal of equality under law through legislative advocacy and public education. LCCR consists of more than 200 national organizations representing persons of color, women, children, organized labor, people with disabilities, older Americans, LGBT Americans, and major religious groups. On behalf of LCCR, I am privileged to represent the civil and human rights community in submitting testimony for the record to the Committee.

Incidentally, LCCR itself recently became a member of another sizeable coalition, Americans for Financial Reform. Organized in response our nation's worst financial crisis since the Great Depression, Americans for Financial Reform is a coalition of nearly 200 national, state and local consumer, employee, investor, community and civil rights organizations that have come together to spearhead a campaign for real reform in our banking and financial system.

Why LCCR Favors a Very Different Approach to Consumer Protection

Because this is my first opportunity to speak before your Committee, I would like to begin by explaining what has brought LCCR to the table today, and why we believe that the creation of a Consumer Financial Protection Agency would be such an important step forward in protecting the civil rights of the communities that we represent. Much of LCCR's interest in the proposal relates squarely back to what has always been one of the key goals of the civil rights movement: expanding and preserving the right to the American Dream of homeownership.

Homeownership, I am sure you can agree, is vital because it is the means by which most Americans build wealth and improve their own lives and the lives of their families, and because it is essential to the development of stable, healthy communities that make all Americans proud. With this in mind, for decades, the civil rights community has struggled to break down the barriers to fair housing, as well as the barriers to the credit that most Americans need to obtain housing. Despite the considerable progress that we have witnessed since the enactment of the Fair Housing Act more than four decades ago, the resistance that racial and ethnic minority communities have faced in the effort to obtain fair and sustainable mortgage loans – from the practice of redlining to the scourge of predatory lending that emerged in its place – lies very much at the root of the financial and economic crisis in which we now find ourselves today.

For years, LCCR, our member organizations, and our allies argued that the modern system of mortgage lending was profoundly flawed. While we have long believed that *responsible* subprime lending serves a valuable role in creating opportunities for many people who might otherwise never own a home or obtain credit, we grew increasingly concerned throughout the past decade that much of the financial services industry had essentially thrown the "responsible" part of "responsible subprime lending" out the window. We saw that countless numbers of irresponsible and abusive loans were being made, not only in the communities that we represent but throughout our nation, with terms that were virtually guaranteed to strip borrowers of wealth and plunge them deeper into debt. Moreover, we also saw that mortgage loans were often extended in a discriminatory fashion, with racial and ethnic minority borrowers being two to three times more likely to be steered into higher-cost subprime loans than white borrowers – and with strong disparities persisting *even after* credit factors were taken into account.[1]

To make matters worse, however, our alarm in recent years over rampant predatory and discriminatory lending practices was matched only by our immense frustration in trying to get policymakers to actually do something about it. Indeed, until the national housing boom had already turned into a national foreclosure epidemic, we were unable to get most policymakers to even acknowledge the existence of a problem.

The efforts of civil rights and consumer advocacy organizations to enlist the help of federal banking regulators fell on deaf ears[2] – which, of course, is essentially why we are here today. In

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[1] *See, e.g.* Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, at 19 (available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf), May 2006; National Community Reinvestment Coalition, *Income is No Shield Against Racial Differences in Lending: A Comparison of High-Cost Lending in America's Metropolitan Areas* (available at http://ncrc.org/pressandpubs/documents/NCRC%20metro%20study%20race%20and%20income%20disparity%20July%2007.pdf), July 10, 2007; Rich Brooks and Ruth Simon, "Subprime Debacle Traps Even Very Credit-Worthy," *Wall Street Journal*, December 3, 2007 at A1.

[2] Federal regulatory agencies were equally dismissive of the warnings of individual federal and state regulators. See, e.g., Edmund L. Andrews, "Fed Shrugged as Subprime Crisis Spread," *New York Times*, Dec. 18, 2007 ("Edward M. Gramlich, a Federal Reserve governor . . . warned nearly seven years ago that a fast-growing new breed of lenders was luring many people into risky mortgages they could not afford. But when Mr. Gramlich privately urged Fed examiners to investigate mortgage lenders affiliated with national banks, he was rebuffed by Alan Greenspan, the Fed chairman."); Atty. Gen. Lisa Madigan (IL), Hearing on "Federal and State Enforcement of Financial Consumer and Investor Protection Laws," House Committee on Financial Services, Mar. 20, 2009 "(I remember meeting with my consumer fraud lawyers and being told that this terrible wave of foreclosures was coming – years before it made the headlines. I also recall attending a meeting with federal regulators two years ago at which I voiced my concerns about the oncoming crisis. At that time, however, Wall Street was still making money on mortgage-backed securities. The federal regulators did not share my concerns.").

particular, even though the Federal Reserve Board had been equipped by Congress since 1994 with the legal authority[3] to eliminate predatory subprime lending practices, it inexplicably refused to exercise that authority until July 2008 – well after many subprime lenders had already collapsed, others were in the process of exiting the market, and countless numbers of Americans had already lost their homes because they were stuck in mortgage loans that they had no hope of repaying.

Two other key federal bank regulators, the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC) also repeatedly failed to use the regulatory and enforcement tools at their disposal. From 1987 to the present, for example, the OCC brought only four formal enforcement actions under the Equal Credit Opportunity Act (ECOA)[4] and its implementing regulations, and from 2000 through 2008, it did not refer a single case under ECOA to the U.S. Department of Justice on matters involving racial or national origin discrimination in mortgage lending.[5] Likewise, the OTS made no referrals for racial or national origin discrimination in mortgage lending from 2000 through 2006, even though the Department of Justice filed its own complaint in 2002 against Mid America Bank, an OTS-regulated thrift, in such a case.[6]

At the same time that the OTS and OCC failed to enforce laws to protect consumers and eliminate discrimination in the lending practice, they also went far out of their way to prevent state regulators from picking up the slack – which is particularly troubling given the federal government's proud history of usually taking the lead in protecting civil rights. Most notably, the OCC in 2005 blocked the New York Attorney General from trying to investigate whether federal banks violated that state's civil rights laws, a move that was thankfully just rejected by the U.S. Supreme Court.[7] In another instance, the OCC's preemption rules stopped the West Virginia Attorney General from investigating allegations of abusive credit card practices by Capital One, after it converted into a national bank in 2008 – even though the investigation had begun in 2005 and was limited solely to the years before Capital One's conversion.[8]

I could provide additional examples where federal regulators failed to enforce antidiscrimination or predatory lending laws while preventing other entities from doing the same. Instead, I have attached to my statement, to be included as part of my testimony, a policy brief by the Center for Responsible Lending that goes into far greater detail, very appropriately entitled "Neglect and

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[3] The Home Ownership and Equity Protection Act of 1994 (HOEPA) states that the Federal Reserve "shall prohibit" mortgage loans that are "unfair, deceptive or designed to evade the provisions" of HOEPA, or that "are associated with abusive lending practices, or that are otherwise not in the interest of the borrower." 15 U.S.C. §1639(l)(2).

[4]Center for Responsible Lending, "Neglect and Inaction: An Analysis of Federal Banking Regulators' Failure to Enforce Consumer Protections," July 13, 2009, at 4 (attached).

[5] Information on OCC's enforcement actions is contained in annual reports that the U.S. Attorney General provides to Congress. *See* U.S. Attorney General, Annual Report to Congress Pursuant to the Equal Credit Opportunity Act, available at http://www.usdoj.gov/crt/housing/housing_special. php.

[6] *See* http://www.usdoj.gov/crt/housing/documents/midamericacomp.php.

[7] *Cuomo v. Clearing House Ass'n, L.L.C.*, 2009 U.S. LEXIS 4944 (2009).

[8] *Capital One Bank (USA), N.A. v. McGraw*, 563 F. Supp. 2d 613 (S.D. W.Va. 2008). While ruling in favor of Capital One, the court noted that West Virginia's investigation was "hijacked" by the conversion and added that "it is questionable whether the OCC will be as motivated or as effective in protecting the consumers of West Virginia as is the West Virginia Attorney General. Nevertheless, it is my duty to apply the law as it is, not as I would have it be." *Id.* at 622-3.

Inaction: An Analysis of Federal Banking Regulators' Failure to Enforce Consumer Protections." I should note that the Center for Responsible Lending is far from alone in finding that federal bank regulators have been asleep at the switch. As the Committee is surely aware, for example, the Department of Treasury's Inspector General concluded that the OTS' supervision of IndyMac Bank FSB "failed to prevent a material loss to the Deposit Insurance Fund" and that "the thrift's high-risk business strategy warranted more careful and much earlier attention."[9]

While LCCR has been particularly focused in recent years on the problems associated with discriminatory and predatory mortgage lending, our concerns with inadequate federal regulation certainly extend to other financial products and services as well, such as abusive credit card practices and payday lending. Travis Plunkett of the Consumer Federation of America, in his testimony before the Senate Banking Committee earlier this week,[10] provided an excellent review in his written statement of the consequences of inadequate or nonexistent federal regulation of those areas of consumer finance, and I very much share his concerns.

The problem with relying on federal bank regulators to protect our communities is fairly simple; it lies in the basic structure of our current regulatory system. It is a structure that is virtually designed to fail consumers. When regulators are financially dependent on the institutions they are tasked with policing, particularly in the case of extraordinarily powerful ones that always have the option of seeking more friendly police, the resulting relationship will inherently be too close to make room for the interests of other parties.

I see no reason to believe that the dynamics of this relationship will change, especially because the mainstream financial services industry lobby has not expressed any serious interest in changing them. On that note, I would remind the Committee that this is the very same lobby that, for years, insisted to Congress that predatory lending was not a widespread problem in its industry, and that any additional regulation would undermine "access to credit." It is the same lobby that insisted to Congress that the problems would be "contained" to the subprime sector, when it was surely in a position to know what lay ahead. And as home foreclosure rates skyrocketed, to the point where it brought our entire financial system to its knees in the process, it is the same lobby that insisted to Congress that the industry didn't need legislation to keep borrowers in their homes. Everyone should be far more skeptical of the industry lobby this time around. It is time to let others call the shots when it comes to protecting American consumers.

Safeguarding Civil Rights in the Consumer Finance Protection Agency

Given the obvious inability of the existing financial regulatory system to adequately look out for the interests of our communities, LCCR strongly believes that the only option is to create a new regulator that will. Your new legislation, the "Consumer Financial Protection Agency Act of 2009" (H.R. 3126), will move the responsibility for enforcing most consumer protection laws into an agency whose sole mission is, simply put, to protect consumers. While that appears to be

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[9] Office of Inspector General, Audit Report: "Safety and Soundness: Material Loss Review of IndyMac Bank, FSB," U.S. Dept. of Treasury, Feb. 26, 2009, at 3.

[10] Travis Plunkett, Consumer Federation of America, Hearing: "Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation," Senate Committee on Banking, Housing, and Urban Affairs, July 14, 2009

a radical concept to some, LCCR very much appreciates all of the efforts that you and President Obama are making to turn it into a reality.

Because systemic racial and ethnic discrimination was such a significant underlying cause of our nation's financial crisis, LCCR believes that the proposed Consumer Financial Protection Agency (CFPA) needs to be set up in a way that makes effective civil rights enforcement a key part of its mission. To that end, I am happy to provide the following recommendations:

1) **Civil rights must be part of the agency's stated mission.** The bill's mandate is to "promote transparency, simplicity, fairness, accountability, and access" in the consumer financial products and services market. In addition, we believe the CFPA must explicitly be tasked with protecting the civil rights of consumers as a way of reducing the disparities I have noted above.

2) **Fair lending compliance and enforcement must be built into the agency's formal structure.** Civil rights must be prioritized as a part of the agency structure. The best way to do this would be to create a Civil Rights/Fair Lending Compliance and Enforcement Office. Such an office should serve a dual function – first, to ensure that the CFPA itself operates in a manner that affirmatively furthers fair housing; and second, to ensure that financial market players comply with fair lending statutes. The CFPA must also have the appropriate power and resources to vigorously enforce the fair lending laws under its auspices – the Equal Credit Opportunity Act (ECOA), the Home Mortgage Disclosure Act, and other appropriate fair lending statutes. It should have sufficient authority and resources to conduct fair lending examinations, engage in compliance activities, and write rules. In addition, this office needs to be headed by a senior position who reports directly to the Director of the CFPA.

3) **The enforcement authority under the Fair Housing Act, currently held by HUD and the Department of Justice, should not be diminished.** The Department of Housing and Urban Development (HUD) should be encouraged to write fair lending rules for the Fair Housing Act in consultation with the CFPA. HUD's already developed mechanism for processing individual fair lending complaints and enforcing the fair lending provisions of the Fair Housing Act should be left intact.

4) **All agencies engaged in regulating financial institutions, or enforcing civil rights and fair lending statutes, must cooperate and openly share information.** Many federal agencies and departments are engaged in enforcing the fair lending laws. For instance, the Department of Justice investigates companies that have demonstrated a pattern and practice of violating the ECOA or the FHA, HUD enforces the Fair Housing Act, and the CFPA will enforce the ECOA (among many other enumerated laws). In order for each department or agency to do its work efficiently and effectively, it is vital that they are able to cooperate with each other. For example:

    - The agencies should consult with each other when issuing rules, guidance, or investigation procedures.

- The CFPA should be given authority to engage in joint investigations with HUD and the Department of Justice.

- Regulatory and enforcement agencies should create a shared database of complaints received, examinations initiated, reports issued, violations found, and enforcement actions taken. Such information should be available to any federal or state consumer protection, regulatory or fair lending enforcement agency. In addition, the CFPA should have a mandate to refer potential FHA violations to HUD. Currently, financial regulatory agencies have this obligation under the ECOA.

- HUD should be given access to the CFPA's reports of examinations, to facilitate its enforcement of the FHA.

5) **CFPA rules should be enforceable by individuals and those who violate CFPA rules must be accountable to the individuals they harm.** More specifically, the bill should include a private right of action by consumers.

6) **The CFPA must have clear authority to impose mandates/sanctions on institutions found to be out of compliance with fair lending statutes.** It is imperative that financial regulators not be able to circumvent fair lending requirements, laws, or rules, even when taking emergency measures. Indeed, the CFPA should be given sign-off authority to certify compliance with applicable fair lending and other related laws, before any regulator can approve a merger, acquisition, branch opening or closing, or prior to granting emergency funds or approving emergency measures.

7) **The CFPA Consumer Advisory Council should include individuals with fair lending and civil rights expertise.**

LCCR's Fair Housing Task Force is currently in the process of finalizing proposed language that would incorporate these recommendations into H.R. 3126. We look forward to following up with your staff on our suggestions.

Before I conclude, I want to briefly point out one key difference between President Obama's CFPA proposal and H.R. 3126. President Obama's legislation would transfer jurisdiction over the Community Reinvestment Act of 1977 (CRA) to the CFPA, while H.R. 3126 would not. I know that there have been discussions with a number of stakeholders over whether such a move would be practical. Regardless of where jurisdiction over the CRA is ultimately placed, LCCR believes that strengthening the law is absolutely vital to ensuring that our communities have access to fair, responsible sources of credit. For this reason, we support H.R. 1479, the "Community Reinvestment Modernization Act of 2009," and we look forward to working with you toward its enactment.

Again, thank you for inviting me to testify today. I would be happy to answer any questions you may have.

CENTER FOR RESPONSIBLE LENDING

NEGLECT and INACTION
An Analysis of Federal Banking Regulators' Failure to Enforce Consumer Protections

CRL Policy Brief **July 13, 2009**

INTRODUCTION

For too long the responsibility for protecting consumers has been fragmented among various federal regulators whose primary focus was the safety and soundness of the banking system. Consumer protection often went neglected, if anything, an afterthought or a box to check. Federal regulators' failure to restrain abuses that led to today's credit crisis demonstrates the need for a single agency focused on protecting consumers to ensure financial institutions flourish in a sustainable way. To succeed in protecting consumers, this agency must have the complete set of tools necessary, which are now spread across different agencies. This agency will need: the power to write rules, the ability to examine all financial institutions to ensure they are complying with the rules, and the power to enforce the law when those rules are violated. A consolidated single agency focused on consumer protection will also benefit financial institutions. Financial institutions will be able to rely on a single baseline of protections for all providers, which will eliminate regulatory arbitrage on one hand and a race to the bottom to compete with the worst lenders on the other.

Congress is considering creating such an agency, the Consumer Financial Products Administration (CFPA).

The Three Agencies That Failed to Protect Consumers

The failure of the bank regulators to protect consumers is a systematic problem that has stretched over at least several decades. The fix must involve a complete overhaul of the existing system for protecting consumers. Two of the frontline federal bank regulators, the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC), have come to view banks as customers rather than entities to be regulated. Regulators at these agencies, which rely on fees from the banks they charter and regulate, have been reluctant to take actions that could cause an institution to switch to another charter and regulator, thereby taking their fees with them. In this classic race to the bottom, each agency has defended practices that hurt consumers. Worse, the regulators not only failed to act, they intervened to prevent state authorities from acting to stop such practices.

The Federal Reserve, which is the primary writer of rules to protect consumers, has a similar record. It waited more than 14 years to implement rules Congress gave it to address unfair and deceptive trade practices in the mortgage lending market and has missed many opportunities to act on behalf of consumers to prevent abusive financial practices in other areas.

Frederic Mishkin, former Fed Board governor who recently testified before Congress, has acknowledged that the demands of systemic regulators and those of consumer protection regulators need to be separate to ensure that both needs are adequately met, stating "The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator."[1]

Analysis of Banking Regulators' Failures in Enforcing Consumer Protections

The following analysis provides examples of federal regulators' failure to enforce existing consumer protection regulations. The results, as even a quick reading of news headlines over the last 18 months shows, have been devastating for millions of Americans, stripping families of hundreds of billions of dollars of wealth and, thus, denying them the financial security necessary to send a child to college, start a small business, or retire.

The examples below are hardly an exhaustive list. Rather, they are representative of the regulatory lapses that have nearly broken our financial system. Though the Federal Reserve played a major role in this grim record, we have focused on examples from the OCC and the OTS as the two agencies that most aggressively blocked state officials from passing and enforcing laws to protect their residents from unfair and deceptive financial practices.

Failures on Rules and Exam Guidance

The agencies failed to enact rules and exam guidance on predatory mortgage lending and when they did act, those rules were often too late or not enforced.

Subprime lending, and the abuses that accompanied it, began in the 1990s and peaked from 2005-07. However, regulators were slow to act with respect to the mortgage market despite an epidemic of weakened underwriting standards for all loans, particularly subprime and nontraditional loans.

- A 2005 OCC survey of credit underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions." In fact, 28% of the banks eased standards, leading the 2005 OCC survey to be its first survey where examiners "reported net easing of retail underwriting standards."[2]

- Despite the 2005 survey, the agencies took an additional two years to issue interagency guidance on underwriting or purchasing subprime loans. The agencies issued joint guidance on underwriting nontraditional loans in late September 2006, a full nine months after they first solicited comments on proposed guidance on that topic.[3] It is unclear to what degree the nontraditional guidance was enforced as lax underwriting standards continued in the nontraditional market until the market collapse.[4] While the agencies explicitly required lenders to evaluate a borrower's ability to repay a nontraditional loan based on the fully indexed rate and based on a fully amortizing repayment schedule, they did not implement similar explicit rules for subprime loans for another 10 months, finally issuing parallel guidance on underwriting subprime loans in July 2007.[5]

- Even without the new guidance, the regulators could have used rules already in place to at least mitigate the impact of subprime lending, but failed to act. The agencies did issue guidance as early as 1999 on subprime lending,[6] with a second guidance in 2001 that explicitly described predatory lending as including: "Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation…"[7] Despite these guidances, however, there is little evidence of cases where the agencies prevented lenders from devising new products that failed to evaluate the borrowers' ability to repay the loan.[8]

- Under the OCC's watch, national banks moved aggressively into risky "Alt-A" low-documentation and no-documentation loans during the housing boom.[9] A 2004 OCC rule prohibiting the origination of unaffordable mortgages "was vague in design and execution, allowing lax lending to proliferate at national banks and their mortgage lending subsidiaries through 2007," law professor Patricia McCoy has testified.[10] Big national banks continued rolling up huge volumes of poorly underwritten subprime loans and low- and no-documentation loans. For example, in 2006 more than 62 percent of the first-lien home purchase mortgages made by National City Bank and its OCC-supervised subsidiary, First Franklin Financial, were high-priced subprime loans. As these loans began to go bad in large numbers in 2007 and 2008, National City Corp. reported five straight quarters of net losses. It was saved from receivership only by a "shotgun marriage" to PNC Financial Services Group.[11]

- Fourteen years ago, Congress required the Federal Reserve Board (the Board) to prohibit mortgage lending acts and practices for all originators that are abusive, unfair or deceptive, but the Board took no action until July 2008 — even though borrowers, state regulators, and advocates repeatedly raised concerns about abuses in the subprime market, and hard evidence demonstrated the destructive results of abusive practices.[12]

Failures to Enforce Consumer Protection and Fair Lending Laws

The OCC and the OTS have failed, again and again, to use the regulatory and enforcement tools available to it to rein in bad practices and irresponsible lending.

- ***Fair lending enforcement inaction.***

- From 1987 to the present, the OCC brought only four formal enforcement actions under Equal Credit Opportunity Act, 15 U.S.C. § 1691c(a)(1)(A), and its implementing regulation, and from 2000 to 2008, the OCC made no referrals under ECOA to the U.S. Department of Justice of matters involving race or national origin discrimination in mortgage lending.[13]

- OCC inaction is even more troubling given the evidence of potential discrimination among national banks. For example, studies show national banks routinely originated a disproportionate number of subprime loans among minority borrowers. For example, one study found that national banks were 4.15 times more likely to make higher-cost refinance loans to African-Americans than they were to make higher-cost loans to white borrowers.[14] In addition, two former Wells Fargo employees have signed declarations that the bank's sales staffers steered minorities into high-cost subprime loans.[15]

- Although the OTS has recently increased the number of ECOA referrals to the DOJ, from 2000 to 2006 the OTS made no referrals for race or national origin discrimination in mortgage lending. Despite the lack of referrals, in 2002 DOJ filed a complaint alleging that Mid America Bank, an OTS-regulated bank, engaged in a pattern or practice of redlining on the basis of race. Among the allegations made by DOJ was that 34-branch Mid America had never opened a full-service branch office in a census tract with a majority African-American or majority African-American/Hispanic population. The complaint also alleged that the bank made nearly $6 billion in single-family residential real-estate loans between 1996 and 2000, but that only 1% of that amount went to census tracts with majority African American populations.[16]

• ***Consumer protection enforcement inaction.***

- The OCC did not exercise its consumer protection authority to address unfair and deceptive practices under the FTC Act for *twenty-five years.*[17] The OCC's first action using its power to go after banks' unfair and deceptive practices came only after a decade in which the target bank "had been well known in the ... industry as the poster child of abusive consumer practices" and after the OCC was "embarrassed ... into taking action" by a California prosecutor.[18]

- Between 2000 and 2008, as the mortgage market grew wildly and abusive practices against homeowners flourished, the OCC took exactly *two* public enforcement action against banks for unfair and deceptive practices in mortgage lending – both against small Texas banks.[19]

- The OCC's enforcement record is also thin when it comes to credit cards, bank accounts and other consumer concerns. From 1997 to 2007, the

Federal Reserve Board reported just nine formal enforcement actions against banks by the OCC under TILA.[20] An academic researcher found that most OCC actions regarding violations of consumer lending laws have targeted small national banks – even though "ten large banks accounted for four-fifths of all complaints" received by the OCC's Customer Assistance Group in 2004.[21] The Customer Assistance Group receives roughly 70,000 complaints and inquiries each year on consumer issues.[22] Despite the hundreds of thousands of complaints and inquiries it fielded between 2000 and 2008, the OCC took just *a dozen* public enforcement actions during this span for unfair and deceptive practices relating to home mortgages, credit cards and other consumer loans.[23]

- ***Ignoring servicing abuses.*** A Louisiana bankruptcy judge has issued a series of rulings that Wells Fargo violated the law in a "systematic" manner in how it handles consumers' mortgage accounts by failing "to notify borrowers of the assessment of fees, costs, or charges at the time they are incurred." She also found that Wells' mortgage servicing operations charged unjustifiable fees, including multiple late fees based on a single late payment, and misapplied consumers' monthly payments by deducting late fees before applying payments to principal and interest.[24] While the Federal Trade Commission has recognized the abuses present in mortgage servicing and taken enforcement actions in recent years to crack down on such abuses by the non-bank entities it regulates, the OCC has done little to address such abuses, even though the Louisiana federal court rulings make it clear national banks are not immune from such improper behavior.

- ***Case study: A First Union borrower's story.*** The case of Dorothy Smith, a 67-year-old homeowner is East St. Louis, Ill., illustrates the OCC's lack of concern for consumers. As described in a 2007 article in the *Wall Street Journal*, Ms. Smith, who was living on $540 month in government benefits, was taken in by a home repair contractor and a mortgage broker who landed her in a mortgage from First Union National Bank. The loan contract required her to pay two-thirds of her income – $360 a month – for 15 years, followed by a balloon payment of more than $30,000. After receiving Ms. Smith's complaint about First Union, the OCC brushed her off, saying that it couldn't intercede in a "private party situation regarding the interpretation or enforcement of her contract. . . . The OCC can provide no further assistance."[25]

- ***Ignoring abusive preacquired account marketing programs.*** Numerous national banks have taken part in abusive "preacquired account marketing programs," in which banks provide third-parties, such as telemarketers, with personal information about credit card or mortgage account holders and their accounts to use in targeted marketing for usually low-value, high-margin add-on products. In addition, such programs potentially leave account holders vulnerable to unauthorized withdrawals from their accounts by unscrupulous vendors. State attorneys general have pursued these unfair and deceptive practices vigorously against all the participants in these schemes, including major OCC-regulated national banks Chase, Citi, and First USA-Bank One.[26] The OCC, by contrast, not only failed to uncover such abuses in its supervision of these entities, but affirmatively went to court in 2001 to try to prevent states from protecting consumers against such abuses by national banks.[27]

- ***Weak response to bank that aided telemarketing fraud.*** Evidence came to light in late 2006 as part of a Department of Justice prosecution of telemarketing fraud that Wachovia might be facilitating the fraud by turning a blind eye to highly questionable "remotely created checks" that the fraudsters were depositing.[28] Wachovia continued to do business with the fraudsters despite a huge rate of charge-backs (a fraud red-flag), and warnings by its own risk management staff (advising the bank to sever the relationship despite the loss of a revenue-generating customer), by other banks, and even by the Social Security Administration.[29] OCC examiners apparently did not discover Wachovia's extensive relationships with the fraudsters during their own investigation, but only pursued an expanded inquiry after being informed of the extensive relationships by private attorneys for the fraud victims and prosecutors.[30] Additionally, the OCC's initial settlement with Wachovia provided a cumbersome and lengthy claims process that would have left many harmed consumers without restitution and would have allowed Wachovia to retain any unclaimed funds. Only after lawyers for the victims, joined by three members of Congress as amici, went to court objecting to this settlement did the OCC amend the settlement to provide for direct restitution payments to the victims.[31]

- The OCC has repeatedly defended its thin public record of enforcement by claiming, in essence, that it takes care of problems in the privacy of the home. Indeed, the OCC conceives of secrecy, rather than transparency, as a virtue of its consumer protection efforts.[32] Far from providing the kind of transparency that brings accountability, the agency's message instead is to tell consumers, in short: "Trust Us."[33]

Aggressive Preemption of State Law and State Law Enforcement

In contrast to their lack of consumer protection and fair lending enforcement, the OCC and OTS have been aggressive in preempting state law and preventing state attorneys general from enforcing non-preempted state laws against national banks and thrifts. The two agencies' general pronouncements on preemption are well known. Below are specific examples of how their conduct has undermined consumer protection.

- The OCC did more than allow National City's aggressive expansion into risky lending (see above), it also shielded National City from state law enforcement. At the request of National City Mortgage, the OCC stopped a Washington State inquiry into its mortgage practices in 2002.[34] The following year the parent, National City Bank and its subprime operating subsidiary First Franklin, successfully sought an OCC ruling exempting national banks from state anti-predatory mortgage lending laws.[35] Six years later First Franklin made the OCC's own list of the "Worst Ten in the Worst Ten"—the originators with the largest number of foreclosures in the metropolitan areas with the highest foreclosure rates.[36]

- Rather than enforcing the fair lending laws, the OCC has expended substantial resources in preventing state attorneys general from enforcing state civil rights against national banks and has consistently intervened in lawsuits on behalf of its financial institutions rather than borrowers.[37]. A lending discrimination investigation initiated in 2005 by the New York Attorney General, was still being blocked by the OCC until this June when the Supreme Court ruled that the OCC could no longer prevent New York from enforcing its civil rights laws.

- As a product of the OCC's pronouncements on preemption, a multi-year investigation conducted by the West Virginia Attorney General into abusive credit card practices of Capital One was stopped dead in its tracks in 2008 by the conversion of Capital One into a national bank. A federal district judge determined that the OCC's regulations left him no choice but to block the Attorney General from continuing the investigation—even if the investigation was limited to the time before Capital One became a national bank—although he recognized that Capital One sought "to usurp West Virginia's power to investigate whether national banks have violated West Virginia consumer protection law" and that the West Virginia's Attorney General's "lawful investigation was hijacked by Capital One's conversion to a national bank."[38] The decision forced the West Virginia Attorney General to tell consumers who had complained about Capital One that he was powerless to address their concerns.

- The OCC has encouraged national banks to disregard simple requests about mortgage delinquency and modification rates from state officials seeking to address the foreclosures crises in their jurisdictions.[39] Such data is essential to formulating solutions that keep borrowers in their homes.

Failures on Safety and Soundness Are Linked to Consumer Protection Failures

The OCC and the OTS's desire to protect the institutions they regulate and their reluctance to enforce rules and regulations was not limited to consumer protection. In safety and soundness and other areas, there have been similar lapses. In some instances these lapses also illustrate how a more focused consumer protection agency could have mitigated the scope of the crisis.

- Defenders of the OCC and the OTS have argued that the banks and thrifts under their supervision were largely victims of unforeseeable market downturns. This argument is belied by the superior performances of banking institutions overseen by other regulators. State-chartered thrifts and banks performed significantly better during the crisis in terms of loan quality than OTS-supervised national thrifts and OCC-supervised national banks, FDIC data shows. As of Sept. 30, 2008, the rate of 1-4 family residential loans from national banks that were past due or in "nonaccrual status" was *twice* that of state banks; federal thrifts' rate was *more than four times* that of state thrifts.[40]

- ***Countrywide: A three-part failure.*** The implosion of the nation's largest mortgage lender is instructive, given that three of the main federal regulators – the OCC, the OTS and the Federal Reserve – shared responsibility for overseeing Countrywide Financial and Countrywide Bank. Investigations by CRL and law-enforcement authorities produced compelling evidence that Countrywide targeted borrowers for unfair and unsafe loans that have left many struggling to save their homes.[41] Under the watch of the OCC and, later, the OTS, the company boosted its loan volume by making large numbers of poorly unwritten pay option ARM mortgages and home equity lines of credit—loans that were approved with little scrutiny of borrowers' long-term ability to stay current as monthly payments began to rise.[42] A single agency with oversight over consumer protection in all of Countrywide's entities, including the non-federally regulated lender, would have been much more effective in preventing harm to consumers and the market in general.

- ***Inspector general rebukes.***

  - Reports by the Treasury Department's inspector general have supported the conclusion that the OCC did a poor job of making sure that banks underwrote loans responsibly. ANB Financial failed in 2008 due to risky lending, unsound underwriting and other problems; the inspector general found that the OCC identified most of ANB's problems in 2005, but it "took no forceful action" until 2007, when it was too late to save the bank.[43] The inspector general found a similar pattern in the 2008 failures of FNB Nevada and First Heritage Bank; the OCC knew about problems as early as 2002, and found additional problems in 2005, 2006 and 2007, but failed to take timely and aggressive action to curb the affiliated institutions' risky practices.[44]

  - In 2008, the OTS presided over a flurry of unprecedented financial meltdowns. Five thrifts with assets totaling $354 billion collapsed, led by Washington Mutual Savings Bank, the largest banking failure in American history. Seven others holding assets totaling another $350 billion have been sold or were caught up in their parent companies' bankruptcies. The failures of these institutions – and the harm they caused consumers – were the fruits of years of inaction by the OTS.[45] The OTS turned a blind eye as WaMu, IndyMac Bank and other thrifts engaged in a spree of unsafe, abusive lending.[46] A series of inspector general reports have concluded that the OTS failed to rein in reckless lending practices at the institutions it oversaw. The reports cited serious supervisory shortcomings leading up to the failures of Superior Bank[47] in 2001, NetBank[48] in 2007 and IndyMac[49] and Downey Financial[50] in 2008. The reports criticized the OTS for moving too slowly to respond to obvious problems at the thrifts and for failing to quell the institutions' breakneck lending strategies.

- The inspector general also found that the OTS so pliable in its supervision that it allowed some thrifts to hide the consequences of their imprudent business strategies by falsifying financial reports. The OTS expressly allowed two institutions to backdate capital infusions, and took no action against four others that did so without permission. [51]

- In 2005, a group of senior risk managers crafted a plan requiring that loan officers document that borrowers could afford the full monthly payment on option ARMs. A former bank official told the Washington Post that the OTS signed off on the plan, but "never said anything" after top bank executives rejected the plan.[52]

- ***Weak enforcement on money laundering.*** In another example highlighting the OCC's elastic style of law enforcement, Treasury's inspector general found that agency had failed to take aggressive action against Wells Fargo despite five years of "numerous and recurring deficiencies" in the bank's anti-money-laundering controls. Top OCC officials overruled examiners who recommended tougher action against the bank. The inspector general concluded that "OCC's failure to take formal enforcement action against Wells sent the wrong message to the banking industry about OCC's resolve to ensure that banks comply" with the Bank Secrecy Act's provisions against money laundering.[53]

CONCLUSION

The OTS and the OCC aren't consumer protection agencies. No amount of tinkering with their policies and procedures will change that. Their cultures, their funding streams and their organizational structures make it inevitable that they will tend to side with the institutions they oversee rather than with average consumers or simply focus on issues they view as a higher priority than consumer protection. An agency with a consumer protection mission, accountable to the public, and with the tools to succeed, is the only way to ensure that we do not repeat the mistakes of the past.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

For additional information, please visit our website at **www.responsiblelending.org**.

[1] Subcommittee on Domestic Monetary Policy and Technology Hearing, *Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation*, July 9, 2009, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/mishkin_testimony.pdf.

[2] Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005*; see also Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006).

[3] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration, "Interagency Guidance on Nontraditional Mortgage Product Risks," 71 Fed. Reg. 58609 (Oct. 4, 2006), *available at* http://www.federalreserve.gov/boarddocs/srletters/2006/SR0615a2.pdf

[4] See *In Re Washington Mutual, Inc. Securities Litigation*, No. 2:08-MD-1919 MJP (W.D. Wash) (Former employees allege in the court documents that, well into 2007, WaMu underwrote pay option ARM loans based on the borrowers' ability to afford the low "teaser" payment—and not the full payment that inevitably would cause borrowers' monthly obligations to skyrocket).

[5] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration, "Statement on Subprime Mortgage Lending," 72 Fed. Reg. 37569 (July 10, 2007).

[6] Interagency Guidance on Subprime Lending (Mar. 1, 1999), *available at* http://www.fdic.gov/news/news/financial/1999/FIL9920a.html.

[7] 2001 Interagency Expanded Guidance for Subprime Lending Programs (Feb. 2, 2001), *available at* http://files.ots.treas.gov/25137.pdf.

[8] On March 7, 2007, the FDIC did enter a cease and desist order against Fremont Bank that, in part, addressed the lack of underwriting involved in Fremont's subprime loans. The FDIC's action was the rare instance of a regulator taking aggressive action against a subprime lender. Unfortunately, it came after much of the damage by Fremont's loans had already been done. See http://www.fdic.gov/bank/individual/enforcement/2007-03-00.pdf

[9] See *Consumer Protections in Financial Services: Past Problems, Future Solutions: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (statement of Patricia A. McCoy, Professor of Law, Univ. of Conn.), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=40666635-bc76-4d59-9c25-76daf0784239.

[10] Id.

[11] Id.

[12] See, e.g. Edmund L. Andrews, Fed Shrugged as Subprime Crisis Spread, N.Y. Times (Dec. 18, 2007), available at http://www.nytimes.com/2007/12/18/business/18subprime.html.

[13] Information on OCC's enforcement actions is contained in annual reports that the U.S. Attorney General provide to Congress. See U.S. Attorney General, Annual Report to Congress Pursuant to the Equal Credit Opportunity Act, *available at* http://www.usdoj.gov/crt/housing/housing_special. php.

[14] Cal. Reinvestment Coal., *Who Really Gets Higher-Cost Home Loans?* 3, 18 (2005).

[15] Affidavits by Elizabeth M. Jacobson and Tony Paschal in *Mayor and City Council of Baltimore v. Wells Fargo Bank*, No. 1:08-cv -00062-BEL (D. Md.), Documents 74-16 and 74-17.

[16] See http://www.usdoj.gov/crt/housing/documents/midamericacomp.php
[17] See Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246 & n.25, 1253 (2003) (conceding that "[a]n obvious question is why it took the federal banking agencies more than twenty-five years to reach consensus on their authority to enforce the FTC Act").
[18] Duncan A. MacDonald (former General Counsel, Citigroup Inc.'s Europe and North American card business), Letter to the Editor, *Comptroller Has Duty to Clean Up Card Pricing Mess*, Am. Banker, Nov. 21, 2003, at 17; *see also* Frontline, *Secret History of the Credit Card*, Transcript at 16-17, http://www.pbs.org/wgbh/pages/frontline/shows/credit/etc/script.html.
[19] In 2005, the OCC required that Laredo National Bank set aside $14 million to cover refunds to borrowers who'd been harmed by the bank's home loan practices. In 2003, it required Clear Lake National Bank to provide $100,000 in restitution to borrowers who'd received tax-lien mortgage loans and to review a portfolio of mortgage loans to determine if similar violations existed. See *Improving Federal Consumer Protection in Financial Services: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 18 (2007) (statement of John C. Dugan, Comptroller of the Currency).; cf. *Credit Card Practices: Current Consumer and Regulatory Issues: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 110th Cong. 14-15, 18 (2007).
[20] Information on OCC's enforcement actions is contained in annual reports that the Federal Reserve Board provides to Congress. See Board of Governors of the Federal Reserve System, Annual Report, *available at* http://www.federalreserve.gov/ boarddocs/rptcongress/ .
[21] Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 Ann. Rev. Banking & Fin. L. 225, 237-52 (2004).
[22] See *Improving Federal Consumer Protection in Financial Services: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 18 (2007) (statement of John C. Dugan, Comptroller of the Currency).
[23] See OCC, Consumer Protection News: Unfair and Deceptive Practices, http://www.occ.gov/Consumer/Unfair.htm.
[24] See *In re Stewart*, 391 B.R. 327 (Brank. E.D. La. 2008); *In re Jones*, 366 B.R. 584 (Bankr. E.D. La. 2007)
[25] Greg Ip & Damian Paletta, *Lending Oversight: Regulators Scrutinized In Mortgage Meltdown --- States, Federal Agencies Clashed on Subprimes As Market Ballooned*, Wall Street Journal (Mar.ch 22, 2007).
[26] For instance, Chase entered into a settlement with California and other state attorneys general in 2006 to repay victims of such a scheme $14.5 million. See *People v. Chase Bank USA, N.A.*, No. GIC850483 (Cal. Super. Ct. Dec. 2006), *available at* http://ag.ca.gov/cms_attachments/press/pdfs/2006-12-11_Chase_Settlement_Judgment.pdf.
[27] See *Minnesota v. Fleet Mortgage Co.*, 181 F. Supp. 2d 995 (D. Minn. 2001).
[28] See *United States v. Payment Processing Ctr., LLC*, 461 F. Supp.2d 319, 330 n.11 (E.D. Pa. 2006).
[29] See Charles Duhigg, *Bilking the Elderly, With a Corporate Assist*, N.Y. Times, May 20, 2007, at 1; Charles Duhigg, *Papers Show Wachovia Knew of Thefts*, N.Y. Times, Feb. 6, 2008, at C1.
[30] See Plaintiffs' Memorandum in Support of the Petition for Approval of the Agreed Attorneys' Fees and Costs, *Faloney v. Wachovia Bank*, No. 07-1455 (E.D. Pa.) and *Harrison v. Wachovia Bank*, No. 08-755 (E.D. Pa.) at 3-4, 12, 15.
[31] See Motion and Brief of Representatives Barney Frank, Edward Markey and Joseph Sestak, in support of the Intervenor Faloney Plaintiff's Motion for an Injunction Under the All Writs Act, *USA v. Payment Processing Center, LLC*, No. 06-0725 (E.D. Pa. May 29, 2008); Press Release, OCC, Wachovia Enter Revised Agreement to Reimburse Consumers Directly (Dec. 11, 2008), *available at* http://www.occ.gov/ftp/ release/2008-143.htm.
[32] See *Improving Federal Consumer Protection in Financial Services: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 131-32 (2007) (written statement of John C. Dugan, Comptroller of the Currency) (explaining OCC primarily ensures consumer protection through "behind the scenes" supervision).
[33] See Stephanie Mencimer, *No Account*, The New Republic, Aug. 27, 2007, at 14.
[34] See Eric Nalder, *Mortgage System Crumbled While Regulators Jousted*, Seattle Post-Intelligencer, Oct. 11, 2008, at A1.
[35] See 68 Fed. Reg. 46,264 (Aug. 5, 2003).

[36] See Letter from John Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel (Feb. 12, 2009).(listing First Franklin and two other significant subprime lenders under OCC's supervision on the list).
[37] See, e.g., *Cuomo v. The Clearing House Association and the* OCC, 129 S. Ct. 1695 (2009).
[38] *Capital One Bank (USA), N.A. v. McGraw*, 563 F. Supp. 2d 613 (S.D. W. Va. 2008).
[39] See State Foreclosure Prevention Working Group, *Analysis of Subprime Mortgage Servicing Performance: Data Report No. 1*, at 7 (Feb. 2008), *available at* http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf.
[40] See McCoy, testimony, *supra*.
[41] See, e.g., *The People of the State of California v. Countrywide Financial Corp.*, Los Angeles Superior Court, June 24, 2008. Available, *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1588_firstamendedcomplaint.pdf#xml=http://search.doj.ca.gov:8004/AGSearch/isysquery/d9682d50-f6f7-4c18-9b74-dd03bca6cf28/2/hilite/ . Seehttp://ag.ca.gov/cms_attachments/press/pdfs/n1588_firstamendedcomplaint.pdf#xml=http://search.doj.ca.gov:8004/AGSearch/isysquery/d9682d50-f6f7-4c18-9b74-dd03bca6cf28/2/hilite/; see also *Unfair and Unsafe: How Countrywide's irresponsible practices have harmed borrowers and shareholders*, CRL Issue Paper (Feb. 7, 2008). Available at http://www.responsiblelending.org/mortgage-lending/research-analysis/unfair-and-unsafe-countrywide-white-paper.pdf .), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/unfair-and-unsafe-countrywide-white-paper.pdf .
[42] Countrywide Financial Corporation, Q3 2007 Earnings Call, Oct. 26, 2007. See; see also Gretchen Morgenson, *Inside the Countrywide Spending Spree*, N.YY. Times (August. 26, 2008)); Gretchen Morgenson & Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender*, N.Y. Times (Nov. 11, 2007).
[43] Office of Inspector General, Department of the Treasury, *Material Loss Review of ANB Financial, National Association* (Nov. 25, 2008) OIG-09-013.
[44] Office of Inspector General, Department of the Treasury, *Material Loss Review of First National Bank of Nevada and First Heritage Bank, National Association* (February 27, 2009) OIG-09-033.
[45] In 2004, as warning signs of dangerous practices in the mortgage market grew, then-OTS director James Gilleran made it clear his agency was determined to keep a pliable attitude toward policing the home lenders: "Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion." Between 2001 and 2004, the OTS slashed its staff by 25% and changed its examination structure to emphasize having lenders do "self-evaluations" of their compliance with consumer protection laws. By 2005, the OTS had a new director, John Reich, but the message was similar. When concerns were raised about lenders' lack of concern for borrowers' ability to repay their loans, Reich cautioned that regulators should not interfere with thrifts that "have demonstrated that they have the knowhow to manage these products through all kinds of economic cycles." See Binyamin Appelbaum & Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer*, Wash. Post (Nov. 23, 2008).
[46] For more details on OTS's regulatory failures, see Michael Hudson and Jim Overton, *The Second S&L Scandal: How OTS allowed reckless and unfair lending to fleece homeowners and cripple the nation's savings and loan industry*, Center for Responsible Lending (Jan. 2009), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/the-second-s-l-scandal.pdf.
[47] See, e.g., *The People of the State of California v. Countrywide Financial Corp.*, Los Angeles Superior Court, June 24, 2008, *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1588_firstamendedcomplaint.pdf#xml=http://search.doj.ca.gov:8004/AGSearch/isysquery/d9682d50-f6f7-4c18-9b74-dd03bca6cf28/2/hilite/ ; see also *Unfair and Unsafe: How Countrywide's irresponsible practices have harmed borrowers and shareholders*, CRL Issue Paper (Feb. 7, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/unfair-and-unsafe-countrywide-white-paper.pdf.
[48] Office of Inspector General, Department of the Treasury, *Material Loss Review of NetBank, FSB* (Apr. 23, 2008) OIG-08-032.
[49] Office of Inspector General, Department of the Treasury, *Material Loss Review of IndyMac*

Bank, FSB (Feb. 26, 2009) OIG-09-032.
[50] Office of Inspector General, Department of the Treasury, *Material Loss Review of Downey Savings and Loan FA* (June 15, 2009) OIG-09-039.
[51] The inspector general discovered, for example, that OTS's western regional director had allowed IndyMac to count money it received from its bank holding company in May 2008 in a quarterly report outlining its financial condition as of March 31, 2008. See Binyamin Appelbaum and Ellen Nakashima, *Regulator Let IndyMac Falsify Report*, Washington Post (December 23, 2008) and Cheyenne Hopkins, *Treasury IG Faults OTS For Allowing Backdating*, American Banker (May 22, 2009).
[52] Appelbaum & Nakashima, *Banking Regulator Played Advocate Over Enforcer, supra.*
[53] Office of Inspector General, Department of the Treasury, *Bank Secrecy Act: OCC Did Not Take Formal Enforcement Action Against Wells Fargo Bank for Significant BSA Deficiencies* (Aug. 18, 2006) OIG-06-034.

Americans for Financial Reform
Accountability, Fairness, Security

United States House of Representatives
Washington, D.C. 20515

July 15, 2009

Dear Representative,

We, the nearly 200 national, state and local consumer, employee, investor, community and civil rights organizations of Americans for Financial Reform, write today to ask you to support the Consumer Financial Protection Agency Act of 2009, H.R. 3126, sponsored by Chairman Barney Frank.

Our consumer financial safety net is broken. For too long the financial wellbeing of hard-working Americans has taken a back seat to Wall Street's balance sheet. The seven federal agencies charged with protecting consumers of financial products have other responsibilities that have taken precedence over consumer protection. Some are hamstrung by insufficient resources and burdensome statutory requirements or have been captured by the financial services industry. Some have just lacked the will to protect consumers. We need an oversight body charged solely with protecting consumers from unfair, deceptive, and irresponsible financial products, one that is truly independent and has adequate resources to succeed. Had such an agency existed over the past decade, the financial crisis might have been less severe or avoided altogether.

The Consumer Financial Protection Agency (CPFA) will be that agency. It will have broad authority to police products like home mortgages and credit cards, services like credit reports, and debt collection. It would promote clear terms in contracts as well as fair and safe financial products and services. Rather than hampering the states' efforts to protect their citizens, as the Office of the Comptroller of Currency and Office of Thrift Supervision have done, the CPFA would create a federal floor of financial protection.

American consumers did not create adjustable-rate subprime mortgages. Nor did they profit from steering homeowners who qualified for safe, affordable mortgages into exploding loans. But consumers are paying the price of unfair and irresponsible financial products—through record foreclosures, rising unemployment and taxpayer bailouts. On behalf of the millions of Americans whom we represent, we urge you to support H.R. 3126 and help build a strong financial future for America.

Sincerely,

Americans for Financial Reform

Hearing on "Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve" before the Subcommittee on Domestic Monetary Policy and Technology of the U.S. House Committee on Financial Services

Prepared Statement of Patricia A. McCoy
Director, Insurance Law Center
-- and --
George J. and Helen M. England Professor of Law
University of Connecticut School of Law

2:00 p.m., Thursday, July 16, 2009 – 2128 Rayburn House Building

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2:00 p.m., Thursday, July 16, 2009 – 2128 Rayburn House Building

Chairman Watt, Ranking Member Paul, and Members of the Subcommittee: Thank you for inviting me here today to discuss restructuring the financial regulatory system. I applaud the subcommittee for exploring bold new approaches to financial regulation needed to address our nation's economic challenges.

In my remarks today, I testify in support of the Consumer Financial Protection Agency Act of 2009, proposed by the Administration. The Act would transfer many of the consumer financial protection responsibilities of federal banking regulators to a single, dedicated agency whose sole mission is consumer protection. This step is essential for three reasons. First, during the housing bubble, our current system of fragmented regulation drove lenders to shop for the easiest legal regime. Second, the ability of lenders to switch charters put pressure on regulators – both state and federal – to relax credit standards. Finally, federal banking regulators have routinely sacrificed consumer protection for the short-term profitability of banks. Creating one, dedicated regulator charged solely with consumer financial protection would establish uniform standards and enforcement for all lenders and help eliminate another death spiral in lending. Although I examine this issue through the lens of mortgage regulation, my discussion is equally relevant to other forms of consumer credit, such as credit cards and payday loans.

The reasons for the breakdown of the home mortgage market and the private-label market for mortgage-backed securities are well known by now. Our broken system of mortgage finance and the private actors in that system – ranging from mortgage brokers, lenders, and appraisers to the rating agencies and securitizers – bear direct responsibility for this breakdown in standards.

There is more to the story, however. In 2006, depository institutions and their affiliates, which were regulated by federal banking regulators, originated about 54% of all higher-priced home loans. In 2007, that percentage rose to 79.6%.[1] In some states, mortgages originated by state banks and thrifts and independent nonbank lenders were regulated under state anti-predatory lending laws. In other states, however, mortgages had no meaningful state regulation. Consequently, regulatory failure was to blame as well as reckless business practices. That failure was not confined to states, but pervaded federal banking regulation as well.

Neither of these phenomena – the collapse in lending criteria nor the regulatory failure that accompanied it – was an accident. Rather, they occurred because mortgage originators and

[1] Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *The 2007 HMDA Data*, FED. RES. BULL. A107, A124 (Dec. 2008), available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf.

regulators became locked in a competitive race to the bottom to relax loan underwriting and risk management. The fragmented U.S. system of financial services regulation exacerbated this race to the bottom by allowing lenders to shop for the easiest regulators and laws.

I open by describing how our fragmented regulatory system encouraged lenders to shop for lenient regulators. Then I document regulatory failure by federal banking regulators. Finally, I discuss how the Consumer Financial Protection Agency Act of 2009 solves these problems.

I. The Regulatory Story: Race to the Bottom

It is a basic tenet of banking law that banks should not extend credit without proof of ability to repay. Federal banking regulators[2] had ample authority to enforce principle through safety and soundness and federal consumer protection laws. Nevertheless, they refused to exercise their substantial powers of rule-making, formal enforcement, and sanctions to crack down on poorly underwritten loans until it was too late. Their abdication allowed irresponsible loans to multiply. Furthermore, their green light to banks to invest in investment-grade subprime mortgage-backed securities and CDOs left the nation's largest banks struggling with toxic assets. These problems were a direct result of the country's fragmented system of financial regulation, which caused regulators to compete for turf.

A. The Fragmented U.S. System of Mortgage Regulation

In the United States, the home mortgage industry operates under a fragmented regulatory structure which varies according to entity.[3] Banks and thrift institutions are regulated under federal banking laws and a subset of those institutions – namely, national banks, federal savings associations, and their subsidiaries – are exempt from state anti-predatory lending and credit laws due to federal preemption. In contrast, mortgage brokers and independent non-depository mortgage lenders escape federal banking regulation but have to comply with state laws. Only state banks and thrifts in some states (a dwindling group) are subject to both sets of laws.

Under this dual system of regulation, depository institutions are subject to a variety of federal examinations, including fair lending, Community Reinvestment Act, and safety and soundness examinations, but independent nondepository lenders are not. Similarly, banks and thrifts must comply with other provisions of the Community Reinvestment Act, including reporting requirements and merger review. Federally insured depository institutions must also meet minimum risk-based capital requirements and reserve requirements, unlike their independent non-depository counterparts.

Some federal laws applied to all mortgage originators. Otherwise, lenders could change their charter and form to shop for the friendliest regulatory scheme.

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[2] The four federal banking regulators include the Federal Reserve System, which serves as the central bank and supervises state member banks; the Office of the Comptroller of the Currency, which oversees national banks; the Federal Deposit Insurance Corporation, which operates the Deposit Insurance Fund and regulates state nonmember banks; and the Office of Thrift Supervision, which supervises savings associations.

[3] This discussion is drawn from Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 110 (Nicolas P. Retsinas & Eric S. Belsky eds., Joint Center for Housing Studies of Harvard University & Brookings Institution Press, 2008).

B. Applicable Law

Despite these differences in regulatory regimes, the Federal Reserve Board did have the power to prohibit reckless mortgages across the entire mortgage industry. The Board had this power by virtue of its authority to administer a federal anti-predatory lending law known as "HOEPA."

1. Federal Law

Following deregulation of home mortgages in the early 1980s, disclosure became the prevailing form of federal mortgage regulation. The federal Truth in Lending Act (TILA),[4] passed in 1968, mandates uniform disclosures regarding cost for home loans. Its companion law, the federal Real Estate Settlement Procedures Act of 1974 (RESPA),[5] requires similar standardized disclosures for settlement costs. Congress charged the Federal Reserve with administering TILA and the Department of Housing and Urban Development with administering RESPA.

In 1994, Congress augmented TILA and RESPA by enacting the Home Ownership and Equity Protection Act (HOEPA).[6] HOEPA was an early federal anti-predatory lending law and prohibits specific abuses in the subprime mortgage market. HOEPA applies to all residential mortgage lenders and mortgage brokers, regardless of the type of entity.

HOEPA has two important provisions. The first consists of HOEPA's high-cost loan provision,[7] which regulates the high-cost refinance market. This provision seeks to eliminate abuses consisting of "equity stripping." It is hobbled, however, by its extremely limited reach – covering only the most exorbitant subprime mortgages – and its inapplicability to home purchase loans, reverse mortgages, and open-end home equity lines of credit.[8] Lenders learned to evade the high-cost loan provisions easily by slightly lowering the interest rates and fees on subprime loans below HOEPA's thresholds and by expanding into subprime purchase loans.

HOEPA also has a second major provision, which gives the Federal Reserve Board the authority to prohibit unfair or deceptive lending practices and refinance loans involving practices that are abusive or against the interest of the borrower.[9] This provision is potentially broader than the high-cost loan provision, because it allows regulation of both the purchase and refinance markets, without regard to interest rates or fees. However, it was not self-activating. Instead, it depended on action by the Federal Reserve Board to implement the provision, which the Board did not take until July 2008.

2. State Law

Before 2008, only the high-cost loan provision of HOEPA was in effect as a practical matter. This provision had a serious Achilles heel, consisting of its narrow coverage. Even though the

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4 15 U.S.C. §§ 1601–1693r.

5 12 U.S.C. §§ 2601–2617.

6 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b).

7 15 U.S.C. § 1602(aa)(1)–(4); 12 C.F.R. § 226.32(a)(1), (b)(1).

8 15 U.S.C. § 1602(i), (w), (bb); 12 C.F.R. § 226.32(a)(2) (1997); EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).

9 15 U.S.C. § 1639(*l*)(2).

Federal Reserve Board lowered the high-cost triggers of HOEPA effective in 2002, that provision still only applied to 1% of all subprime home loans.[10]

After 1994, it increasingly became evident that HOEPA was incapable of halting equity stripping and other sorts of subprime abuses. By the late 1990s, some cities and states were facing rising foreclosures and some jurisdictions were contemplating regulating subprime loans on their own. Many states already had older statutes on the books regulating prepayment penalties and occasionally balloon clauses. These laws were relatively narrow, however, and did not address other, new abuses that were surfacing in subprime loans.

Consequently, in 1999, North Carolina became the first state to enact a comprehensive anti-predatory lending law.[11] Soon, other states followed suit and passed anti-predatory lending laws of their own. These newer state laws implemented HOEPA's design but frequently expanded coverage or imposed stricter regulation on subprime loans. By year-end 2005, twenty-nine states and the District of Columbia had enacted one of these "mini-HOEPA" laws. Some states also passed stricter disclosure laws or laws regulating mortgage brokers. By the end of 2005, only six states – Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota – lacked laws regulating prepayment penalties, balloon clauses, or mandatory arbitration clauses, all of which were associated with exploitative subprime loans.[12]

Critics, including some federal banking regulators, have blamed the states for igniting the credit crisis through lax regulation. Certainly, there were states that were largely unregulated and there were states with weak mortgage regulation. Mortgage brokers were loosely regulated in too many states. Similarly, the states never agreed on a uniform system of mortgage regulation.

Nevertheless, this criticism of the states disregards the hard-fought efforts by a growing number of states – which eventually grew to include the majority of states – to regulate abusive subprime loans within their borders. State attorneys general and state banking commissioners spearheaded some of the most important enforcement actions against deceptive mortgage lenders.[13]

C. The Ability to Shop For Lax Laws and Regulators

State-chartered banks and thrifts and their subsidiaries had to comply with the state anti-predatory lending laws. So did independent nonbank lenders and mortgage brokers.

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10 EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).

11 N.C. GEN STAT. § 24-1.1E.

12 *See* Raphael Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan Wachter, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47-66 (2008), full working paper version available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005423.

13 For instance, in 2002, state authorities in 44 states struck a settlement with Household Finance Corp. for $484 million in consumer restitution and changes in its lending practices following enforcement actions to redress alleged abusive subprime loans. Iowa Attorney General, *States Settle With Household Finance: Up to $484 Million for Consumers* (Oct. 11, 2002), available at www.iowa.gov/government/ag/latest_news/releases/oct_2002/Household_Chicago.html. In 2006, forty-nine states and the District of Columbia reached a $325 million settlement with Ameriquest Mortgage Company over alleged predatory lending practices. *See, e.g.*, Press Release, Iowa Dep't of Justice, Miller: Ameriquest Will Pay $325 Million and Reform its Lending Practices (Jan. 23, 2006), *available at* http://www.state.ia.us/government/ag/latest_news/releases/jan_2006/Ameriquest_Iowa.html.

For the better part of the housing boom, however, national banks, federal savings associations, and their mortgage lending subsidiaries did not have to comply with the state anti-predatory lending laws due to federal preemption rulings by their federal regulators. This became a problem because federal regulators did not replace the preempted state laws with strong federal underwriting rules.

1. Federal Preemption

The states that enacted anti-predatory lending laws did not legislate in a vacuum. In 1996, the federal regulator for thrift institutions – the Office of Thrift Supervision or OTS – promulgated a sweeping preemption rule declaring that henceforth federal savings associations did not have to observe state lending laws.[14] Initially, this rule had little practical effect because any state anti-predatory lending provisions on the books back then were fairly narrow.[15]

Following adoption of the OTS preemption rule, federal thrift institutions and their subsidiaries were relieved from having to comply with state consumer protection laws. That was not true, however, for national banks, state banks, state thrifts, and independent nonbank mortgage lenders and brokers.

The stakes rose considerably starting in 1999, when North Carolina passed the first comprehensive state anti-predatory lending law. As state mini-HOEPA laws proliferated, national banks lobbied their regulator – a federal agency known as the Office of the Comptroller of the Currency or OCC – to clothe them with the same federal preemption as federal savings associations. They succeeded and, in 2004, the OCC issued its own preemption rule banning the states from enforcing their laws impinging on real estate lending by national banks and their subsidiaries.[16] In a companion rule, the OCC denied permission to the states to enforce their own laws that were *not* federally preempted – state lending discrimination laws are one example – against national banks and their subsidiaries. After a protracted court battle, the controversy ended up in the U.S. Supreme Court, which upheld the OCC preemption rule.[17]

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[14] 12 C.F.R. §§ 559.3(h), 560.2.

[15] Bostic et al., *supra* note 12; Office of Thrift Supervision, *Responsible Alternative Mortgage Lending: Advance notice of proposed rulemaking*, 65 Fed. Reg. 17811, 17814-16 (2000).

[16] Office of the Comptroller of the Currency, *Bank Activities and Operations; Final rule*, 69 FED. REG. 1895 (2004) (codified at 12 C.F.R. § 7.4000); Office of the Comptroller of the Currency, *Bank Activities and Operations; Real Estate Lending and Appraisals; Final rule*, 69 FED. REG. 1904 (2004) (codified at 12 C.F.R. §§ 7.4007-7.4009, 34.4). National City Corporation, the parent of National City Bank, N.A., and a major subprime lender, spearheaded the campaign for OCC preemption. *Predatory lending laws neutered*, ATLANTA JOURNAL-CONSTITUTION, Aug. 6, 2003.

[17] Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007); Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System*, 23 ANN. REV. BANKING & FINANCE LAW 225 (2004). The Supreme Court later overturned part of the OCC visitorial powers rule. Cuomo v. Clearing House Ass'n, L.L.C., ___ U.S. ___ (2009). The OCC and the OTS left some areas of state law untouched, namely, state criminal law and state law regulating contracts, torts, homestead rights, debt collection, property, taxation, and zoning. Both agencies, though, reserved the right to declare that any state laws in those areas are preempted in the future. For fuller discussion, see. McCoy & Renuart, *supra* note 3.

OTS and the OCC had institutional motives to grant federal preemption to the institutions that they regulated. Both agencies depend almost exclusively on fees from their regulated entities for their operating budgets. Both were also eager to persuade state-chartered depository institutions to convert to a federal charter. In addition, the OCC was aware that if national banks wanted federal preemption badly enough, they might defect to the thrift charter to get it. Thus, the OCC had reason to placate national banks to keep them in its fold. Similarly, the OTS was concerned about the steady decline in thrift institutions. Federal preemption provided an inducement to thrift institutions to retain the federal savings association charter.

2. The Ability to Shop for the Most Permissive Laws

As a result of federal preemption, state anti-predatory lending laws applied to state-chartered depository institutions and independent nonbank lenders, but not to national banks, federal savings associations, or their mortgage lending subsidiaries. The only anti-predatory lending provisions that national banks and federally chartered thrifts had to obey were HOEPA and agency pronouncements on subprime and nontraditional mortgage loans.[18] Of these, HOEPA had extremely narrow scope. Meanwhile, agency guidances lacked the binding effect of rules and their content was not as strict as the stronger state laws.

This dual regulatory system allowed mortgage lender to play regulators off one another by threatening to change charters. Mortgage lenders are free to operate with or without depository institution charters. Similarly, depository institutions can choose between a state and federal charter and between a thrift charter and a commercial bank charter. Each of these choices allows a lender to change regulators.

A lender could escape a strict state law by switching to a federal bank or thrift charter or by shifting its operations to a less regulated state. Similarly, a lender could escape a strict regulator by converting its charter to one with a more accommodating regulator.

Countrywide, the nation's largest mortgage lender and a major subprime presence, took advantage of this system to change its regulator. One of its subsidiaries, Countrywide Home Loans, was supervised by the Federal Reserve. This subsidiary switched and became an OTS-regulated entity as of March 2007. That same month, Countrywide Bank, N.A., converted its charter from a national bank charter under OCC supervision to a federal thrift charter under OTS supervision. Reportedly, OTS promised Countrywide's executives to be a "less antagonistic" regulator if Countrywide switched charters to OTS. Six months later, the regional deputy

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18 Board of Governors of the Federal Reserve System et al., Interagency Guidance on Subprime Lending (March 1, 1999); OCC, Abusive Lending Practices, Advisory Letter 2000-7 (July 25, 2000); OCC et al., Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001); OCC, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans, Advisory Letter 2003-3 (Feb. 21, 2003); OCC, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, Advisory Letter 2003-2 (Feb. 21, 2003); OCC, OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices, 70 Fed. Reg. 6329 (2005); Department of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Product Risks; Final guidance, 71 Fed. Reg. 58609 (2006); Department of the Treasury et al. Statement on Subprime Mortgage Lending; Final guidance, 72 Fed. Reg. 37569 (2007). Of course, these lenders, like all lenders, are subject to prosecution in cases of fraud. Lenders are also subject to the Federal Trade Commission Act, which prohibits unfair and deceptive acts and practices (UDAPs). However, federal banking regulators were slow to propose rules to define and punish UDAP violations by banking companies in the mortgage lending area.

director of the OTS West Region, where Countrywide was headquartered, was promoted to division director. Some observers considered it a reward.[19]

The result was a system in which lenders could shop for the loosest laws and enforcement. This shopping process, in turn, put pressure on regulators at all levels – state and local – to lower their standards or relax enforcement. What ensued was a regulatory race to the bottom.

II. Regulatory Failure

Federal preemption would not have been such a problem if federal banking regulators had replaced state laws with tough rules and enforcement of their own. Those regulators had ample power to stop the deterioration in underwriting standards that mushroomed into a full-blown crisis. However, they refused to intervene in disastrous lending until it was too late. As a result, federally regulated lenders – as well as all lenders operating in states with weak regulation – received *carte blanche* to loosen their lending standards free from regulatory intervention.

A. The Federal Reserve Board

The Federal Reserve Board had the statutory power, starting in 1994, to curb lax lending not only for depository institutions, but for all lenders across-the-board. It declined to exercise that power in any meaningful respect, however, until after the nonprime mortgage market collapsed.

In the mortgage lending area, the Fed's supervisory process has three major parts and breakdowns were apparent in two out of the three. The only part that appeared to work well was the Fed's role as the primary federal regulator for state-chartered banks that are members of the Federal Reserve System.[20]

As the second part of its supervisory duties, the Fed regulates nonbank mortgage lenders owned by bank holding companies but not owned directly or indirectly by banks or thrifts. During the housing boom, some of the largest subprime and Alt-A lenders were regulated by the Fed, including the top- and third-ranked subprime lenders in 2006, HSBC Finance and Countrywide Financial Corporation, and Wells Fargo Financial, Inc.[21]

The Fed's supervisory record with regard to these lenders was mixed. On one notable occasion, in 2004, the Fed levied a $70 million civil money penalty against CitiFinancial Credit Company

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19 Richard B. Schmitt, *Regulator takes heat over IndyMac*, LOS ANGELES TIMES, Oct. 6, 2008; see also Binyamin Appelbaum & Ellen Nakashima, *Regulator Played Advocate Over Enforcer*, WASHINGTON POST, November 23, 2008. The official later retired following a capital contribution backdating scandal.

20 In general, these are community banks on the small side. In 2007 and 2008, only one failed bank – the tiny First Georgia Community Bank in Jackson, Georgia, with only $237.5 million in assets – was regulated by the Federal Reserve System. It is not clear whether the Fed's performance is explained by the strength of its examination process, the limited role of member banks in risky lending, the fact that state banks had to comply with state anti-predatory lending laws, or all three. While more state member banks have since failed, the deepening recession was likely a contributing factor to their failure.

In the following discussion on regulatory failure by the Federal Reserve Board, the OTS, and the OCC, the data regarding failed and near-failed banks and thrifts come from federal bank regulatory and S.E.C. statistics, disclosures, press releases, and orders; rating agency reports; press releases and other web materials by the companies mentioned; statistics compiled by the *American Banker*; and financial press reports.

21 Data provided by *American Banker*, available at www.americanbanker.com.

and its parent holding company, Citigroup Inc., for subprime lending abuses.[22] Apart from that, the Fed did not take public enforcement action against the nonbank lenders that it regulated. That may be because the Federal Reserve did not routinely examine the nonbank mortgage lending subsidiaries under its jurisdiction. The late Federal Reserve Board Governor Edward Gramlich stated as much in a speech in 2007. Only then did the Fed kick off a "pilot project" to examine the nonbank lenders under its jurisdiction on a routine basis for loose underwriting and compliance with federal consumer protection laws.[23]

Finally, the Board is responsible for administering most federal consumer credit protection laws, including HOEPA. When former Governor Edward Gramlich served on the Fed, he urged then-Chairman Alan Greenspan to exercise the Fed's power to address unfair and deceptive loans under HOEPA. Greenspan refused, preferring instead to rely on non-binding statements and guidances.[24] This reliance on statements and guidances had two disadvantages: one, major lenders routinely dismissed the guidances as mere "suggestions" and, two, guidances did not apply to independent nonbank mortgage lenders.

The Federal Reserve did not relent until July 2008, when under Chairman Ben Bernanke's leadership, it finally promulgated binding HOEPA regulations banning specific types of lax and abusive loans. Even then, the regulations were mostly limited to higher-priced mortgages, which the Board confined to first-lien loans of 1.5 percentage points or more above the average prime offer rate for a comparable transaction, and 3.5 percentage points for second-lien loans. Although shoddy nontraditional mortgages below those triggers had also contributed to the credit crisis, the rule left those loans – plus prime loans – mostly untouched.[25] While badly needed, the rules were too little and too late.

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22 Federal Reserve, Citigroup Inc. New York, New York and Citifinancial Credit Company Baltimore, Maryland: Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent, May 27, 2004.

23 Edward M. Gramlich, Boom and Busts, The Case of Subprime Mortgages, Speech given August 31, 2007, Jackson Hole, Wyo., at symposium titled "Housing, Housing Finance & Monetary Policy," sponsored by the Federal Reserve Bank of Kansas City, pp. 8-9, available at www.kansascityfed.org/publicat/sympos/2007/pdf/2007.09.04.gramlich.pdf; Speech by Governor Randall S. Kroszner At the National Bankers Association 80th Annual convention, Durham, North Carolina, October 11, 2007.

24 House of Representatives, Committee on Oversight and Government Reform, "The Financial Crisis and the Role of Federal Regulators, Preliminary Transcript" 35, 37-38 (Oct. 23, 2008), available at http://oversight.house.gov/documents/20081024163819.pdf. Greenspan told the House Oversight Committee in 2008:

> Well, let's take the issue of unfair and deceptive practices, which is a fundamental concept to the whole predatory lending issue.
>
> The staff of the Federal Reserve . . . say[] how do they determine as a regulatory group what is unfair and deceptive? And the problem that they were concluding . . . was the issue of maybe 10 percent or so are self-evidently unfair and deceptive, but the vast majority would require a jury trial or other means to deal with it . . .

Id. at 89.

25 Federal Reserve System, *Truth in Lending: Final rule; official staff commentary*, 73 FED. REG. 44522, 44536 (July 30, 2008). The Board set those triggers with the intention of covering the subprime market, but not the prime market. *See id.* at 44536-37.

In the home mortgage area, the Board also abdicated its authority to keep Truth-in-Lending Act disclosures up-to-date. The last time the Board did a major overhaul of the TILA rules was in 1981. These TILA disclosures worked tolerably well under the old market conditions featuring fixed-rate mortgages. In the 1990s, however, the market changed with the introduction of risk-based pricing. By that time, the Fed's sorely outdated Truth-in-Lending Act disclosures were not equipped to produce accurate, timely disclosures for subprime loans and exotic adjustable-rate mortgages.[26] Nevertheless, the Fed dragged its feet on issuing new rules. It did not get around to issuing a narrow new rule under TILA on bait-and-switch tactics and payment shock disclosures until July 30, 2008 and when it did, Congress immediately passed legislation declaring the rule insufficient.[27] As for comprehensive reform, the Board did not even initiate a full review of its TILA rules for closed-end mortgages until 2007. It still has not completed that review.[28]

On October 23, 2008, in testimony before the U.S. House of Representatives Oversight Committee, Greenspan admitted that "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief." House Oversight Committee Chairman Henry Waxman asked Greenspan whether "your ideology pushed you to make decisions that you wish you had not made?" Greenspan replied:[29]

> Mr. GREENSPAN. . . . [Y]es, I found a flaw, I don't know how significant or permanent it is, but I have been very distressed by that fact. . . .
>
> Chairman WAXMAN. You found a flaw?
>
> Mr. GREENSPAN. I found a flaw in the model that defines how the world works, so to speak.
>
> Chairman WAXMAN. In other words, you found that your view of the world, your ideology, was not right, it was not working.

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[26] As early as 1998, the Federal Reserve Board and the Department of Housing and Urban Development were aware that Truth in Lending Act disclosures did not come early enough in the nonprime market to allow meaningful comparison shopping. That year, the two agencies issued a report diagnosing the problem. In the report, HUD recommended changes to the Truth in Lending Act to require mortgage originators to provide binding price quotes before taking loan applications. The Federal Reserve Board dissented from the proposal, however, and it was never adopted. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & DEP'T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS, CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, at 28 - 29, 39 - 42 (1998), *available at* www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

[27] *Compare* Federal Reserve System, *Truth in Lending: Final rule; official staff commentary*, 73 Fed. Reg. 44522 (July 30, 2008) *with* Mortgage Disclosure Improvement Act of 2008 (MDIA), Pub. L. No. 110-289, tit. V, § 2502(a)(6), 122 Stat. 2855-2856 (July 30, 2008). In the MDIA, Congress issued a rebuke to the Federal Reserve by mandating stronger payment shock disclosures and notice of any interest rate hikes before the loan closing. Congress further amended these provisions of the MDIA in the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, enacted on October 3, 2008.

[28] The Board also seriously delayed revamping TILA disclosures for credit cards, but did issue a comprehensive new final rule on credit card disclosures in January 2009. Federal Reserve System, *Truth in Lending: Final rule*, 74 FR 5244 (Jan. 29, 2009).

[29] House of Representatives, Committee on Oversight and Government Reform, "The Financial Crisis and the Role of Federal Regulators, Preliminary Transcript" 36-37 (Oct. 23, 2008), available at http://oversight.house.gov/documents/20081024163819.pdf.

Mr. GREENSPAN. Precisely. That's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well. [30]

B. Regulatory Lapses by the OCC and OTS

Federal preemption might not have devolved into a banking crisis of systemic proportions had OTS and the OCC replaced state regulation for their regulated entities with a comprehensive set of binding rules prohibiting lax underwriting of home mortgages. Instead, federal banking regulators, including the OCC and OTS, issued a series of "soft law" advisory letters and guidelines against predatory or unfair mortgage lending practices by insured depository institutions.[31] Federal regulators disavowed binding rules during the run-up to the subprime crisis saying that guidelines were more flexible and the agencies enforced those guidelines through bank examinations and informal enforcement actions.[32] Informal enforcement was usually limited to negotiated, voluntary agreements between regulators and the entities that they supervised, making it easy for management to drag out negotiations to soften any restrictions and bid for more time. Furthermore, examinations and informal enforcement are highly confidential, making it easy for a lax regulator to hide its tracks.

1. The Office of Thrift Supervision

Although OTS was the first agency to adopt federal preemption, it managed to fly under the radar during the subprime boom, overshadowed by its larger sister agency, the OCC. After 2003, while commentators were busy berating the OCC preemption rule, OTS allowed the largest federal savings associations to embark on an aggressive campaign of expansion through option payment ARMs, subprime loans, and low-documentation and no-documentation loans.

Autopsies of failed depository institutions in 2007 and 2008 show that five of the seven biggest failures were OTS-regulated thrifts. Two other enormous thrifts during that period – Wachovia Mortgage, FSB and Countrywide Bank, FSB -- were forced to arrange hasty takeovers by large bank holding companies to avoid failing. By December 31, 2008, thrifts totaling $355 billion in assets had failed in the previous sixteen months on OTS' watch.

The reasons for these thrift failures evince fundamental regulatory lapses by OTS. Almost all of the thrifts that failed in 2007 and 2008 – and all of the larger ones -- succumbed to massive levels of imprudent home loans. IndyMac Bank, FSB, which became the first major thrift institution to fail during this crisis, in July 2008, manufactured its demise by becoming the top originator of low-documentation and no-documentation loans. These loans, which became known as "liar's loans," infected both the subprime market and credit to borrowers with higher

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30 Testimony of Dr. Alan Greenspan before the House of Representatives Committee of Government Oversight and Reform, October 23, 2008, available at http://oversight.house.gov/documents/20081023100438.pdf.

31 See note 18 *supra*.

32 Office of the Comptroller of the Currency, *Bank Activities and Operations; Real Estate Lending and Appraisals; Final rule*, 69 FED. REG. 1904 (2004).

credit scores. By 2006 and 2007, over half of IndyMac's home purchase loans were subprime loans and IndyMac Bank approved up to half of those loans based on low or no documentation.

Washington Mutual Bank, popularly known as "WaMu," was the nation's largest thrift institution in 2008, with over $300 billion in assets. WaMu became the biggest U.S. depository institution in history to fail on September 25, 2008, in the wake of the Lehman Brothers bankruptcy. WaMu was so large that OTS examiners were stationed there permanently onsite. Nevertheless, from 2004 through 2006, despite the daily presence of the resident OTS inspectors, risky option ARMs, second mortgages, and subprime loans constituted over half of WaMu's real estate loans each year. By June 30, 2008, over one fourth of the subprime loans that WaMu originated in 2006 and 2007 were at least thirty days past due. Eventually, it came to light that WaMu's management had pressured its loan underwriters relentlessly to approve more and more exceptions to WaMu's underwriting standards in order to increase its fee revenue from loans.[33]

Downey Savings & Loan became the third largest depository institution to fail in 2008. Like WaMu, Downey had loaded up on option ARMs and subprime loans. When OTS finally had to put it into receivership, over half of Downey's total assets consisted of option ARMs and nonperforming loans accounted for over 15% of the thrift's total assets.

In short, the three largest depository institution failures in 2007 and 2008 resulted from high concentrations of poorly underwritten loans, including low- and no-documentation ARMs (in the case of IndyMac) and option ARMs (in the case of WaMu and Downey) that were often only underwritten to the introductory rate instead of the fully indexed rate. During the housing bubble, OTS issued no binding rules to halt the proliferation by its largest regulated thrifts of option ARMs, subprime loans, and low- and no-documentation mortgages. Instead, OTS relied on oversight through guidances. IndyMac, WaMu, and Downey apparently treated the guidances as solely advisory, however, as evidenced by the fact that all three made substantial numbers of hazardous loans in late 2006 and in 2007 in direct disregard of an interagency guidance on nontraditional mortgages issued in the fall of 2006 and subscribed to by OTS that prescribed underwriting ARMs to the fully indexed rate.[34]

The fact that all three institutions continued to make loans in violation of the guidance suggests that OTS examinations failed to result in enforcement of the guidance. Similarly, OTS fact sheets on the failures of all three institutions show that the agency consistently declined to institute timely formal enforcement proceedings against those thrifts prohibiting the lending practices that resulted in their demise. In sum, OTS supervision of residential mortgage risks was confined to "light touch" regulation in the form of examinations, nonbinding guidances, and occasional informal agreements that did not work.

2. The Office of the Comptroller of the Currency

The OCC has asserted that national banks made only 10% of subprime loans in 2006. But this assertion fails to mention that national banks moved aggressively into Alt-A low-documentation

33 Peter S. Goodman & Gretchen Morgenson, *Saying Yes, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008.

34 Department of the Treasury et al., *Interagency Guidance on Nontraditional Mortgage Product Risks; Final guidance*, 71 FED. REG. 58609 (2006).

and no-documentation loans during the housing boom.[35] This mattered a lot, because the biggest national banks are considered "too big to fail" and pose systemic risk on a scale unmatched by independent nonbank lenders. We might not be debating bailouts of Citibank and Bank of America today had the OCC stopped them from expanding into toxic mortgages and bonds.

Like OTS, "light touch" regulation was apparent at the OCC. Unlike OTS, the OCC did promulgate one rule, in 2004, prohibiting mortgages to borrower who could not afford to repay. However, the rule was vague in design and execution, allowing lax lending to proliferate at national banks and their mortgage lending subsidiaries through 2007.

In disregard of the 2004 rule, through 2007, large national banks continued to make large quantities of poorly underwritten subprime loans and low- and no-documentation loans. In 2006, for example, fully 62.6% of the first-lien home purchase mortgages made by National City Bank, N.A., and its subsidiary, First Franklin Mortgage, were higher-priced subprime loans. Starting in the third quarter of 2007, National City Corporation reported five straight quarters of net losses, largely due to those subprime loans. Just as with WaMu, the Lehman Brothers bankruptcy ignited a silent run by depositors and pushed National City Bank to the brink of collapse. Only a shotgun marriage with PNC Financial Services Group in October 2008 saved the bank from FDIC receivership.

The five largest U.S. banks in 2005 were all national banks and too big to fail. They too made heavy inroads into low- and no-documentation loans. The top-ranked Bank of America, N.A., had a thriving stated-income and no-documentation loan program which it only halted in August 2007, when the market for private-label mortgage-backed securities dried up. Bank of America securitized most of those loans, which may be why the OCC tolerated such lax underwriting.

Similarly, in 2006, the OCC overrode public protests about a "substantial volume" of no-documentation loans by JPMorgan Chase Bank, N.A., the second largest bank in 2005, on grounds that the bank had adequate "checks and balances" in place to manage those loans.

Citibank, N.A., was the third largest U.S. bank in 2005. In September 2007, the OCC approved Citibank's purchase of the disreputable subprime lender Argent Mortgage, even though subprime securitizations had slowed to a trickle. Citibank thereupon announced to the press that its new subsidiary – christened "Citi Residential Lending" – would specialize in nonprime loans, including reduced documentation loans. But not long after, by early May 2008, after Bear Stearns narrowly escaped failure, Citibank was forced to admit defeat and dismantle Citi Residential's lending operations.

The fourth largest U.S. bank in 2005, Wachovia Bank, N.A., originated low- and no-documentation loans through its two mortgage subsidiaries. Wachovia Bank originated such large quantities of these loans – termed Alt-A loans – that by the first half of 2007, Wachovia Bank was the twelfth largest Alt-A lender. These loans performed so poorly that between December 31, 2006 and September 30, 2008, the bank's ratio of net write-offs on its closed-end home loans to its total outstanding loans jumped 2400%. Concomitantly, the bank's parent company, Wachovia Corporation, was reported its first quarterly loss in years due to rising

[35] Testimony by John C. Dugan, Comptroller, before the Senate Committee on Banking, Housing, and Urban Affairs, March 4, 2008.

defaults on option ARMs made by Wachovia Mortgage, FSB, and its Golden West predecessor. Public concern over Wachovia's loan losses triggered a silent run on Wachovia Bank in late September 2008, following Lehman Brothers' failure. To avoid receivership, the FDIC brokered a hasty sale of Wachovia to Wells Fargo after Wells Fargo outbid Citigroup for the privilege.

Wells Fargo Bank, N.A., was in better financial shape than Wachovia, but it too made large quantities of subprime and reduced documentation loans. In 2006, over 23% of the bank's first-lien refinance mortgages were high-cost subprime loans. Wells Fargo Bank also securitized substantial numbers of low- and no-documentation mortgages in its Alt-A pools. In 2007, a Wells Fargo prospectus for one of those pools stated that Wells Fargo had relaxed its underwriting standards in mid-2005 and did not verify whether the mortgage brokers who had originated the weakest loans in that loan pool complied with its underwriting standards before closing. Not long after, as of July 25, 2008, 22.77% of the loans in that loan pool were past due.

As the Wells Fargo story suggests, the OCC depended on voluntary risk management by national banks, not regulation of loan terms and practices, to contain the risk of improvident loans. A speech by the then-Acting Comptroller, Julie Williams, confirmed as much. In 2005, Comptroller Williams, in a speech to risk managers at banks, coached them on how to "manage" the risks of no-doc loans through debt collection, higher reserves, and prompt loss recognition. Securitization was another risk management device favored by the OCC.

Three years later, in 2008, the Treasury Department's Inspector General issued a report that was critical of the OCC's supervision of risky loans. Among other things, the Inspector General criticized the OCC for not instituting formal enforcement actions while lending problems were still manageable in size. In his written response to the Inspector General, the Comptroller, John Dugan, conceded that "there were shortcomings in our execution of our supervisory process" and ordered OCC examiners to start initiating formal enforcement actions on a timely basis. [36]

The OCC's record of supervision and enforcement during the subprime boom reveals many of the same problems that culminated in regulatory failure by OTS. Like OTS, the OCC usually shunned formal enforcement actions in favor of examinations and informal enforcement. Neither of these supervisory tools obtained compliance with the OCC's 2004 rule prohibiting loans to borrowers who could not repay. Although the OCC supplemented that rule later on with more detailed guidances, some of the largest national banks and their subsidiaries apparently decided that they could ignore the guidances, judging from their lax lending in late 2006 and in 2007. The OCC's emphasis on managing credit risk through securitization, reserves, and loss recognition, instead of through product regulation, likely encouraged that *laissez faire* attitude by national banks.

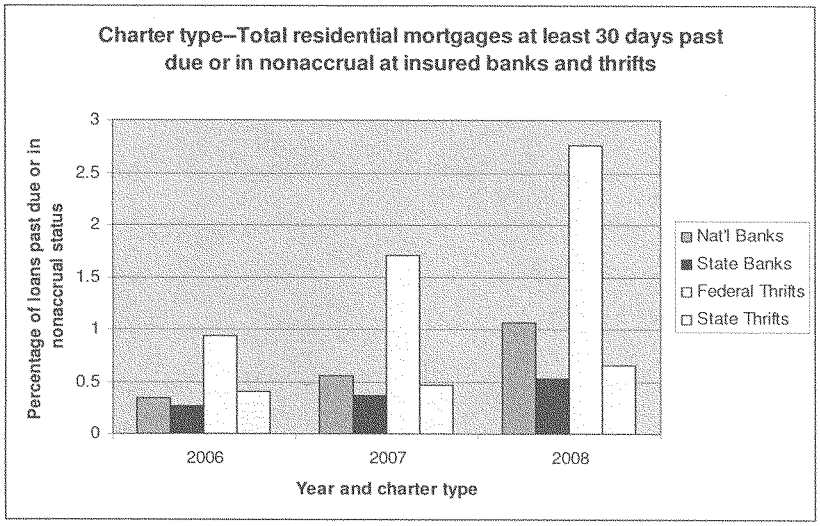
C. Judging by the Results: Loan Performance By Charter

OCC and OTS regulators have argued that their agencies offer "comprehensive" supervision resulting in lower default rates on residential mortgages. The evidence shows otherwise.

[36] Office of Inspector General, Department of the Treasury, "Safety and Soundness: Material Loss Review of ANB Financial, National Association" (OIG-09-013, Nov. 25, 2008).

Data from the Federal Deposit Insurance Corporation show that among depository institutions, federal thrift institutions had the worst default rate for one-to-four family residential mortgages from 2006 through 2008. (See Figure 1).

Figure 1. Total Performance of Residential Mortgages by Depository Institution Charter



Source: FDIC Statistics on Depository Institutions

The second-worst performance record among depository institution lenders went to national banks. State thrifts had better default rates than either type of federally chartered institution in 2007 and 2008. State banks consistently had the lowest default rates of all.

Among these charter types, the only ones that enjoy federal preemption are national banks regulated by the OCC and federal thrift institutions regulated by the OTS. State banks and state thrift institutions do not. Thus it appears, at least among depository institutions, that federal preemption was associated with *higher* default rates, not lower rates, during 2006 through 2008, when credit standards hit bottom and the mortgage market imploded.

These data do not address whether that independent nonbank lenders have even higher default rates in some states and that may in fact be the case. Nevertheless, the data undercut the assertion that federal preemption reduces default rates among mortgages by depository institution lenders. To the contrary, the lowest default rates were at state banks and thrifts, which are subject both to state and federal regulation.

III. The Consumer Financial Protection Agency Act of 2009

Dual regulation and the resulting crazy quilt of laws encouraged lenders to shop for the lightest rules. In turn, this pressured regulators to weaken their standards and to relax enforcement of safety and soundness and consumer protection laws.

Casting underwriting standards to the wind in a seemingly obscure corner of the consumer credit market ended up triggering a global recession. This crisis shows that the United States ignores consumer protection at its peril. If it was not clear before, we now know that systemic stability and consumer protection are inextricably linked.

To correct the regulatory lapses that I have described, our financial regulatory system needs to adopt three reforms:

- *First,* Congress should adopt uniform minimum consumer protection standards for all financial services providers nationwide, regardless of entity, charter, or location.

- *Second,* the authority for administering and enforcing these standards should be housed in one federal agency whose sole mission is consumer protection.

- *Third,* to avoid the risk of agency inaction, Congress should give parallel enforcement authority to federal banking regulators and the states.

The Consumer Financial Protection Agency Act of 2009 accomplishes all three objectives.

A. Uniform Federal Safety Standards For Consumer Credit

The downward spiral in underwriting standards drove home the need for uniform consumer protection standards that apply to all financial services providers. Adopting a uniform federal floor would prevent lenders, brokers and other financial providers from seeking safe havens in legal regimes that do little to protect consumers.

The Consumer Financial Protection Agency Act of 2008 ("the Act") solves this problem by creating one set of uniform federal laws that apply to all financial services providers across the country, regardless of entity, charter, or geographic location. To prevent regulators from competing to relax the interpretation of those laws, furthermore, the Act consolidates the authority to administer those laws in one agency. That agency is the new Consumer Financial Protection Agency ("Agency").

The Act would give the Agency jurisdiction over the following types of consumer financial protection laws and apply almost all of these laws to all financial services providers:

- *Unfair Practices:* First, in Section 1031 of the bill, the Agency would have authority to define and prevent unfair or deceptive acts and practices in consumer financial services. While federal banking regulators have this power, they resisted using it until far too late, after the mortgage market melted down. Section 1031 also represents an improvement over the high-cost loan provisions in HOEPA, which proved too narrow and rigid and failed to address new abuses as they appeared in the mortgage market.

- *Deceptive Marketing*: Second, Section 1033 of the bill would authorize the Agency to write rules banning unfair sales practices in consumer financial services. The bill delegates this responsibility to the Agency, partly due to evidence that the Federal Reserve Board was slow to crack down on deceptive marketing practices during the housing bubble. A related provision, Section 1037, would allow the Agency to set forth the duties of front-line personnel such as loan officers or brokers who deal directly with consumers when providing a consumer financial product and to make sure that their compensation methods do not undermine those duties.

- *Transparency and Disclosure:* Third, Section 1032 would empower the Agency to adopt rules mandating better consumer disclosures. This and other sections of the bill direct the Agency to re-design disclosures based not on speculation, but on empirical tests using real consumers and pilot disclosure forms. The bill would transfer this responsibility to the Agency due to the Federal Reserve Board's protracted hesitation and delay in revamping disclosures. The Agency would also be responsible for producing a badly needed, combined TILA-RESPA mortgage disclosure form.

- *Safer Loans:* Fourth, in the provision on standard consumer financial products found in Section 1035, the bill would allow the Agency to gently "nudge" consumers toward safer financial products, such as fixed-rate mortgages, with easy-to-understand terms. Consumers would be offered a relatively safe, plain-vanilla product first. This would make it easier for consumers to comparison shop and help them avoid "snow jobs" by standardizing the terms of safer products and bringing those products front and center to consumers' attention. At the same time, consumers would remain free to choose different products with other features subject to warnings or other safeguards.

- *Existing Consumer Financial Protection Laws:* Finally, the bill would transfer the authority to administer other existing federal consumer financial protection laws to the Agency. These laws would include the Truth in Lending Act, HOEPA, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Fair Credit Billing Act, and the Home Mortgage Disclosure Act.[37]

[37] The Agency would also receive responsibility for administering the Consumer Leasing Act, the Electronic Fund Transfer Act, the Truth in Savings Act, the Alternative Mortgage Transaction Parity Act, the S.A.F.E. Mortgage Licensing Act, the Community Reinvestment Act, the privacy provisions in title V of the Gramm-Leach-Bliley Act, and provisions of the Federal Deposit Insurance Act dealing with deposit insurance disclosures.

B. A Dedicated Federal Agency Whose Sole Mission is Consumer Protection

1. Federal Regulators Cannot Serve Two Masters

The housing bubble and hazardous mortgages by federally regulated depository institutions show that we cannot expect consumer protection to be paramount to federal banking regulators when times are good. At the top of the economic cycle, federal banking regulators are prone to interpret their safety and soundness mandate in favor of the short-term profitability of the banks they regulate, to the detriment of the long-term welfare of consumers. For this reason, the consumer protection function should be removed from federal banking regulators and housed in its own agency whose sole mission is consumer protection.

The bank regulatory agencies' own mission statements make it clear that consumer protection is a low priority. For example, the Federal Reserve Board divides its duties into four general areas:[38]

- "conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- "supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- "providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system."

In the Fed's description, monetary policy comes first, followed by banking supervision. Consumer protection does not even merit its own bullet point.

Similarly, safety and soundness regulation is the paramount mission of the OCC and OTS. The OCC describes its mission as having four objectives, with consumer protection coming last:[39]

- "To ensure the safety and soundness of the national banking system.
- "To foster competition by allowing banks to offer new products and services.
- "To improve the efficiency and effectiveness of OCC supervision, including reducing regulatory burden.
- "To ensure fair and equal access to financial services for all Americans."

Like the OCC, OTS describes safety and soundness as its principal job:[40]

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38 THE FEDERAL RESERVE SYSTEM, PURPOSES & FUNCTIONS 1 (9th ed. 2005).

39 Comptroller of the Currency, *About the OCC* (viewed February 28, 2009), available at http://www.occ.treas.gov/aboutocc.htm.

40 Office of Thrift Supervision, *Mission and Goals* (viewed February 28, 2009), available at http://www.ots.treas.gov/?p=MissionGoal.

"To supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs."

In theory, safety and soundness and consumer protection should normally overlap. In practice, they have not, as recent experience has shown. During the housing boom, federal banking regulators too often equated short-term profitability, including profits from excessive fees on consumers,[41] with safety and soundness. In their effort to protect the short-term profitability of banks and thrifts, federal regulators often dismissed consumer protection as conflicting with that mission. When agencies derive most of their operating budgets from assessments on the entities they regulate – as do the OCC and OTS – the pressure to sacrifice consumer protection for profit maximization by those entities can be overwhelming.[42]

I served on the Federal Reserve Board's Consumer Advisory Council from 2002 through 2004 and saw firsthand how resistant federal banking regulators were to instituting basic consumer protections during the run-up to the current crisis. Repeatedly over that period, I and other members of that Council warned the Federal Reserve's staff and governors about rising foreclosures and other dangers associated with reckless subprime loans. We urged the Board to exercise its powers under HOEPA to strengthen protections for subprime and nontraditional mortgages, but to no avail. During my tenure on the Council, the late Governor Gramlich told me during a break at one of the Council's public meetings that there was not enough support on the Board to expand HOEPA's protections. Governor Gramlich was truly sympathetic to those concerns, but was not able to convince his fellow Board members, including Chairman Greenspan. These experiences confirmed my belief that banking regulators often dismiss the consumer protection piece of their mission.

Some critics argue that removing consumer protection responsibilities from federal banking regulators and housing them in their own dedicated agency would undercut the safety and soundness of banks. As the current crisis shows, however, entrusting consumer protection to the federal banking agencies is no guarantee of bank safety and soundness. Indeed, having a separate federal watchdog for consumer credit would help place healthy, countercyclical constraints on the tendency of federal banking regulators to sacrifice long-term safety for short-term profits at the top of the credit cycle. It would also encourage forward-looking regulation as new problems arise, instead of laggard, backward-looking regulation of the type recently issued by the Federal Reserve.

The Act contains three main safeguards to help ensure that the Agency's actions comport with bank safety and soundness. First, the National Bank Supervisor would be the only permanent member of the Agency's Board. Second, at numerous points throughout the bill, the Act mandates consultation or coordination by the Agency with its fellow federal regulators, including federal banking regulators and the Securities and Exchange Commission and Commodity

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41 Examples include regulators' slow response to curtailing large prepayment penalties and their continued indecision on costly overdraft protection on checking accounts.

42 For instance, the OCC derives 95% of its budget from assessments on national banks. The twenty largest national banks contribute almost 60% of those assessments. See, e.g., Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PENN. L. REV. 1, 93-94 (2008); Testimony of Arthur E. Wilmarth, Jr., Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (Apr. 26, 2007).

Futures Trading Commission.[43] Finally, the Agency must file regular reports with Congress to enable Congress to exercise its oversight power.

2. A Separate Federal Consumer Credit Agency Offers Other Strong Advantages

A wide range of experts across the political spectrum, from the Treasury Department under former Secretary Paulson to former Federal Reserve governors and the Congressional Oversight Panel, have recommended housing consumer financial protection in its own agency.[44] A separate federal agency dedicated to consumer protection for all consumer credit would offer several distinct advantages. First, it would rescue consumer financial protection from its current orphan state and make consumers the Agency's top priority. Second, it would consolidate industry-wide enforcement in the Agency, meaning that all financial services providers would be subject to the same level of enforcement.

This latter point is necessary to thwart shopping for the easiest regulator. Under the current regime, consumer compliance examinations and enforcement are divided among federal banking regulators and sometimes other agencies, even though the Federal Reserve Board writes the rules for most federal consumer credit laws. Other federal consumer financial protection laws – such as Section 5 of the Federal Trade Commission Act and the Community Reinvestment Act – are individually implemented by the four federal banking regulators with respect to their regulated entities. Each agency can make its own choice about the extent to which it enforces or does not enforce the law. Ending this fragmentation of enforcement would discourage lenders from switching charters in search of the easiest regulator.

Finally, transferring consumer credit laws to one agency whose sole mission is consumer protection would provide regulators with a complete overview of the entire consumer credit market, its structure, and emerging issues. Right now, consumer financial protection suffers from a silo mentality because it is parceled out among so many agencies. Consolidating it in one agency would overcome this silo mentality. In addition, consolidation would concentrate expertise for consumer financial products in one agency. The provisions of the Act authorizing a research division and periodic reporting requirements are essential to developing and deploying this expertise.

3. How to Avoid Future Agency Inaction

Consolidating oversight in one federal agency poses a final concern about agency capture and inaction. The FTC, for example, had a vigorous enforcement record on mortgage abuses during the Clinton Administration but a lackluster record during the George W. Bush Administration, at least until 2008. During that same period, OCC and OTS preemption raised industry capture concerns. These problems are not unique to those agencies, moreover. Administrations and

43 See, e.g., §§ 1016, 1022, 1031 of the Act.

44 THE DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 170-74 (March 2008) (proposing a Conduct of Business Regulatory Agency), available at www.treasury.gov; CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM 30-37 (Jan. 2009), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf. Just last week, former Federal Reserve governors Laurence H. Meyer and Frederic S. Mishkin testified before this Subcommittee advocating transferring the Federal Reserve's consumer protection functions to the new Agency.

agency chairs come and go, which means that over its lifetime, every agency will have periods of drift and inaction. Not every agency head can be a Ben Bernanke or a Sheila Bair.

The drafters of the Act thought long and hard about this issue and carefully designed the bill to counteract possible agency inaction. The Act takes a two-pronged approach. First, it makes federal consumer financial protection standards a floor, not a ceiling. Second, it vests back-up enforcement authority in fellow federal regulators and in the states.

i. A Minimum Federal Floor

To address the concern that at some point in the future, the Agency, with respect to its rule-making authority, might drag its feet on needed reforms, the Act specifies that federal consumer financial protection standards will operate as a floor. As such, the federal standards will preempt state laws that are weaker. However, states would remain free to enact stricter consumer protections so long as those protections are consistent with the federal statute. The Agency would retain the power to determine whether a state law was consistence. § 1041.

A minimum federal floor, rather than a ceiling, is critical for three reasons. First, that approach provides an important safeguard against the possibility that the Agency might adopt unduly weak rules or fail to update the rules. Second, states are closer to local conditions and often more responsive to emerging problems at home. A federal floor would preserve the states' ability to protect their citizens. Finally, giving latitude to the states to adopt stricter standards would preserve the states' important role as laboratories of experimentation. Enabling individual states to test other approaches would help prevent federal rules from becoming ossified. This dual federal-state approach, in fact, may have resulted in lower default rates on mortgages at state banks and thrifts (Figure 1).

Bankers have voiced fears that a patchwork of state laws will make compliance too costly and complex. Those fears are vastly overstated. In fact, in the past, when Congress has enacted federal consumer legislation as a floor, only a handful of states have passed stronger statutes of their own.[45] Bankers have managed to adjust to those few variations. In all other states, the federal standard prevails standing alone.

[45] For example, in the Depository Institutions Deregulation and Monetary Control Act of 1980, Congress allowed states to opt out of federal deregulation of usury caps on first-lien residential mortgages. Fourteen states originally opted out, although some of those later repealed their usury caps. Similarly, only six states exercised their right to opt out of federal preemption under the Alternative Mortgage Transaction Parity Act. Elizabeth Renuart and Kathleen E. Keest, *The Cost of Credit: Regulation, Preemption, and Industry Abuses* §§ 3.9.4.1, 3.10.1, 3.10.2 (Boston: National Consumer Law Center, 3d ed. 2005 and annual supplement).

ii. Back-up Enforcement Power

In financial services regulation, we have experienced starkly different models of enforcement, depending on the regulatory scheme. For national banks and federal savings associations, especially after 2004, the OCC and OTS invoked their visitorial powers to argue that they had sole enforcement power for any consumer protection abuses by their regulated entities. Then those agencies resisted vigorous enforcement action against abusive mortgages, while continuing to assert that no other agency had authority to act in their stead.

In contrast, when the Securities and Exchange Commission succumbed to lax enforcement in the late 1990s and 2000s, state attorneys general retained the power to prosecute securities fraud on their own. That power resulted in landmark actions by the attorneys general of New York, Massachusetts, and Connecticut, among other states, and lit a fire under the S.E.C. to initiate actions of its own. Similarly, in insurance regulation, the decentralization of enforcement among the fifty states meant that when there were serious market conduct problems, some states were likely to take enforcement even if others were not. The Act incorporates these lessons by giving back-up enforcement authority to other federal regulators and the states to provide a strong antidote to any inaction by the Agency.

Vis-à-vis other federal regulators, to avoid traffic jams, the Act gives primary enforcement to the Agency. Other federal regulators, however, can recommend enforcement to the Agency. Furthermore, if the Agency fails to initiate enforcement within 120 days of a recommendation, then the federal regulator that made the recommendation may take enforcement action of its own.[46]

Vis-à-vis the states, the Act gives state attorneys general the power to enforce the Act upon notice to the Agency. The Agency can intervene as of right if it chooses.

In sum, the Act would put an end to the regulatory arbitrage that fueled the credit crisis and give consumers a needed voice. I would welcome any questions.

46 Nothing in the Act affects the enforcement authority of the Department of Justice, the S.E.C., or the Commodity Futures Trading Commission.