FEDERAL REGULATOR PERSPECTIVES ON FINANCIAL REGULATORY REFORM PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 23, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–77

U.S. GOVERNMENT PRINTING OFFICE

54–868 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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FEDERAL REGULATOR PERSPECTIVES ON FINANCIAL REGULATORY REFORM PROPOSALS

Wednesday, September 23, 2009

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

The committee met, pursuant to notice, at 2:21 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Moore of Kansas, McCarthy of New York, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Klein, Perlmutter, Foster, Minnick, Adler, Kosmas, Himes, Peters, Maffei; Bachus, Castle, Royce, Manzullo, Biggert, Capito, Hensarling, Garrett, Neugebauer, Price, McHenry, Marchant, McCarthy of California, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. At the request of the Minority, we will have opening statements. And the gentleman from Delaware is recognized for 2½ minutes.

Mr. CASTLE. Thank you very much, Mr. Chairman. I will probably be briefer than that.

I would like to thank the regulators who are here. Mr. Geithner this morning referenced the fact that while he recognizes there is some disagreement, he believes that it is protecting your territory, if you will. And I guess to some degree that is part of it. But I opine that I think it goes a little beyond that. I think we are very interested in what you have to say.

I don't think there is any disagreement amongst any of us here that we do need to tighten the regulation of our financial services in this country. But how we do it and the creation of a new authority to look at products or whatever is a matter that is very important. Perhaps it needs to be done, but at least it is very important in terms of what we are doing. So I look forward to your testimony. I look forward to your reform recommendations, and I hope that we can continue to work together to make a difference.

There was also yesterday a memorandum I think circulated among the Democratic Members about the CFPA bill, and we are very interested in that, in exactly where that is going. That is the bill in general. I am not sure what is in the memo per se. But that is something else we have to pay attention to.

But we appreciate you being here and look forward to your testimony, and hopefully together we can do whatever is in the best interest of the country.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia is recognized for 2½ minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. Thank you for this hearing.

I want to start by thanking you, Ms. Bair, for your quick response and coming to the phone and talking with us about the particular situation in my home State of Georgia, where, as you know, unfortunately we almost got a double tragedy, of course, with the flooding that is going on there now, but, of course, with our flood of bank foreclosures. And I appreciate your comments on that and doing everything we can to stem the tide of losing banks. That is an unfortunate thing that my State, unfortunately, leads the Nation in this regard.

I guess my major concern that I want to certainly put before this panel today, and I will get to some of it in my questions, simply that the fact that there needs to be a heightened awareness and interest and emphasis placed upon what we are doing and must do to reclaim the confidence of the American people in our economic system. We have, I think, played a much heavier hand and placed a greater interest on dealing with our banks, Wall Street, who are apparently getting well now, under the belief that as we move forward with unfreezing the credit markets and making sure that we help bail out Wall Street, we have forgotten to place the necessary emphasis on doing something to help Main Street, to help people. So now here we are with unemployment hovering at 10 and 11 percent, and in some communities they are at Depression levels.

I think there ought to be something for us to discuss today on what we are going to do as we move forward to make sure we are getting jobs created in this country, because that, in all reasoning, is the key to getting our economy back moving. It is jobs. Unemployment continues to go up. And as we spoke, Ms. Bair—and unfortunately home foreclosure rates are continuing to go up.

So the fundamental question becomes to me is there seems to be a freezing of the arteries within the banking system. We need to get to the fundamental reason why banks are not lending, why are they not lending, especially to small businesses which create the jobs?

And with that I will yield back the balance of my time.

The CHAIRMAN. The gentleman from New Jersey is recognized for 2½ minutes.

Mr. GARRETT. I thank the chairman, and I will just be brief.

Just a couple of points. One is to follow up on the point that Mr. Castle was raising a moment ago. We find ourselves on this side of the table in somewhat of a quandary as to where we should go for the expertise in the reform that we are looking to do for this country. And I preface that by saying that contrary to what some people would like to say, some people have said earlier this morning, that there are some out there who see no need whatsoever for reform in this marketplace, there is no one, there is no one on either side of the aisle who believes that no reform is necessary. Ev-

eryone agrees that mistakes were made in the past, and we need to sit down and hopefully in a bipartisan manner try to fix the situation. But doing so, those of us somewhat laymen in these topical areas look to those who sit on that side of the table for the expertise in order to bring us this.

Earlier, as Mr. Castle said and as I said during the earlier hearing, as I am sure was pointed out to you, the Treasury Secretary makes the point that when we hear from the regulators, that they have their own particular areas of—their own particular areas of interests and concerns, their own turf battles that they are working on. The question that I couldn't put back to him was that if that is the case, then why in the world would the Administration be suggesting that we should actually expand that authority and expand that power to those very same bureaucrats, if you will, or regulators, if all they are interested in is looking at their narrow area of responsibility? I wasn't able to give that question to the Secretary, but I will allow you to touch upon that if that is an area.

And the other question, I guess, I would like to hear from you is we now have several different proposals. We have the Administration's proposal coming out. And I understand the chairman has said with regard to CFP, trying to narrow that in. And I think the chairman has gone at least in the right direction of that as to who they would apply to.

Mr. Hensarling from Texas was trying to hear from the Secretary whether we really are going to narrow that into, as to which financial institutions should be covered and what have you. I would be curious from the panel as well as to where the panel comes in on those issues as well, whether the chairman is going closer in the direction to where we were originally, that this should really be looking at banking institutions and the areas where the problems were in the first place and not in the rest of the financial market; or is the Administration correct and just say this is much broader than that, and we should be applying a program of reform to an area that really the problems didn't originate from and start trying to impose bank regulations on an area where we know that those bank regulations didn't work in the past. I appreciate your testimony.

The CHAIRMAN. I will recognize myself now for 4 minutes. That will use up our time, and then the gentleman from Texas will use up time from the other side in total.

I will be dealing with some of the consumer issues. And let me say to my friends, the regulators, I welcome a chance to have a serious conversation with you about consumer affairs. I must tell you that I don't remember too many of those in the past. It does appear to be of minute interest in consumer affairs from some of you, consumer protections.

But I want to talk about the continuing problem we have dealt with before. The gentleman from Georgia alluded to it. I appreciate the fact that those of you who are regulators here have been urging the people who work for you, the examiners, to encourage responsible lending. But I am afraid from all the information I get that we are not there yet.

Now, I understand that there is the problem of a culture in which you work. I think it is probably the case that no examiner

in history has been in serious trouble for a loan that didn't get made. There have been examiners who have found themselves in difficulty because they were accused of allowing loans to be made that shouldn't have been made. I have sympathy for the people who do these jobs, and they are sometimes caught in the shifting winds. But I just emphasize again—and I appreciate that, Chairman Bair, you attended a meeting in Nevada recently, very much appreciated by Congresswoman Berkeley and the others from Nevada. And we have this constant—many of us across the aisle, we are told by the community bankers that they find the examiners difficult in terms of the lending. And you say, and I believe you completely, that you were trying to ease that.

I just would emphasize that it takes constant work. We are trying to change culture and change incentives. We need to keep doing this, because the sense that the regulators on the ground, your representatives on the ground, are not in sync with what you are saying in Washington continues. I am sure it is not entirely fair, but when you go into our line of work, you waive your right to not deal with things that are unfair. And perception is part of reality. So this is really very, very important for us, for you to do.

Secondly, obviously the Chair has a serious responsibility with regard to the fund, and I do believe that there have been unduly alarmist views about the insurance fund. And I welcome the chance, Chairman Bair, for you to address that and reassure people.

We have been at this for a very long time. The deposit insurance has been one of the great successes in regulation and economic activity, and we will continue that. I will say—and this is a choice for you to make—I understand that there is a need for increased funding. It does seem to me that it would be procyclical in the wrong way to raise the assessment now. There have been people who say if you don't raise the assessments on the banks, you are subsidizing the banks. No, let us be very clear. No one is talking about anything other than a loan to the fund.

Now, where the money comes from will still be discussed. But it seems to me the case is overwhelming for there to be loans to the fund to be paid back by the banks in their assessments, but in the future; that is, to make it countercyclical rather than procyclical. This is not the time to raise the assessments on the banks. We will have money lent, I hope, to the fund, which will be paid back out of assessments. And if we are successful with our regulation, and things work well, and the economy works well, we may well get another period where—I don't know how long it was we didn't have any bank failures, 10 years or more. If we get back into such a period, as we all hope we do, the assessments, the loans can then be paid back under existing assessments without any increase.

So I do want to refute the notion that by forgoing an assessment increase today and instead borrowing the money, we are somehow letting the banks off the hook. We are simply saying that, yes, we understand that the banks will have to pay for this, but it will be far better from everybody's standpoint to defer that repayment until the better time that we hope is coming.

My time has expired.

The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I yield to the ranking member.

Mr. BACHUS. I just wanted to acknowledge that there are two funds at the FDIC, and one is the contingent loss fund of $30 billion that you do never hear about. And I don't—obviously there are challenges, but I appreciate the chairman mentioning that.

Mr. NEUGEBAUER. I thank the ranking member, and I thank the chairman for holding this hearing today. Obviously, there is a lot of discussion out there about regulatory reform. And I think everyone agrees there were some flaws in the current system, and we need to look at ways to make the system better.

I think while we have—different ideas have been put forward on how best to accomplish that, and quite honestly, as we had Treasury Secretary Geithner in here, he has a different perspective particularly when it comes to consumer protection. In fact, to be blunt, he wants to fire our witnesses from the consumer protection. And I don't know how you feel about being fired, but that is his proposal.

And so the question I had for him today, and Chairman Frank indicated earlier that you have a lackluster performance in the consumer protection area, and the question is, if you think that you need to continue to hold that role, why do you think that you should do that? And evidently your testimony previously has been that you think that bifurcating that is not a good process. I tend to agree with that. But I think one of the questions that you all are going to have to answer is what—why should you get to keep that if, in fact, you missed the boat in this previous round?

One of the things that we are moving down a road that I think many of us are concerned about is that we seem to be moving to consumer protection, but many of us think that we are taking away consumer choices. I think we have to be very careful with that, because the consumers are—quite honestly, when given the right information, are very smart, and I think disclosure helps them make the choices in their best interests. I don't think they particularly want the Federal Government to do that.

I think one of the things that—the analogy that I would use here is that we seem to be moving in a direction where little Johnnie gets hurt on the playground, and so we go and remove the playground so that Johnnie doesn't get hurt again. The truth is Johnnie likes the playground. Consumers like the choices they have. They like a lot of the financial products that they have, and they are very concerned that the Federal Government is about to take the playground away, and I don't think that they support that. I don't support that.

But what we do need to do is make sure that we have a regulatory structure that protects the investments of the people who are involved in those transactions, but also provides a robust financial market for consumers to be able to have good choices for their products.

The CHAIRMAN. The time for opening statements has been consumed. And we will now begin with the Chair of the Federal Deposit Insurance Corporation, Chairwoman Bair.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to return this afternoon to continue testifying on reforming the Nation's financial regulatory system.

Differences in the regulation of capital, leverage, and consumer protection and the almost complete lack of regulation of over-the-counter derivatives created an environment in which regulatory arbitrage became rampant. Reforms are urgently needed to close those gaps. At the same time, we must recognize that much of the risk in the system involved firms that are already subject to extensive financial regulation.

One of the lessons of the past few years is that regulation alone is not enough to control imprudent risk taking with our dynamic and complex financial system. So at the top of the must-do list is a need to stop future bailouts and reinstill market discipline. The government needs a way to say no. We need a statutory mechanism to resolve large financial institutions in an orderly fashion that is similar to what we have for depository institutions. While this process can be painful for shareholders and creditors, it is necessary, and it works.

Unfortunately, measures taken during the year, while necessary to stabilize credit markets, have only reinforced the doctrine that some financial firms are simply "too-big-to-fail." In fact, the markets are more concentrated than before.

We also need disincentives for excessive growth in risk-taking. We need a better way of supervising systemically important institutions and a framework that proactively identifies risks before they threaten the financial system. We have called for a strong oversight council with rulemaking authority. It would closely monitor the system for problems such as excessive leverage, inadequate capital and overreliance on short-term funding, and have a clear statutory mandate to act to prevent systemwide risks.

Finally, the FDIC strongly supports creation of a Consumer Financial Protection Agency as a stand-alone Federal regulator. As embodied in H.R. 3126, the agency would eliminate regulatory gaps between bank and nonbank financial products and services by setting robust national standards for consumer protection. However, it is essential to focus examination and enforcement on the nonbank sector to protect consumers from some of the most abusive products and practices. We believe this bill would be even stronger if amended to include a well-defined mechanism that provides oversight of nonbanks in partnership with State regulators.

To be sure, there is much to be done if we are to prevent another financial crisis, but at a minimum we need to scrap the "too-big-to-fail" doctrine, set up a strong oversight council to prevent systemic risk, and create a strong consumer watchdog that offers real protection from abusive financial products and services.

Thank you.

[The prepared statement of Chairman Bair can be found on page 49 of the appendix.]

The CHAIRMAN. Comptroller Dugan.

STATEMENT OF THE HONORABLE JOHN C. DUGAN, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate this opportunity to continue where we left off last time in discussing the Treasury Department's proposal for regulatory reform.

As I testified in July, the OCC supports many elements of the proposal, including the establishment of a council of financial regulators to identify and monitor systemic risk and enhanced authority to resolve systemically significant financial firms.

We also believe it would be appropriate to extend consolidated supervision to all systemically significant financial firms. The Federal Reserve already plays this role for the largest bank holding companies, but during the financial crisis, the absence of a comparable supervisor for large securities and insurance firms proved to be an enormous problem. The proposal would fill this gap by extending the Federal Reserve's holding company regulation to such firms which we believe would be appropriate.

However, one aspect of the proposal goes much too far, which is to grant broad new authority to the Federal Reserve to override the primary banking supervisor on standards, examination, and enforcement applicable to the bank. Such override power would alter our present working relationship with the Federal Reserve that works very well and fundamentally undermine the authority and accountability of the banking supervisor.

We also support the imposition of more stringent capital and liquidity standards on systemically significant financial firms. This would help address their heightened risk to the system and mitigate the competitive advantage they could realize from being designated as systemically significant.

Similarly, the OCC supports the proposals calling for more forward-looking loan loss provisioning, which is an issue that I have spent a great deal of time on as co-Chairman of the Financial Stability Board's Working Group on Provisioning. Unfortunately, our current system unacceptably discourages banks from building reserves during good times when they can most afford it, and requires them to take larger provisions for loan losses during downturns when it weakens vulnerable banks and inhibits needed lending.

And we support the proposal to effectively merge the OTS into the OCC.

Finally, we support enhanced consumer financial protection standards and believe that a dedicated consumer protection agency, the CFPA, could help achieve that goal. However, we have significant concerns with the parts of the proposed CFPA that would consolidate all financial consumer protection rulewriting, examination, and enforcement in one agency, which would completely divorce these functions from safety and soundness regulation.

It makes sense to consolidate all consumer protection rulewriting in a single agency with the rules applying to all financial providers of a product, both bank and nonbank, but we believe the rules must be uniform, and that banking supervisors must have mean-

ingful input into formulating them, and unfortunately, the proposed CFPA falls short on two counts.

First, the rules would not be uniform because the proposal would expressly authorize States to adopt different rules for all financial firms, including national banks, by repealing the Federal preemption that has always allowed national banks to operate under uniform Federal standards. This repeal of the uniform Federal standards option is a radical change that will make it far more difficult and costly for national banks to provide financial services to consumers in different States having different rules, and these costs will ultimately be borne by the consumer. The change will also undermine the national banking charter and the dual banking system that has served us well for nearly 150 years.

Second, the rules do not afford meaningful input from banking supervisors, even on real safety and soundness issues, because in the event of any dispute, the proposed CFPA would always win. The new agency needs to have a strong mechanism for ensuring meaningful bank supervisor input into the CFPA rulemaking.

Finally, the banking agencies should continue to be responsible for examination and enforcement, not the CFPA. I believe there are real benefits to an integrated approach to consumer compliance and safety and soundness exams, a process that I think has worked well over time. Moreover, moving bank examination and enforcement functions to the CFPA would only distract it from its most important and most daunting implementation challenge, which is establishing an effective enforcement regime for the shadow banking system of the tens of thousands of nonbank providers that are currently unregulated or lightly regulated, like nonbank mortgage brokers and originators. We believe the CFPA's resources should be focused on this fundamental regulatory gap rather than on already regulated depository institutions.

Thank you.

[The prepared statement of Comptroller Dugan can be found on page 98 of the appendix.]

The CHAIRMAN. Mr. Bowman.

STATEMENT OF JOHN E. BOWMAN, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. BOWMAN. Good afternoon, Chairman Frank, Ranking Member Bachus, and members of the committee. Thank you for the opportunity to testify today.

When I testified here 2 months ago, my remarks concentrated on addressing real problems underlying the financial crisis. In my written testimony today, I debunk the myth of regulatory arbitrage by the industry.

In my brief remarks here this afternoon, I would also like to emphasize that we will not solve the potential problems of tomorrow by merging regulatory agencies. There are five reasons why consolidation would neither solve those problems, nor promote efficiency, especially if the thrift charter is preserved.

First, as you know, the OTS conducts consolidated supervision of thrifts and their holding companies. Although I do not believe the OTS is the proper regulator for systemically important conglomerates, I think it makes perfect sense for the agency to continue to

supervise thrift holding companies, particularly for the many local consumer and community lenders across America who should not be asked to bear the cost and the inefficiency of a separate holding company regulatory scheme.

Although larger thrifts tend to get the headlines, the overwhelming majority of thrifts are small, conservative lenders that offer home mortgages, car loans, and other day-to-day financial services to people in towns and cities, suburban and rural, across the country. Quite a few are community-based mutual institutions—much like the Bailey Building and Loan in the movie, "It's a Wonderful Life"—that had been integral parts of their communities for decades. They did not contribute to the financial crisis, and they should not have to pay for it.

The health of the financial services industry is improving, but it is by no means robust. The transition cost of thrifts converting to a different supervisor and a separate holding company regulator would be an unnecessary burden at a difficult time.

My second point also relates to the fact there is no efficiency to be gained by merging regulatory agencies that do not fit together. Currently, thrifts report their financial status to the OTS through quarterly thrift financial reports, while banks file call reports under consolidation proposals. Either thrifts would need to spend money to overhaul their financial reporting systems, or the consolidated agency would need to operate and maintain two different reporting systems. Either approach would undercut efficiency.

The third point is that trillion-dollar megabanks have almost nothing in common with small community thrifts. If these different types of businesses were supervised by a single regulator, the needs of the community-oriented majority could be too often overlooked by a bureaucracy forced to focus on the institutions that pose the greatest risks to the financial system.

A fourth point is that multiple viewpoints among regulators foster better decisionmaking. OTS's leadership of banning unfair credit card practices is just one example. Remember that countries with a single monolithic bank regulator fared no better than the United States during this financial crisis we are currently undergoing.

My fifth and final point dovetails with the first two. Consolidating agencies would take years, cost the industry millions of dollars, and generate upheaval in the day-to-day supervision of the financial institutions. All of this would be done to achieve a forced fit of fundamentally different agencies that regulate the fundamentally different charters and institutions; in effect, trying to pound a square peg into a round hole with no efficiencies or other benefits for taxpayers, consumers or the industry.

To reiterate my remarks to this committee 2 months ago, the proposed consolidation could not address the problems that caused the financial crisis or could cause the next one.

Thank you again, Mr. Chairman. I am happy to respond to your questions.

[The prepared statement of Mr. Bowman can be found on page 65 of the appendix.]

The CHAIRMAN. Next—and I am very proud that we have maintained the rule here of including our State colleagues in banking, insurance and in regulation and securities. There are people who

consider you State regulators a nuisance, but we think you are an important part of the system. So we have Mr. Joseph Smith, who is the North Carolina Commissioner of Banks, and he is here on behalf of the Conference of State Bank Supervisors.

STATEMENT OF JOSEPH A. SMITH, JR., NORTH CAROLINA COMMISSIONER OF BANKS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. SMITH. Chief nuisance, right. Good afternoon, Chairman Frank, Ranking Member Bachus, and distinguished members of the committee. I appreciate the opportunity to continue our discussion of financial services regulatory reform.

First and foremost, the decisions that you make will determine the industry's structure and its impact on communities, small businesses, and consumers across the country. My colleagues and I are very concerned that we could end up with a highly concentrated and consolidated industry that holds too much sway over the Federal Government and is unmoved by the needs of consumers and communities.

The States have made the industry—that is, the financial services industry—more diverse and accountable. You see this in the fact that the States have chartered over two-thirds of the Nation's 8,000 banks, and you see this in the fact that the States serve as incubators and models for consumer protection.

We hope that we can agree that the outcome of reform cannot be less diversity and less accountability, and yet we are hearing proposals that will undermine both diversity and accountability, proposals that will drive us towards greater centralization and consolidation. In our view, a consolidated banking system and industry would be in conflict with the health of our State and local economies and would further erode public confidence.

I would like to make a few brief points on some specific issues and proposals. First, it is important to preserve the role of State law and the role of the States to set and enforce tougher consumer protection standards. Nationally chartered banks must not be able to hide behind preemptive regulatory declarations, declarations that are directly contrary to long-standing congressional intent. We oppose any effort to undermine the provisions in H.R. 3126, preserving the ability of the States to set and enforce tougher consumer protection standards.

Second, creating a single monolithic regulator as a means of improving financial regulation relies on the faulty assumption that regulator consolidation leads to a safer and stronger banking system. Such a structure would diminish regulatory accountability and discipline. It would lead to further industry consolidation and facilitate regulatory capture by the Nation's largest financial institutions. A single Federal regulator, a regulator that both charters and examines national banks and examines State-chartered institutions, would irreparably harm the dual banking system and the diversity that is the hallmark of that system.

Finally, regulatory reform must directly address and end "too-big-to-fail." This means regulatory safeguards to prevent growth driven by excessive risk-taking and leverage, a clear path for resolving large interconnected institutions, and no discretionary safe-

ty net. Only in this manner will we be able to preserve the financial system's stability and protect taxpayers from potential unlimited liability from failed firms.

As always, sir, it is an honor to appear before you. Thank you very much. I look forward to answering your questions.

[The prepared statement of Mr. Smith can be found on page 132 of the appendix.]

The CHAIRMAN. Thank you.

I will begin the questioning. And I know that there are questions that some of the regulators have about their authority and whether it is turf or not. So, Mr. Bowman, you spoke out against the abolition of the OCC and the OTS and their becoming one national entity. You thought that was a mistake.

Mr. Dugan, what do you think about the proposal to replace the current OCC and OTS with one national bank supervisor?

Mr. DUGAN. Mr. Chairman, as I put it in my written remarks from last time—

The CHAIRMAN. I apologize for not reading them, Mr. Dugan. I do not always do my homework. Pull the microphone a little closer, please.

Mr. DUGAN. Sorry.

I support the proposal in that kind of consolidation.

The CHAIRMAN. Mr. Bowman, you don't agree with the argument that this is consolidation, it doesn't make sense? I am wondering whether—let me say there does seem to be some analogy here with the consumer protection. That is, people seem to be in favor of other people losing their jurisdiction much more than they are of their own. That is not surprising.

But to Mr. Bowman, the arguments against the consumer agency are the same as against a consolidation, which most people think is more the OTS moving into the OCC. You do not. I am not surprised. I just want to say I do think institutional position does have some impact on people's views on this.

Let me ask you further on the question of the importance of leaving the consumer function with the safety and soundness regulator. Now, I have agreed with that to some extent; not the consumer function, that is why one of the differences that I have with the Administration had to do with the Community Reinvestment Act. That does seem to me to be very much, when we talk about volumes of loans, etc., safety and soundness. But I am a little troubled by the implication that a good enforcement of the credit card law or rules about truth in lending or others, that those somehow would implicate safety and soundness. Is that the argument, that we are afraid that if people enforce consumer protection laws too vigorously, this will call into question safety and soundness?

Mr. Dugan?

Mr. DUGAN. No. That is not exactly what I meant. What I meant was as we do our supervision for safety and soundness, we often find consumer protection issues and vice versa. And I attached a bunch of real-world examples.

The CHAIRMAN. That is fine.

Will there be anything preventing you from telling the agency—it did seem to me the way this is presented—and I will tell you this gets into the discussion—that there is somehow something risky

about separating consumer protection for safety and soundness, because obviously safety and soundness is of prime importance. So you are not suggesting that this is going to be riskier. When you say you don't want safety and soundness separated from consumer protection, you are not suggesting that this would in any way undercut safety and soundness?

Mr. DUGAN. There are some places it could undermine safety and soundness in the Administration's proposal because—

The CHAIRMAN. Which parts?

Mr. DUGAN. To the extent that there is a dispute about whether there is a safety and soundness issue, the way it is currently drafted, the CFPA would always win.

The CHAIRMAN. Okay. So our proposal, which is going to have a way in which that is decided between the agencies—and I want to deal with this. But you do believe that safety and soundness—I guess the implicit point there is that too vigorous a protection of consumer rights might somehow implicate safety and soundness; otherwise you would have a dispute. And your problem is it is one-sided.

Our proposal will—and by the way, people have described us as moving away. I haven't moved away from anything. I didn't have anything to start with. I never liked "plain vanilla." As I have said, I remember the days when the bars had to serve food if they were going to serve liquor, and they served some of the most God-awful food known to human beings. And I think trying to force someone to do good is a very, very qualitatively different and, I think, often futile effort rather than preventing them from doing bad. I have never been much of a compulsory do-gooder. But if we were to have a mechanism which allowed for a fair resolution and even maybe weighted more towards the bank regulators of a dispute, would there still be a safety and soundness issue?

Mr. DUGAN. I think that would help, but that is not the only issue.

The CHAIRMAN. I understand that. And I understand that—Chairwoman Bair, again, do you see—is it a safety and soundness issue if we separate out consumer protection from you?

Ms. BAIR. I think it is an examination quality issue.

The CHAIRMAN. Okay. But is it a safety and soundness issue?

Ms. BAIR. Well, I think there could be conflicts.

The CHAIRMAN. But if we resolve the conflicts. It might be if there was a conflict between the two?

Ms. BAIR. As an insurer for all banks, you do need to have some emphasis on safety and soundness, too. The government is ultimately at risk for the viability of the institutions.

The CHAIRMAN. I understand that, but I do think it is important for the safety and soundness regulators to be able to say, wait a minute, you have gone too far. Although do you think in general that vigorous consumer law enforcement undercuts safety and soundness?

Ms. BAIR. No. Just the opposite. I think a good quality consumer compliance examination function complements and supports safety and soundness.

The CHAIRMAN. My time has expired. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I want to go back to some of the comments I made in my opening statement. Chairman Bair, we will start with you. What was the FDIC doing in relationship to consumer protection, say, over the last 5 or 10 years? In other words—because quite honestly, as I said, some folks don't think you all were doing anything.

Ms. BAIR. The first thing I would like to say is we don't have the authority to write consumer rules. We have never had that. That has always been vested in the Federal Reserve Board. Two years ago, I came to this committee and asked for the ability to do that. Mr. Dugan did the same thing.

I will be happy to give you our comment letters to the Federal Reserve Board on subprime lending, on yield spread premiums, on credit cards, and on overdraft protection. We have vigorously pressed for a number of years for stronger consumer protections in key areas. My examiners are only as good as the rules they have to enforce. So that is that.

Number two, in enforcing the rules we do have, we have done a reasonable job. Could we do better? Yes. That has been one of the things that I have tried to do as Chairman of the FDIC. We have increased the number of our compliance examiners, we have increased and streamlined our General Counsel section that brings these enforcement cases, and overall, we do have a pretty good record. I am happy to give you the numbers concerning our enforcement cases if you would like.

We care about consumer protection. We care about protecting bank customers. No, we don't want to lose that. And if you want to call that turf, that is fine, but that is who we are.

Mr. NEUGEBAUER. Thank you.

So your response, let me be clear, is that in response to the consumer protection, you weren't doing anything, what you are saying is in that area, for example, FDIC, you do not feel like you had any jurisdictional authority to address consumer issues?

Ms. BAIR. We feel we did not have strong enough rules against abuses like overdraft protection and credit card and subprime lending. Our subprime lending cases were brought as safety and soundness cases because those weren't prudent loans either. But we didn't have rules in place to tackle it from a consumer protection standpoint.

Mr. NEUGEBAUER. Mr. Dugan, is that your position as well?

Mr. DUGAN. It is similar. We also did not have any rulewriting authority in this area. But we did have considerable examination and enforcement responsibilities with respect to the rules that were on the books, and we think we did a decent job with that.

I would make one other very fundamental point, though. A number of the problems that caused the crisis, while consumer protection contributed to it, a big chunk of that was pure and simple underwriting problems. A big chunk of that was outside of the banking system. And we did not have any authority over that in terms of examining and supervising it, and even the rules that were adopted didn't apply to them. And so you had this uneven world where you had two different systems applying to the regulated and the unregulated, and that was a fundamental problem.

Mr. NEUGEBAUER. Thank you, Mr. Dugan.

Mr. Bowman?

Mr. BOWMAN. Yes. Two examples. First, we do have some rulewriting authority in terms of consumer complaints, and we took the lead in coming up with an unfair and deceptive acts and practices rule that related to credit card practices and other activities. Second, we have additional authority as it relates to deceptive advertising and issues like that, which we have used to enforce consumer rules and regulations against those institutions we regulate and their holding companies.

Fair lending referrals to the Department of Justice have been fairly constant throughout. In the last couple of years, formal enforcement actions brought against our institutions are up somewhat dramatically as a result of increased consumer complaints that we are receiving.

But I would share Comptroller Dugan's concern about the number of consumer complaints and abuses that existed outside of the regulated depository institution area where we don't have the authority to regulate or oversee. One of the advantages, in my opinion, of something like the Consumer Financial Products Agency, would be a uniform set of regulations that would be applicable to all providers of consumer products and services.

Mr. NEUGEBAUER. My time is limited. So what I hear you all saying is, if you had the rules, if you had a uniform set of rules, that individually your agencies are capable of enforcing that and making that a part of your standard regulatory process. But what you are saying, in defense of what others have said about taking that just totally away from you, is that you haven't really been given the opportunity to execute that with the proper rulemaking authority. Is that what I am hearing you say?

Ms. BAIR. I think the examination and enforcement apparatus with regard to banks is already in place. Give us stronger rules, and you can immediately leverage those resources. I would absolutely echo what Comptroller Dugan said, especially that many consumer abuses in mortgages occurred outside regulated depository institutions. If we have strong rules, we have the examination forces and capabilities to enforce them. With the existing rules, we have had 639 total formal and informal consumer actions since 2006. We also have had another 91 referrals to the Department of Justice for fair lending. We have a good record of enforcing the rules that we have in place now.

The CHAIRMAN. The gentleman's time has expired. I am going to recognize the gentlewoman from New York, and I will ask her to just give me 30 seconds of her time.

If I could just say that I am a great admirer of Chairman Bair and of Mr. Dugan. In fact, I actively urged your continuation in your reappointment. But I have to be honest with you, in all the conversations we have had, I do not remember either of you ever coming to me and saying, here is this consumer problem. You have come to me, as you should, with problems in the regulatory area, in the financing area, etc., but I do not recall either of you ever coming to me and saying that you didn't have strong enough rules. I do not recall either of you ever coming to me and saying, here is a defect in consumer protection, as you often did in your general area.

Ms. BAIR. Mr. Chairman, I will provide my previous testimony. We have absolutely testified about the need for additional consumer protection authority.

The CHAIRMAN. I will apologize if that is the case, because my recollection is that you have been much more energetic with us on those other areas and not on consumer protection. But—

Mr. DUGAN. I would be happy to respond to that as well.

The CHAIRMAN. The gentlewoman from New York.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. I appreciate the hearings from this morning and this afternoon, and I appreciate the testimony that we have been hearing.

This is a learning curve for a lot of people. Hopefully, a lot of people are watching this on TV so they can actually hear what went down over the past year. And to be very honest with you, it is a learning session for many Members. We sit here on the committee, but there are many Members who are sitting outside that really have no idea what we are talking about. These are difficult subjects. And if you are not in the financial world, it is extremely difficult for the average person to even pick this up.

Now, I guess the questions that I want to go to, again, go to the Consumer Financial Protection Agency and what the rules and regulations are going to be. There are many who feel we definitely need something like this, and I am one of them. But we also want to make sure as we do this, we are not going to strangle those corporations that we are trying to help, so they are healthy. It is a fine line when you start to think about it.

But I guess one of the things that I would like to have an answer—and I apologize if it was in the full context of your words—but how would a conflict between the agency and a regulatory be solved? And who is going to be on the top of that to make those decisions when you bring all these together?

Ms. BAIR. I think subprime is an example. Early on, when subprime expanded, it was viewed positively. Lenders that were making these loans were getting some plaudits in the media and elsewhere because they were broadening homeownership. As we saw later, these loans didn't perform, and they weren't serving anyone's interest because long-term, they weren't affordable.

There can be differences in perspective on this, and you need synergies between the two. You need both perspectives to be able to evaluate a practice. This is one example of where a tool originally introduced in the nonbank sector spilled into banks. This tool, a type of mortgage product that was originally touted by those offering it as a way to expand homeownership, really ended up hurting a lot of people. But early on, nobody caught it on the safety and soundness side or the consumer protection side. This type of thing can happen in benign environments if a product appears to look good. With a low teaser rate, you can buy a house for a couple of years and figure it out later. Or you can have have a very low downpayment. Ultimately, we saw that did not work.

In more benign times, you can get into a situation where a product that looks on the surface like it is going to be proconsumer is actually not. If you look deeper in terms of underwriting quality, it is not in the consumer's long-term interest and certainly not in the lender's long-term interest.

Mr. DUGAN. I would just echo those remarks. If you only have one set of views, I think you can have problems in emphasizing that aspect of it if you don't have them both blended together and balanced, one against the other, when you have an issue like that. Nontraditional mortgages, the payment option mortgages, were something we identified very early on as having both safety and soundness problems and underwriting problems. We began to try to take action in the national banking system, as my fellow banking regulators did. We couldn't get at the place that was really cranking them out because we didn't have rules that applied in that area. So I think you would need a mixture of the two, and the notion that you can completely separate them gives us pause.

Mrs. MCCARTHY OF NEW YORK. One of the other things I just want to bring up, and, Chairman Bair, we had talked about this. If you watch TV, and it doesn't matter whether it is early in the morning or late at night or the middle of the day, we are still seeing a tremendous amount, in my opinion, of predatory lenders on TV. I know it is not particularly in this committee that we can deal with it, but this is a perfect example where I see the two entities of different parts of the government aren't working together.

We are here talking about—talking about giving consumers protection, and it is blasted all over the TV, it is on every telephone pole in my area: We will get you insurance, we will get you your loan for your house, no downpayment. How far have we actually come on protecting our consumers?

Ms. BAIR. Congresswoman, that is right. Banks are not doing this. If they were banks, we could stop it. We have both rules now. The Fed finally moved forward with rules under the Home Owner's Equity Protection Act and we have an enforcement mechanism for banks. The nonbank sector is lightly regulated or virtually unregulated in many, if not most, of these areas, and it is a daunting task to try to identify those people, get them registered, get them licensed, and have some type of examination and enforcement mechanism. That is really where the void is, and that is where the focus of this new agency should be. That, in and of itself, is a daunting task.

So we think the best leverage in examination and enforcement resources is for this new agency to write rules for everybody, but on the enforcement side focus on nonbank financial service providers that, you are absolutely right, are still out there.

Mrs. MCCARTHY OF NEW YORK. I thank you all for your testimony.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman Bair, you have opined in the past at some time or another that the creation of the CFPA may not solve the fundamental causes of the mortgage crisis, and that concerns me. You had a lot of entities that weren't even banking entities issuing mortgages. Obviously earnings statements by the people obtaining the mortgages weren't always obtained. There are a lot of fundamental problems with that, and my concern is that if we are to create this particular new agency, and it doesn't have the authority to deal with those problems or the mechanical ability to deal with those problems, that would be an issue.

But I am also concerned what happens if we don't create the agencies in terms of how do we catch these problems that apparently we didn't catch before. I would be interested in your comments on that.

Ms. BAIR. You need the CFPA because you need strong rules across-the-board for banks and nonbanks. There has been a lot of arbitrage between the more heavily regulated banking sector and the nonbanking sector. Unless you have a new agency that not only writes rules for both banks and nonbanks, but also has some viable examination and enforcement mechanism for the nonbank sector, you are not going to address the problem. We can keep regulating banks and deploy more examiners. But if somebody else can offer a loan that is completely outside that framework, you are not going to solve the problem. Banks will lose more market share or this will put competitive pressure on them to lower their standards, which is exactly what happened with subprime mortgages.

There really needs to be a laserlike focus on the nonbank sector. You don't fix that problem unless you make sure you have both rules and enforcement mechanisms that apply across-the-board.

Mr. CASTLE. In short, it is the nonbank sector that is the disturbing part of it as far as you are concerned?

Ms. BAIR. Yes. You have to deal with that, or you are not going to solve the problem.

Mr. CASTLE. Thank you.

Mr. Dugan, how important is uniformity in setting the standards for national banks? And what do you see as some of the problems raised by the Administration's proposal to establish a Consumer Financial Protection Agency which at the same time allows the 50 States to set their own standards for national banks operating within their borders? It seems to me you are getting into a double structure there, and I would be interested in your comments on that.

Mr. DUGAN. You put your finger on a very important point. As we were just talking about, there has been a rulewriting gap in not having uniform standards. The notion of having a new agency that could set some uniform rules at the national level is a very powerful and good thing.

But in the same breath, I think you undermine this principle by then inviting the States to add additional rules on each of these areas. And in a world in which the delivery of financial products and services, particularly national banks that operate across State borders, it is a technology that doesn't respect boundaries. If you have ATM cards or credit cards or debit cards or instant credit checks, you have a world in which you touch many States, and the efficient delivery of it requires a single set of rules.

That is what has allowed a lot of these products to flourish, and I think the danger you would have is twofold by having many different standards apply. First, you would have a lot more cost in figuring out how to comply with 50 different rules on how to disclose things, an account opening, interest rates, or rules on compensation.

Second, you create tremendous legal uncertainty and exposure in different areas by having different rules and not knowing which States' rules would apply. And the problem is that those costs will

get passed on to consumers either in the form of higher prices or less availability of the products and services.

Mr. SMITH. Excuse me, Representative Castle, may I respond to that as well?

Mr. CASTLE. Let me ask another question, Commissioner. You can respond to that one and the one I am going to ask next, if you will. This is to Mr. Dugan as well.

Do you think that the creation of CFPA will result in less competition and higher costs, which you just indicated it would, but would force the multi-State banks to operate in, say, one bank, just California and New York or whatever—one State, excuse me, California, New York or whatever it may be. Are you going to see more of that if this were to—

Mr. DUGAN. I don't know if that would happen, but I think you can have circumstances where rather than incur the compliance costs of a bunch of different rules, they would take a particular large State, and, if it had a different rule, try to conform their systems to that one State, even if it is different from the rules adopted at the national level pursuant to notice and comment pursuant to all the deliberative process that the new CFPA would have. It would undermine that thought. I think you could have a real issue there.

Mr. CASTLE. Commissioner Smith, you have a little more time.

The CHAIRMAN. Well, I would ask unanimous consent to—he is a State bank supervisor representative, and it is a very relevant question. I would ask unanimous consent that he get an additional minute to respond to the question.

Mr. SMITH. I will try.

First of all, sir, if I might say so, we have just had a financial meltdown under subprime. The States were all over subprime for years. No one has ever said, to my knowledge, that the State regulation caused the subprime crisis. In fact, if anything, the State regulation was on top of the subprime crisis before anybody else.

It is astonishing to me to hear the regulators of enterprises that have lost billions of dollars somehow related to subprime say they weren't involved then. This is an astonishing proposition.

It seems to me in cases where there are appropriate Federal standards or where Federal standards are enforced, the States have other things to do right now than fry these fish. We will work with the Federal Government. We have worked with the Federal Government on the SAFE Act. We thank you for adopting that. Forty-nine States have adopted similar legislation to license mortgage originators so that we can get our arms around this issue, and we have been doing this stuff for years. So I think it is really quite unfair to say that allowing States to have higher standards to protect consumers somehow damages the financial system.

The CHAIRMAN. Well, it is an appropriate segue to the gentleman from North Carolina, who has been a leading activist here in the subprime crisis, and I am about to recognize him.

I would just say to my friend, no one ever said this was the answer to the subprime crisis. The answer to the subprime crisis was the subprime bill that we passed. That is what we thought was the answer to that. This was never meant to be the answer to that.

The gentleman may have forgotten that we did pass the subprime bill.

The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

There is a division in the existing law between safety and soundness regulation and consumer protection regulation. Chairwoman Bair said that you had testified or that you had commented as part of the public comment period when the Fed adopted rules that applied to institutions for which you all have principal safety and soundness responsibility—and actually, Comptroller Dugan, you did as well—you commented not for stronger rules, but for weaker rules. You opposed in the public comments many parts of the credit card regulation.

Mr. Dugan, I understand that you don't have rulemaking authority. You didn't have rulemaking authority. You do have the authority to bring enforcement actions. The great, great bulk of credit card business was with national banks. It is now like the top 3 banks have 75 percent of the business. It was a little bit less sometime back, but it has always been dominated by national banks. And there were no enforcement actions. Now—yes, sir? Am I missing something?

Mr. DUGAN. Yes. First, you are missing something. We brought a number of enforcement actions against credit card banks, particularly the subprime credit card lenders, where we brought so many enforcement actions against them that they stopped doing business as national banks.

Second, we enforced the rules that applied to credit card companies. The rules that you are talking about, the suggestions and the practices that caused Congress to pass a statute that applies to them, we will enforce those, too. But we can't make up rules. In fact, we are prohibited from adopting anything that looks like a rule if it is given to another agency by statute.

Mr. MILLER OF NORTH CAROLINA. Well, the statute now is that you can enforce the Federal Trade Commission's unfair and deceptive trade practices—acts and practices rule, and you can do that by enforcement action.

Mr. DUGAN. But we can't write a rule under that. Only the Federal Reserve can. We have requested that authority.

Mr. MILLER OF NORTH CAROLINA. You can bring enforcement actions with respect to specific practices as a violation of the—

Mr. DUGAN. We do. And we have brought 11 of them in the last 9 years against significant companies, and we have issued guidances related to it, but we can't define them as a matter—

The CHAIRMAN. Just to clarify, that was 11 in 9 years?

Mr. DUGAN. Those kind of specific enforcement actions.

Mr. MILLER OF NORTH CAROLINA. That is more than I thought you had brought. But did you bring any enforcement actions with respect to charging the double-cycle billing, for charging interest on a balance that had already been paid off?

Mr. DUGAN. Double-cycle billing was expressly permitted by regulation, by the Federal Reserve. There is no way we could have brought an action against them as an unfair and deceptive practice that the regulation permitted.

Mr. MILLER OF NORTH CAROLINA. Okay. Raising the interest rates on an existing balance. That was expressly allowed?

Mr. DUGAN. If it is adequately disclosed to consumers that can happen to their balances when they do something, it is not an unfair and deceptive practice to raise it. It is now unlawful to do that because Congress acted.

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. DUGAN. But that rule was not in place.

Mr. MILLER OF NORTH CAROLINA. Okay. You have said on several occasions that there were a great many practices that you simply stopped banks from doing by dissuading them from doing it as part of your supervision.

Mr. DUGAN. Right.

Mr. MILLER OF NORTH CAROLINA. Given what has gone on in the economy in this decade, can you give us some idea of the kinds of things you have talked them out of doing? Given what happened and what was allowed, what did you talk them out of? Was it human trafficking? Conflict minerals? What did you talk them out of?

Mr. DUGAN. Okay. I will give you a couple of examples, and then I will also say that a bunch of the practices, the very worst subprime mortgage lending, was not occurring inside national banks or State banks for that matter. It was in unregulated State entities where the States were in charge of them. And the numbers show that.

In terms of the things that we have leaned on people, payday lending was something where the payday lenders tried to get ahold of national banking franchises to run payday lending operations in them, and we stopped it. We stopped them from so-called renting the national bank charter to do that. I mentioned subprime lending and credit cards, where we saw a number of abuses that caused real problems. Both on the consumer protection side and the safety and soundness side, we came down very hard on it, and we essentially ended that practice for the monoline stand-alone subprime lenders in the credit card business. I can provide you other examples and specific cases and would be happy to do that for the record.

Mr. MILLER OF NORTH CAROLINA. My time is nearly up.

The CHAIRMAN. I will take the last 20 seconds to say, I would note, Mr. Dugan, you mentioned the failure to do the subprime regulation in the nonbanks. The authority to do that was lodged in one those safety and soundness regulators whose autonomy you are protecting, the Federal Reserve. Your proposal would keep that in the Federal Reserve, your position. Because the Federal Reserve has made your consumer protections, and you have said leave them with the safety and soundness regulator. The fact is, as Mr. Miller also pointed out, you said, well, we couldn't do that; the Federal Reserve gave them the permission to do it. So the consequence of what you are saying, don't give any enforcement powers to this, the Federal Reserve refused to use the enforcement powers, and you are for the status quo with the Federal Reserve.

Mr. DUGAN. That is not what I am saying. What I was saying was—

The CHAIRMAN. Excuse me, Mr. Dugan, it is when you say that we should not create a consumer agency—

Mr. DUGAN. I didn't say that.

The CHAIRMAN. —and give it enforcement powers. You did say that. You said we shouldn't give the consumer agency the enforcement and examination powers. They should be left with the safety and soundness regulator. That includes the Federal Reserve, whose inaction you have frequently cited.

Mr. DUGAN. I am sorry if I created a misunderstanding. What I was trying to say was we should give the new CFPA rule-writing power—

The CHAIRMAN. And not examination and enforcement.

Mr. DUGAN. —and examination enforcement with respect to nonbanks.

The CHAIRMAN. Right. But not with respect to banks, which is where the credit card issue came in. You cited an example of the credit card situation where you were in fact debarred from taking action, when Mr. Miller asked you, because the Federal Reserve, a safety and soundness bank regulator, explicitly allowed the banks to do it. And according to your position, that status quo would continue.

Mr. DUGAN. No, because I think the new CFPA would write the rules, would have that issue—

The CHAIRMAN. But there were rules that were written that the Fed wouldn't use. Do you think the Federal Reserve has done a good job in consumer protection?

Mr. DUGAN. No, what I am saying is that 75 percent of those credit card companies are regulated by national banks, 25 percent—

The CHAIRMAN. And the regulations allow them to do all those things.

The hearing will now recess. We will return after the votes.

[recess]

Mr. KANJORSKI. [presiding] The committee will be in order.

Mr. Scott of Georgia is recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

Let me ask, it is a great pleasure to have the three of you here, who are our primary regulators in our system. But I would like to take the gist of my questions on the state of the economy now. Because in the final analysis, a major reason why we are putting these financial reforms in place is to, quite honestly, save our economy and our financial system.

But if I am the American people out watching us and trying to glean something from what is a very complex, complicated issue, our report card for the American people would get an "F" right now.

And I want to ask you, Ms. Bair, Comptroller Dugan, Mr. Bowman, and also you, Mr. Smith, why are we at the state that we are after spending $700 billion in TARP money, $700 billion in bailout money, $700 billion in economic recovery? We are looking at almost $2 trillion that we directly put out within the last 7 or 8 months, and yet, as you and I have discussed, Ms. Bair, and I would like for you to lead off, because the indicators are not very good for us. Home foreclosures are still ratcheting through the roof. Bank clos-

ings are at a record rate, especially in my home State of Georgia. Unemployment is at 10 percent, and in some areas at Depression levels. Banks that we are supervising and you are regulators of are not lending, particularly to small businesses, therefore bringing out bankruptcies there.

So to me, the American people are probably saying, what good does it do for us to be sitting up dealing with these regulatory reforms when, in fact, where is the report on what we have been doing? Why is it that we can't see the jobless numbers go down? Why is it that banks are not moving to mitigate loans? Why is it that banks are not restructuring? And at the same time that this is happening, many of them are going back to their same old ways of bonuses and salaries.

The American people have a right to be very angry. So could you please respond to why we are in the state we are in? And what are we doing to get these banks to unleash this money and make loans and mitigate loans so that people can—we can really stimulate the economy and keep people in their homes? I think if we do that, that is the way in which we are going to stop all of these bank foreclosures and small businesses going into bankruptcy.

And Ms. Bair, I would particularly like for you, because we moved to give the FDIC the authority and funding to move within the foreclosure area particularly to deal with this area, could you really tell us how we are progressing there, and why we are not doing more?

Ms. BAIR. Well, a couple of things. Regarding loan modifications, that is something certainly we advocated. And some of the work we did with the IndyMac loan modification program was used by Treasury and HUD to launch their own HAMP program. This is not something we are doing, though we support it and have tried to provide technical assistance.

They estimate they can get about 500,000 loans modified in the near future. It is making a dent, but it was never meant to be the complete cure. It is not, but it can help a significant number of folks stay in their homes.

To get banks to lend, we have taken a number of steps. We are asking our examiners to do a lot. There was some bad lending going on. There was some lending based on rising collateral values that shouldn't have happened. So, because there was too much credit out there, there needed to be some type of pull back. But the challenge is to make sure it doesn't pull back so far that the creditworthy loans, the prudent loans, are not being made.

We have tried to strike this balance with our examiners. We want our banks to lend. We want prudent lending. But, we don't want them to overreact. There are a lot of cross-currents. There are a lot of people saying that regulation wasn't tough enough; we need to be tougher. And there are other people saying, you are being too tough. It is a hard balance to strike.

We have tried to provide clarity in a number of key areas. We have said very specifically that we want commercial loans restructured also. We want small business loans restructured, too. Loss mitigation is a good business practice, whether it is for residential mortgages or commercial mortgages. That needs to be disclosed and done properly. We want the appropriate loans restructured.

We don't want good loans written down just because the collateral value has fallen. We don't want that to happen. We have made that very clear.

Mr. SCOTT. I know my time is running out. It is about to run out, too. But I did want to get to, why are so many banks closing, especially in the State of Georgia? What is there? Is there something we can point to that is going on in Georgia to explain why so many of these banks are closing?

Ms. BAIR. There are a lot of banks in Georgia. It was a boom area. Now, many of the boom areas are bust areas. There is residential mortgage distress and a lot of commercial real estate distress as well. In Georgia, like other parts of the country, it is broader economic problems that are feeding losses on bank balance sheets, which is driving closures as well.

One of the best things you can do for the banking system, especially community banks, is to get the economy going again quickly, keep the unemployment rate down, get those retailers back in business, and get those hotels full again. Those are the kinds of things that will help banks as well. In Georgia, bank closures were a symptom of a lot of banks existing in the State, plus it was a great boom area. And as in other areas, like Florida, southern California, and Nevada, Georgia is having a severe bust now.

Mr. SCOTT. I would just like to ask unanimous consent just for 30 more seconds. Is that possible?

Mr. KANJORSKI. The price is you are going to assume the Chair right after your next question.

Mr. SCOTT. Okay. I will be willing to pay that price. Thank you.

Mr. Dugan, I wanted to go to one specific thing. You and I have discussed this, I believe, in my office. And I wanted to know, have we made any progress? Because I think there is so much more our banks can do that they are not doing in terms of lending. But there is a practice that is going on within the banking system that I think that we do need to address. I spoke to you about that, and I wanted to know if we have moved on that. And that is this, that we have been receiving some complaints from some of our constituency that when they have multiple services at these banks where one will have their savings account, their checking account, and then they will go borrow maybe a home equity loan, and then—or another loan, but without any acquiescence to the customer, the bank has the right, apparently, which I think is wrong, to without any—with total disregard to the customer, to go into one of the other accounts, get money out of that account to pay for something in the other account. It puts that customer and that consumer at a very disadvantage without having a notification, without knowing. He may think he has so much money there, but the bank has already gone in and got it to pay something else, maybe the home equity loan. And I was wondering, I know you were concerned about that, and I wanted to find out if you moved on that and what we need to do to stop that.

Mr. DUGAN. I am not sure that we have seen that as a rampant problem in the system. There are some rights related to set off when you have some issues, but I don't believe that banks can routinely use one account to pay the debts of another bank. But I will

get back to you on that, on where we are on that, if I could, for the record.

Let me just also say that earlier this week, I did spend some time with Georgia community national bankers in Atlanta, and would just echo all of the comments that my colleague just said about the situation in Georgia and some of the issues that they have.

Mr. SCOTT. All right. I just want to say, we need your help in Georgia. And we want to stop this trend of banks foreclosing and a lot of the other things that are going. So I appreciate your attention on these two matters. Thank you.

Mr. BACHUS. Mr. Chairman, one thing, I hope you will allow some of the people on the other side some liberal time, by which I mean I am not protesting the additional time, but I would allow that courtesy to be extended on—

Mr. KANJORSKI. If it is Mrs. Biggert, we are going to allow her 18 minutes.

Mr. BACHUS. Thank you.

Mr. KANJORSKI. The gentlelady from Illinois, Mrs. Biggert, is recognized.

Mrs. BIGGERT. Thank you, Mr. Chairman.

I am not one of many words. That is why you said that.

Chairman Bair, I have had some of my community bankers come in to see me, and they have some real concerns, particularly with where they have been required to reserve 3 percent of all of their fully performing construction loans and land development loans. And so that has significantly impaired their CPA capital ratio so that they have been rated barely adequately capitalized. And then, in turn, they were told, well, now you can't get any TARP money or to withdraw their application because of the just barely adequately capitalized. And they are concerned that if they had gotten TARP funds, they would be well capitalized and not in danger of becoming undercapitalized.

And the other issue that they worry about is there might be these special assessments that they would have from the FDIC. What should I tell them to do?

Ms. BAIR. We understand the additional stress that another special assessment would create. So we are actively considering other options. The FDIC Board will be meeting next week and will be voting on some options for public comment. We very much understand the stress that another special assessment could place on smaller institutions. We are looking at this issue very carefully and evaluating other options as well.

On the TARP, obviously the TARP is not an FDIC program. There is an interagency process where the primary regulator will make an initial set of recommendations to an interagency group, and then make recommendations to the Treasury Department. The standard remains viability without the funding. This is a difficult determination to make. If that test is not passed—if there is a question about that—then it is a very difficult judgment to make. We have suggested a matching program so that banks can show a strength in their ability to raise nongovernment money on at least a dollar-for-dollar basis. That might be another way to build some flexibilities into the program.

I can't respond to the 3 percent reserving requirement. I am unaware that we have a carte blanche rule like that. I can check that and get back to you. The general rule is, if it is a performing loan and if the borrower has the documented capacity to continue making the loan—has the income, the balance sheet to support continued payments—then generally it should not be classified. I can talk with our staff, and if there is a specific instance you would like to bring to our attention, I can have our supervisory staff address that.

Mrs. BIGGERT. Have you explored the idea of a shared equity loss program and where the FDIC would match private equity and increase capital? In other words, instead of having them go under and then bring in somebody with the 90 percent, would that be a way of—

Ms. BAIR. Well, we have a statutory prohibition against providing open bank assistance unless there is a systemic risk determination, which is hard to do with the smaller institutions. We have made a systemic risk determination with the Treasury and the Federal Reserve Board to undertake a troubled asset relief program—the PPIF or legacy loan program. We just did a test sale of a legacy loan mechanism with our receivership assets. And we are now looking at how we might use that for open institutions.

I think it is a matter of evaluating what the criteria should be for institutions that are viable and have franchise value or would be viable with this additional help and can raise private capital. I think there is a good case to use such a mechanism if they can meet that criteria. However, we do have strong statutory restrictions against providing open bank assistance. And we do not have authority to make a direct capital investment in an open bank.

Mrs. BIGGERT. Then just a quick question for several people, but beyond the authority to write and enforce Unfair and Deceptive Practices Act rules and enforce mortgages and credit card rules, did any of you actually write consumer protection rules? And who wrote them? And who currently writes them, the consumer protection rules and regulations?

Ms. BAIR. As both Comptroller Dugan and I have said, the OCC and the FDIC do not have authority to write UDAP rules. We don't. We have asked. We really have. We can provide our testimony and show you we have asked for that authority.

Mrs. BIGGERT. Did you have any say? I guess the answer is the Fed, but—

Ms. BAIR. The Federal Reserve Board had that rulemaking authority. We filed comment letters with the Federal Reserve Board encouraging them to promulgate rules. We have never had the authority to do that ourselves, to write rules.

Mrs. BIGGERT. All right. Thank you. I yield back.

Mr. SCOTT. [presiding] The gentleman from Texas, Mr. Hensarling, is recognized.

Mr. HENSARLING. Thank you, Mr. Chairman.

Last month, The Wall Street Journal had a rather disturbing article, which I assume you are familiar with. I will quote from it: "Treasury Secretary Timothy Geithner blasted top U.S. financial regulators in an expletive-laced critique last Friday, as frustration grows over the Obama administration's faltering plan to overhaul

U.S. financial regulation, according to people familiar with the meeting.

"Mr. Geithner told the regulators Friday that 'enough is enough,' said one person familiar with the meeting. Mr. Geithner said regulators had been given a chance to air their concerns, but that it was time to stop, this person said. Friday's roughly hour-long meeting was described as unusual not only because of Mr. Geithner's repeated use of obscenities but because of the aggressive posture he took with officials from Federal agencies generally considered independent of the White House."

The article asserts that at least three of the four of you were in attendance at that meeting. Assuming that to be true for our first three panelists, is The Wall Street Journal story accurate?

I will start with you, Chairman Bair.

Ms. BAIR. Congressman, I don't like to comment, I am sorry, on private meetings. I will tell you, though, that any input we provided to Congress has been independent. I used to work for Congress. I understand being an independent agency. When you ask for my views, I am going to give them to you. And I also am giving you my views based upon what I think are the best mechanisms to put in place from a regulatory reform standpoint and a consumer protection standpoint.

Mr. HENSARLING. Thank you.

Comptroller Dugan?

Mr. DUGAN. I would agree with that. I would say there was a candid exchange of views, and it hasn't in any way affected my job and my duty as Comptroller to call these issues as I see them and be fully independent, as Congress has expressly provided with respect to my agency and the other agencies up here.

Mr. HENSARLING. Mr. Bowman?

Mr. BOWMAN. I would agree with both of those statements. And I really think that our opinions of our respective independence from the White House and/or the Treasury, can be found in our respective testimonies both here and in the Senate. And I think that really does speak for our position on where we go and how independent we are.

Mr. HENSARLING. I thank you.

Clearly, I didn't hear it was inaccurate, but I respect that you wish to keep it confidential. I understand that.

But I do think it is important that this committee hear your commitment to independence. Your opinion, and I have disagreed with your opinions on many occasions, and I assume that on future occasions, I will disagree again. But it is a terribly important opinion. It is a terribly relevant opinion. And this committee needs to know it is an independent opinion.

And I am not quite sure how one proves a negative, but with articles like this, you can understand a number of us on the committee remain concerned.

Perhaps this will be a bit simpler question to answer. The CFPA, as presently constituted in the Administration's White Paper and in Chairman Frank's bill—and I know we have this memo floating around ostensibly from Chairman Frank to members of his committee. I haven't heard the chairman either verify or deny the accu-

racy of that memo. So, theoretically, the bill may change. But again, I don't know the accuracy of this memo.

My question is this: The CFPA as presently constituted, in your professional opinion, could it or would it lead to less credit and more costly credit for families and small businesses in our economy?

Again, I suppose going left to right to make it easy, Chairman Bair? Apparently, it wasn't that easy of a question.

Ms. BAIR. With so many of these issues, it depends on who is the head of the agency and how it is structured, and I think that the structure is in flux: Chairman Frank's observation about placing the focus prohibiting bad practices as opposed to identifying and enforcing good practices may help address that concern.

Mr. HENSARLING. So is it fair to say, potentially yes, but you don't know?

Ms. BAIR. Yes.

Mr. HENSARLING. Comptroller Dugan, do you have an opinion on the matter?

Mr. DUGAN. I think part and parcel of it is this repeal of uniform standards for national banks and for Federal thrifts. And as I testified or mentioned earlier, I do think that could lead to the kind of increased costs that could in turn increase potential litigation exposure, that could in turn result in increased costs to consumers of financial products, but also restricted availability of products and services.

Mr. HENSARLING. So, as presently written, your answer would be yes. Is that a fair assessment?

Mr. DUGAN. Yes, with the preemption piece in it, yes.

Mr. HENSARLING. Mr. Bowman?

Mr. BOWMAN. I agree with both of the responses. It could result in additional costs and a reduction in credit. But we will see what it looks like at the end of the process.

Mr. HENSARLING. Just so you don't get lonely, Commissioner Smith, we will let you answer the question as well.

Mr. SMITH. I will give you the best answer, which is that, when we adopted State legislation to address predatory lending, we were called reverse redliners. It was said we were reducing credit availability at the time we did it. And I wish we had reduced it sooner, because what happened was the result of the loans that were made during the period I am talking about, which was 2005 to 2007, let's say, was that millions of families went out of their homes. So the answer to the question may well be, yes, there would be less credit. The question really is whether that is a bad thing or not.

Mr. SCOTT. The gentleman's time has expired.

I recognize the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

I have a couple of questions. My primary concern in this regulatory reform is the whole issue really of not so much "too-big-to-fail," but "too-interconnected-to-fail." I am not sure that they are not synonymous. And I am not sure how that is being dealt with. But that is another issue for another committee hearing, I think.

It may be important for me to focus on the issue of whether we need a regulator, which is why I think you are here. Do any of you

know who Dennis Blair is? He is the Director of National Intelligence. And the reason that he is there is because, after 9/11, we discovered, to our dismay and to our great pain and embarrassment, that we had agencies not communicating with one another. We had the FBI and the CIA, both having intelligence on the 9/11 terrorists, and they were not sharing. And so, in an attempt to correct a problem, we now have a Director of National Intelligence who is the cop, so we don't have those problems again.

Any time we have a crisis and we can identify a problem, don't all of you agree, do all of you agree that then we need to make some adjustments? Who believes that we should not make an adjustment?

Ms. BAIR. We all support reform very vigorously. Absolutely.

Mr. DUGAN. We agree with that. And even though I would say that, in a crisis, it brings regulators more together to have to share than—

Mr. CLEAVER. Yes, but the question, Mr. Dugan, is what brings them together, the crisis and the declaration that we should come together?

Mr. DUGAN. I would say, first of all, we have to work together on a bunch of things because we have to put out common rules on things. And John Bowman and I are both on the FDIC Board. We vote on things like the assessment that we were talking about earlier. So we inevitably have a lot of interaction with each other, unlike some other regulatory agencies.

And I think the caldron and the crucible of a crisis brings you even more together. But I think it is also true that this crisis has identified issues that need to be addressed through changes in the regulatory framework and structure, which I think we all support.

Mr. CLEAVER. Okay. So how do you think the average U.S. citizen will respond if the chairman of the committee hits the gavel and says, okay, everybody has learned how to function better, we are not going to have any reform in spite of the fact that the world economy almost ran off a cliff? How many of you think that the American citizens are going to say, oh, that is good?

Ms. BAIR. No one, sir.

Mr. DUGAN. No one, sir.

Mr. CLEAVER. So we need to do something, you would agree. Who would independently move? We have 3 banks controlling 75 percent of the credit card debt in this country. There is something wrong with that. Do you agree? More than 75 percent of the credit card debt held by 3 companies?

Mr. DUGAN. It is more than 3, because the banks that we supervise, national banks, have about 75 percent depending upon how you count it, and it is more than 3 banks.

Mr. CLEAVER. So Wells, Bank of America, and J.P. Morgan. Who else?

Mr. DUGAN. Actually, Citi is bigger into credit cards than Wells is. And then U.S. Bank is, and then you have American Express and Discover. It is dominated by a smaller group of providers than other financial services. That is definitely the case. But it is a business of scale. And because it demands such an investment in systems and products, it naturally leads to larger providers.

I think you have to watch that in terms of any time you have a smaller number of people providing the same product, you get into questions over time of whether it raises competition questions. But there are certain products that lend themselves to having more or fewer providers in it.

Mr. CLEAVER. One final question: Was it 9 cases in 11 years or 11 cases in 9 years?

Mr. DUGAN. The latter. Under UDAP. That is right.

Mr. CLEAVER. Is that good or bad?

Mr. DUGAN. I would say two things. Number one, first of all, we are supervisors. We see these institutions every day. And we get a lot of things done before you ever get to the question of a formal enforcement action. We do it through our normal supervision. We do it through matters requiring attention. We do it through informal actions. And that is the advantage of having supervisors in there. They can get corrective action taken right away when they see things before they turn into enforcement kinds of problems, number one.

Number two, as we talked about earlier, some of the practices that people complained about were not illegal. And we couldn't make them illegal because we didn't have the power to write rules with respect to them.

Mr. SCOTT. The gentleman's time has expired.

Now we will recognize the gentleman from Georgia, Mr. Price.

Mr. PRICE. Thank you, Mr. Scott. I appreciate that.

I want to thank you all for your patience. My friend from Missouri says we have to do something. We have to do something. Is it possible do the wrong thing? Is that possible? Everybody agrees.

Mr. DUGAN. Yes.

Mr. PRICE. We can do the wrong thing.

Mr. DUGAN. Right.

Mr. PRICE. So the goal of this committee obviously ought to be to do the right thing, and not just do anything at all or something. And I think we need to remember that as we try to devise a system that is more responsive and works better for people as opposed to the one we currently have and also the one we might be reinforcing with some current rules.

Mr. Dugan and Mr. Bowman, I want to talk a little bit about, please, the new recent guidance that the OCC and the OTS have put forward, the ban on no-interest/no-payment activity promotions that are done oftentimes by retailers. Some retailers say that their no-interest/no-payment for a period of time comprises a significant portion of their business, sometimes up to 20 percent. The repayment on those is in many instances very, very high. It works well. It works well for people, and it works well for the retailers. Why would you do that?

Mr. DUGAN. We have something called our account management guidance that applies to all credit card providers. We were seeing some real problems in our portfolio about people not making consumers even pay a very small amount due. This was masking losses over time that they were continuing to report as income. It was a truly unsafe and unsound practice, and it was also resulting in consumers getting deeper and deeper into debt.

Mr. PRICE. So the information that I have from retailers that they have a payment rate of over 90 percent, or approaching 90 percent on no-interest/no-payment credit for a period of time, is that not accurate?

Mr. DUGAN. Well, I have seen the letter that they provided, and we will respond to the particulars of the letter. And I would be happy to do that. I think the particular point we would make is we are treating them exactly the same way we treat other credit card providers.

Mr. PRICE. That is my concern.

Mr. DUGAN. We are trying to get indications that the customer can repay the loans. We are not saying that they can't do no-interest. But they have to make some regular payments, repayments to demonstrate the capacity and ability to repay to address safety and soundness.

Mr. PRICE. This one-size-fits-all notion tends to result in decreased flexibility and decreased responsiveness to the consumer. And Washington can run the whole show, there is no doubt about it. But it may result in a system that is not as helpful for the American people.

Mr. Bowman?

Mr. BOWMAN. I wouldn't add anything more to what Mr. Dugan has said. The attempt is to ensure, first of all, that the consumer appreciates the obligation to repay. Ninety percent of them do, according to the letter that we received. The goal is to keep the examiners mindful of the particular product, the consumer and the institution mindful of what it is they have and the ability to ensure that repayments are provided for.

Mr. PRICE. So you both are telling me then that it is possible that this ban isn't an absolute ban?

Mr. DUGAN. What I would like to do is respond in detail to each of the items in the letter. And I think that can give some color to it.

Mr. PRICE. Great. I look forward to that.

Chairman Bair, as my friend from Georgia said, we are having awful, awful problems down there. And I am not convinced that the FDIC isn't contributing to the awful problems that we are having. In many instances, the banks that I have talked to that the FDIC has come in and taken over, the consequences of that are real. There are real-life consequences to the people in those communities. Some of these small community banks where they have performing assets, performing loans, they have been asked by the—they have been demanded by the FDIC to increase their capitalization.

And they do so. And still they dot every "i" and they cross every "t," and then the knock comes on the door on Friday afternoon. The consequences to these decisions that the FDIC takes are massive, and they are not necessarily favorable to the community and to the individuals in those communities. We have had this conversation before. And we have been assured of flexibility and responsibleness and reasonableness by the FDIC personnel. I understand it is a tough job. But we are killing communities. We are killing communities with action that, from many individuals' perspectives, doesn't need to be taken.

Ms. BAIR. The process close a bank is made by the chartering authority. So, for a State bank, it is made by the State bank supervisor. For a federally-chartered institution, it is the OTS or the OCC. There is a dialogue, obviously, with the FDIC, in alerting us to the possibility that a bank could fail, in preparing for the closure and monitoring the resolution process. But, the resolution process is governed by a strict statutory regimen of Prompt Corrective Action. This was an outgrowth of the savings and loan crisis where Congress rightfully felt that there had been too much forbearance. And it is true that once an institution becomes nonviable, the longer you wait for it to be closed and resolved, the higher the costs will be, because it will continue to lose money. Such institutions are not doing much healthy lending anymore, and will continue to lose franchise value. We take this very seriously.

I am painfully aware of the concerns and the drama surrounding the closure of an institution. But in these instances, this needed to be done.

We make every effort to market and sell the bank in advance of the resolution. And usually for a community bank, we have been successful in selling it to another community bank, another bank servicing that area which is healthier and is in a better position to provide credit services and deposit services to the community. We can't always do that. In most cases, we have been successful.

Mr. PRICE. The problem with that is oftentimes those individuals who come in know nothing about the community. There are no relationships. And in the process of doing that—and again people who have dotted every "i" and crossed every "t," jumped through all the hoops and thought they were moving in the right direction based upon the FDIC, then they are removed, and folks who come in are from somewhere else, and the local community is without a local lender.

Ms. BAIR. We try to avoid that. We absolutely try to avoid that. If there are specific resolutions which you would like to talk about later, I would be happy to do that. But if an institution has insufficient capital and it cannot raise new capital, there is not much we can do about it.

Mr. PRICE. That is not the case.

I appreciate that, Mr. Chairman.

Mr. SCOTT. Chairman Bair, and just before I get to Mr. Green, as we both pointed out, we both represent Georgia. There is a particular problem with Georgia. And some of us feel very strongly, as the gentleman from Georgia, Mr. Price, has said that there is more that the FDIC can do to help us in Georgia. And there are things that they might not be doing that are helping to cause the problem in Georgia.

There are just too many banks closing in the State of Georgia, and we want to put a stop to that. I would appreciate it, and I am sure the people of Georgia would appreciate it very much if the FDIC could review how they are dealing with the banks in Georgia to work with a plan to see if we can't stop this very terrible pattern. Because it is just not fair nor right. Thank you. Thank you for that. I wanted to get that out.

I now recognize the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you.

Mr. Price, did you get your concern addressed? Because I see that the two of you are very much concerned about this. Would you need an additional 30 seconds? You are good? Okay. Thank you.

Let me thank all of you for appearing today. And I would like to first mention to you that "too-big-to-fail" in my world is the right size to regulate. Not only is it the right size to regulate, but as you approach becoming "too-big-to-fail," I think you are the right size to regulate. I absolutely think that we must find a way to avoid another AIG. I cannot imagine doing nothing and allowing circumstances to manifest themselves again such that we will have another AIG. It would be unconscionable for us to do nothing. And it would be unconscionable for us to, under the guise of doing something, do nothing. It would be unconscionable for us to allow the paralysis of analysis to prevent us from doing anything. We do have to act.

And I think that when Mr. Cleaver, in his defense, talked about doing something, I would hope that it would be presumed that he was talking about doing the right thing, as it has been said. I rarely find him suggesting that we do the wrong thing, in his defense.

So having said this, let me just ask a few questions to see if we can agree on some things that are floating around that are not necessarily entirely true. CRA: Did the CRA cause the economic crisis that we are having to contend with?

Chairwoman—by the way, I would have had Chairwoman, not Chairman, but if you—

Ms. BAIR. Just not "Chair Bair." I don't like that.

Mr. GREEN. Did it cause the crisis?

Ms. BAIR. No, it did not. No.

Mr. GREEN. Comptroller?

Mr. DUGAN. No, it did not.

Mr. GREEN. Acting director?

Mr. BOWMAN. No, it did not.

Mr. GREEN. Commissioner?

Mr. SMITH. Absolutely did not.

Mr. GREEN. Did not. The CRA did not cause the current crisis. And I would hope that would echo through the halls of Congress such that at least we can put that to rest.

Did overregulation of the market create the problem that we are trying to contend with, an overregulated market? In words that may not be suitable, but did a lack—did laissez-faire, the lack of laissez-faire create the problem?

Chairwoman Bair?

Ms. BAIR. No, a lack of laissez-faire did not cause the problem, no.

Mr. DUGAN. I agree.

Mr. BOWMAN. I agree.

Mr. SMITH. I have already testified that I don't think that is the case.

Mr. GREEN. Okay. I just want to build this record, because we continually hear that it was an overregulated market that created the circumstance. We continually hear that it was the CRA that created the circumstance. And at some point, people who are in-

volved, engaged, and who study these things, their opinions ought to count for something.

Notwithstanding your opinions, by the way, my belief is that we have entered an era of time where there is no indisputable truth. We will find some person in some distant corner of the world who differs with you, and we will find a way to give this person credibility such that this person will carry as much weight as all of you who study these things quite regularly. And I consider you experts to some degree.

Moving along, with reference to a Consumer Financial Protection Agency, whether we bifurcate or consolidate, leaving that aside, bifurcation, the question of bifurcation, should we have a consumer protection agency? Because, and I ask this because, quite frankly, there are some who contend that there is no need for a consumer protection agency, that things will work themselves out if we just allow time to pass, as opposed to do something with the passage of time.

Chairwoman Bair, do we need a consumer protection agency?

Ms. BAIR. Yes, I think we do.

Mr. GREEN. Comptroller?

Mr. DUGAN. To go back and touch on your earlier question, there was a rule-writing gap, and there was an implementation gap so that different firms were treated differently with respect to consumer protection. And I think a CFPA is a way to get at that.

Mr. GREEN. I take it from this you would say yes, but I understand that there may be—we all have different opinions about how it should come into being. But are we at a point where we can say we need to do this?

Acting Director, please, sir?

Mr. BOWMAN. The answer is yes.

Mr. GREEN. And Mr. Commissioner?

Mr. SMITH. Yes. But I think, in fairness to myself and my colleagues at the table here, that each of us has reservations about the current proposal.

Mr. GREEN. I understand. That is why I took bifurcation and consolidation off of the board. My time is up, but as I leave you, I just want to say this: We are charged with the responsibility of, in some sense, being the watchdog for the public. We have a duty to act positively, to try to avoid unintended consequences. But if we don't act, our inaction will become our action. And that inaction is going to create another circumstance that we will have to cope with in the future.

Thank you, Mr. Chairman.

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

Mr. Royce.

Mr. ROYCE. Thank you.

Let me ask a quick question. This has to do with something that I remember the Federal Reserve bringing to us in, I think it was about 2004, where they laid out a concern they had with the Government-Sponsored Enterprises. And their worry was that, unless they could regulate for systemic risk and have the ability to reduce the portfolios some, they were worried that with a $1.5 trillion portfolio, and a mandate that we had built up over the years that half of it had to be subprime and Alt-A loans and so forth, that it

was leveraged 100 to 1, and so they were saying, we could have a systemic risk problem if we don't have sufficient regulation to allow us to address this. Do you think that could have been a contributor to the problem in terms of what happened in the GSEs? If I could ask the panel?

Ms. BAIR. Yes, I think the GSEs did contribute to the problem.

Mr. DUGAN. I would agree that was a contributing factor.

Mr. BOWMAN. Agreed.

Mr. SMITH. Agreed.

Mr. ROYCE. And I guess that comes around to one of the problems with the CRA, because under the CRA, there was leverage in order to get to that goal. Those who were pushing the CRA saw a certain advantage in terms of having that subprime portfolio held by Fannie Mae and Freddie Mac.

But in any event, let me go down a line of questions, because with distance comes some perspective on some of these issues. And I wanted to quote from something Ms. Bair said. She said we need to develop a resolution regime that provides for the orderly wind down of large, systemically-important financial firms without imposing large costs to the taxpayers.

In contrast to the current situation, this new regime would not focus on propping up the current firm and its management. Now, if we take Treasury Secretary Geithner's reform proposal, it reads, and it comes from a different direction it seems to me, it says the regime also should provide for the ability to stabilize a failing institution by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm.

And this sounds like you and the Secretary have different ideas on the options that should be available to regulators when it comes to resolving a failed institution. So I would ask if you believe what the Treasury Secretary is suggesting amounts to granting permanent bailout authority, or is there a distinction that I am missing? Because as I read it, it suggests, or he suggests that we grant authority to prop up failed institutions, as we have in recent months, without necessarily moving them through an unwinding process.

And here is why I think it is important. I think if there is any ambiguity as to what would happen should an institution run into trouble, then the market is going to view that institution as government-backed, as was the case with Fannie and Freddie. And if that is the perception by the market, then you are going to have a moral hazard problem. And that is why I feel that is something we should avoid going forward.

And I was going to ask you, Ms. Bair, about my concern about that.

Ms. BAIR. I agree with you. It needs to be quite clear that shareholders and creditors will take losses if these big firms become nonviable and have to be closed. It should be a wind down, not a conservatorship or Government-run enterprise. It needs to be quite clear what will happen. You will not get market discipline back until this is clear. Recent measures have exacerbated the problem. Some people joke now we have more GSEs because of these. We are part of these programs, and we support these programs, but we didn't really have an option. But going forward we should have a

resolution mechanism in place that works for large, interconnected financial institutions that allows them to be closed. It is very important to be able to tell the public: no more AIGs. It just shouldn't happen.

Mr. ROYCE. I appreciate that. Now, my last question I would like to ask the panel about the costs associated with the Consumer Financial Protection Agency if we do not do that under the existing safety and soundness regulators, if we go out and set up a separate agency, a bifurcated agency. Who ultimately will bear the costs of creating and funding this agency? I don't think it is hard to imagine that the costs would be passed on by the institutions in a competitive market that those costs would end up going onto the customers. So you increase operating and compliance costs and you increase the eventual costs to the consumer. So it seems to me more logical that you would handle that within the—under the safety and soundness regulator, because you would also have the sharing of expertise that regulator has. And so I was going to ask that question.

Mr. DUGAN. As you said, we do have a regime already in place. We already examine people, we already have a system for doing it, and we do combine our supervision for consumer protection and safety and soundness. It is more efficient and will be less costly to get the same level of coverage than it would be to have a whole separate agency. Now, in terms of who gets assessed for it, it was not entirely clear how that would work in the Administration's proposal. And there are other proposals to have the Federal Reserve pay for some of it. So I don't know how that is all going to shake out. But in terms of the costs to consumers, I think they would be higher.

Mr. ROYCE. Thank you, very much.

Thank you, Mr. Chairman.

Mr. GREEN. [presiding] Mr. Klein is recognized for 5 minutes.

Mr. KLEIN. Thank you, Mr. Chairman.

And thank you all for your service. Tough responsibilities right now, but we appreciate you taking this on and sticking with it. I would like to just approach this in a before, you know, before all this occurred and what brought us up to this point, and then currently, what are we doing, and then going forward? Just the before, very simply, back home where I am from, and I think around the country, people are upset. They are anxious. They are frustrated. They know a lot of money went out, and they don't see it translating into bank loans to them, or frustrated in dealing with lending capacity. And I think that—I want to spend a minute on that.

The current, of course, relates to, what do we do right now? What can we do to get the economy going? And we all understand it is about liquidity. If we think about the RTC a number of years ago, ultimately we got through that because there was access to capital. And whether a building was worth $1 million and sold for $500,000, there was a market, at some free enterprise point buyer and seller, and they came through that. On a going forward basis, a lot of discussion today, and we do appreciate your recommendations on what is being proposed. Chairman Frank has a number of suggestions which I think are worth considering, but we will have those continuing discussions over the next few weeks.

But what I want to focus on for a few minutes is just an echo of what you have heard all day today. And that is—I am from Florida.

Ms. Bair, you have heard my comments before on this, and I appreciate the opportunity to state it again.

That is the access to capital, the strictness and the rigidity, if you will, the inflexibility of banks dealing with existing loans, and defaults based on covenants.

I had somebody come in my office today, he even said I could use his name, Wayne Cotton from Design Flooring Distributors in Fort Lauderdale. He had a little over $1 million line of credit, steady as you go, for all these years. He is a leader in the community on a lot of levels. He has buildings to back up and everything else. And because his receivables are down and he is in the building business, if you will, he does interior work, the bank said, we are calling the loan. He got a letter. It said, pay up. Here is the date you have to pay up, and that is it. It is one of our major banks, a bank that took TARP money. And he is as frustrated as all get out, as you can only imagine. And to me, the question is this. Why is it that some of these concepts of borrower capacity, the individual borrower, personal guarantee, whatever it may be, the idea of substitute collateral, being able to put other collateral in place so maybe his receivables and that commitment is down, but maybe the loan can stay in place if there is some type of substitute collateral that can be applied? Why not the principle, and it is not tangible, but the principle of "time heals?" Over time, particularly in real estate, some of this will return to some point.

We are not getting the banks to consider many of these principles at all. A little bit of sitting down with common sense across the table and saying, all right, you have a problem here, your collateral base is down a little bit, but maybe if you put near piece of real estate in here that has this amount of equity in it, we can still make this work instead of us calling the loan. And there is no ability to refinance, no ability to find another loan. So can you just share with me those two or three principles why is it that can't be integrated or introduced and the examiners consider that or encourage that kind of behavior with the banks? Start out with Ms. Bair, if you don't mind.

Ms. BAIR. We especially encourage our banks to work with their individual borrowers and provide flexibilities. These are individual credit determinations. I don't know the specific circumstances, obviously, but we do encourage banks to work with their borrowers. This is a very difficult judgment, though, for both banks and examiners to be making because we can't let the banks indefinitely defer loss. If the loan has gone bad, a bank should recognize it now, not later. There are those countervailing pressures, and there are critics on the other side as well. It is a very difficult balance.

But, we have a very clear policy. We have said this numerous times to our examiners and to our banks. We want them to work with their borrowers—their commercial borrowers, as well as their residential borrowers. Even if they have some credit distress, banks should try to restructure the loan or provide some relief, rather than just foreclosing or cutting off the loan. Where that makes sense from a loss mitigation standpoint, it needs to be appro-

priately disclosed and reported. But we absolutely encourage them to work with those borrowers and show flexibility.

Mr. KLEIN. And I cannot tell you enough how that is not in any meaningful sense translating into the local Florida market—where I am from. I can just speak to my local market in south Florida. It is just not happening enough. And I am seeing a little bit of movement, but we have 90 percent of the way to go. And it is just holding back everything in the economy from small businesses. SBA loans, we waived the fees. Ninety percent—if I was in a bank, I would say, wow, that is a good quality loan. Why aren't banks taking up SBA loans?

Ms. BAIR. That I don't know. I have been hearing this. I heard this during my trip to Las Vegas.

I am actually going to be in Florida in a couple of months, and I am going to be meeting with some bankers. I am hearing that small business lending is absolutely key. It is an area where community banks in particular are the lifeblood for small businesses. This has been raised with me. I am concerned about it. I am going to be looking into it more. I can only tell you what we have done now. We have tried to convey to our banks the need for flexibility and our support for prudent lending. If there is more we can do, we want to.

Mr. KLEIN. Mr. Dugan?

Mr. DUGAN. I would agree with everything Chairman Bair said. I just spent some time with a group of Florida bankers in a meeting earlier this week and heard some of the same issues. We do not tell bankers not to make particular loans. A banker makes a judgment, and I am pretty sure it wouldn't shock you to know that sometimes the regulators get blamed for loans not being made when—

Mr. KLEIN. More from the borrower's side—

Mr. DUGAN. We are in a deep recession. Florida is a place where there has been a lot of trouble with commercial real estate. I think there has been a risk-preferring posture that has gone to risk-avoiding, and that is partly due to the economy and to where people are as much as it is due to examination policies.

But I quite agree that if the borrower can show ways that they can repay the loan, then that is something we encourage our people to work with. But I do have to caution you that time does not always make things better; sometimes time makes things worse. And we get, as Chairman Bair said, quite criticized, and our resolution costs go up. Our Inspectors General fault us for not acting swiftly enough. You mentioned the RTC; that was all after-the-fact, postclosure stuff, where all that stuff ran through it. So it is a complicated balance. We strive hard to do it. We hear you. We will keep at it.

Ms. WATERS. [presiding] Mr. Bachus.

Mr. BACHUS. Thank you.

One thing that we have not—I don't think has come up is the effect of the unregulated subprime affiliates of depository institutions, and I know, Comptroller Dugan, you—at one time, the OCC issued a list of how many of the subprime lenders that failed actually were not regulated by either Federal or State regulators. Would you like to comment on that and the effect that has?

Mr. DUGAN. I don't think there is any serious question that the overwhelming proportion of subprime loans that have caused the worst problems, the highest foreclosure rates were in nonbanks; that is, entities that were not regulated by banking regulators. And we have data, and we—

Mr. BACHUS. It was very impressive.

Mr. DUGAN. We will be providing some additional statistics. If you look at the worst foreclosure rates in the worst cities, it was not from the regulated institutions. It is the flip side of people who think that the CRA has caused the problems, which is only done in banks, CRA lending, and the data just does not show it. And it is why we believe having a rulewriter that can write rules that apply the same to banks as well as nonbanks, and why the importance of having new Federal attention being paid to nonbanks to bring their compliance level up to the level of banks is so important. That is the powerful part of the idea behind a CFPA.

Mr. BACHUS. And I am not sure it has to be done through that agency. It could simply be that the existing agencies could take responsibility. But someone ought to be regulating that market. And we have passed registration for mortgage originators. But does anyone else want to comment on that?

Mr. SMITH. I do think the money for those loans had to come from somewhere. Most of the originators weren't banks themselves, they weren't mortgage lenders themselves, they were funded by somebody, so I am interested in those statistics.

I do think the power of the CFPA is exactly what the Comptroller says, which is it will apply to everybody across-the-board in the same way the SAFE Act promises to apply regulation, license your kind of regulation across-the-board as well.

Mr. BACHUS. But if you had underwriting standards, and you said, we are going to regulate underwriting standards, you could—

Mr. SMITH. Whoever was providing the money—someone provided financing to these alleged unregulated subprime originators.

Mr. BACHUS. I understand that, but I think even banks—and one of the problems was not only were they unregulated subprime lenders, but they were also—the depository institutions purchased them. And it was actually Wachovia who did that, Bank of America, Merrill Lynch. You could go on and on.

Mr. SMITH. Somehow the regulated institutions filled with Ph.D.s and so forth were fooled by the people I did deal with, because I do regulate the mortgage market, many of whom hadn't completed high school.

Mr. BACHUS. Right. Also regional banks. We had regional banks that did not do the subprime business because they couldn't originate them, and they didn't buy affiliates who did. And because of that, they were shut out of the mortgage business, and they went into a concentration of real estate. And now they are commercial real estate, and now that is their problem. But it was a problem over here that actually created that problem.

Mr. Bowman, the House Republicans have proposed the most sweeping consolidation of regulators under one regulator with different charters, which is a different approach. I do want to say this, and I want to acknowledge your testimony. I think you do make—your argument has merit that you are really not addressing

the arbitrage when you just go from 54 to 53, although I guess you could make the argument that you—but it certainly is—I think you do make—your argument has merit.

One thing you say here that I think has—I have not heard before, but I think it is something that should be pointed out, the OTS did not regulate the largest banks that failed. The OTS regulated the largest banks that were allowed to fail, and that is one distinction. There were other, much larger institutions that were not allowed to fail. And I do think that there are—your argument at least—I think it deserves consideration.

Mr. BOWMAN. Congressman, thank you.

I would like to add that in terms of the concept of arbitrage in general, we also do not believe that financial institutions, depository institutions and their holding companies go out and select a regulator, be it a State regulator or one of the Federal regulators, based upon what they hope to be a series of less than vigorous enforcement supervision. We just don't think that happens. We think it is an argument that doesn't hold a lot of water at the end of the day.

Mr. BACHUS. All right. And you do get facts and figures—you had people moving from the OTS to the OCC. You had them moving. And they can also move from State to State, which you pointed out.

Mr. BOWMAN. That is exactly right.

Mr. BACHUS. So I do think that you make a good point, and I think it is something that as we move forward, we—and as we try to decide that. The OTS has been to a certain extent, I think, maybe the sacrificial lamb in all that, I think.

Mr. BOWMAN. Thank you.

Mr. BACHUS. And then there are other arguments that you made that I am not sure that most Members, including me, have considered, and that is many of the members were concentrating not only in real estate, which obviously was a major problem, but were also concentrating in California, those institutions that failed. And that was just as Atlanta—the other earlier conversations—Atlanta was a boom area, and your institutions happened to be in those areas that went up very fast and came down very fast.

Ms. WATERS. Thank you very much, Mr. Bachus.

I will recognize myself for 5 minutes. Let me thank our panelists for being here today. Thank you for your patience.

I would like very much to talk about the Consumer Finance Protection Agency, and I would also like to talk about the plight of small banks and regional banks, but I don't have enough time to do so. So I have decided that I am going to spend some time talking about the plight of minority banks, and before I do that, let the record show that my husband is an investor in a minority institution, and also let me disclose for the record that our broker, Merrill Lynch, has been taken over by a systemically important bank, the Bank of America. So I guess I better disclose that also.

Now, having said that, the OTS and the FDIC are required to provide assistance to minority-owned banks under section 308 of FIRREA. The law requires banking regulators to preserve the present number of minority banks; preserve the minority character—or preserve the minority character of these banks in cases involving mergers or acquisitions of minority banks; provide tech-

nical assistance to prevent the insolvency of institutions that are not currently insolvent; promote and encourage the creation of new minority banks; and provide the training, technical assistance and education programs.

The Federal Reserve and the OCC are not statutorily required to assist minority-owned banks, but you do have policies and programs to assist minority-owned banks. This appears to me to be opportunities that may be missed. Given what I have just read, what I have just indicated, I don't understand what you do to assist minority-owned banks in the ways that are described by law. And I would like to ask each of you if you could tell me if this is an area that perhaps you would just like to improve, if you haven't done a lot, or that you have done a lot, and I just don't know about it.

I will start with Ms. Sheila Bair.

Ms. BAIR. We have an annual conference for minority depository institutions. We bring together technical experts and sources of capital investment, regulators speak, and we provide technical assistance. We have a program at Historically Black Colleges to help train bank management and to support careers with minority depository institutions.

In terms of a resolution function, again, the resolution process is governed by Prompt Corrective Action, which is triggered by capital levels at banks, and is a very strict process. There is not a lot of flexibility there.

Ms. WATERS. What do you do to promote and encourage the creation of new minority banks?

Ms. BAIR. We don't charter banks, but as part of the deposit insurance application process, we would weigh heavily in the balance of serving unmet needs in particular communities. We have had a few minority depository institution (MDI) failures and have actively recruited other MDIs to bid. We let them know about these situations. Acting Director Bowman and I personally intervened with Dwelling House in Pittsburgh to try to stabilize the situation and made some calls, and unfortunately we couldn't find an MDI acquirer. But it is something I have a personal interest in and a commitment to. And certainly if there are other ways we should be addressing this, I would be open to suggestions.

Ms. WATERS. I would like to know—while I am talking with you, let me talk a little bit about the opportunities that are being created as you dissolve and take over banks. You have some way by which you are selling off or asking the management of assets of those banks. You have other things that you are doing. Is there anything included in your efforts to include minority-owned banks in any way?

Ms. BAIR. Well, if there is a minority depository institution that will be closed, our resolution staff will get on the phone and actively recruit other minority depository institutions and ask them to review the institution to bid. I think there were two situations where we had an MDI failure and were able to sell it to another MDI.

Ms. WATERS. What about nonminority-owned banks that are being taken over? How do you outreach to banks or organizations that would like to take over failed banks?

Ms. BAIR. Well, I personally have had several meetings with those who have a particular interest in investing in MDIs. As part of our preresolution marketing process, we actively reach out to other MDIs to bid on MDIs that are going to fail.

Somewhat related, we also have a good contractor outreach program. We have a very good record on minority contractors. Through a variety of outreach tools, we do have a strong commitment in this area. And again, if there are other things we can do, I would be open to suggestions.

Ms. WATERS. I think I have heard you talk about this before. This week we have the annual legislative conference of the Black Caucus in town, and we have money managers and minorities and financial services, various financial service organizations, and this is the number one topic because of the bailout, because of the $700-and-what billion that the citizens have made available to save the financially—the systemically important institutions. Minorities are complaining about a lack of involvement and opportunities across-the-board, from the Treasury to the FDIC to—you name it, and I just wish we had something to tell them this weekend.

Ms. BAIR. Congresswoman, we do have a good record. I have gotten a lot of positive feedback on our programs. If there are individuals who are complaining that they don't think there is appropriate access or education, I would like to know that, because I have gotten a lot of good feedback about our programs, and I think we have a very good story to tell on our minority contracts. We are happy to give those numbers to you. Again, if there are other things we can be doing, we are open to suggestions, but I have gotten a lot of positive feedback on our outreach efforts.

Mr. BOWMAN. Congresswoman, if I could also add that we at the OTS in April of this year put together the Minority Depository Institution Advisory Committee, which is made up of 12 members, not all of whom are parts of existing minority depository institutions, but are other members of the community, including those that may or may not be a source of financing going forward. We have now met 4 times. We have discussed many different issues, including the very issues that you are asking about in terms of assistance: how to bring minority investors into the system; and how to bring additional capital that they would bring with them. We have going at the present time probably three different fairly active discussions with three groups of minority investors who are interested in looking at all institutions, not just minority institutions that are on the verge of failure or possible failure, but other institutions as well.

Ms. WATERS. If I may, there is a constant complaint about the inability to raise capital with these small and minority-owned banks. And they say, why can't we go to the Fed, why can't we be considered just as the systemically important banks are being considered for capital, for loans? What do you tell them when you meet with them about access to capital other than going out and finding private investors? Of course they are looking for that, and they are simply not looking for it from minority investors, they are looking for capital, period. What do you tell them, and how do you assist them in accessing capital?

Mr. BOWMAN. I think Chairman Bair referred to an instance at one of our institutions in Pennsylvania where she and others worked very hard to assist the minority institution in locating available capital. Ultimately, for a variety of reasons, it just was not there.

The availability of capital today for all of our institutions, except some of the larger ones, is very, very difficult to come by regardless of who the investor might be or who the interested parties might be. The ability of any institution to raise capital continues to be a problem.

Ms. WATERS. Well, I guess, again, if I may, what the small and minority banks are saying is just as the bailout assisted the big banks, that are "too-big-to-fail," why can't government come up with a program to assist small and minority-owned banks? And they remind us that they are not the ones that had the subprime meltdown, they weren't doing that kind of lending, yet they stand on the sidelines and they watch as the very people who caused the problem are assisted because they are "too-big-to-fail."

What can you think about, what possibly could happen for getting capital for these small and minority-owned banks? What kind of—would you, for example, be an advocate for assisting minority-owned banks with bailout money in different ways than is being done now?

Mr. BOWMAN. Certainly.

Ms. WATERS. Well, why don't you?

Mr. BOWMAN. We can have some of those conversations with the people who have the money, which includes Secretary Geithner and Chairman Bernanke. We can also have conversations with the Congress who can appropriate money.

Ms. WATERS. Well, here is what you can do. You can tell them that there is a law, FIRREA, that you are charged with preserving the present number of minority banks, preserving the minority character of these banks, providing technical assistance to prevent the insolvency, promote and encourage the creation of new minority banks, and provide the training, technical assistance and education; and you can tell them that this is all smoke and mirrors unless you have access to capital, and you think that something different ought to be done. Can we talk about that at some point, how we can assist these banks?

Ms. BAIR. As regulators, we cannot be a source of capital. The FDIC is specifically prohibited by statute from making investments in open banks. So I think the TARP program is probably the most immediately available source if you are looking for government sources for capital. And certainly we can continue to do what we can appropriately. We have something called bank match where private investors who are interested in investing in smaller banks can go to our Web site.

Ms. WATERS. Let me ask you this, Ms. Bair: Is it possible that when you take over a bank and you have these assets to be managed, is it possible that some of these small and minority-owned banks could be a part of managing the assets of the failed banks? You have to contract it out to somebody, right?

Ms. BAIR. Well, we sell the assets. Most of these assets are sold when the bank fails.

Ms. WATERS. You sell them rather than manage them; is that right?

Ms. BAIR. Yes, that is right. So the acquirer will be the manager. We do have some assets that are harder to manage, and I believe we do have minority contractors helping with that. I can get those numbers for you. And we certainly are open to others who have an interest. I have met with a variety of groups who have interest. Mickey Collins, who is going to be talking to your caucus on Friday, has an extensive minority contractor outreach program. We want to make sure they understand the door is open, how the process works, the process of applying, and what opportunities exist.

Ms. WATERS. So you are selling the nonperforming assets or the performing assets of the banks that you take over, and the minorities who have been applying to purchase assets, I suppose there have been some, have been able to access those opportunities at this time?

Ms. BAIR. It is a competitive bidding process, so whomever has the best price wins the bid. But, yes, I can think of at least two situations where a minority depository institution has been the successful bidder.

Ms. WATERS. Thank you.

Are there any other ideas that you would like to share that—about how you can carry out FIRREA for the OTS and the FDIC? Any other ideas that you may have? And for the Federal Reserve and the OCC that are not statutorily required to assist, you are attempting to do something, I am told?

Mr. DUGAN. Absolutely. And two points. We have a very active minority outreach technical assistance program that we take very seriously, and we participate actively in the conference that the FDIC sponsors each summer. We work with our minority institutions in a variety of ways, including, where appropriate, to try to match them up with other investors. For example, in the post-Katrina situation, we worked to match minority institutions up with potential investors at that time. And it is true we are not technically covered by that provision, but we try to act as if we are. We certainly would have no objection to being included in the same language. So I will be happy to provide more details on exactly the types of things that we have been doing, which, as I said, have been quite active.

Mr. BOWMAN. Congresswoman, your question is exactly the kind of questions we are posing to our Minority Depository Institution Advisory Committee, asking them for some additional insight and ideas that might help other minority depository institutions going forward. And we would be happy to share the results of some of those discussions with you if you would like.

Ms. WATERS. Okay. I was just—my staff who works on this just passed me a note about the Temporary Liquidity Program. That is under what, FDIC?

Ms. BAIR. Yes, that is a debt guarantee program and a transaction account guarantee program.

Ms. WATERS. Would you explain to me how you use this program to guarantee debt? As I understand it, the banks sell debt and raise capital. How does the program work?

Ms. BAIR. We are winding it down actually. It is scheduled to expire October 31st. This is an emergency program we put in place early last October after the Lehman situation when the market was seizing up. It allowed most bank holding companies and thrift holding companies, for a temporary time period to issue debt, unsecured debt, that was guaranteed by the FDIC for a fee. We have collected over $9 billion so far from charging our guarantee fee. We have had no losses on the debt program.

Also, as part of that, we added a transaction account guarantee. This was particularly helpful for the smaller banks. This enables participating banks to cover noninterest-bearing transaction accounts with unlimited deposit insurance—insurance without caps. That program will go to June 30th.

Ms. WATERS. Should it be extended?

Ms. BAIR. We have extended it until June 30th of next year. It is Congress' call if it should go beyond that. Congress sets our deposit insurance limits. This is something we did under a very extraordinary systemic risk procedure, which I am advised that we don't have the authority to make permanent. But we have extended it to June 30th of next year, and hopefully we will be stabilized by then.

Ms. WATERS. Is this something we should explore for assistance to the small and minority-owned banks between now and June 30th?

Ms. BAIR. They have until June 30th of next year. It would be an open question whether they would feel there was a need after that. It does cost; obviously we charge a premium for it, because there are losses associated with that particular program. But, again, our deposit insurance limits typically are defined by Congress. We did this in an extraordinary process.

So it really would be Congress' call whether the program should be extended beyond June 30th. A lot of banks are feeling that they will be able to exit it and will not need it after that.

Ms. WATERS. Let me just close by saying I know that you have had a number of seminars around the country. I understand there was one in Irvine, California, and that you have a database of minority-owned banks that invited small banks—that was invited to that conference?

Ms. BAIR. Yes.

Ms. WATERS. We were not aware of it, and some of our small banks were not aware of it.

I would like to—at some point in time, would each of you perhaps meet to talk about how we can perhaps share some information? And I would like to know more about how your programs work under FIRREA in particular, who the people are, how the programs are executed. And perhaps I can visit your institutions and you can have me talk with your people. They can talk with me about how they do this, and how it all works, and perhaps we can see how we can use some of our experiences to advise you about some possibilities for being more effective with FIRREA and other programs that are not necessarily under FIRREA.

With that, thank you very much. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing

record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

With that, this hearing is adjourned. Thank you very much.

[Whereupon, at 5:31 p.m., the hearing was adjourned.]

A P P E N D I X

September 23, 2009

September 23, 2009, afternoon hearing
Statement by the Honorable Kenny Marchant
House Committee on Financial Services
Hearing on "The Administration's Proposals for Financial Regulatory Reform"

Thank you Chairman Frank for holding this hearing and inviting the banking regulators back to follow up on their July hearing. I was encouraged by many of the comments I heard from the regulators regarding the CFPA, and I'm curious to delve into these issues even more.

I'm interested in hearing the opinions of our witnesses on how they envision their agencies would interact with the CFPA. That is, since we are separating safety and soundness from consumer protection, which trumps the other when there is a conflict? Since the CFPA will take over responsibility for much of the jurisdiction of the various regulators, does this mean your resources and staff will be transferred to the new agency? Also, I am unclear as to where CRA fits into this discussion since this is one of the few areas the CFPA's jurisdiction will not cover.

I have no doubt that the activities of this proposed agency will drive up the cost of credit. And it could drive many financial services companies to get out or certain lines of business altogether—the cost and regulatory burden too much to sustain business. As credit is the lifeblood of our economy, the broader ramifications are abundantly clear. Make no mistake; the actions of this agency will cost our economy jobs.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

REGULATORY PERSPECTIVES ON FINANCIAL REGULATORY REFORM PROPOSALS

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

July 24, 2009

2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the importance of reforming our financial regulatory system. The issues under discussion today rival in importance those before the Congress in the wake of the Great Depression.

The proposals put forth by the Administration regarding the structure of the financial system, the supervision of financial entities, the protection of consumers, and the resolution of organizations that pose a systemic risk to the economy provide a useful framework for discussion of areas in vital need of reform. However, these are complex issues that can be addressed in a number of different ways. We all agree that we must get this right and enact regulatory reforms that address the fundamental causes of the current crisis within a carefully constructed framework that guards against future crises.

It is clear that one of these causes was the presence of significant regulatory gaps within the financial system. Differences in the regulation of capital, leverage, complex financial instruments, and consumer protection provided an environment in which regulatory arbitrage became rampant. Reforms are urgently needed to close these regulatory gaps.

At the same time, we must recognize that much of the risk in recent years was built up, within and around, financial firms that were already subject to extensive regulation and prudential supervision. One of the lessons of the past several years is that regulation and prudential supervision alone are not sufficient to control risk-taking within a dynamic and complex financial system. Robust and credible mechanisms to ensure that market participants will actively monitor and control risk-taking must be in place.

We must find ways to impose greater market discipline on systemically important institutions. In a properly functioning market economy there will be winners and losers, and when firms -- through their own mismanagement and excessive risk taking – are no longer viable, they should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. Unfortunately, the actions taken during the past year have reinforced the idea that some financial organizations are too big to fail. The solution must involve a practical, effective and highly credible mechanism for the orderly resolution of these institutions similar to that which exists for FDIC-insured banks. In short, we need an end to too big to fail.

The notion of too big to fail creates a vicious circle that needs to be broken. Large firms are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without consideration of the firms' risk profile. Investors and creditors believe their exposure is minimal since they also believe the government will not allow these firms to fail. The large firms leverage these funds and become even larger, which makes investors and creditors more complacent and more likely to extend credit and funds without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks

of failure and loss because they have become too big, believing that regulators will avoid taking action for fear of the repercussions on the broader market and economy.

If anything is to be learned from this financial crisis, it is that market discipline must be more than a philosophy to ward off appropriate regulation during good times. It must be enforced during difficult times. Given this, we need to develop a resolution regime that provides for the orderly wind-down of large, systemically important financial firms, without imposing large costs to the taxpayers. In contrast to the current situation, this new regime would not focus on propping up the current firm and its management. Instead, under the proposed authority, the resolution would concentrate on maintaining the liquidity and key activities of the organization so that the entity can be resolved in an orderly fashion without disrupting the functioning of the financial system. Losses would be borne by the stockholders and bondholders of the holding company, and senior management would be replaced. Without a new comprehensive resolution regime, we will be forced to repeat the costly, ad hoc responses of the last year.

My testimony discusses ways to address and improve the supervision of systemically important institutions and the identification of issues that pose risks to the financial system. The new structure should address such issues as the industry's excessive leverage, inadequate capital and over-reliance on short-term funding. In addition, the regulatory structure should ensure real corporate separateness and the separation of the bank's management, employees and systems from those affiliates. Risky activities, such as proprietary and hedge fund trading, should be kept outside of insured banks and subject to enhanced capital requirements.

Although regulatory gaps clearly need to be addressed, supervisory changes alone are not enough to address these problems. Accordingly, policymakers should focus on the elements necessary to create a credible resolution regime that can effectively address the resolution of financial institutions regardless of their size or complexity and assure that shareholders and creditors absorb losses before the government. This mechanism is at the heart of our proposals -- a bank and bank holding company resolution facility that will impose losses on shareholders and unsecured debt investors, while maintaining financial market stability and minimizing systemic consequences for the national and international economy. The credibility of this resolution mechanism would be further enhanced by the requirement that each bank holding company with subsidiaries engaged in non-banking financial activities would be required to have, under rules established by the FDIC, a resolution plan that would be annually updated and published for the benefit of market participants and other customers.

The combined enhanced supervision and unequivocal prospect of an orderly resolution will go a long way to assuring that the problems of the last several years are not repeated and that any problems that do arise can be handled without cost to the taxpayer.

Finally, I will discuss our support for the establishment of a new consumer protection agency for financial products. I also will recommend changes to assure

appropriate recognition of the relationship between the safety and soundness of insured banks and their consumer practices in both the structure of the new agency, as well as its role in examination and enforcement.

Improving Supervision and Regulation

The widespread economic damage that has occurred over the past two years has called into question the fundamental assumptions regarding financial institutions and their supervision that have directed our regulatory efforts for decades. The unprecedented size and complexity of many of today's financial institutions raise serious issues regarding whether they can be properly managed and effectively supervised through existing mechanisms and techniques. Our current system clearly failed in many instances to manage risk properly and to provide stability. Many of the systemically significant entities that have needed federal assistance were already subject to extensive federal supervision. For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive.

Insufficient attention was paid to the adequacy of complex institutions' risk management capabilities. Too much reliance was placed on mathematical models to drive risk management decisions. Notwithstanding the lessons from Enron, off-balance sheet-vehicles were permitted beyond the reach of prudential regulation, including holding company capital requirements. The failure to ensure that financial products were appropriate and sustainable for consumers caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Lax lending standards employed by lightly regulated non-bank mortgage originators initiated a downward competitive spiral which led to pervasive issuance of unsustainable mortgages. Ratings agencies freely assigned AAA credit ratings to the senior tranches of mortgage securitizations without doing fundamental analysis of underlying loan quality. Trillions of dollars in complex derivative instruments were written to hedge risks associated with mortgage backed securities and other exposures. This market was, by and large, excluded from federal regulation by statute.

A strong case can be made for creating incentives that reduce the size and complexity of financial institutions. A financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet on the performance of those banks and that regulator.

Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns. In contrast to the standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both their size and complexity. To address pro-cyclicality, the capital standards should provide for higher

capital buffers that increase during expansions and are available to be drawn down during contractions. In addition, these firms should be subject to higher Prompt Corrective Action standards under U.S. laws and holding company capital requirements that are no less stringent than those applicable to insured banks. Regulators also should take into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.

The Need for a Financial Services Oversight Council

The significant size and growth of unsupervised financial activities outside the traditional banking system -- in what is termed the shadow financial system -- has made it all the more difficult for regulators or market participants to understand the real dynamics of either bank credit markets or public capital markets. The existence of one regulatory framework for insured institutions and a much less effective regulatory scheme for non-bank entities created the conditions for arbitrage that permitted the development of risky and harmful products and services outside regulated entities.

A distinction should be drawn between the direct supervision of systemically-significant financial firms and the macro-prudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for the identification of a prudential supervisor for any potential systemically significant entity. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships.

The macro-prudential oversight of system-wide risks requires the integration of insights from a number of different regulatory perspectives -- banks, securities firms, holding companies, and perhaps others. Only through these differing perspectives can there be a holistic view of developing risks to our system. As a result, for this latter role, the FDIC supports the creation of a Council to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. In addition, for systemic entities not already subject to a federal prudential supervisor, this Council should be empowered to require that they submit to such oversight, presumably as a financial holding company under the Federal Reserve -- without subjecting them to the activities restrictions applicable to these companies.

Supervisors across the financial system failed to identify the systemic nature of the risks before they were realized as widespread industry losses. The performance of the regulatory system in the current crisis underscores the weakness of monitoring systemic risk through the lens of individual financial institutions and argues for the need to assess emerging risks using a system-wide perspective. The Administration's proposal addresses the need for broader-based identification of systemic risks across the economy and improved interagency cooperation through the establishment of a new Financial Services Oversight Council. The Oversight Council described in the Administration's proposal currently lacks sufficient authority to effectively address systemic risks.

In designing the role of the Council, it will be important to preserve the longstanding principle that bank regulation and supervision are best conducted by independent agencies. Careful attention should be given to the establishment of appropriate safeguards to preserve the independence of financial regulation from political influence. The Administration's plan gives the role of Chairman of the Financial Services Oversight Council to the Secretary of the Treasury. To ensure the independence and authority of the Council, consideration should be given to a configuration that would establish the Chairman of the Council as a Presidential appointee, subject to Senate confirmation. This would provide additional independence for the Chairman and enable the Chairman to focus full time on attending to the affairs of the Council and supervising Council staff. Other members on the Council could include, among others, the federal financial institution, securities and commodities regulators. In addition, we would suggest that the Council include an odd number of members in order to avoid deadlocks.

The Council should complement existing regulatory authorities by bringing a macro-prudential perspective to regulation and being able to set or harmonize prudential standards to address systemic risk. Drawing on the expertise of the federal regulators, the Oversight Council should have broad authority and responsibility for identifying institutions, products, practices, services and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, and completing analyses and making recommendations. In order to do its job, the Council needs the authority to obtain any information requested from systemically important entities.

The crisis has clearly revealed that regulatory gaps, or significant differences in regulation across financial services firms, can encourage regulatory arbitrage. Accordingly, a primary responsibility of the Council should be to harmonize prudential regulatory standards for financial institutions, products and practices to assure that market participants cannot arbitrage regulatory standards in ways that pose systemic risk. The Council should evaluate differing capital standards which apply to commercial banks, investment banks, and investment funds to determine the extent to which differing standards circumvent regulatory efforts to contain excess leverage in the system. The Council could also undertake the harmonization of capital and margin requirements applicable to all OTC derivatives activities -- and facilitate interagency efforts to encourage greater standardization and transparency of derivatives activities and the migration of these activities onto exchanges or Central Counterparties.

The Council also could consider requiring financial companies to issue contingent debt instruments -- for example, long-term debt that, while not counting towards the satisfaction of regulatory capital requirements, automatically converts to equity under specific conditions. Conditions triggering conversion could include the financial companies' capital falling below prompt corrective action mandated capital levels or regulators declaring a systemic emergency. Financial companies also could be required to issue a portion of their short-term debt in the form of debt instruments that similarly automatically convert to long-term debt under specific conditions, perhaps tied to liquidity. Conversion of long-term debt to equity would immediately recapitalize banks

in capital difficulty. Conversion of short-term debt to long-term debt would ameliorate liquidity problems.

Also, the Council should be able to harmonize rules regarding systemic risks to serve as a floor that could be met or exceeded, as appropriate, by the primary prudential regulator. Primary regulators would be charged with enforcing the requirements set by the Council. However, if the primary regulators fail to act, the Council should have the authority to do so. The standards set by the Council should be designed to provide incentives to reduce or eliminate potential systemic risks created by the size or complexity of individual entities, concentrations of risk or market practices, and other interconnections between entities and markets. Any standards set by the Council should be construed as a minimum floor for regulation that can be exceeded, as appropriate, by the primary prudential regulator.

The Council should have the authority to consult with systemic and financial regulators from other countries in developing reporting requirements and in identifying potential systemic risk in the global financial market. The Council also should report to Congress annually about its efforts, identify emerging systemic risk issues and recommend any legislative authority needed to mitigate systemic risk.

Some have suggested that a council approach would be less effective than having this authority vested in a single agency because of the perception that a deliberative council such as this would need additional time to address emergency situations that might arise from time to time. Certainly, some additional thought and effort will be needed to address any dissenting views in council deliberations. However, a Council with regulatory agency participation will provide for an appropriate system of checks and balances to ensure that decisions reflect the various interests of public and private stakeholders. In this regard, it should be noted that the board structure at the FDIC, with the participation of the Comptroller of the Currency and the Director of the Office of Thrift Supervision, is not very different from the way the Council would operate. In the case of the FDIC, quick decisions have been made with respect to systemic issues and emergency bank resolutions on many occasions. Based on our experience with a board structure, we believe that decisions could be made quickly by a deliberative council.

Resolution Authority

Even if risk-management practices improve dramatically and we introduce effective macro-prudential supervision, the odds are that a large systemically significant firm will become troubled or fail at some time in the future. The current crisis has clearly demonstrated the need for a single resolution mechanism for financial firms that will preserve stability while imposing the losses on shareholders and creditors and replacing senior management to encourage market discipline. A timely, orderly resolution process that could be applied to both banks and non-bank financial institutions, and their holding companies, would prevent instability and contagion and promote fairness. It would enable the financial markets to continue to function smoothly, while providing for an

orderly transfer or unwinding of the firm's operations. The resolution process would ensure that there is the necessary liquidity to complete transactions that are in process at the time of failure, thus addressing the potential for systemic risk without creating the expectation of a bailout.

Under the new resolution regime, Congress should raise the bar higher than existing law and eliminate the possibility of open assistance for individual failing entities. The new resolution powers should result in the shareholders and unsecured creditors taking losses prior to the government, and consideration also should be given to imposing some haircut on secured creditors to promote market discipline and limit costs potentially borne by the government.

Limitations of the current resolution authority

The FDIC's resolution powers are very effective for most failed bank situations (see Appendix). However, systemic financial organizations present additional issues that may complicate the FDIC's process of conducting an efficient and economical resolution. As noted above, many financial activities today take place in financial firms that are outside the insured depository institution where the FDIC's existing authority does not reach. These financial firms must be resolved through the bankruptcy process, as the FDIC's resolution powers only apply to insured depository institutions. Resolving large complex financial firms through the bankruptcy process can be destabilizing to regional, national and international economies since the timing is uncertain and the process can be complex and protracted and may vary by jurisdiction.

By contrast, the powers that are available to the FDIC under its statutory resolution authorities can resolve financial entities much more rapidly than under bankruptcy. The FDIC bears the unique responsibility for resolving failed depository institutions and is therefore able to plan for an orderly resolution process. Through this process, the FDIC works with the primary supervisor to gather information on a troubled bank before it fails and plans for the transfer or orderly wind-down of the bank's assets and businesses. In doing so, the FDIC is able to maintain public confidence and perform its public policy mandate of ensuring financial stability.

Resolution authority for systemically important financial firms

To ensure an orderly and comprehensive resolution mechanism for systemically important financial firms, Congress should adopt a resolution process that adheres to the following principles:

- The resolution scheme and processes should be transparent, including the imposition of losses according to an established claims priority where stockholders and creditors, not the government, are in the first loss position.

- The resolution process should seek to minimize costs and maximize recoveries. The resolution should be conducted to achieve the least cost to the government as a whole with the FDIC allocating the losses among the various affiliates and subsidiaries proportionate to their responsibilities for the cost of the failure.

- There should be a unified resolution process housed in a single entity.

- The resolution entity should have the responsibility and the authority to set assessments to fund systemic resolutions to cover working capital and unanticipated losses.

- The resolution process should allow the continuation of any systemically significant operations, but only as a means to achieve a final resolution of the entity. A bridge mechanism, applicable to the parent company and all affiliated entities, allows the government to preserve systemically significant functions. It enables losses to be imposed on market players who should appropriately bear the risk. It also creates the possibility of multiple bidders for the financial organization and its assets, which can reduce losses to the receivership.

- The resolution entity must effectively manage its financial and operational risk exposure on an on-going basis. The receivership function necessarily entails certain activities such as the establishment of bridge entities, implementing purchase and assumption agreements, claims processing, asset liquidation or disposition and franchise marketing. The resolving entity must establish, maintain and implement these functions for a covered parent company and all affiliated entities.

Financial firms often operate on a day-to-day basis without regard to the legal structure of the firm. That is, employees of the holding company may provide vital services to a subsidiary bank because the same function exists in both the bank and the holding company. However, this intertwining of functions can present significant issues when trying to wind down the firm. For this reason, there should be requirements that mandate greater functional autonomy of holding company affiliates.

In addition, to facilitate the resolution process, the holding companies should have an acceptable resolution plan that could facilitate and guide the resolution in the event of a failure. Through a carefully considered rulemaking, each financial holding company should be required to make conforming changes to their organization to ensure that the resolution plans could be effectively implemented. The plans should be updated annually and made publicly available.

Congress also should alter the current process that establishes a procedure for open bank assistance that benefits shareholders and eliminates the requirement that the resolution option be the least costly to the Deposit Insurance Fund (DIF). As stated

above, shareholders and creditors should be required to absorb losses from the institution's failure before the government.

Current law allows for an exception to the standard claims priority where the failure of one or more institutions presents "systemic risk." In other words, once a systemic risk determination is made, the law permits the government to provide assistance irrespective of the least cost requirement, including "open bank" assistance which inures to the benefit of shareholders. The systemic risk exception is an extraordinary procedure, requiring the approval of super majorities of the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President.

We believe that the systemic risk exception should be narrowed so that it is available only where there is a finding that support for open institutions is necessary to address problems which pervade the system, as opposed to problems which are particular to an individual institution. Whatever support is provided should be broadly available and justified in that it will result in least cost to the government as a whole. If the government suffers a loss as a result an institution's performance under this exception, the institution should be required to be resolved in accordance with the standard claims priority.

Had this narrower systemic risk exception been in place during the past year, open institution assistance would not have been permitted for individual institutions. An individual institution would likely have been put into a bridge entity, with shareholders and unsecured creditors taking losses before the government. Broader programs that benefit the entire system, such as the Temporary Liquidity Guarantee Program and the Federal Reserve's liquidity facilities, would have been permitted. However if any individual institution participating in these programs had caused a loss, the normal resolution process would be triggered.

The initiation of this type of systemic assistance should require the same concurrence of the supermajority of the FDIC Board, the Federal Reserve Board and the Treasury Department (in consultation with the President) as under current law. No single government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process. Further, to ensure transparency, these determinations should be made in consultation with Congress, documented and reviewed by the Government Accountability Office.

Other improvements to the resolution process

Consideration should be given to allowing the resolution authority to impose limits on financial institutions' abilities to use collateral to mitigate credit risk ahead of the government for some types of activities. The ability to fully collateralize credit risks removes an institution's incentive to underwrite exposures by assessing a counterparty's ability to perform from revenues from continuing operations. In addition, the recent

crisis has demonstrated that collateral calls generate liquidity pressures that can magnify systemic risks. For example, up to 20 percent of the secured claim for companies with derivatives claims against the failed firm could be haircut if the government is expected to suffer losses. This would ensure that market participants always have an interest in monitoring the financial health of their counterparties. It also would limit the sudden demand for more collateral because the protection could be capped and also help to protect the government from losses. Other approaches could include increasing regulatory and supervisory disincentives for excessive reliance on secured borrowing.

As emphasized at the beginning of this statement, a regulatory and resolution structure should, among other things, ensure real corporate separateness and the separation of the bank's management, employees, and systems from those of its affiliates. Risky activities, such as proprietary trading, should be kept outside the bank. Consideration also should be given to enhancing restrictions against transactions with affiliates, including the elimination of 23A waivers. In addition, the resolution process could be greatly enhanced if companies were required to have an acceptable resolution plan that and guides the liquidation in the event of a failure. Requiring that the plans be updated annually and made publicly available would provide additional transparency that would improve market discipline.

Funding Systemic Resolutions

To be credible, a resolution process for systemically significant institutions must have the funds necessary to accomplish the resolution. It is important that funding for this resolution process be provided by the set of potentially systemically significant financial firms, rather than by the taxpayer. To that end, Congress should establish a Financial Company Resolution Fund (FCRF) to provide working capital and cover unanticipated losses for the resolution.

One option for funding the FCRF is to pre-fund it through a levy on larger financial firms -- those with assets above a certain large threshold. The advantage of pre-funding the FCRF is the ability to impose risk-based assessments on large or complex institutions that recognize their potential risks to the financial system. This system also could provide an economic incentive for an institution not to grow too large. In addition, building the fund over time through consistent levies would avoid large procyclical charges during times of systemic stress.

Alternatively, the FCRF could be funded after a systemic failure through an assessment on other large, complex institutions. The advantage to this approach is that it does not take capital out of institutions until there is an actual systemic failure. The disadvantages of this approach are that it is not risk sensitive, it is initially dependent on the ability to borrow from the Treasury, it assess institutions when they can least afford it and the institution causing the loss is the only one that never pays an assessment.

The systemic resolution entity should have the authorities needed to manage this resolution fund, as the FDIC does for the DIF. The entity should also be authorized to borrow from the Treasury if necessary, but those borrowings should be repaid by the financial firms that contribute to the FCRF.

International issues

Some significant challenges exist for international banking resolution actions since existing bank crisis management and resolution arrangements are not designed to deal specifically with cross-border banking problems. However, providing resolution authority to a specific entity in the U.S. would enhance the ability to enter into definitive memoranda of understanding with other countries. Many of these same countries have recognized the benefits of improving their resolution regimes and are considering improvements. This provides a unique opportunity for the U.S. to be the leader in this area and provide a model for the effective resolution of failed entities.

Dealing with cross-border banking problems is difficult. For example, provisions to allow the transfer of assets and liabilities to a bridge bank or other institution may have limited effectiveness in a cross-border context because these actions will not necessarily be recognized or promptly implemented in other jurisdictions. In the absence of other arrangements, it is presumed that ring fencing will occur. Ring fencing may secure the interests of creditors or individuals in foreign jurisdictions to the detriment of the resolution as a whole.

In the United States, the Foreign Bank Supervision Enhancement Act of 1991 requires foreign banks that wish to do a retail deposit-taking business to establish a separately chartered subsidiary bank. This structural arrangement ensures that assets and capital will be available to U.S. depositors or the FDIC should the foreign parent bank and its U.S. subsidiary experience difficulties. In this sense, it is equivalent to "pre-packaged" ring fencing. An idea to consider would be to have U.S. banks operating abroad to do so through bank subsidiaries. This could streamline the FDIC's resolution process for a U.S. bank with foreign operations. U.S. operations would be resolved by the FDIC and the foreign operations by the appropriate foreign regulator. However, this would be a major change and could affect the ability of U.S. banks to attract foreign deposits overseas.

Resolution Authority for Depository Institution Holding Companies

To have a process that not only maintains liquidity in the financial system but also terminates stockholders' rights, it is important that the FDIC have the authority to resolve both systemically important and non-systemically important depository institution holding companies, affiliates and majority-owned subsidiaries in the case of failed or failing insured depository institutions. When a failing bank is part of a large, complex holding company, many of the services essential for the bank's operation may reside in

other portions of the holding company, beyond the FDIC's authority. The loss of essential services can make it difficult to preserve the value of a failed institution's assets, operate the bank or resolve it efficiently. The business operations of large, systemic financial organizations are intertwined with business lines that may span several legal entities. When one entity is in the FDIC's control while the other is not, it significantly complicates resolution efforts. Unifying the holding company and the failed institution under the same resolution authority can preserve value, reduce costs and provide stability through an effective resolution. Congress should enhance the authority of the FDIC to resolve the entire organization in order to achieve a more orderly and comprehensive resolution consistent with the least cost to the DIF.

When the holding company structure is less complex, the FDIC may be able to effect a least cost resolution without taking over the holding company. In cases where the holding company is not critical to the operations of the bank or thrift, the FDIC should be able to opt out -- that is, allow the holding company to be resolved through the bankruptcy process. The decision on whether to employ enhanced resolution powers or allow the bank holding company to declare bankruptcy would depend on which strategy would result in the least cost to the DIF. Enhanced authorities that allow the FDIC to efficiently resolve failed depository institutions that are part of a complex holding company structure when it achieves the least costly resolution will provide immediate efficiencies in bank resolutions.

Consumer Protection

Many of the current problems affecting the safety and soundness of the financial system were caused by a lack of strong, comprehensive rules against abusive lending practices applying to both banks and non-banks, and lack of a meaningful examination and enforcement presence in the non-bank sector. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems, not just for consumers, but for institutions and investors as well. As the ultimate insurer of over $6 trillion in deposits, the FDIC has both the responsibility and vital need to ensure that consumer compliance and safety and soundness are appropriately integrated.

To protect consumers from potentially harmful financial products, the Administration has proposed to establish a single primary federal consumer-products regulator, the Consumer Financial Protection Agency (CFPA). The CFPA would regulate providers of consumer credit, savings, payment and other financial products and services. Under the proposal, the agency would be the sole rule-making authority for consumer financial protection statutes and would have supervisory and enforcement authority over all providers of consumer credit. It would set a floor on consumer regulation and supervision and would guarantee the ability of states to adopt and enforce stricter laws for institutions of all types, regardless of charter.

The proposal would eliminate regulatory gaps between insured depository institutions and non-bank providers of financial products and services by establishing strong, consistent consumer protection standards across the board. It also would address another gap by giving the CFPA authority to examine non-bank financial service providers that are not currently examined by the federal banking agencies. In addition, the Administration's proposal would eliminate the potential for regulatory arbitrage that exists because of federal preemption of certain State laws. By creating a floor for consumer protection and by allowing more protective State consumer laws to apply to all providers of financial products and services operating within a State, the CFPA should significantly improve consumer protection.

The Administration's proposal could be made even more effective with a few targeted, but critical changes, which would strengthen oversight for all financial service providers, as well as assure no disruption in consumer compliance oversight of banks. As the banking regulators' experience over the past few years has graphically illustrated, consumer protection issues and the safety and soundness of insured institutions go hand-in-hand. There is a direct correlation between effective consumer compliance programs and safe and sound institutions. Examination and supervision for safety and soundness and consumer protection need to be closely coordinated and reflect a comprehensive understanding of institutions' management, operations, policies, and practices, and the bank supervisory process as a whole. Consumer protection and risk supervision both benefit from the synergies created by this holistic approach and the ready and timely access to expertise and critical information. Separating consumer protection examination and supervision from those other supervisory efforts could undermine the effectiveness of both, with the unintended consequence of weakening bank oversight.

Also, since most of the problem products and practices that contributed to the current crisis began outside the banking industry, focusing examination and enforcement on the non-bank sector is key to addressing most of the abusive lending practices faced by consumers. For example, a recent Treasury Department report indicated that 94 percent of high cost mortgages were made outside the traditional banking sector.[1] However, the Administration proposal does not address the means by which the CFPA will be able to garner the resources or and infrastructure to supervise products and services offered by non-banks. Simply moving the examination and supervision functions from the financial institution regulators to the FCPA will not address the lack of supervision of non-bank entities because the financial institution examiners are already fully engaged with their banking sector institutions. Further, spreading the available resources over both non-banking and banking institutions would only serve to diminish the CFPA's effectiveness overall.

The CFPA should have sole rule-writing authority over consumer financial products and services and the federal banking regulators should be required to examine for and enforce those standards. If the bank regulators are not performing this role properly, the CFPA should retain backup examination and enforcement authority to address any situation where it determines that a banking agency is providing insufficient

[1] Financial Regulatory Reform: A New Foundation, U.S. Department of the Treasury (June 17, 2009), at 69.

supervision. By freeing the CFPA from direct supervision and enforcement of depository institutions, the CFPA would be able to focus its examination and enforcement resources on the non-bank financial providers that provide financial products and services that have not previously been subject to federal examination and clear supervisory standards.

Accordingly, the federal banking agencies should retain the authority to examine and supervise insured institutions for both consumer protection compliance and safety and soundness. The CFPA should be given the authority to examine and supervise non-bank consumer product and service providers and back-up enforcement authority over insured depository institutions. Giving the CFPA authority to write rules for all consumer product and service providers would ensure strong and uniform consumer protection standards for all consumer product and service providers.

In addition, as the only federal regulator with exposure to all insured financial institutions, the FDIC should be represented on the CFPA Board. The FDIC is the primary federal supervisor for the largest number of banks (including many larger ones), and maintains an active examination staff on-site in the largest major banks as back up supervisor. The FDIC's direct supervision of the majority of the nation's community banks provides it with a unique perspective and a "Main Street" orientation that resulted in it being an early proponent of affordable and sustainable mortgage loan modifications, improved economic inclusion, and the prevention of abusive lending practices. Moreover, the FDIC's deposit insurance function involves a significant consumer protection role with regard to consumer deposits that affects all institutions, but is unique to the FDIC.

Some have questioned why prudential supervisors should have a position on the CFPA board when the views of the CFPA would not necessarily be reflected in the activities of the prudential supervisor. To address this criticism, the FDIC would support the addition of the CFPA Chairman as a member of our board of directors. The Administration's proposal to merge the two national chartering agencies will create a vacancy on the FDIC Board that could be filled by the CFPA Chairman. This would increase the visibility of consumer protection as a core mission of the FDIC. In addition, this type of reciprocal arrangement could provide benefits for both safety and soundness and consumer protection regulation and supervision.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially those that are systemically important to the financial system. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial institutions -- especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.

APPENDIX A

The FDIC's resolution authority

The FDIC has standard procedures that go into effect when an FDIC-insured bank or thrift is in danger of failing. When the FDIC is notified that an insured institution is in danger of failing, we begin assembling an information package for bidders that specifies the structure and terms of the transaction. FDIC staff review the bank's books, contact prospective bidders, and begin the process of auctioning the bank -- usually prior to its failure -- to achieve the best return to the bank's creditors and the Deposit Insurance Fund (DIF).

When the appropriate federal or state banking authority closes an insured depository institution, it appoints the FDIC as conservator or receiver. On the day of closure by the chartering entity, the FDIC takes control of the bank and in most cases removes the failed bank's management. Shareholder control rights are terminated, although shareholders maintain a claim on any residual value remaining after depositors' and other creditors' claims are satisfied.

Most bank failures are resolved by the sale of some or all of the bank's business to an acquiring bank. FDIC staff work with the acquiring bank, and make the transfer as unobtrusive, seamless and efficient as possible. Generally, all the deposits that are transferred to the acquiring bank are made immediately available on-line or through ATMs. The bank usually reopens the next business day with a new name and under the control of the acquiring institution. Those assets of the failed bank that are not taken by the acquiring institution are then liquidated by the FDIC.

Sometimes banks must be closed quickly because of an inability to meet their funding obligations. These "liquidity failures" may require that the FDIC set up a bridge bank. The bridge bank structure allows the FDIC to provide liquidity to continue the bank's operations until the FDIC has time to market and sell the failed bank. The creation of a bridge also terminates stockholders rights as described earlier.

Perhaps the greatest benefit of the FDIC's process is the quick reallocation of resources. It is a process that can be painful to shareholders, creditors and bank employees, but history has shown that early recognition of losses with closure and sale of non-viable institutions is the fastest path back to economic health.

Embargoed until
September 23, 2009, at 2:00 p.m.

Statement of

John E. Bowman
Acting Director, Office of Thrift Supervision

regarding

Federal Regulator Perspectives on Financial Regulatory Reform Proposals

before the

Committee on Financial Services
United States House of Representatives

September 23, 2009

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Testimony on

Federal Regulator Perspectives on Financial Regulatory Reform Proposals

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I. Introduction

Good afternoon, Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for the opportunity to testify today on the Administration's Proposal for Financial Regulatory Reform (Administration Proposal). We appreciate the Committee's efforts to improve supervision of financial institutions in the United States. We share the Committee's commitment to reforms to prevent any recurrence of the significant challenges facing the financial sector.

In my testimony this afternoon I will discuss several aspects of financial regulatory restructuring. Some of the proposals are necessary to ensure that we do not experience another financial crisis. Conversely, there are other proposals which, in our view, do not address the causes of the financial crisis and will not shield the nation from another one.

II. Goals of Regulatory Restructuring

The recent turmoil in the financial services industry has exposed major regulatory gaps and other significant weaknesses that must be addressed. Our evaluation of the specifics of the Administration Proposal is predicated on whether or not those elements address the core principles the Office of Thrift Supervision (OTS) believes are essential to accomplishing true and lasting reform:

1. **Ensure Changes to Financial Regulatory System Address Real Problems** — Proposed changes to financial regulatory agencies should be evaluated based on whether they would address the causes of the economic crisis or other true problems.
2. **Protect Consumers** — One federal agency should have as its central mission the regulation of financial products and that agency should establish the rules and standards for all consumer financial products.
3. **Establish Uniform Regulation** — All entities that offer financial products to consumers must be subject to the same consumer protection rules and regulations, so under-regulated entities cannot gain a competitive advantage over their more regulated counterparts. Also, complex derivative products, such as credit default swaps, should be regulated.
4. **Create Ability to Supervise and Resolve Systemically Important Firms** — No provider of financial products should be too big to fail, achieving through size and complexity implicit federal government backing to prevent its collapse — and thereby gaining an unfair advantage over its less insulated competitors.

As a general matter the OTS supports all of the fundamental objectives that are at the heart of the Administration Proposal. Based on our analysis using these principles, we believe certain aspects of the Administration Proposal and other proposals do not address real problems and do nothing to prevent a future crisis. We will discuss these proposals including the elimination of the thrift charter, the dismantling of the Office of the Comptroller of the Currency (OCC) and OTS to create the National Bank Supervisor, the consolidation of the Federal banking agencies (FBAs), and the elimination of certain exceptions to the Bank Holding Company Act of 1956 (BHCA). We will also discuss the elements of the Administration Proposal that address and ameliorate real problems and, where appropriate, make alternative suggestions or express concern with some of the proposal's provisions.

III. Elements of Financial Regulatory Restructuring

A. Administration Proposal to Eliminate the Thrift Charter

The OTS does not support the provision in the Administration Proposal to eliminate the federal thrift charter and require all federal thrift institutions to change their charter to the National Bank Charter or a state bank. We believe the business models of federal banks and thrift institutions are fundamentally different enough to warrant two distinct federal banking charters.

It is important to note that elimination of the thrift charter would not have prevented the current mortgage meltdown, nor would it help solve current problems or prevent future crises. Savings associations generally are smaller institutions that have

strong ties to their communities. Many thrifts never made higher risk mortgages such as low-documentation loans. Most thrifts did not participate in the private originate-to-sell model; they prudently underwrote mortgages intending to hold the loans in their own portfolios until the loans matured.

Forcing thrifts to convert to banks or state chartered savings associations would not only be costly, disruptive and punitive for thrifts, but could also make credit less available to credit-worthy U.S. consumers, limiting homeownership and stimulation to the economy.

We also strongly support retaining the mutual form of organization for insured institutions. Generally, mutual institutions are weathering the current financial crisis better than their stock competitors. The distress in the housing markets has had a much greater impact on the earnings of stock thrifts than on mutual thrifts over the past year. Through the first two quarters of 2009, mutual thrifts reported a return on average assets (ROA) of 0.34 percent, while stock thrifts reported an ROA of negative 0.31 percent. We see every reason to preserve the mutual institution charter and no compelling rationale to eliminate it.

OTS also supports retention of the dual banking system with both federal and state charters for banks and thrifts. This system has served the financial markets in the United States well. The states have provided a charter option for banks and thrifts that have not wanted to have a federal charter. Banks and thrifts should be able to choose whether to operate with a federal charter or a state charter.

B. Proposed Consolidation of the Regulators

The Administration has proposed abolishing both the OCC and the OTS, and transferring functions of the two agencies to a new agency called the National Bank Supervisor.

Some members of Congress propose further consolidation, merging not only the OTS and the OCC, but also the prudential regulatory functions of the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC), which share supervisory authority with the states over state-chartered banks.

The OTS opposes both of these proposals for several reasons, the first of which is fundamental: these proposals do not address the very real problems that led to the current financial crisis and, instead of improving the supervision of insured depository institutions, threaten to make it worse.

1. Institution Failures

There is no evidence that regulatory consolidation would have prevented failures among banks and thrifts, or made the financial crisis any less severe.

Failures by insured depository institutions during the financial crisis have cut across all types and sizes of institutions, and all charter types.

In terms of numbers of bank failures during the crisis, most banks that have failed were state-chartered institutions, whose primary federal regulator is not the OTS.

In terms of the largest failures, some were regulated by the OTS. Washington Mutual, which failed in September 2008 at no cost to the deposit insurance fund, was the largest bank failure in U.S. history. However, institutions much larger than Washington Mutual — for example, Citigroup and Bank of America — collapsed, but the federal government prevented their failures by authorizing open bank assistance. By law, this assistance can be granted only to prevent failure. These "too big to fail" institutions are not regulated by the OTS. The OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were *allowed to fail.*

Another important point is that "ground zero" in the financial crisis is the home mortgage sector and consumer lending, the traditional bread-and-butter of the thrift industry. The economic crisis grew out of a sharp downturn in the residential real estate market, including significant and sustained home price depreciation, a protracted decline in home sales, a plunge in rates of real estate investment, and a sharp increase in unemployment rates. By law, thrifts must keep a majority of their assets in home mortgages and other consumer retail lending activities. OTS-regulated institutions were particularly affected because their business models focus on this segment of the

marketplace. Although today's hindsight is 20/20, no one predicted during the peak of the housing boom in 2006 that nationwide home prices would plummet by more than 30 percent.

Also, the two largest failures among OTS-regulated institutions during the crisis concentrated their mortgage lending in California, one of the states most damaged by the real estate decline. California has had significant retraction in the real estate market, including double-digit declines in home prices and record rates of foreclosure.

2. Regulatory Arbitrage

One of the most frequently cited rationales for consolidation of bank and thrift regulatory agencies is to prevent regulatory arbitrage, or institutions "shopping" among regulators to find the one most to their liking.

Currently, the U.S. has 54 chartering authorities: each of the 50 states, the District of Columbia, Puerto Rico, plus the OTS, and the OCC. The Administration proposal would reduce the number from 54 to 53 by merging the OTS and OCC. Similarly, the more far reaching proposal to create a single federal bank regulator would also only reduce the number from 54 to 53. Moreover, although not a chartering authority, both of these proposals would add the new Consumer Financial Protection Agency (CFPA). Either proposal would presumably leave the door open for arbitrage between federal and

state charters, and among the charters of the states. If arbitrage were truly an overriding concern, the issue of arbitrage would be addressed across-the-board.

The OTS disagrees with the suggestion that banks have converted to the thrift charter because OTS was a more lenient regulator. Institutions chose the charter type that best fit their business model. The argument about arbitrage stems largely from the conversion of Countrywide, which left the supervision of the OCC and the FRB in March 2007 and came under OTS regulation. This conversion took place after the height of the housing and mortgage boom; Countrywide made most of its high-risk loans through its holding company affiliates before receiving a thrift charter.

An often-overlooked fact is that a few months before Countrywide's conversion, in October 2006, Citibank converted two thrift charters from OTS supervision to the OCC. Those two Citibank charters totaled more than $232 billion — more than twice the asset size of Countrywide ($93 billion).

Citibank and Countrywide changed their charters based on their respective business models and operating strategies. Any suggestion that either company sought to find a more lenient regulatory structure is without merit.

Moreover, figures on charter conversions over the past decade demonstrate that there has been no stampede to OTS supervision. To the contrary, from 1999 to 2008, there were 45 more institutions that converted away from the thrift charter (164) than

converted to the thrift charter (119). Of those that converted to the OTS, more than half were state-chartered thrifts (64). In dollar amounts during the same 10-year period, $223 billion in assets converted to the thrift charter from other charter types and $419 billion in assets converted away from the thrift charter to other charter types.

3. Diversity of Viewpoints

No single regulator has a monopoly on good ideas about financial regulation and how best to protect consumers. A relatively small agency such as the OTS can take a leadership role that can result in meaningful reform. For example, the OTS took the lead in 2007 in initiating a rulemaking process to prohibit unfair credit card practices. This initiative culminated in the adoption of a final interagency rule, later followed by Congressional passage of legislation.

Before the OTS acted, the approach to addressing such credit card practices was to provide consumers with information to help them compare and shop among competing products. The OTS determined that although improving consumer disclosures was a good step, some harmful practices could not be addressed effectively through improved disclosure alone.

Recognizing this, the OTS initiated a rulemaking process to address unfair or deceptive practices prohibited by the Federal Trade Commission Act. On August 6, 2007, the agency issued an advance notice of proposed rulemaking, requesting comment

on the adequacy of the agency's current rules. Based on a review of comments from consumer advocates, industry representatives, members of Congress and the general public, agency officials began working to issue a Notice of Proposed Rulemaking and invited the FRB and National Credit Union Administration (NCUA) to join the effort. A combined approach would provide consumers with uniform protections regardless of which type of financial institution issued their credit card.

In May 2008, the three agencies issued a Notice of Proposed Rulemaking that generated 66,000 comments and led to a final rule the following December. The rule banned practices often cited as unfair to consumers, such as raising interest rates on existing credit card balances when consumers were paying their credit card bills on time. The rule also required that consumers receive a reasonable amount of time to make their credit card payments, prohibited payment allocation methods that unfairly maximized interest charges and, in the subprime credit card market, limited fees that reduced the credit available to consumers.

This rulemaking process is just one example of how the diversity of federal financial institution regulators produces a diversity of viewpoints, opinions and approaches that inform and enrich supervision and improve decision-making.

The current regulators act as checks and balances on one another, ensuring that decisions are well-thought out and reflect divergent opinions. Such a dynamic is on

display routinely among the members of the FDIC Board, where the FDIC, the OCC and the OTS are all represented.

4. Cost to the Industry

The bank and thrift industry is stabilizing but significant challenges remain. Industry health is improving but, after a debilitating recession, it is by no means robust. In this climate, the last thing government should do is impose unnecessary costs on the recovering industry.

However, that is exactly what the consolidation proposals would do. Thrifts would need to convert to banks and thrift holding companies would have to convert to bank holding companies, racking up legal bills and consulting costs.

Thrifts would also need to spend money to overhaul their financial reporting systems to generate quarterly Call reports, instead of the current quarterly Thrift Financial Reports.

In return for these sizable industry investments, U.S. taxpayers would get nothing. None of the four federal regulators receives appropriations from Congress, so consolidation would not lower budget outlays or reduce the tax burden by a single cent.

In fact, it is likely that the industry would pass these costs on to consumers in the normal course of business.

Given these factors, members of Congress should consider whether the costs are worth any benefits. In the rush to address what went wrong, policy-makers should not try to "fix" non-existent problems, or attempt to fix real problems with flawed solutions. There is no useful purpose or efficiency to be gained by putting together regulatory agencies that do not fit together. Doing so will detract from the resources necessary to regulate efficiently a significant segment of the financial industry. Submerging agencies into a large bureaucracy will make it harder to hone in on issues unique to different types of institutions.

5. Focus on Big Banks

The trillion-dollar mega-banks of today have almost nothing in common with the thousands of small community banks that dot the countryside across America. The mega-banks are vast and complex, assessing their risks through high-tech computer models, conducting large commercial transactions and compartmentalizing their operations according to business line.

Although the mega-banks control the lion's share of banking assets in this country, most of the banks in America are not mega-banks. Small community banks are far greater in number. They have traditional business models, knowing their customers

and meeting the everyday financial needs of families and small businesses. Mega-banks are fundamentally different. They are nationwide financial firms and global conglomerates engaged in much more complex transactions.

What does a $100 million thrift that offers mortgages, small business loans and other types of small consumer loans within its local community have in common with a complex bank involved in structured transactions and complicated derivatives?

If these two very different types of businesses are supervised by a single regulator, there is a very real danger of the needs of the community-oriented majority being pushed to the back seat by the enormous asset size, risk and complexity of the big banks.

Regulatory policymaking functions that have successfully kept consumer-and-community lenders safe and sound would be subsumed within a single, large bureaucratic hierarchy. A bureaucracy dealing with institutions of such disparate financial weight would necessarily gravitate toward using its time and resources primarily on the most massive institutions that posed the greatest risk to the financial system. In times of stress, this concentration on large banks would be most evident. The resulting loss of independent regulatory policymaking by the division of the new bureaucracy assigned to smaller consumer-and-community-based institutions would not well serve the public that continues to depend on community banks to meet its day-to-day financial needs.

Consumer and community lenders — part of the financial fabric of this nation — could suffer not only from inattention, but also the weight and cost of regulations designed to address the risks of much more complex institutions. The necessary "differential regulation" for institutions that are fundamentally different may disappear. The result could be that instead of talking in person with a mortgage loan officer in a bank lobby, prospective homeowners would have no choice but to be directed to dial a toll-free number into the telephone bank of a complex nationwide institution. A loss of relationship banking would be a loss for all financial services consumers.

It is critical that all regulatory agencies be structured and operated in a manner that ensures the appropriate supervision and regulation of all depository institutions, regardless of size or complexity.

6. Future of the OTS

The thrift charter and the type of financial institution based on it have well served this country's need for consumer-and-community financial services through good times and bad since the charter was created in 1933. If the thrift industry continues to exist and fulfill its mission, an independent OTS is the federal agency best equipped to regulate, supervise and examine that industry.

Thrifts generally are traditional consumer and community lenders, and thrifts historically have exerted strong, beneficial and stabilizing leadership in American

communities. Thrifts generally keep the loans they make in their portfolios and in general were not the lenders that contributed to the mortgage meltdown by making untenable loans and securitizing them. Thrifts tend to be small, local, conservative lenders that provide home mortgages, car loans and other day-to-day financial services to people in the cities, towns, suburban and rural areas across America.

Thrifts are required by law to concentrate on consumer retail lending activities. During the current financial crisis, trouble surfaced and worsened when home mortgage lending often became a means for nonbanks to churn profits without regard to the long-term viability of mortgages, instead of a core business of banks and thrifts to help credit-worthy Americans become homeowners.

In the second quarter of 2009, OTS-regulated institutions originated $62.4 billion in home mortgages, which is their highest volume of originations since the third quarter of 2007. Many large banks have not yet returned to a significant level of lending due to their continuing need to increase capital and prepare for risks from a downturn in the commercial real estate market. For OTS thrifts, net income in the second quarter returned to positive territory, while commercial banks were still running in the negative, with a net loss of $3.7 billion.

The OTS employs a considerable pool of expert examiners, experienced legal practitioners, and economists who constitute the most highly qualified team in the nation to evaluate and regulate the risks involved in a concentration in mortgage lending.

Dismantling the OTS and folding it into a larger entity would threaten the independent policy judgment and specialized skills that the OTS has developed over the past 20 years to measure and monitor interest rate risk. The OTS has an internally designed, developed, and run interest rate risk model, as well as specialized examination procedures designed to assess the risks of housing lenders.

The nation benefits from having a federal banking agency dedicated to regulating institutions focused primarily on responsible mortgage lending. If home ownership remains a national policy objective, it makes sense to retain a federal banking agency that specializes in appropriate regulation of housing lenders.

C. Administration Proposal to Eliminate the Exceptions in the Bank Holding Company Act for Thrifts and Special Purpose Banks

1. Elimination of the Exception in the Bank Holding Company Act for Thrifts

Because a thrift is not considered a "bank" under the BHCA,[1] the FRB does not regulate entities that own or control only savings associations. The OTS supervises and regulates such entities pursuant to the Home Owners Loan Act (HOLA).

As part of the recommendation to eliminate the federal thrift charter, the Administration Proposal would also eliminate the savings and loan holding company

[1] 12 U.S.C. 1841(c)(2)(B) and (j).

(SLHC). The Administration's draft legislation repeals section 10 of the HOLA concerning the regulation of SLHCs and also eliminates the thrift exemption from the definition of "bank" under the BHCA. A SLHC would become a bank holding company (BHC) by operation of law and would be required to register with the FRB as a BHC within 90 days of enactment of the act.

Notably, these provisions also apply to the unitary SLHCs that were explicitly permitted to continue engaging in commercial activities under the Gramm-Leach-Bliley Act of 1999.[2] Such an entity would either have to divest itself of the thrift or divest itself of other subsidiaries or affiliates to ensure that its activities are "financial in nature."[3]

The Administration justifies the elimination of SLHCs, by arguing that the separate regulation and supervision of bank and savings and loan holding companies has created "arbitrage opportunities." The Administration contends that the intensity of supervision has been greater for BHCs than SLHCs.

Our view on this matter is guided by our key principles, one of which is to ensure that changes to the financial regulatory system address real problems. We oppose this provision because it does not address a real problem. As is the case with the regulation of thrift institutions, OTS believes that entities became SLHCs based on the business model of the entity.

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[2] 12 U.S.C. 1467a(c)(9)(C).
[3] 12 U.S.C. 1843(k).

The suggestion that the OTS does not impose capital requirements on SLHCs is not correct. Although the capital requirements for SLHCs are not contained in OTS regulations, savings and loan holding company capital adequacy is determined on a case-by-case basis for each holding company based on the overall risk profile of the organization. In its review of a SLHC's capital adequacy, the OTS considers the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

On average, SLHCs hold more capital than BHCs. The OTS conducted an internal study comparing SLHC capital levels to BHC capital levels. In this study, OTS staff developed a Tier 1 leverage proxy and conducted an extensive review of industry capital levels to assess the overall condition of holding companies in the thrift industry. We measured capital by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio. Based on peer group averages, capital levels (as measured by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio) at SLHCs were higher than BHCs, prior to the infusion of Troubled Assets Relief Program funds, in every peer group category. The consistency in results between both ratios lends credence to the overall conclusion, despite any differences that might result from use of a proxy formula.

As this study shows, the facts do not support the claim that the OTS does not impose adequate capital requirements on SLHCs. The proposal to eliminate the SLHC exception from the BHCA is based on this and other misperceptions. Moreover, in our

view the measure penalizes the SLHCs and thrifts that maintained solid underwriting standards and were not responsible for the current financial crisis. The measure is especially punitive to the unitary SLHCs that will be forced to divest themselves of their thrifts or other subsidiaries.

The OTS supervises both thrifts and their holding companies on a consolidated basis. Under the Administration Proposal, thrifts and their holding companies would be supervised by different agencies. We believe the prudential supervisor of thrifts should continue to regulate their holding companies, except in the case of a thrift that is systemically significant.[4]

SLHC supervision is an integral part of OTS oversight of the thrift industry. OTS conducts holding company examinations concurrently with the examination of the thrift subsidiary, supplemented by offsite monitoring. For the most complex holding companies, OTS utilizes a continuous supervision approach. We believe the regulation of the thrift and holding company has enabled us to effectively assess the risks of the consolidated entity, while retaining a strong focus on protecting the Deposit Insurance Fund.

The OTS has a wealth of expertise regulating thrifts and holding companies. We have a keen understanding of small, medium-sized and mutual thrifts and their holding companies. Consolidated supervision is particularly important for these entities because

[4] With respect to this question we express our opinion only concerning thrifts and their holding companies. We express no opinion as to banks and BHCs.

separate regulation of the thrift and holding company would be especially costly, burdensome and inefficient for them. We are concerned that if the FRB became the regulator of these holding companies, it would focus most of its attention on the largest holding companies to the detriment of small and mutual SLHCs.

With regard to holding company regulation, OTS believes thrifts with non-systemic holding companies should have strong, consistent supervision by a single regulator. Conversely, a systemically important SLHC should be regulated by the systemic regulator. This is consistent with our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms.

2. Elimination of the Exception in the Bank Holding Company Act for Special Purpose Banks

The Administration Proposal would also eliminate the BHCA exceptions for a number of special purpose banks, such as industrial loan companies, credit card banks, trust companies, and the so-called "nonbank banks" grandfathered under the Competitive Equality Banking Act of 1987. Neither the FRB nor OTS regulates the entities that own or control these special purpose banks, unless they also own or control a bank or thrift. As is the case with unitary SLHCs, the Administration Proposal would force these entities to divest themselves of either their special purpose banks or other entities. The

Administration's rationale for the provision is to close all the so-called loopholes under the BHCA and to treat all entities that own or control any type of a bank equally.

Once again our opinion on this aspect of the Administration Proposal is guided by the key principle of ensuring that changes to the financial regulatory system address real problems that caused the crisis. There are many causes of the financial crisis, but the inability of the FRB to regulate these entities is not one of them. Forcing companies that own special purpose banks to divest one or more of their subsidiaries is unnecessary and punitive. Moreover, it does not address a problem that caused the crisis or weakens the financial system. Accordingly, we do not support this provision.

D. Creation of the Consumer Financial Protection Agency

The Administration Proposal, as outlined in H.R. 3126 (the Bill), calls for the establishment of the CFPA to regulate the offering of all consumer financial products and services. The CFPA would acquire the consumer protection authority and staff of the current FBAs and the NCUA, including rulemaking, examination and enforcement regarding consumer protection issues. CFPA regulations would serve as a floor, not a ceiling, with respect to state laws; states would be empowered to enforce CFPA rules. Finally, CFPA would define standards for "plain vanilla" products (e.g., 30-year fixed rate mortgages) that are simple and have straightforward pricing. All providers and intermediaries would be required to offer these products prominently, alongside other products they may offer.

1. Rulemaking Authority

The OTS supports consolidating rulemaking authority over all consumer protection regulation in one federal regulator. This regulator should be responsible for promulgating all consumer protection regulations that would apply uniformly to all entities that offer financial products, whether an insured depository institution, state-licensed mortgage broker or mortgage company.

Under the current system multiple agencies, including, but not limited to, the Department of Housing and Urban Development, the Federal Trade Commission, the FRB, the FDIC, the NCUA, the OCC and the OTS, each have consumer rule writing functions. This system has led to inconsistent regulation, a lack of accountability and, too often, a lack of timely action to implement regulations for the laws passed by Congress to protect consumers.

2. Uniform Regulation

As the Administration Proposal notes, in the years immediately preceding the financial crisis, 94 percent of the high cost mortgages were originated outside of the regulated banking industry. As a general matter, these entities are not examined and are not subject to the same regulatory scrutiny with respect to consumer protection laws and regulations to the same extent as depository institutions. One of the causes of the financial crisis was the inability of the regulatory system to protect consumers from inappropriate financial practices of nonbank lenders. Effective supervision and regulation of nonbank financial providers would go a long way to ameliorating this problem.

As the OTS has advocated for some time, one of the paramount goals of any new framework should be to ensure that similar bank or bank-like products, services, and activities are treated in the same way in a regulation, whether they are offered by a chartered depository institution or an unregulated financial services provider. The product should receive the same review, oversight, and scrutiny regardless of the entity offering the product. Consumers do not understand — nor should they need to understand — distinctions between the types of lenders offering to provide them with a mortgage. They deserve the same service, care, and protection from any lender. The "shadow bank system," where bank or bank-like products are offered by nonbanks using different standards, should be subject to as rigorous supervision as banks.

3. Authority over Depository Institutions

Unlike the Bill, the OTS recommends retaining primary consumer-protection-related examination and supervision authority for insured depository institutions with the FBAs and the NCUA. The OTS believes that the CFPA should have primary examination and enforcement power over entities engaged in consumer lending that are not under the jurisdiction of the FBAs.

Safety and soundness and consumer protection examination and enforcement powers should not be separated for insured depository institutions because safety-and-soundness examinations complement and strengthen consumer protection. By separating safety-and-soundness functions from consumer protection, the CFPA and an FBA could each have gaps in their information concerning an institution. Neither agency would see a complete picture, to the detriment of both consumer protection and safety and soundness.

Moreover, in its desire to protect consumers, the CFPA could require actions by a depository institution that would be potentially unsafe or unsound. This could lead to potential conflicts with the FBA. For example, the consumer agency might direct an institution to offer mainly 30-year, fixed rate mortgages that would be friendly to consumers. However, a concentration in these types of mortgages could create safety and soundness concerns by increasing interest rate risk and lowering capital, thereby resulting in fewer loans available for consumers.

Separating consumer regulation from safety and soundness could also result in inefficiencies and possible duplication in supervision. A bank or thrift would be examined by its primary federal regulator and, in addition, could be examined by the consumer protection agency. A state chartered institution may have yet another layer of supervision and examination. Moreover, in the case of very large institutions, the systemic regulator would also apply a layer of supervision under the Administration's Proposal.

4. Nationwide Standards

The proposed consumer protection legislation would effectively end the consistent, nationwide system of federal standards by requiring banks and thrifts to comply with potentially inconsistent consumer protection laws in all 50 states, as well as local governments. State attorneys general could interpret and enforce CFPA rules differently. Federal institutions would have to comply with a patchwork of state regulatory regimes, which would subject them to significant compliance and legal costs, and the constant threat of litigation. This could result in additional costs to consumers

and might affect the financial system and the economy during a time when the economic health of the nation is a paramount concern.

Without federal preemption to ensure a consistent set of regulations and policies to protect consumers nationwide, the consumer protection agency would be unable to write simple, understandable disclosures to be applied nationwide. Whatever disclosures the agency might develop to address federal requirements would need to be supplemented with state (and local) disclosures. All of the foregoing could lead ultimately to unintended results, including more complex and lengthier disclosures for consumers, two-to-three sets of disclosures (federal, state and local) with different and perhaps inconsistent information, higher-cost financial services for consumers and perhaps the elimination of some services altogether. OTS believes that where there is strong federal consumer law, preemption should be retained, and where strong nationwide protections are not in place, they should be established.

5. Standard Products

The Bill is designed to establish rules to ensure that consumers are provided with options among various financial products or services to enable them to make informed choices about features, terms and risks that are best for them. Nonetheless, we are concerned about the consumer protection agency defining standards for financial products and services that would require institutions to offer certain products (e.g. 30-year fixed rate mortgages). The imposition of such a requirement could result in safety and soundness concerns and stifle credit availability and innovation.

OTS does not believe that federal regulators should dictate the types of products that lenders must offer. Although we believe strongly that government regulators should prohibit products or practices that are unfair to consumers, the government should not be overly prescriptive in defining lenders' business plans or mandating that certain products be offered to consumers.

Defining standards for financial products would put a government seal of approval on certain favored products and would effectively steer lenders toward these products. It could have the unintended consequence of fewer choices for consumers by stifling innovation and inhibiting the creation of products that could benefit consumers and financial institutions.

E. Supervision and Resolution of Systemically Important Firms

The Administration Proposal would provide for the consolidated supervision and regulation of any systemically important financial firm regardless of whether the firm owns an insured depository institution. The authority to supervise and regulate systemically important firms would be vested in the FRB. The FRB would be authorized to designate systemically important firms if it determined that material financial distress at the company could pose a threat, globally or in the United States, to financial stability or the economy during times of economic stress.[5] The FRB, in consultation with

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[5] The FRB would be required to base its determination on the following criteria:

> "(i) the amount and nature of the company's financial assets;
> "(ii) the amount and types of the company's liabilities, including the degree of reliance on short-term funding;
> "(iii) the extent of the company's off-balance sheet exposures;
> "(iv) the extent of the company's transactions and relationships

Treasury, would issue rules to guide the identification. Systemically important firms would be subjected to stricter and more conservative prudential standards than those that apply to other BHCs, including higher standards on capital, liquidity and risk management. They would also be subject to Prompt Corrective Action.

The Administration Proposal also calls for the creation of a Financial Services Oversight Council (Council) made up of the Secretary of the Treasury and all of the Federal financial regulators. Among other responsibilities, the Council would make recommendations to the FRB concerning institutions that should be designated as systemically important. Also, the FRB would consult the Council in setting material prudential standards for such firms and in setting risk management standards for systemically important systems and activities regarding payment, clearing and settlement.

The Administration Proposal provides a regime to resolve systemically important firms when the stability of the financial system is threatened. The resolution authority would supplement and be modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act. The Secretary of the Treasury could invoke the resolution authority only after consulting with the President and upon the written recommendation of two-thirds of the members of the FRB, and the FDIC or SEC as appropriate. The Secretary would have the

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with other major financial companies;
"(v) the company's importance as a source of credit for households, businesses and State and local governments and as a source of liquidity for the financial system;
"(vi) the recommendation, if any, of the Financial Services Oversight Council; and
"(vii) any other factors that the Board deems appropriate.

TitleII, Section 204. Administration Draft Legislation.
http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf

ability to appoint a receiver or conservator for the failing firm. In general, that role would be filled by the FDIC, though the SEC could be appointed in certain cases. In order to fund this resolution regime, the FDIC would be authorized to impose risk-based assessments on systemically important firms.

OTS's views on these aspects of the Administration Proposal is guided by our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms. The U.S. economy operates on the principle of healthy competition. Enterprises that are strong, industrious, well–managed and efficient succeed and prosper. Those that fall short of the mark struggle or fail and other, stronger enterprises take their places. Enterprises that become "too big to fail" subvert the system when the government is forced to prop up failing, systemically important companies — in essence, supporting poor performance and creating a "moral hazard."

The OTS agrees there is a pressing need for a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose unacceptable risk to financial stability. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including, but not limited to, companies involved in banking, securities and insurance.

We also support the establishment of a strong and effective Council. Each of the financial regulators would provide valuable insight and experience to the systemic risk regulator.

We also strongly support providing a resolution regime for all systemically important firms. Given the events of recent years, it is essential that the federal government have the authority and the resources to act as a conservator or receiver and to provide an orderly resolution of systemically important institutions, whether banks, thrifts, bank holding companies or other financial companies. The authority to resolve a distressed systemically important firm in an orderly manner would ensure that no bank or financial firm is "too big to fail." A lesson learned from recent events is that the failure or unwinding of systemically important companies has a far reaching impact on the economy, not just on financial services.

The continued ability of banks, thrifts and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator should be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy and

other factors, should be as comparable as possible for entities that have multinational businesses.

F. Strengthening Supervision and Regulation of Securitization Markets

One of the factors contributing to the financial crisis was the lack of incentives for lenders and securitizers to consider the performance of the underlying loans after asset backed securities were issued. Once these loans were originated, the majority of them were removed from bank balance sheets and sold into the securitization market. These events seeded many residential mortgage-backed securities with loans that were not underwritten adequately and that caused significant problems later when home values fell, mortgages became delinquent and the true value of the securities became increasingly suspect.

In response to this problem, both the Administration Proposal and the Mortgage Reform and Anti-Predatory Lending Act of 2009 (H.R. 1726) as passed by the House, would require creditors to retain an economic interest in a material portion (at least 5 percent) of the credit risk of certain mortgage loans that the creditor transfers, sells, or conveys to a third party. The FBAs would have the authority to make exceptions and to apply the risk retention provisions to securitizers.

The OTS has spoken out many times about how, under the current regulatory environment, nonbank mortgage originators are not subject to prudential regulation and have very little stake in the performance of a loan after origination. Many of the recent excesses in the mortgage market might have been avoided if all mortgage originators had

a significant, vested interest in the performance of loans they originated. The OTS has long recommended linking compensation for loan originators to responsible underwriting practices to assure that they offer appropriate loans to borrowers who have a reasonable prospect of repaying the loan. Mortgage brokers should receive their commission in separate installments over a predetermined period based on the continued good performance of the mortgage. We believe this requirement would result in more sustainable mortgages.

In another effort to ensure that loans are adequately underwritten, in September 2008 the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale were forced to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

The Administration Proposal would also bring markets for all derivatives and asset-backed securities "into a coherent and coordinated regulatory framework that requires transparency and improves market discipline." It would also increase the transparency and standardization of securitization markets and strengthen the regulation of credit rating agencies.

The OTS is on record supporting regulation of derivative products such as credit default swaps, where tremendous risk exposure has been disguised in opaque and complex ways. We also believe that many of the recent problems associated with derivatives resulted in part from over-reliance on credit rating agencies.

IV. Conclusion

In conclusion, we support the goals of the Administration and this Committee to create a reformed system of financial regulation that fills regulatory gaps and prevents the type of financial crisis that we have just endured. We believe that in the near term Congress can enact legislation that fulfills such goals. Such legislation should include: 1) The creation of an agency dedicated to establishing regulations applicable to all providers of consumer financial products; 2) A mechanism to supervise and resolve systemically important firms; and 3) The strengthening of regulation of securitization markets.

Thank you again, Mr. Chairman, Ranking Member Bachus and Members of the Committee for the opportunity to testify on behalf of the OTS.

We look forward to working with the Members of this Committee and others to create a system of financial services regulation that promotes greater economic stability for providers of financial services and the nation.

For Release Upon Delivery

STATEMENT of

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

July 24, 2009

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent those of the President.

Statement of

John C. Dugan

Comptroller of the Currency

before the

Committee on Financial Services

U.S. House of Representatives

July 24, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I appreciate this opportunity to discuss the Administration's Proposal for reforming and restructuring the regulation of financial services in the United States.[1] The events of the last two years – including the unprecedented distress and failure of financial firms, the accumulation of toxic subprime assets in our financial system, and the steep rise in foreclosures – have exposed gaps and weaknesses in our regulatory framework. The Proposal put forward by the Treasury Department for strengthening that framework is thoughtful and comprehensive. I support many of its proposed reforms, but I have significant concerns with two parts of it, *i.e.*, (1) the scope of authority of the newly proposed Consumer Financial Protection Agency (CFPA), and its related elimination of uniform national standards for national banks; and (2) the proposed broad authority of the Federal Reserve, as systemic risk regulator, to override authority of the primary banking

[1] *See* U.S. Department of the Treasury, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (June 2009) (the Proposal), available on the Treasury Department's Financial Stability website at www.financialstability.gov/docs/regs/FinalReport_web.pdf.

supervisor. Both relate to the way in which important new authorities would interact with the essential functions of the dedicated prudential banking supervisor.

My testimony begins with a brief summary of the key parts of the Proposal we generally support, but then focuses more extensively on our two major areas of concern. We will, of course, be happy to provide additional comments as detailed legislative language on other parts of the Proposal becomes available.

I. Key Provisions Supported by the OCC

Set forth below are key parts of the Proposal that we generally support, which are not intended to be an exhaustive list of the Proposal's suggested reforms.

- **Establishment of a Financial Stability Oversight Council.** This council would consist of the Secretary of the Treasury and all of the federal financial regulators, and would be supported by a permanent staff. Its general role would be to identify and monitor systemic risk, and it would have strong authority to gather the information necessary for that mission, including from any entity that might pose systemic risk. We believe that having a centralized and formalized mechanism for gathering and sharing systemically significant information, and making recommendations to individual regulators, makes good sense.
- **Enhanced authority to resolve systemically significant financial firms.** The Federal Deposit Insurance Corporation (FDIC) currently has broad authority to resolve a distressed systemically significant depository institution in an orderly manner. No comparable resolution authority exists for large bank holding companies, or for systemically significant financial companies that are not banks, as we learned painfully with the problems of such large financial companies as

Bear Stearns, Lehman Brothers, and AIG. The Proposal would extend resolution authority like the FDIC's to such nonbanking companies, while preserving the flexibility to use the FDIC or another regulator as the receiver or conservator, depending on the circumstances. This is a sound approach that would help maximize orderly resolutions of systemically significant firms.

- **Designation of the Federal Reserve as the consolidated supervisor of all systemically significant financial firms.** Working with the OCC and the other bank regulators, the Federal Reserve Board already has strong authority as consolidated supervisor to identify and address problems at large, systemically significant bank holding companies. In the financial crisis of the last two years, the absence of a comparable authority with respect to large securities firms, insurance companies, and government-sponsored enterprises that were not affiliated with banks proved to be an enormous problem, as a disproportionate share of the financial stress in the markets was created by these institutions. The lack of a consistent and coherent regulatory regime applicable to them by a single regulator helped mask problems in these nonbanking companies until they were massive. And gaps in the regulatory regime constrained the government's ability to deal with them once they emerged. The Proposal would extend the Federal Reserve's consolidated bank holding company regulation to systemically significant nonbanks in the future, which would appropriately address the regulatory gap. However, as discussed below, one aspect of this part of the proposal goes too far, *i.e.*, the new Federal Reserve authority to "override" the primary banking supervisor, which would undermine the authority – and the

accountability – of the banking supervisor for the soundness of banks that anchor systemically significant holding companies.

- **Strengthened regulation of systemically significant firms, including through higher capital requirements and stronger liquidity requirements.** We support the concept of imposing more stringent prudential standards on systemically significant financial firms to address their heightened risk to the system and to mitigate the competitive advantage they could realize from being designated as systemically significant. However, in those instances where the largest asset of the systemically significant firm is a bank – as may often be the case – the primary banking supervisor should have a strong role in helping to craft the new standards.
- **Effective merger of the Office of Thrift Supervision (OTS) into the Office of the Comptroller of the Currency (OCC), with a phase-out of the federal thrift charter.** In proposing to restructure the banking agencies, the Proposal appropriately preserves an agency whose only mission is banking supervision. This new agency would serve as the primary regulator of federally chartered depository institutions, including the national banks that comprise the dominant businesses of many of the largest bank holding companies. To achieve this goal, the Proposal would effectively merge the OTS into the OCC. It would also eliminate the federal thrift charter – but not the state thrift charter – with all federal thrifts required to convert to either a national bank, state bank, or state thrift, over the course of a reasonable transition period. (State thrifts would then be treated as state "banks" under Federal law.) We believe this approach to the

agency merger is preferable to one that would preserve the federal thrift charter, with federal thrift regulation being conducted by a division of the merged agency. With the same deposit insurance fund, same prudential regulator, same holding company regulator, and a narrower charter (a national bank has all the powers of a federal thrift plus many others), there would no longer be a need for a separate federal thrift charter. In addition, the approach in the Proposal avoids the considerable practical complexities and costs of administering two separate statutory and regulatory regimes that are largely redundant in many areas, and needlessly different in others. Indeed, if the federal thrift charter is not preserved, we see no reason for the government to incur the cost of changing the 146-year-old name of the agency as the Office of the Comptroller of the Currency, since the sole mission of the agency would remain the supervision and regulation of national banks. Finally, it is critical that the legislation implementing this aspect of the Proposal be unambiguously clear that the new agency is independent from the Treasury Department and the Administration to the same extent that the OCC and OTS are currently independent.[2]

- **Changes in accounting standards that would allow banks to build larger loan loss reserves in good times to absorb more losses in bad times.** One of the problems that has impaired banks' ability to absorb increased credit losses while continuing to provide appropriate levels of credit is that their levels of loan loss reserves available to absorb such losses were not as high as they should have been

[2] For example, current law provides the OCC with important independence from political interference in decision-making in matters before the Comptroller, including enforcement proceedings; provides for funding independent of political control; enables the OCC to propose and promulgate regulations without approval by the Treasury; and permits the agency to testify before Congress without the need for the Administration's clearance of the agency's statements.

entering the crisis. One reason for this is the currently cramped accounting regime for building loan loss reserves, which is based on the concept that loan loss provisions are permissible only when losses are "incurred." The Proposal calls for accounting standard setters to improve this standard to make it more forward looking so that banks could build bigger loan loss reserves when times are good and losses are low, in recognition of the fact that good times inevitably end, and large loan loss reserves will be needed to absorb increased losses when times turn bad. The OCC strongly supports this part of the Proposal. In fact, I co-chaired an international task force under the auspices of the Financial Stability Board to achieve this very objective on a global basis, which we hope will contribute to stronger reserving policy both here and abroad.

- **Enhanced consumer protection.** The Proposal calls for enhanced consumer protection standards for consumer financial products through new rules that would be written and implemented by the new Consumer Financial Protection Agency. The OCC supports strong, uniform federal consumer protection standards. While we generally do not have rulewriting authority in this area, we have consistently applied and enforced the rules written by the Federal Reserve (and others), and, in the absence of our own rulewriting authority, have taken strong enforcement actions to address unfair and deceptive practices by national banks. We believe that an independent agency like the CFPA could appropriately strengthen consumer protections, but we have serious concerns with the CFPA as proposed. We believe the goal of strong consumer protection can be accomplished better through CFPA rules that reflect meaningful input from the

federal banking agencies and are truly uniform. We also believe that these rules should continue to be implemented by the federal banking agencies for banks, under the existing, well established regulatory and enforcement regime, and by the CFPA and the states for nonbank financial providers, which today are subject to different standards and far less actual oversight than federally regulated banks. This is discussed in greater detail below.

- **Stronger regulation of payments systems, hedge funds, and over-the-counter derivatives, such as credit default swaps.** The Proposal calls for significant enhancements in regulation in each of these areas, which we support in concept. We will provide more detailed comments about each, as appropriate, once we have had more time to review the implementing legislative language.

II. Key Concerns

Let me now turn to the two parts of the proposal with which I have the most significant concerns: the CFPA; and the broad proposed authority for the Federal Reserve, as systemic risk regulator, to override the primary banking supervisor in its fundamental supervisory duties.

A. The Proposed Consumer Financial Protection Agency

Today's severe consumer credit problems can be traced to the multi-year policy of easy money and easy credit that led to an asset bubble, with too many people getting loans that could not be paid back when the bubble burst. With respect to these loans – especially mortgages – the core problem was lax underwriting standards. Inadequate consumer protections – such as inadequate and ineffective disclosures – contributed to this problem, because in many cases consumers did not understand the significant risks of

complex loans that had seductively low initial monthly payments. Both aspects of the problem – lax underwriting and inadequate consumer protections – were especially acute in loans made by nonbank lenders that were not subject to federal regulation.

Making a loan that cannot be repaid is obviously bad for the borrower, but it is also fundamentally unsound banking. The fact that the underwriting and consumer dimensions of the mortgage problem are so intertwined makes it especially important to be clear about where the problems were – and where they were not – in developing the best solutions.

For example, some have suggested that the Community Reinvestment Act (CRA) caused the subprime lending crisis. That is simply not true. As the Administration's Proposal expressly recognizes, and as I have testified before, far fewer problem mortgages were made by institutions subject to CRA – that is, federally regulated depository institutions – than were made by mortgage brokers and originators that were not depository institutions. The Treasury Proposal specifically notes that CRA-covered depository institutions made only 6 percent of recent higher-priced mortgages provided to lower-income borrowers or in areas that are the focus of CRA evaluations.[3] Moreover, our experience with the limited portion of subprime loans made by national banks is that they are performing better than non-bank subprime loans. This belies any suggestion that the banking system, and national banks in particular, were any sort of haven for abusive lending practices.

I want to acknowledge that H.R. 3126, which incorporates the CFPA portion of the Proposal, addresses one significant concern about the scope of the proposed new agency's authority. The Treasury Proposal would have transferred to the CFPA the

[3] Proposal, *supra* note 1, at 69-70.

responsibility for administering CRA. H.R. 3126, as introduced earlier this month by Chairman Frank, retains that responsibility in the federal banking agencies. I believe that is the right approach. CRA is not a consumer protection law. Instead, it is a law that, at its core, encourages depository institutions – and only depository institutions – to lend in their communities. The terms of the statute strongly link that lending to safety and soundness – which is one reason that the statute has worked well and an important reason why the federal banking agencies should continue the successful work they have done to implement it.

In terms of changes to financial consumer protection regulation, legislation should be targeted to the two types of fundamental gaps that fueled the current mortgage crisis. The first gap relates to consumer protection rules themselves, which were written under a patchwork of authorities scattered among different agencies; were in some cases not sufficiently robust or timely; and importantly, were not applied to all financial services providers, bank or nonbank, uniformly. The second gap relates to implementation of consumer protection rules, where there was no effective mechanism or framework to ensure that nonbank financial institutions complied with rules to the same extent as regulated banks. That is, the so-called "shadow banking system" of nonbank firms, such as finance companies and mortgage brokers, provides products comparable to those provided by banks, but is not subject to comparable oversight. This shadow banking system has been widely recognized as central to the most abusive subprime lending that fueled the mortgage crisis.

A new Consumer Financial Protection Agency could be one mechanism to target both the rulewriting gap and the implementation gap. In terms of the rulewriting gap, all

existing consumer financial protection authority could be centralized in the CFPA and strengthened as Congress sees fit, and that authority could be applied to all providers of a particular type of financial product with rules that are uniform. In terms of the implementation gap, the CFPA could be focused on supervision and/or enforcement mechanisms that raise consumer protection compliance for nonbank financial providers to a similar level as exists for banks – but without diminishing the existing regime for bank compliance. And in both cases, the CFPA could be structured to recognize legitimate bank safety and soundness concerns that in some cases are inextricably intertwined with consumer protection – as is the case with underwriting standards.

Unfortunately, the Proposal's CFPA falls short in addressing the two fundamental consumer protection regulatory gaps. In terms of the rulewriting gap, it does provide a mechanism for centralized authority and stronger rules that could be applied to all providers of financial products. But the rules would not be uniform; that is, because the Proposal authorizes states to adopt different rules, there could be fifty different standards that apply to providers of a particular product or service, including national banks. As I will discuss further below, these differences would needlessly raise the cost of compliance, and therefore the cost of consumer products and services.

In terms of the implementation gap, the Proposal does not provide any specific direction for how the CFPA would put in place a supervision and enforcement framework to address fundamental compliance problems in the shadow banking system. Indeed, instead of focusing only on the daunting challenge of actually regulating this largely unsupervised sector, the Proposal would dilute both CFPA and state examination and enforcement resources by extending them to already regulated depository institutions as

well. In addition, by transferring all consumer compliance examination and enforcement responsibilities from the depository institution regulators to the CFPA, the Proposal would create a less effective system for consumer protection oversight of those institutions. And in all of this, the Proposal's attempt to completely divorce consumer protection from safety and soundness raises real potential problems.

Let me address each of these issues in greater detail through the prism of the CFPA's key regulatory powers: rulewriting; and the implementation of rules through examination, supervision, and enforcement.

1. Rulewriting

As noted, to address the rulewriting gap, the Proposal's CFPA provides a mechanism for centralizing authority and adopting stronger financial protection rules that would apply to all providers of financial products. Our two fundamental concerns are that the rules actually applied under the CFPA scheme would not be uniform; and that a stronger role for federal banking supervisors is needed in writing the rules in order to provide better protection for consumers when they obtain financial products, while ensuring safe and sound banking practices in providing those products.

a. Lack of Uniform Rules and National Bank Preemption

A core principle of the Proposal is its recognition that consumers benefit from uniform rules.[4] Yet this very principle is expressly undermined by the specific grant of authority to states to adopt different rules; by the repeal of uniform standards for national

[4] *See, e.g.,* Proposal, *supra* note 1, at 69 (discussing the proposed CFPA, observing that "[f]airness, effective competition, and efficient markets require consistent regulatory treatment for similar products," and noting that consistent regulation facilitates consumers' comparison shopping); and at 39 (discussing the history of insurance regulation by the states, which "has led to a lack of uniformity and reduced competition across state and international boundaries, resulting in inefficiency, reduced product innovation, and higher costs to consumers.").

banks; and by the empowerment of individual states, with their very differing points of view, to enforce federal consumer protection rules – under all federal statutes – in ways that might vary from state to state. In effect, the resulting patchwork of federal-plus-differing-state standards would effectively distort and displace the federal agency's rulemaking, even though the CFPA's rule would be the product of an open public comment process and the behavioral research and evaluative functions that the Proposal highlights. In particular, for the first time in the nearly 150-year history of the national banking system, federally chartered banks would be subject to this multiplicity of state operating standards, because the Proposal sweepingly repeals the ability of national banks to conduct any retail banking business under uniform national standards.

This is a profound change and, in my view, the rejection of a national standards option is unwise and unjustified, especially as it relates to national banks. Given the CFPA's enhanced authority and mandate to write stronger consumer protection rules, there should no longer be any issue as to whether sufficiently strong federal consumer protection standards would be in place and applicable to national banks. In this context there is no need to authorize states to adopt different standards for such banks. Likewise, there would be no need to authorize states to enforce federal rules against national banks – which would inevitably result in differing state interpretations of federal rules – because federal regulators already have broad enforcement authority over such institutions and the resources to exercise that authority fully.

More fundamentally, we live in an era where the market for financial products and services is often national in scope. Advances in technology, including the Internet and the increased functionality of mobile phones, enable banks to do business with

customers in many states. Our population is increasingly mobile, and many people live in one state and work in another – the case for many of us in the Washington, D.C. metropolitan area.

In this context, regressing to a regulatory regime that fails to recognize the way retail financial services are now provided, and the need for an option for a single set of rules for banks with multi-state operations and multistate customers, would discard many of the benefits consumers reap from our modern financial product delivery system. The Proposal's balkanized approach could give rise to significant uncertainty about which sets of standards apply to institutions conducting a multistate business, generating major legal and compliance costs, and major impediments to interstate product delivery.

This issue is very real. There are a number of areas in which complying with different standards set by individual states would require a bank to determine which state's law governs – the law of the state where a person providing a product or service is located, the law of the home state of the bank employing that person, or the law of the state where the customer is located. It is far from clear how a bank could do this based on objective analysis, and any conflicts could result in penalties and litigation in multiple jurisdictions.

Examples include rules regarding compensation practices for individuals providing a particular financial product, or permissible rates of interest for bank services. Today the maximum permissible interest rate is derived from the bank's home state, but states could claim that it should be the rate of the state in which the customer resides, or the rate of the location where the loan is made. States could have different standards for exerting jurisdiction over interest rates, creating the potential for the laws of two or more

states to apply to the same transaction. And even if the bank gets this all figured out for a particular customer, and for all the product relationships it has with the customer, that would all change if the customer moved.

Such uncertainties have the real potential to confuse consumers, subject providers to major new potential liabilities, and significantly increase the costs of doing business in ways that will be passed on to consumers. It could also cause product providers to pull back where increased costs erase an already thin profit margin – for example, with indirect auto lending across state lines – or where they see unacceptable levels of uncertainty and potential risk.

Moreover, a bank with multi-state operations might well decide that the only sensible way to conduct a national business is to operate to the most stringent standard prevailing in its most significant state market. It should not be the case that the decision by a state legislature about how products should be designed, marketed, and sold should effectively replace a national regulatory standard established by the federal government based on thorough research and an open and nationwide public comment process.

Finally, subjecting national banks to state laws and state enforcement of federal laws is a potentially crippling change to the national bank charter and a rejection of core principles that form the bedrock of the dual banking system. For nearly 150 years, national banks have been subject to a uniform set of federal rules enforced by the OCC, and state banks have been subject to their own states' rules. This dual banking system has worked, as it has allowed an individual state to serve as a "laboratory" for new approaches to an issue – without compelling adoption of a particular approach by all states or as a national standard. That is, the dual banking system is built on individual

states experimenting with different kinds of laws, including new consumer protection laws, that apply to state banks in a given state, but not to state banks in all states and not to national banks. Some of these individual state laws have proven to be good ideas, while others have not. When Congress has believed that a particular state's experiment is worthwhile, it has enacted that approach to apply throughout the country, not only to all national banks, but to state banks operating in other states that have not yet adopted such laws. As a result of this system, national banks have always operated under an evolving set of federal rules that are at any one time the same, regardless of the state in which they are headquartered, or the number of different states in which they operate. This reliable set of uniform federal rules is a defining characteristic of the national bank charter, helping banks to provide a broader range of financial products and services at lower cost, which in turn can be passed along to the consumer.

The Proposal's CFPA, by needlessly eliminating this defining characteristic, will effectively "de-nationalize" the national charter and undermine the dual banking system. What will be the point of a national charter if all banks must operate in every state as if they were chartered in that state? With many consumer financial products now commoditized and marketed nationally, it is difficult to understand the sense of replacing the option of enhanced and reliable federal standards that are uniform, with a balkanized "system" of differing state standards that may be adopted under processes very different from the public-comment and research-based rulemaking process that the CFPA would employ as a federal agency.

b. Inadequate Input by Banking Supervisors into Rulemaking

The Proposal would vest all consumer protection rulewriting authority in the CFPA, which in turn would not be constrained in any meaningful way by safety and soundness concerns. That presents serious issues because, in critical aspects of bank supervision, such as underwriting standards, consumer protection cannot be separated from safety and soundness. They are both part of comprehensive and effective banking supervision. Mortgage lending provides a good example. There is no doubt that abusive marketing and ineffective disclosure practices contributed to the build-up of harmful subprime loans. However, the core of the subprime crisis was an underwriting failure – loans made based on lax underwriting standards. Transparent disclosure regimes alone cannot solve that problem, just as sound underwriting does not guarantee that consumers will understand financial products and make informed choices. The integration of both perspectives is essential to effective, comprehensive supervision.

Despite this integral relationship, the Proposal as drafted would allow the CFPA, in writing rules, to dismiss legitimate safety and soundness concerns raised by a banking supervisor. That is, if a particular CFPA rule conflicts with a safety and soundness standard, the CFPA's views would <u>always</u> prevail, because the legislation provides no mechanism for striking an appropriate balance between consumer protection and safety and soundness objectives. The premise for this result seems to be that the CFPA (and the states, for that matter) will always opt for consumer protection rules that are more stringent from a safety and soundness perspective than rules that would be adopted by the safety and soundness supervisor. Not only is this premise counterintuitive – it is, after all, the safety and soundness supervisor's job to protect safety and soundness – but it is

also not difficult to imagine circumstances in which the CFPA or a state adopts a rule in the name of consumer protection that would increase safety and soundness concerns, especially in the area of underwriting standards. For example, the CFPA could require a lender to offer a standardized mortgage that has simple terms, but also has a low down payment to make it more beneficial to consumers. That type of rule could clearly raise safety and soundness concerns, because lower down payments are correlated with increased defaults on loans – yet a safety and soundness supervisor would have no ability to stop such a rule from being issued.

In short, as applied to depository institutions, the CFPA rules need to have meaningful input from banking supervisors – both for safety and soundness purposes and because bank supervisors are intimately familiar with bank operations and can help ensure that rules are crafted to be practical and workable. A workable mechanism needs to be specifically provided to incorporate legitimate operational and safety and soundness concerns of the banking agencies into any final rule that would be applicable to insured depository institutions. Moreover, I do not believe it is sufficient to have only one banking supervisor on the agency's board, as provided under the Proposal; instead, all the banking agencies should be represented, even if that requires expanding the size of the board.

2. Implementation: Supervision, Examination, and Enforcement

Consumer protection rules are implemented through examination, supervision, and/or enforcement. In this context, the Proposal fails to adequately address the implementation gap I have previously described because it fails to carefully and appropriately target the CFPA's examination, supervision, and enforcement jurisdiction

to the literally tens of thousands of non-depository institution financial providers that are either unregulated, or very lightly regulated. These are the firms most in need of enhanced consumer protection regulation, and these are the ones that will present the greatest implementation challenges to the CFPA. Yet rather than focus the CFPA's implementation responsibilities on solely these firms, the Proposal would effectively dilute both the CFPA's and the states' supervisory and enforcement authorities by extending them to already regulated banks. To do this, the Proposal would strip away all consumer compliance examination and supervisory responsibilities – and for all practical purposes enforcement powers as well – from the federal banking agencies and transfer them to the CFPA. And, although the legislation is unclear about the new agency's responsibilities for receiving and responding to consumer complaints, it would either remove or duplicate the process for receiving and responding to complaints by consumers about their banks. The likely results will be that: (1) nonbank financial institutions will not receive the degree of examination, supervision, and enforcement attention required to achieve effective compliance with consumer protection rules; and (2) consumer protection supervision of banks will become less rigorous and less effective.

In relative terms, it will be easy for the CFPA to adopt consumer protection rules that apply to all providers of financial products and services. But it will be far harder to craft a workable supervisory and enforcement regime to achieve effective implementation of those rules. In particular, it will be a daunting challenge to implement rules with respect to the wide variety and huge number of unregulated or lightly regulated providers of financial services over which the new CFPA would have jurisdiction, *i.e.,* mortgage brokers; mortgage originators; payday lenders; money service transmitters; check

cashers; real estate appraisers; title, credit, and mortgage insurance companies; credit reporting agencies; stored value providers; financial data processing, transmission, and storage firms; debt collection firms; investment advisors not subject to SEC regulation; financial advisors, and credit counseling and tax preparation services, among other types of firms. Likewise, it will be daunting to respond to complaints from consumers about these types of firms. Last year, the OCC helped almost 100,000 consumers who had questions or complaints only about their banks. The CFPA is guaranteed to receive far more, given the vastly broader scope of its jurisdiction.

Yet, although the Proposal would give the CFPA broad consumer protection authority over these types of financial product and service providers, it contains no framework or detail for examining them or requiring reports from them – or even knowing who they are. No functions are specified for the CFPA to monitor or examine even the largest of these nonbank firms, much less to supervise and examine them as depository institutions are when engaged in the same activities. No provision is made for registration with the CFPA so that the CFPA could at least know the number and size of firms for which it has supervisory, examination, and enforcement responsibilities. Nor is any means specified for the CFPA to learn this information so that it may equitably assess the costs of its operations – and lacking that, there is a very real concern that assessments will be concentrated on already regulated banks, for which size and operational information is already available.

In short, the CFPA has a full-time job ahead to supervise, examine, and take enforcement actions against nonbank firms in order to effect their compliance with CFPA rules. In contrast, achieving effective compliance with such rules by banks is far more

straightforward, since an extensive and effective supervisory and enforcement regime is already in place at the federal banking agencies. It therefore makes compelling sense for the new CFPA to target its scarce implementation resources on the part of the industry that requires the most attention to raise its level of compliance – the shadow banking system – rather than also try to undertake supervisory, examination, and enforcement functions with respect to depository institutions.

Similarly, state consumer protection resources, which are subject to the same severe budgetary pressures affecting state governments generally, would be best focused on examining and enforcing consumer protection laws with respect to the nonbank financial firms that are unregulated or lightly regulated – and have been the disproportionate source of financial consumer protection problems. If states targeted their scarce resources in this way, and drew on new examination and enforcement resources of the CFPA that were also targeted in this way, the states could help achieve significantly increased compliance with consumer protection laws by nonbank financial firms. Unfortunately, rather than have this focus, the Proposal's CFPA would stretch the states' enforcement jurisdiction to federally chartered banks, which are already subject to an extensive examination and enforcement regime at the federal level. We believe this dilution of their resources is unnecessary, and it will only make it more difficult to fill the implementation gap that currently exists in achieving effective compliance of nonbank firms with consumer protection rules.

Finally, I firmly believe that, by transferring all consumer protection examination, supervision, and enforcement functions from the Federal banking agencies to the CFPA, the Proposal would create a supervisory system for banks that would be a less effective

approach to consumer protection than the integrated approach to banking supervision that exists today. As previously discussed, safety and soundness is not divorced from consumer protection – they are two aspects of comprehensive bank supervision that are complementary. The removal of all supervision and examination authority from the bank regulators would create fundamental fissures in the supervision of banks' retail businesses. Likewise, if it is the intention of the proposal to remove from the banking agencies the responsibility for receiving and responding to consumer complaints, it will remove a window into potential safety and soundness problems. For example, sometimes consumers raise fairness concerns about products that also present serious business risks. Consumers can be an early warning system for consumer protection problems and for safety and soundness problems.

Today, the banking agencies conduct safety and soundness and consumer compliance examinations on a coordinated basis. Information obtained from exams in one area can lead to follow-up supervisory activities in another. Disclosure deficiencies, aggressive marketing practices, or poor new product development can be symptoms of broader risk control failures that can injure both customers and bank soundness. And credit underwriting weaknesses, which are a core safety and soundness issue, can also constitute the real consumer protection issue of whether consumers are systematically provided credit that they cannot afford. Armed with safety and soundness examination information, bank supervisors have exercised real clout under current law to achieve consumer protection compliance through their ongoing examination presence.

Attached to my testimony are summaries of our actual supervisory experience, drawn from supervisory letters and examination conclusion memoranda, which show the

real life linkage between safety and soundness and consumer protection supervision. I believe these summaries demonstrate that the results would be worse for consumers and the overall prudential supervision of these banks if bank examiners were not allowed to assess and address both safety and soundness and consumer protection issues as part of their integrated supervision.

Complaints that banking supervisors did not do enough to protect consumers are fundamentally more about whether consumer protection rules were sufficiently robust and timely, and less about whether supervisors adequately enforced the rules that were in place, which they generally did. The appropriate way for the CFPA to address these complaints is through its enhanced rulemaking function, not its examination, supervision, and enforcement functions.

Indeed, we believe that transferring bank examination and supervision authority to the CFPA will not result in more effective supervision because the new agency will never have the same presence or knowledge about the institution. Our experience at the OCC has been that effective, integrated safety and soundness and compliance supervision grows from the detailed, core knowledge that our examiners develop and maintain about each bank's organizational structure, culture, business lines, products, services, customer base, and level of risk; this knowledge and expertise is cultivated through regular on-site examinations and contact with our community banks, and close, day-to-day focus on the activities of larger banks. An agency with a narrower focus, like that envisioned for the CFPA, would be less effective than a supervisor with a comprehensive grasp of the broader banking business.

B. Systemic Regulator's Authority to Override Primary Banking Supervisor

Let me now turn to our other major concern with the Proposal, as we have seen it to date. As previously discussed, the Proposal would establish the Federal Reserve Board as the systemic supervisor by providing it with enhanced, consolidated authority over a "Tier 1" financial holding company – that is, a company that poses significant systemic risk – and all of its subsidiaries. In essence, this structure builds on and expands the current system for supervising bank holding companies, where the Board already has consolidated authority over the company, and the prudential bank supervisor is responsible for direct bank supervision.

In testimony provided earlier this year, I urged strongly that Congress, in reforming financial services regulation, preserve a robust, independent bank supervisor that is solely dedicated to the prudential oversight of depository institutions. I continue to believe that the benefits of dedicated, strong prudential supervision are significant. Dedicated supervision assures there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility is well defined, and so is accountability.

In practice, many of the companies likely to be designated as Tier 1 financial holding companies will have at their heart very large banks, many of which are national banks. Because of their core role as financial intermediaries, large banks have extensive ties to the "federal safety net" of deposit insurance, the discount window, and the payments system. Accordingly, the responsibility of the prudential bank supervisor must be to ensure that the bank remains a strong anchor within the company as a whole. Indeed, this is our existing responsibility at the OCC, which we take very seriously

through our continuous on-site supervision by large teams of resident examiners in all of our largest national banks. As a result, the bank is by far the most intensively regulated part of the largest bank holding companies, which has translated into generally lower levels of losses of banks within the holding company versus other companies owned by that holding company – including those large bank holding companies that have sustained the greatest losses.

In the context of regulatory restructuring for systemically significant bank holding companies, preserving a fundamental role for the prudential supervisor of the bank means that its relationship with the systemic supervisor should be complementary; it should not be subsumed or overtaken by the systemic supervisor. Conflating the two roles undermines the bank supervisor's authority, responsibility, and accountability, and would further stretch the role of the Board.

Parts of the Proposal are consistent with this type of complementary relationship between the Board and the prudential bank supervisor. For example, the Board would be required to rely, as far as possible, on the reports of examination prepared by the prudential bank supervisors. This approach reflects the practical relationship that the OCC has with the Board today, a relationship that has worked well, in part because the lines of authority between the two regulators are appropriately defined. And it has allowed the Board to use and rely on our work to perform its role as supervisor for complex banking organizations that are often involved in many businesses other than banking. It is a model well suited for use in a new regulatory framework where the Board assumes substantial new responsibilities, including potential authority over some Tier 1 companies that do not have bank subsidiaries at all.

In one crucial respect, however, the Proposal departs dramatically from that model and is not consistent with its own stated objective of maintaining a robust, responsible, and independent prudential supervisor that will be accountable for its safety and soundness supervision. That is, the Proposal provides the Board with authority to establish, examine, and enforce more stringent standards with respect to the subsidiaries of Tier 1 financial holding companies – including bank subsidiaries – in order to mitigate systemic risk posed by those subsidiaries. This open-ended authorization would allow the Board to impose customized requirements on any aspect of the bank's operations at any time, subject only to a requirement for "consultation" with the Secretary of the Treasury and the bank's primary federal or state supervisor. This approach is entirely unnecessary and unwarranted in the case of banks already subject to extensive regulation. It would fundamentally alter the relationship between the Board and the bank supervisor by superseding the bank supervisor's authority over bank subsidiaries of systemically significant companies, and would be yet another measure that concentrates more authority in, and stretches the role of, the Board.

In addition, while the Proposal centralizes in the Board more authority over Tier 1 financial holding companies, it does not address the current, significant gap in supervision that exists within bank holding companies. In today's regulatory regime, a bank holding company may engage in a particular banking activity, such as mortgage lending, either through a subsidiary that is a bank or through a subsidiary that is not a bank. If engaged in by the banking subsidiary, the activity is subject to required examination and supervision on a regular basis by the primary banking supervisor. However, if it is engaged in by a nonbanking subsidiary, it is potentially subject to

examination by the Federal Reserve, but regular supervision and examination is not required. As a policy matter, the Federal Reserve had previously elected not to subject such nonbanking subsidiaries to full bank-like examination and supervision on the theory that such activities would inappropriately extend "the safety net" of federal protections from banks to nonbanks.[5] The result has been the application of uneven standards to bank and nonbank subsidiaries of bank holding companies. For example, in the area of mortgage lending, banks were held to more rigorous underwriting and consumer compliance standards than nonbank affiliates in the same holding company. While the Board has recently indicated its intent to increase examination of nonbank affiliates, it is not clear that such examinations will be required to be as regular or extensive as the examination of the same activities conducted in banks.

I believe that such differential regulation and supervision of the same activity conducted in different subsidiaries of a single bank holding company -- whether in terms of safety and soundness or consumer protection – doesn't make sense and is an invitation to regulatory arbitrage. Indeed, leveling the supervision of all subsidiaries of a bank holding company takes on added importance for a "Tier 1" financial holding company because, by definition, the firm as a whole presents systemically significant risk.

One way to address this problem would be to include in legislative language an explicit direction to the Board to actively supervise nonbanking subsidiaries engaged in banking activities in the same way that a banking subsidiary is supervised by the

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[5] *See, e.g.*, Chairman Alan Greenspan, "Insurance Companies and Banks Under the New Regulatory Law," Remarks Before the Annual Meeting of the American Council of Life Insurance (November 14, 1999) ("The Gramm-Leach-Bliley Act is designed to limit extensions of the safety net, and thus to eliminate the need to impose bank-like regulation on nonbank subsidiaries and affiliates of organizations that contain a bank."), available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/speeches/1999/19991115.htm.

prudential supervisor, with required regular exams. Of course, adding new required responsibilities for the direct supervision of more companies may serve as a distraction both from the Board's other new assignments under the Proposal as well as the continuation of its existing responsibilities.

An alternative approach would be to assign responsibility to the prudential banking supervisor for supervising certain non-bank holding company subsidiaries. In particular, where those subsidiaries are engaged in the same business as is conducted by an affiliated bank – mortgage or other consumer lending, for example –the prudential supervisor already has the resources and expertise needed to examine the activity. Affiliated companies would then be made subject to the same standards and examined with the same frequency as the affiliated bank. This approach also would ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.

Conclusion

The OCC appreciates the opportunity to testify on proposed regulatory reform, and we would be pleased to provide additional information as the Committee continues its consideration of this important Proposal.

Attachment
to the Statement of John C. Dugan

Examples of How Safety and Soundness
and Consumer Protection Supervision are Linked

Although the Administration's Proposal to create the CFPA is intended to implicate only consumer protection and not safety and soundness, and is premised on a neat division of the two disciplines, supervision of the two areas is inextricably linked. In the OCC model, the two disciplines are interwoven, sometimes performed by the same staff, especially in community banks, and sometimes by integrated teams of specialists. In either case, supervision in one area informs the other in important ways.

The following examples are derived from OCC examiners' supervisory letters and examiner conclusion memoranda and actual examination experience.[6] They demonstrate real-life examples of the interrelationship of safety and soundness and consumer protection supervision in the bank supervision process. This integrated and effective supervisory approach would be dismantled under the Consumer Financial Protection Agency proposal.

EXAMPLE 1: ***A safety and soundness examination of mortgage origination practices identified a potentially significant consumer protection issue.***

During a safety-and-soundness examination of the credit scoring models used in mortgage origination at a bank, the OCC's quantitative modeling expert noted that models being developed for future use included variables that raised potential fair lending risks. Because the modeling expert was part of the group within the OCC that provides modeling support for fair lending examinations, the modeling expert was familiar with fair lending law considerations. The OCC expert discussed this issue with the quantitative modelers working for the bank, who articulated technical reasons for the inclusion of the variables, related to building more consistent models. The OCC expert was able to discuss the issues in depth with the bank, helping to identify potential alternatives for use in the scoring model. The bank revised the model under development and potential fair lending issues thus were avoided.

[6] Supervisory letters typically are provided to bank management at the conclusion of an examination to address exam findings, note violations of law or regulations, or matters requiring attention (MRAs), which are issues that do not necessarily involve violations, but that the OCC requires the bank to nonetheless address. Examiner conclusion memoranda are internal documents prepared at the conclusion of an exam to document examination results.

EXAMPLE 2: ***An examination for fair lending compliance risk resulted in an MRA requiring an enterprise-wide consumer protection (fair lending) risk management program.***

During an examination to evaluate the bank's fair lending compliance risk management program and test compliance with fair lending laws and regulations, examiners found that the bank had not designated fair lending as an enterprise-level risk and did not manage fair lending risk cohesively across the company. Although management maintained an enterprise-level fair lending policy statement, a formal enterprise-level risk management program was not in place. Examiners conveyed the expectation that the bank would have a cohesively stated and implemented mission across all business units, with standard monitoring processes and metrics to measure effectiveness. Examiners required management to submit a detailed action plan to address the issues raised.

EXAMPLE 3: ***A joint safety and soundness and consumer compliance examination of nontraditional mortgage products identified violations related to consumer protection.***

During a joint safety and soundness and consumer compliance examination of nontraditional mortgage products where the primary objective of the review was to assess compliance with OCC Bulletin 2006-41- *Guidance on Nontraditional Mortgage Product Risks,* examiners also evaluated whether nontraditional mortgage disclosures matched the illustrations set forth in OCC Bulletin 2007-28 – *Illustrations of Consumer Information.* Additionally, examiners conducted a concurrent review of stated income products and loans with low or no documentation to determine if the risks involved in these products were sufficiently mitigated. While the exam focused on both safety and soundness and consumer protection issues, the sole violation noted during the exam involved a consumer protection issue. The option ARM payment change notice did not comply with 12 CFR 226.20(c) because it did not include the new interest rate, the prior interest rate and all other rates that applied since the last payment change. The notice also did not include the corresponding index values. It did not indicate if the new payment disclosed any forgone rate increases or if it would fully amortize the loan over the remaining term. As a result of issues identified by examiners, a corrected disclosure form was created and reviewed by examiners during the examination.

EXAMPLE 4: ***A joint safety and soundness and consumer compliance examination of credit cards resulted in an MRA related to consumer protection.***

During a joint safety and soundness and compliance review to assess the adequacy of processes relative to underwriting, account management, collections, and compliance with the credit card Account Management Guidance (OCC Bulletin 2003-1), examiners evaluated credit policies and procedures, controls over a vendor relationship, the quality of MIS, and the bank's marketing plan. Concurrently, examiners also conducted a consumer compliance review that focused on assessing the bank's own testing of controls in place to ensure compliance with the various consumer protection regulations

applicable to credit card lending. While the exam focused on both safety and soundness and consumer protection issues, the sole MRA noted during the exam involved a consumer protection issue. Examiners noted that although the bank had agreed to an action plan for developing appropriate consumer compliance controls, a thorough consumer compliance vendor management program and file testing process had yet to be implemented. Examiners required that the bank develop a comprehensive consumer compliance vendor management program that included file testing for compliance with all applicable consumer protection regulations.

EXAMPLE 5: ***Review of a consumer credit unit required an integrated team of safety and soundness, information technology (IT), and consumer compliance examiners.***

During a review of a bank's consumer credit unit, the OCC utilized safety and soundness, IT, and compliance examiners to specifically address the quantity and direction of portfolio credit risk; assess underwriting practices, including compliance with the *Subprime Mortgage Lending* guidance outlined in OCC Bulletin 2007-26; and evaluate collateral valuation methodologies. Examiners also evaluated credit quality assurance reviews, exception tracking systems, and control systems. Other areas assessed in this joint review included model risks associated with the collection and origination scorecards; marketing practices and controls; the adequacy of management information systems (MIS); loss forecasting methodologies, with an emphasis on the ACL process; information technology systems within the bank, with a focus on the consumer credit unit.

EXAMPLE 6: ***Review of subprime mortgage products required an integrated team of safety and soundness and consumer compliance examiners.***

During the joint safety and soundness and compliance examination of a bank's subprime mortgage products, the primary objective was to assess the propriety of loan origination and risk management processes. Examiners focused on current underwriting and also reviewed controls established to ensure consumer protection against steering and predatory lending practices. Examiners assessed compliance with banking laws, regulations, and guidance, including recent guidance on subprime products. Examiners tested a sample of subprime loans to assess underwriting and consumer protection processes, reviewed written policies and procedures, and also assessed processes used to measure and monitor subprime mortgage performance.

EXAMPLE 7: ***Consumer complaints received by the agency about a third-party service provider triggered a comprehensive review by safety and soundness and consumer compliance examiners of a bank's relationships with that provider***

During a joint safety and soundness and compliance review of a bank's relationships with a third-party service provider, examiners also reviewed other third-party marketing

relationships in existence for the businesses. Examiners reviewed policies and procedures covering due diligence and performance monitoring of third-party marketing relationships. The primary objective was to identify all of the bank's business relationships with this provider and the bank's respective due diligence efforts to monitor and control reputation and compliance/legal risks from these relationships. Products were reviewed to evaluate how they were being marketed, the accuracy and transparency of disclosures to the customer, and whether the products offered value to the consumer. This review was conducted because the third-party provider and its programs were the subject of several recent consumer complaints received by the OCC. It also took into account findings from an earlier credit card UDAP review of marketing, disclosures, and internal controls.

EXAMPLE 8: ***A safety and soundness review of a bank's internal audit function found weaknesses in the compliance audit function.***

During an annual review of a bank's internal audit program, safety and soundness examiners focused on evaluating the scope of audit work performed, the effectiveness of following up and validation activities, and the adequacy of management reporting. Test work was completed using the customary integrated approach of having each functional team complete an assessment of audit work in their areas of expertise. The scope of these reviews focused on work paper samples, call program databases, and corrective action databases.

Examiners identified areas for improvement in compliance audit functions. Examiners noted that an overall "state of compliance" for each significant consumer protection regulation would be beneficial to bank executive management in determining compliance risk areas and spending priorities.

The bank's approach to compliance auditing entailed a highly decentralized line of business approach. Examiners noted that related to the lack of an overall compliance roll-up, the compliance audit process would also benefit from improved scoping of higher risk products/services and deeper analysis of activity and associated risks. Because audit testing occurred almost exclusively as part of the line of business audits, examiners noted that few audit resources were dedicated to review specific compliance risks associated with individual products or services.

EXAMPLE 9: ***A safety and soundness examination of nontraditional mortgages (NTM) and home equity loans resulted in a series of consumer-protection-related recommendations.***

During a safety and soundness review of a bank's consumer finance unit to assess compliance with regulatory guidances including non-traditional, subprime, and home equity mortgages, examiners assessed the adequacy of risk management oversight and control systems. Examiners specifically targeted underwriting of near-prime broker

originated, interest only mortgage loans, subprime broker originated mortgage loans, and subprime retail mortgage loans. The examiners reviewed risk management MIS, third party monitoring, and mortgage loss mitigation and workout programs. During the review the safety and soundness examiners noted consumer protection issues.

While the combined disclosures provided adequately addressed the requirements indicated in the Statement on Subprime Guidance (OCC Bulletin 2007-26) and in the Interagency NTM guidance, examiners determined that it was based on the proposed, not final illustrations. Additionally, examiners identified that the system which generated the disclosures at the time of application for certain loans was not updated as intended with the combined disclosure.

Examiners made the following consumer protection related recommendations to bank management.

The bank should revise the nontraditional mortgage disclosure, *Consumer Finance Division Comparison of Sample Mortgage Features*, to fully comply with OCC Bulletin 2007-28, provide better consistency with other ARM disclosures, and address computation errors. Additionally, bank management should verify the accuracy of the numbers disclosed in the comparison table. Examiners identified small computational errors in numbers in the table under the interest only 5/1 ARM example and an error in the balloon loan footnote.

Examiners also recommended that quality assurance expand its interest-only mortgage review checklist to verify that the NTM disclosure was provided. Additionally, examiners recommended that the bank verify that all software systems are updated with the most current version of the disclosures when changes occur.

EXAMPLE 10: ***During a trust examination, a number of consumer protection issues were identified.***

During a fiduciary review of a bank's personal trust area, trust examiners identified consumer protection MRAs.

Examiners noted that bank management needed to ensure that trust accounts were properly compensated for income lost as a result of bank errors. Examiners identified one account in a sample where an errant transaction resulted in the nominal loss of interest income. The bank did not reimburse the account for the lost income, as required by internal policy. In addition, there was not a process in place to identify errant transactions and ensure that proper compensation is made to an account. Examiners required bank management to compensate the account noted in the sample and identify tools to be used to ensure that similar situations be detected and resolved appropriately going forward.

Examiners further noted that bank management needed to compensate customer accounts for the loss of earnings from the untimely posting of mutual fund dividends and capital gains. Examiners also noted that management needed to establish or modify policies and procedures to define the remedial measures to be taken in similar situations going forward. The untimely posting of payments negatively impacted the accounts involved and benefited the bank. Examiners required bank management to properly compensate all accounts impacted by the posting problems and ensure appropriate policies and procedures were in place to govern recurrences.

TESTIMONY OF

JOSEPH A. SMITH, JR.

NORTH CAROLINA COMMISSIONER OF BANKS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"REGULATOR PERSPECTIVES

ON FINANCIAL REGULATORY REFORM PROPOSALS"

Before the

FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

September 23, 2009, 2:00 p.m.

Room 2128 Rayburn House Office Building

INTRODUCTION

Good afternoon, Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. My name is Joseph A. Smith, Jr. I am the North Carolina Commissioner of Banks and the Chairman of the Conference of State Bank Supervisors (CSBS).

Thank you for inviting CSBS to return today to continue our discussion on financial regulatory reform proposals. CSBS looks forward to working with Congress and the Obama Administration toward a reform plan that makes meaningful and sustainable improvements to our financial system, while strengthening the existing characteristics that have proven to be critical to serving the public and strengthening the economies of local communities and our nation as a whole.

It is clear to the members of CSBS that some form of financial regulatory reform is necessary. The legacy of this crisis could be a highly concentrated and consolidated industry that is too close to and intertwined with the federal government and too distant and unresponsive to the needs of consumers and communities. That need not be the future of our financial industry, though it is where we are heading. The states' concern about this outcome must not be dismissed as a "turf battle". It is a response to a grave concern that a centralized banking system and industry are in conflict with the health of our state and local economies, the financial wellbeing of our citizens and the future of our locally-based free enterprise banking system that has served our country well. The growing belief that this evolving system is "rigged" to the disadvantage of the average citizen erodes the confidence that is necessary to govern. No amount of sophisticated lobbying by the beneficiaries of consolidation should blur our vision of the threats that it poses or silence this important debate.

To avoid that outcome, Congress needs to realign the regulatory incentives around consumer protection, enhance the "checks and balances" inherent in our dual-banking system, and directly address and end "too big to fail." To safely and effectively meet the financial needs of the American people, we need a diverse industry with seamless oversight, not a handful of mega-banks answering to a captive behemoth regulator.

The objectives of regulatory restructuring must be to promote and maintain a financial services industry that is safe, sound, diverse, and competitive. This industry must serve consumers with a wide array of understandable services and products that meet a broad range of financial and borrowing needs, and consumers must have confidence in a legal and regulatory structure that protects them from abusive products or providers. The financial regulatory structure must create incentives for innovation and prudent growth, but it also must have robust safeguards to prevent excessive risk-taking and leveraging to preserve the stability of the system and to protect taxpayers from potentially unlimited liability for failed firms.

Unfortunately, many provisions of the Obama Administration's plan for financial regulatory reform are inconsistent with these objectives. In particular, CSBS is concerned that the Administration's plan inadequately addresses the systemic risks posed by large, complex financial institutions. The Administration's plan leaves open the real prospect of creating a bifurcated industry, with one class of systemically significant large institutions that enjoy real and perceived federal preferences, and the remaining institutions that lack the scale and scope to merit an implicit link to the government and the market advantages such a link confers. This disparate treatment is unsustainable and likely would drive non-systemic institutions to the margins or even out of business. Further, other aspects of the Administration's proposal warrant

further discussion and detail in order to determine whether and how they will serve our broader goals and objectives.

My testimony today will largely be an update from my previous appearance before this Committee on July 24, 2009. My testimony will present our perspective on these issues, discussing five main elements: (1) the proposal to create a new Consumer Financial Protection Agency; (2) concerns about excessive concentration of federal regulatory power; (3) the proposal to apply new federal fees to state-chartered banks over $10 billion in assets; (4) proposals to improve systemic risk oversight; and (5) proposals to improve supervision of large, interconnected financial firms.

A FEDERAL CONSUMER FINANCIAL PROTECTION AGENCY SHOULD BE FOCUSED ON RULEMAKING AND MUST REFLECT THE IMPORTANT ROLE OF THE STATES IN CONSUMER PROTECTION

The Administration's proposed Consumer Financial Protection Agency (CFPA) would be a single primary federal supervisor charged with protecting consumers of credit, savings, payment, and other financial products and services, and with regulating providers of these products and services.

CSBS supports the creation of the CFPA, in concept, and its goals. Public confidence is an essential element of our financial system, and restoring this confidence must be a central goal of this reform effort. Consumer protection standards for all financial service or product providers, such as those to be promulgated by the CFPA, are an important step in restoring and maintaining this public confidence.

Effective consumer protection requires preserving and enhancing the role of the states in setting and enforcing consumer protection standards. Any proposal to create a federal consumer financial protection agency must preserve for states the ability to set higher, stronger consumer protection standards. The Administration's proposal, as well as H.R. 3126, does just that—

explicitly providing that federal consumer protection standards constitute a "floor" for state action. This provision is vital, and any change to the legislation that preempts the ability of the states to adopt consumer protection measures would significantly undermine the very consumer protection goals that H.R. 3126 seeks to serve. To be clear, it would be unacceptable for any federal consumer protection agency to deny states the ability act either in the absence of federal standards or where federal standards do not sufficiently address consumer protection concerns. If the CFPA's rules were to be made preemptive, or classes of institutions exempted from state consumer protection laws, that would be worse than the status quo and we would be compelled to actively oppose its creation.

As introduced, H.R. 3126 creates a system of regulatory checks and balances that will lead to more effective consumer protection and that need not result in the so-called "patchwork quilt." The rhetoric about this provision does not comport with reality. We are very aware of the needs of businesses to operate efficiently across state lines. State-chartered banks across the country do so every day, and regulators coordinate and innovate in order to efficiently oversee such operations. In North Carolina alone, we have several state-chartered institutions that operate successfully in multiple states—from coast-to-coast and in between. Efforts to preempt the field for consumer protection laws are not simply about efficiency. This is a strategy to end, once and for all time, the system that has been responsible for developing and testing consumer protections at the state level that have served as the model or impetus for federal action.

Our experience has been that thoughtful and deliberate federal standards will obviate the need for the states to act and, instead, will enable the states to respond to local developments and emerging risks and practices, many of which are occurring outside the depository world. The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) is one very

recent example of a how this "floor not ceiling" approach has led to strong and uniform standards. The S.A.F.E. Act, passed on July 31, 2008, gave the states one year—until July 31, 2009—to pass legislation to meet minimum licensing and registration requirements for loan originators. The states have risen to the challenge and have unified under a Model State Law. As of today, 49 states and the District of Columbia have enacted or introduced legislation implementing the S.A.F.E. Act. Special recognition must go to Ranking Member Bachus, who first developed the S.A.F.E. Act and its state-federal model for regulation and supervision.

H.R. 3126 restores an important balance between state and federal law that has been undermined in recent years by preemptive regulatory actions inconsistent with explicit Congressional mandates. Congress has repeatedly rejected the option of applying broad preemption to national banks. As recently as 1994, with the passage of the Riegle-Neal Interstate Branching Act, Congress explicitly stated that state consumer protection laws applied to national bank branches. It has only been in the past decade that some federal banking agencies have sought to preempt state consumer protection laws by regulatory fiat. So, to be clear, any effort to make either the CFPA or any federal banking agency preemptive for national banks is a rollback of current law.

Additionally, any federal consumer protection legislation must ensure that state authorities continue to have the power to enforce applicable state and federal laws for all financial entities operating within their borders, regardless of charter type. The Supreme Court recently affirmed this authority with its decision in *Cuomo v. Clearing House Association*, and CSBS supports the provisions of the Administration's proposal and of H.R. 3126 codifying this decision into federal law.

[5]

The strong affirmation in the Administration's proposal and H.R. 3126 of the states' role in consumer protection must be reinforced with a significant emphasis on effective and timely coordination and information sharing between federal and state regulators. Any legislation must include explicit mandates and mechanisms for this coordination and information sharing.

To enhance consumer protection while minimizing regulatory and supervisory inefficiencies, the CFPA's primary focus should be on effective and timely rulemaking and data-gathering. CSBS shares the concerns of others about separating consumer compliance regulation from prudential supervision. We see the two as not necessarily in conflict, but rather—with appropriate checks and balances in place—mutually supporting and reinforcing. Consumer complaints not only identify trends, practices, or products that harm consumers, but also indicate that an institution may be operating in an unsafe or unsound manner. Similarly, an institution that is well capitalized, well managed, and safe and sound effectively provides consumer protection by ensuring that consumer accounts are secure. Separating these two policy goals could eliminate this benefit.

Establishing another primary federal examining authority also risks creating additional unnecessary regulatory burdens, especially for state-chartered depository institutions that are already subject to both federal and state regulatory oversight. While we agree that more comprehensive and consistent consumer protection oversight across all providers of financial services will benefit the financial system and consumers, we also believe that regulatory reform should not create regulatory burdens that distort the playing field.

As such, State Banking Commissioners believe that prudential regulators should continue to examine for safety and soundness and consumer protection compliance, with the CFPA retaining back-up examination and enforcement powers to act in a timely and effective manner

when primary prudential or enforcement bodies fail to exercise their authority or where regulatory gaps exist. Similarly, the CFPA should have back-up enforcement powers; with the prudential federal and state regulatory authorities and state attorneys general sharing primary enforcement authority. This back-up enforcement authority will enable the CFPA to take action when prudential or law enforcement authorities have failed to act, without displacing or duplicating existing cooperative enforcement efforts.

This back-up authority should include clearly articulated thresholds and timelines for action that, if not met by prudential and/or enforcement authorities, trigger action by the CFPA. And, the CFPA needs sufficient enforcement resources to prevent regulatory arbitrage or under-enforcement, but it would be unnecessary, and possibly counterproductive, for it to attempt to lead all enforcement efforts on a routine basis.

This structure will allow the CFPA to accomplish its essential consumer protection mission and objectives, but with a smaller, more efficient agency that leverages the existing resources, relationships, and capabilities of prudential and law enforcement authorities at both the state and federal level. The requirement of timelines and standards that prudential and/or enforcement authorities must meet strengthens accountability in the system and better aligns regulatory incentives with consumer protection goals. The CFPA, as CSBS envisions it, would be armed with the necessary data and information to set effective federal minimum consumer protection standards and to collaborate with state and other federal agencies to ensure these standards are being met by all financial market participants.

CSBS believes it crucial that any federal consumer protection proposal include a mechanism for the federal agency to consult with state authorities in developing and implementing these new standards and regulations. While the Administration's proposal and

H.R. 3126 clearly recognize the important role of the states in consumer protection, neither makes provision for state input into the CFPA's rulemaking process. Recent history shows that state officials often bring important prudential and compliance perspectives to consumer protection issues that federal agencies may lack; therefore, it is essential that reform legislation include a provision for mandated consultation between the CFPA and state banking regulators. This would also help ensure a balanced regulatory approach across state and federally chartered and licensed institutions.

In addition to a mandated consultative role for state banking regulators in the CFPA's rulemaking, we believe that the CFPA Board should include one member with state bank supervisory experience. This mirrors the structure of the current FDIC Board and would help ensure a diversity of regulatory perspectives and equitable treatment across different business models and classes of institutions.

Finally, we have significant concerns about the funding burdens of creating a new federal agency. Both the Administration's proposal and H.R. 3126 authorize the CFPA to collect fees and assessments. CSBS is concerned that the institutions that we oversee will bear a disproportionate financial burden. To avoid this, any legislation must require the CFPA to develop a means for equitably spreading the financial burden across the industry without depleting already limited state regulatory resources. Our proposal for a CFPA focused primarily on rulemaking, with existing prudential regulators maintaining their examination responsibilities and authorities, alleviates this concern somewhat as it envisions a smaller agency.

CREATING A MONOLITHIC FEDERAL REGULATOR WOULD SIGNIFICANTLY WEAKEN THE FINANCIAL SYSTEM

Some policymakers are discussing the creation of a single monolithic federal banking regulator that would go beyond the Administration's proposal of merging the Office of the

Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) into a new agency, the National Bank Supervisor (NBS). Those advocating further regulatory consolidation propose moving the examination and supervision responsibilities of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) in a new single federal regulator. Creating a monolithic regulator as a means of improving financial regulation relies on the faulty assumption that regulatory consolidation leads to a stronger and safer banking system. In fact, the exact opposite is true: such a proposal would increase the fragility of the financial system by increasing industry consolidation, eliminating needed checks and balances, and subordinating the interests of the consumer to the business goals of a handful of mega-banks.

The creation of a monolithic regulator would drastically undermine the community banking system in the U.S., and would greatly weaken the entire financial system as a result. The U.S. financial system's diversity has been a key to its resilience and stability, and community banks are the bedrock of this diversity and resiliency. Throughout the market convulsions of the past two years, thousands of local and regional banks have continued to make credit available to individuals and businesses alike. This ongoing lending activity has prevented a complete economic collapse and has driven economic recovery and development in localities and states throughout the country.

A single monolithic regulator located in Washington would lack an understanding and appreciation of the local and regional needs that community bankers address day-in and day-out. Instead, it would be far too easy for a distant single regulator to focus on its largest, most complex, riskiest, and most politically prominent institutions.

The inevitable result of this is further industry consolidation. Since the natural tendency of a single regulator would be to tailor its regulatory approach to its largest institutions and to

devote the bulk of its resources to overseeing such institutions, CSBS is concerned smaller institutions, the majority of which are state-chartered, would be severely disadvantaged. Eventually, smaller institutions would simply be unable to compete in an environment where all regulations and examinations are geared towards the behemoth money-center banks. The community banks that have led our economy towards recovery would ultimately be gobbled up by the very institutions that currently survive on government and taxpayer subsidies. This outcome would result in the institutionalization of "too big to fail."

In addition to the destruction of the community banking system through industry consolidation, the creation of a monolithic regulator would eliminate checks and balances in financial supervision. As British Lord Acton wrote in 1887, "Power tends to corrupt, and absolute power corrupts absolutely." Our Founding Fathers were wise enough to recognize that those granted power may abuse this power, unless subject to checks upon their authority.

State-chartered institutions benefit from the constructive give and take between their state and federal regulators. The financial system itself has benefited from the debate among state and federal regulators. For example, during the debate over the Basel II capital rules, CSBS and the FDIC advocated for the necessity of a leverage ratio in measuring bank capital. Without the inclusion of the leverage ratio, it is conceivable that our largest institutions would have entered the financial crisis with a lower regulatory capital requirement than they did, making them even more vulnerable to the market downturn. Consolidating existing authority of several agencies under one regulator would severely undermine this system of checks and balances.

The financial crisis has illustrated clearly the need for greater market discipline. Related to this, there needs to be a focus on enhancing and reinforcing regulatory discipline and avoiding a structure that facilitates regulatory capture. Different regulators bring different perspectives

and skill sets that enhance—not reduce—regulatory performance and accountability. And, there is a key difference between a regulator that is also a chartering authority and a regulator that is not a chartering authority. In this regard, the state regulatory system and state-chartered institutions benefit from the involvement of the Federal Reserve and the FDIC. While the views of regulators can certainly conflict, a healthier and more dynamic regulatory environment exists when there is a diversity of regulatory perspectives and authorities are compelled to coordinate and cooperate with one another. Having more than one regulator increases the likelihood that troubling products or practices will be identified early and responses will be timely.

Ultimately, CSBS is concerned the creation of a single federal regulator would be the beginning of the end of the state system: as consolidation accelerates, smaller institutions will be further disadvantaged, and the largest and most politically influential institutions will reinforce the primacy of the federal system. Consumers and the industry will be best served by more coordination and cooperation between regulators, not by the elimination of regulators through consolidation.

NEW FEDERAL FEES ON STATE-CHARTERED BANKS OVER $10 BILLION WOULD LEAD TO INDUSTRY CONSOLIDATION

The Administration's regulatory restructuring plan also includes a proposal that the FDIC and the Federal Reserve charge for their examinations of state-chartered banks over $10 billion in assets. CSBS believes this proposal is discriminatory, will damage the dual-banking system by causing further consolidation into the nation banking system, and will not add any additional supervisory oversight to the banking system.

The new examination fee will be in addition to what state banks already pay for supervision. The proposed new fee would be a third payment on top of the fees state-chartered banks pay to their primary regulators and to the FDIC's Deposit Insurance Fund. In effect, the

new fee would be a prejudicial tax imposed on state banks. Ultimately, this proposal seeks to push all banks over $10 billion into the national banking system and will undoubtedly lead to further consolidation of the financial industry.

The current exam fee and regulatory structure for state-chartered institutions provides for efficient and effective regulation. State-chartered banks currently pay exam fees to their state banking regulators. States vary in their methods of calculating exam fees, but state exam fees for state-chartered institutions of a given size are generally lower than those of a similarly sized federally-chartered institution. Further, like all federally-insured depositories, state-chartered banks pay deposit insurance premiums to the FDIC. State-chartered banks that are members of the Federal Reserve System are required to hold stock in their regional Federal Reserve Bank.

Additionally, all federally-insured depositories—regardless of charter—are subject to consistent requirements regarding frequency of examinations. In the case of state-chartered institutions, state banking regulators have arrangements with the FDIC and the Federal Reserve for joint or alternating exams, providing an added regulatory perspective.

The Administration's proposal to collect additional examination fees for state-chartered institutions is not a new idea. To date, both Democratic and Republican controlled Congresses have rejected similar proposals on eight separate occasions. Further, and perhaps most notably, the FDIC and Federal Reserve also have rejected the need for exam fees. The FDIC and Federal Reserve have had the authority to charge for examinations, but they have chosen not to, and have never supported this proposal.

Another area of concern for the states is that this proposal means higher costs for the vast majority of the banking industry with no additional safety and soundness supervision. Contrary to its stated goal, this proposal has the perverse consequence of eroding supervision.

State-chartered institutions over $10 billion in assets will move to the national system to avoid fee duplication, leaving only the smallest institutions in the state system. As a result, over 80% of industry assets would be under the national bank regulators with the states still regulating 70% of all institutions, funded only by an assessable base of 20% of industry assets. The fixed costs of supervision at the state level will be spread across a much smaller asset base, causing the fees on smaller institutions to rise.

Meeting the funding needs of improved federal financial regulation and avoiding regulatory arbitrage are important objectives. However, imposing an unfair assessment only on larger state-chartered institutions does not make meaningful progress toward either objective. Despite the claims, this proposal's financial benefits for smaller institutions are, at best, questionable. Unfortunately, this proposed fee structure will result in higher exam fees for smaller institutions. Instead of continuing to punish community banks for the risky practices of the nation's largest banks, policy makers should focus on ensuring that the largest, most complex and problematic institutions bear more of the cost of regulation through fees such as the proposed systemic risk assessment.

THE FINANCIAL SERVICES OVERSIGHT COUNCIL SHOULD INCLUDE REPRESENTATIVES OF STATE FINANCIAL REGULATORS

The Administration's plan proposes the creation of a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve Board on the identification of Tier 1 financial holding companies (FHCs), and provide a forum for resolving jurisdictional disputes between regulators. The states agree on a need for a council of multiple regulators charged specifically with the coordination of supervisory efforts to limit the systemic risk posed by certain financial firms.

We are concerned that the current proposal does not include a provision for state involvement in the Financial Services Oversight Council. The proposed Council would include the Treasury Department, the Federal Reserve Board, the proposed NBS, the proposed CFPA, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the FDIC, and the Federal Housing Finance Agency, but no state financial regulator. Given the Council's broad mission, the exclusion of state financial regulators will seriously curtail the Council's view of the financial system and emerging risks. A lack of state participation will impede the Council's stated goals and is simply unacceptable.

The vast majority of insured financial institutions operating within the United States are currently chartered and regulated by the states. States also have oversight of those financial service providers that are not affiliated with a depository institution, such as mortgage brokers, money services businesses, check cashers, and consumer finance companies. States have primary regulatory and supervisory authority over insurance companies, some of which have proven to pose systemic challenges to other financial institutions. Because of our proximity to and knowledge of the entities we regulate, the local economic conditions and consumers, states are often the first to identify emerging trends, practices, products or threats that impact the financial system. An Oversight Council that does not include some mechanism for state involvement will not be informed by this knowledge and proximity and, accordingly will be less likely to fulfill its statutory mission.

The existing Federal Financial Institutions Examination Council (FFIEC) coordinates examination policies and procedures among the federal banking agencies, with input from a State Liaison Committee. CSBS recommends that the Financial Services Oversight Council incorporate a similar State Liaison Committee, comprising state regulators of banks, insurance

companies, securities firms, and mortgage companies. This State Liaison Committee could include other state regulators as needed, to address the regulatory requirements of related industries, such as payday lenders, prepaid funeral contracts, check cashing, money transmitters, real estate appraisers, or any other state-regulated financial service.

The State Liaison Committee would work with the Financial Services Oversight Council through designated staff, but should also provide voting members to the Council. These members would communicate the State Liaison Committee's deliberations on emerging risks and practices. The state members would also serve as a conduit of information from the Council to the state regulatory agencies. This approach would not only encourage a consistent approach to regulation among all state and federal agencies, but also help to identify gaps in regulation or supervision.

AN EFFECTIVE RESOLUTION REGIME FOR SYSTEMICALLY SIGNIFICANT INSTITUTIONS SHOULD BE FOCUSED ON MANAGING FAILURES IN AN ORDERLY FASHION AND MUST ALLOW FIRMS TO FAIL

The President's plan recommends the creation of a resolution regime based on the FDIC's systemic risk exception; that is, a system that would prevent the disorderly closure of a failing bank holding company, including Tier 1 FHCs, if that closure would have serious adverse effects on the financial system or the economy. CSBS supports this recommendation, but has concerns with the procedure outlined by the Administration's proposal.

Under the current proposal, the resolution regime could be initiated by the Treasury, the Federal Reserve, the FDIC or the SEC. Resolution authority would be invoked after consultation with the President and a 2/3 majority of the Federal Reserve Board and the FDIC Board of Directors, but the Treasury would hold the ultimate authority over whether and how to resolve a failing firm, with broad authority to take any necessary action.

Under the proposal, the resolution regime would have the ability to establish conservatorship or receivership for a failing firm. In addition, however, the regime could stabilize a failing institution by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm. In short, the resolution regime would be allowed to use current subsidization techniques to prop up failing institutions. If this provision is written into law, it will effectively allow all systemic institutions to evade the consequences of their risky business practices or unsafe decisions.

If we hope to avoid future calamities that leave taxpayers on the hook for billions of dollars, Congress must not allow the resolution regime to have the power to bail out failing institutions. Firms that are not able to remain in business without taxpayer subsidies must fail. The resolution regime's priority should be to manage these failures in an orderly fashion.

Therefore, we recommend that the FDIC be designated conservator or receiver of any institution that comes under this new resolution regime. Additionally, an institution receiving either a systemic exemption to prompt corrective action or funding from the Federal Reserve's emergency lending facility should automatically be transferred to FDIC conservatorship. The FDIC is an independent agency that has the expertise and experience with managing and/or resolving troubled and failing institutions.

REGULATORY STRUCTURES AND INCENTIVES MUST NOT ENCOURAGE THE EMERGENCE OF "TOO BIG TO FAIL" INSTITUTIONS

The Administration's plan would grant the Federal Reserve Board authority and accountability for consolidated supervision and regulation of Tier 1 FHCs. The prudential standards for Tier 1 FHCs would be stricter and more conservative than those applicable to other financial firms, in order to account for the greater risks that their potential failure would impose on the financial system.

CSBS agrees in principle that the regulatory system would benefit from a single agency tasked with supervising systemically significant financial institutions. While the Federal Reserve Board's current authority as "umbrella supervisor" under Gramm-Leach-Bliley would make the Federal Reserve Board a logical candidate for the systemic risk regulator, CSBS does have some concerns regarding the Federal Reserve Board's ability to serve in this capacity.

Under current statutes, the Federal Reserve has extensive authority to serve as the umbrella supervisor for the financial services industry. Further, we do not believe that any other single agency is a better candidate for this role. That said, we think that consolidated supervision in a single agency eliminates valuable checks and balances to the system and effectively minimizes resources and expertise that should be applied to this crucial activity. We suggest, therefore, that any agency charged with supervising and regulating these large, interconnected institutions must report, in turn, to the Financial Services Oversight Council. Requiring the systemic risk regulator to consult with and perhaps even seek approval from the Council will maintain the system of checks and balances and will provide the responsible agency with an array of external opinions and experience.

More broadly, however, the Administration's plan appears to concede that some Tier 1 FHCs will always be "too big to fail." We do not agree with this assumption. The current crisis has proven that our regulatory structure was simply not capable of properly supervising the nation's largest firms. When it became evident these firms were insolvent, the federal government felt obligated to prop them up, as their failure would have far-reaching, systemic consequences. This decision was difficult, but necessary. The government's subsidization of these institutions has cost American taxpayers billions of dollars and left our government and nation facing tremendous residual liabilities.

As long as some financial institutions are considered too big or too important to fail, no regulatory regime will be able to regulate or supervise them effectively. Instead of repeating these actions in the future, CSBS urges Congress to prevent these firms from becoming too big to fail in the first place. While we believe the Administration's proposal to impose more stringent prudential standards upon Tier 1 FHCs will provide some disincentive from becoming "too big to fail," eventually firms will evade these standards, just as they maneuvered around deposit caps.

We believe it is necessary for Congress to outline these higher prudential standards clearly to ensure that they discourage an institution from becoming "too big to fail" and to demonstrate the real market cost of being a systemically significant institution. We recommend that Congress consider the following requirements for all Tier 1 FHCs:

1. Minimum consolidated capital requirements, including a minimum leverage capital ratio, above the minimums required for other bank holding companies. Regular issuance of non-government guaranteed subordinated debt should, in general, be a component of these requirements with exceptions subject to the approval of the consolidated supervisor.
2. Maintenance of a liquidity risk management plan that is approved at least annually by the consolidated supervisor.
3. Higher PCA standards than are required for non-systemic firms.
4. Maintenance of a liquidation plan that is approved at least annually by the consolidated supervisor.
5. Payment of regular assessments into a fund established for the purpose of resolving Tier 1 holding companies. The assessment will be set annually, or more

frequently as events warrant, by the Financial Services Oversight Council. The fund would be managed by the FDIC separately from the DIF. The fund can be used to facilitate the resolution of Tier 1 FHCs or supplement the deposit insurance fund in times of broad economic stress.

FINANCIAL REGULATION MUST BE COUNTER-CYCLICAL

As we work to restructure our system of financial regulation, we also need to evaluate the process of financial supervision. We are in need of an approach to financial supervision which is more counter-cyclical. To fully achieve this, we need a forward looking supervisory approach and we need to require the industry to build capital and reserves during good economic times when they can most afford to do so. We also believe it is necessary to provide some relief from current accounting and regulatory constraints that make it more difficult to restructure stressed institutions than is necessary.

To achieve our supervisory objectives, we need a change in examination philosophy. The current examination approach, while it includes an institution's policies and practices, is largely driven by quantitative factors. We need a more proactive approach which utilizes informal and formal enforcement powers to address weaknesses in an institution's practices and asset concentrations, regardless of the earnings performance and quantifiable condition of the bank.

In making this assessment, there is tremendous value in the perspective of local public officials and examiners who live and work in these communities. These are the regulators who have the best access to local markets and commercial activity. My colleague, Sarah Bloom Raskin from Maryland, talks about the "crab count" as a key economic driver for many of her banks on the eastern shore. My colleagues in the Midwest are familiar in real time with

agricultural output and the value of farm land. In North Carolina, we are in constant touch, directly and through a broad-based Banking Commission membership, with local businesses, governments and consumers. All of us are also in constant touch with community and regional banks, through which we obtain valuable information regarding local and regional economic conditions. This information is obtained and used at the local level well before it reaches the national economic databases.

Fortunately, the states have examination personnel with the skills and ability to implement this new approach. However as leaders, we must have the political courage to support their judgments. This can be very difficult when the economy is strong and banks are making money.

We must develop better tools for off-site monitoring. The banking industry has a well established and robust system of quarterly data reporting through the FFIEC's Report of Condition and Income (Call Report). This provides excellent data for use by all regulators and the public. We need to explore greater standardization and enhanced technology to improve the timeliness of the data, especially during times of economic stress.

We will not be able to, nor should we desire, to eliminate all problems in banks. While they are regulated and hold the public trust, financial firms are largely private enterprises. They should be allowed to take risks, generate a return for shareholders, and suffer the ramifications when they miscalculate. In contrast to institutions deemed too big to fail, this process works for a majority of institutions. Our best protections during an economic decline are strong reserves and high capital standards. Bank regulators need to regain control over the accounting rules as they pertain to a bank's allowance for loan and lease losses. The widely expected approach that the level of reserves should track with the quality of the loan portfolio, left community banks in

the cross hairs of the accounting profession and some of the federal regulators who criticized banks for not being able to fully support their high level of reserves. As a result, I believe some banks entered this recession with far fewer reserves than they would have preferred.

We support the Treasury Department's September 3 announcement of core principles for regulatory capital standards. Higher capital standards, especially for systemically significant firms, will enhance the stability of the financial system. The Administration calls for high quality forms of capital in all firms and substantially higher capital requirements for Tier 1 FHCs. This is a significant step towards increasing the cost of being a significant risk to the financial system, as firms are forced to internalize the costs of this risk.

The largest institutions have long promised that their size and complexity minimized their risks, allowing them to hold lesser amounts of capital. According to the FDIC, as of December 31, 2007, banks over $10 billion in assets had an average leverage capital ratio of 7.41%. This was 200 basis points (b.p.) less than banks with assets between $1 billion and $10 billion, 256 b.p. less than banks with assets between $100 million and $1 billion, and an astonishing 610 b.p. less than bank with assets less than $100 million. As the financial crisis was unfolding and the serious economic recession began, our largest institutions were poorly positioned leading to the extraordinary assistance by the federal government to protect the financial system. Even with this assistance, this differential continues today with the largest institutions holding considerably less capital than the overwhelming majority of the industry. Meaningful, higher capital standards are a must to provide the foundation for counter-cyclical regulation and should be adopted immediately.

As we work to improve capital standards, Congress should also investigate the effectiveness of Prompt Corrective Action (PCA) during the recent crisis. We believe there is

sufficient evidence that the requirements of PCA have caused unnecessary failures and more costly resolutions.

Congress should also consider how the deposit insurance fund can help to provide a counter-cyclical approach. We believe Congress should authorize the FDIC to assess premiums based on an institution's total assets, which is a more accurate measure of the total risk to the system. Congress should revisit the cap on the fund and require the FDIC to build the fund during strong economic times and reduce assessments during periods of economic stress. This type of structure will help the whole industry when they need it most.

DE NOVO INTERSTATE BRANCHING

CSBS supports the Administration's proposal to eliminate the remaining restrictions on interstate banking. While Riegle-Neal intended to leave this decision in the hands of the states, inconsistencies in federal law have created contradictory rules about how financial institutions can branch across state lines. The contradictions affect state-chartered banks disproportionately. Federally-chartered savings institutions are not subject to de novo interstate branching restrictions, and creative interpretations from the Comptroller of the Currency have exempted most national banks as well. The Administration's proposal would restore competitive equity by allowing *de novo* interstate branching for all federally-insured deposit institutions.

RETAINED ECONOMIC INTEREST ("SKIN IN THE GAME")

The Administration's proposal includes a requirement that loan originators or sponsors retain an economic interest in a material portion of the credit risk for any such loan that the creditor transfers, sells or conveys to a third party. As we have no experience with such a requirement, we do not know what the impact will be, but it is not unreasonable to imagine such

a requirement could reshape the mortgage industry and have a significant impact upon credit availability.

In our experience, corporate risk alone may not alter our outcomes. Both bank and nonbank lenders that seemingly had "skin in the game" made risk decisions that resulted in their failure. And more would have failed if not for government intervention. It is possible that risk retention could have the opposite of the desired effect. It could result in an industry consolidation that creates more banks that are considered too big to fail that pose even greater and seemingly intractable risks to our financial system and economy. Additionally, from our state perspective it is not difficult to imagine an industry so consolidated and systemic that it is seemingly unaccountable to consumers.

If the goal is to encourage sound underwriting and good origination practices there may be better and more holistic ways to revise the current system of originations. One possible idea would be to limit an originator's upfront earnings potential by spreading a future income stream out over the life of the loan. Our belief is that the transparency provided by unique identifiers applicable to the entire industry of originators also provides important incentives and checks on poor lending standards and abusive practices.

CONCLUSION

CSBS applauds this Committee and the Administration for seeking a comprehensive response to the obvious need for improvement in our system of financial regulation. We now look to the members of this Committee to bring your specialized knowledge and legislative experience to this proposal in order to ensure that it accomplishes its stated objective: a system to ensure a safer, sounder financial system that provides fair, stable access to credit and investment to all sectors of our economy.

We look forward to working with you toward a solution that reduces systemic risk, assures fairness for consumers, preserves the unique diversity of our financial system, and enhances state-federal coordination to create a seamless network of supervision for all industry participants.

Thank you again for the opportunity to share our views this afternoon. I look forward to any questions you may have.

NASCUS
National Association of State Credit Union Supervisors

Submission for the Record
For House Financial Services Committee Hearing on Federal Regulator Perspectives on Financial Regulatory Reform Proposals, September 23, 2009, 2 p.m.
National Association of State Credit Union Supervisors (NASCUS)

The National Association of State Credit Union Supervisors (NASCUS) [1] appreciates the opportunity to provide a submission for the record of the House Financial Services Committee Hearing on Federal Regulator Perspectives on Financial Regulatory Reform Proposals, September 23, 2009.

NASCUS has been committed to enhancing state credit union supervision and advocating for a safe and sound state credit union system since its inception in 1965. NASCUS is the sole organization dedicated exclusively to the promotion of the dual chartering system and advancing the autonomy and expertise of state credit union regulatory agencies.

As regulatory reform is debated in your Committee, it might be suggested that if the U.S. financial system were created by design, the current system may not have been deliberately engineered. However, the dual regulatory regime of state and federal regulators as well as charter choice allows for competition, diversity and innovation – elements that remain critical for our nation's consumers and financial institutions.

The President recognized the value of our dual financial regulatory system in his March 2009 recommendations to Congress titled *Financial Regulatory Reform: A New Foundation.* In the report, the Obama Administration recommends that state supervision and credit union dual chartering are maintained, as well as an independent credit union regulator.

[1] NASCUS is the professional association of the 48 state credit union regulatory and territorial agencies that charter and supervise the nation's 3,100 state-chartered credit unions.

NASCUS encourages the Committee to reaffirm the President's recommendations in its regulatory reform legislation. The Obama Administration's recommendation to retain dual chartering and preserve state authority is consistent with NASCUS' priorities for regulatory reform. In this submission for the hearing record, NASCUS will emphasize the following as critical elements of regulatory reform:

- Preserve Dual Chartering and State Authority
- Partner with State Regulators on Consumer Protection and Uphold State Consumer Protection Laws
- Affirm Consultation with State Regulators on Systemic Risk
- Allow Credit Unions to Access Supplemental Capital

Preserve Dual Chartering and State Authority

Today's regulatory system is structured so that the states and the federal government act independently and in partnership to supervise financial institutions. The dual chartering system for financial institutions has successfully functioned for more than 140 years, since the National Bank Act was passed in 1863. It is important that Congress continue to recognize the distinct roles played by state and federal regulatory agencies.

Dual chartering remains viable in the financial marketplace because of the distinct benefits provided by charter choice and the commitment to safety and soundness shared by state and federal regulators. Any modernized regulatory restructuring must recognize charter choice and dual supervision. The fact that laws differ for governing state and federal credit unions is positive for credit unions and consumers. Individual institutions can select the charter that will benefit their members or consumers the most. Further, state and federal regulators can draw on combined expertise to ensure the system remains safe and sound. Congress must continue to recognize and to reaffirm the distinct roles played by state and federal regulatory agencies.

The dual chartering system is threatened by the preemption of state laws and the push for a more uniform regulatory system. In this Congress, discussion continues on a possible consolidation of regulatory authorities. It is critical that any regulatory consolidation does not threaten state

authority or dual chartering. It is also important that new policies do not squelch the innovation and enhanced regulatory structure provided by the dual chartering system. As stated previously, dual chartering benefits consumers, provides enhanced regulation and allows for innovation in our nation's credit unions. A dual regulatory system also allows for the necessary balance of power between the states and the federal government.

Partner with State Regulators on Consumer Protection and Reaffirm State Consumer Protection Laws

The nation's state credit union regulators share a responsibility with our federal regulatory counterparts to protect consumers against unfair, deceptive and fraudulent practices in the financial services market. NASCUS supports enhanced federal consumer safeguards to compliment the robust state oversight, and encourages the Committee to consider formalizing consultation with state regulators in H.R. 3126, the Consumer Financial Protection Agency (CFPA) Act of 2009, as well as adding provisions to minimize regulatory burden.

For the CFPA to be successful, it must consult and cooperate with state regulatory authorities. It is important that state regulatory authorities are involved in the exercise of the powers granted by the CFPA so that existing knowledge and standards developed at the state level are leveraged to protect consumers to the maximum degree possible. By drawing on the expertise of state regulators and their ability to more readily identify emerging issues at the local level, the CFPA can detect and address those issues before they become federal in scope.

Further, while there is no question that enhancing consumer protection is a laudable goal given the economic climate, it must be accomplished in a manner that builds on existing regulatory success without undue regulatory burden for financial institutions. As currently written, H.R. 3126 could add another examination layer for state credit unions, resulting in the possibility of three examinations, one by the state regulator, another by the insurer (the National Credit Union Administration) and then by the CFPA. By partnering with state regulators on consumer protection, additional regulatory burden can be minimized.

As a regulators' association, NASCUS understands the need for a regulatory agency to have unambiguous regulatory authority, as detailed for the CFPA in H.R. 3126. However, where, as in

this case, there exists multiple examination regimes in place, particularly for state-chartered entities, NASCUS believes there should be a minimal threshold for the CFPA to demonstrate a compelling reason why reliance on existing examinations is ineffective or impractical. This minimal showing vindicates fundamental states' rights, is within the spirit of the dual chartering system and is a balanced safeguard against excessive regulatory burden.

NASCUS encourages you to seek state regulatory expertise and partner with the states wherever possible as consumer protection legislation moves forward. State regulators also ask you to defend against federal preemption so that strong state statutes can continue to successfully protect consumers.

Affirm Consultation with State Regulators on Systemic Risk

NASCUS understands that the Committee is studying how to properly address systemic risk in the U.S. financial services system. Certainly, the evolution of the financial services industry and the expansion of risk outside of the more regulated depository financial institutions reflect that further consideration needs to be given to expanded systemic risk supervision.

Many suggest that the Federal Reserve System, due to its structural role in the financial services industry, might be well suited to be assigned an expanded role in this area. There is also legislation pending in the 111th Congress to create a systemic risk council of federal regulators.

State regulators and their rich knowledge and expertise must have a valued role in the nation's mechanisms to mitigate systemic risk. NASCUS requests that the Committee recognize that the states need to have a seat at the table when addressing systemic risk issues. State regulators are in a position to detect problems on the local level before they may become a greater national risk. The states' involvement in systemic risk mitigation and detection is critical. We encourage this Committee to formalize the states' role in systemic risk mitigation as legislation proceeds.

Allow Credit Unions to Access Supplemental Capital

NASCUS has long supported comprehensive capital reform for credit unions and believes that given the economic climate, reform in this area is critical and timely. Credit unions need access

to supplemental capital. NASCUS encourages Congress to consider credit union capital reform as part of regulatory modernization efforts.

Unlike other financial institutions, credit union access to capital is limited to reserves and retained earnings from net income. Since net income is not easily increased in a fast-changing environment, state regulators recommend additional capital-raising capabilities for credit unions. Access to supplemental capital will enable credit unions to respond proactively to changing market conditions, enhancing their future viability and strengthening their safety and soundness.

Allowing credit unions access to supplemental capital with regulatory approval and oversight will improve their ability to react to market conditions, grow safely into the future and serve their members in this challenged economy. It would also provide a tool for credit unions to use if they face declining net worth or liquidity needs. We feel strongly that now is the time to permit this important change.

A simple fix to the Federal Credit Union Act would authorize state and federal regulators the discretion, when appropriate, to allow credit unions to use supplemental capital. It would provide further stability for credit unions in this unpredictable market as well as provide an additional layer of protection to the National Credit Union Share Insurance Fund (NCUSIF).

NASCUS follows several guiding principles in our quest for supplemental capital for credit unions. First, a capital instrument must preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Next, it must preserve credit unions' tax-exempt status. Finally, regulatory approval would be required before a credit union could access supplemental capital. We realize that supplemental capital will not be allowed for every credit union, nor would every credit union need access to supplemental capital.

A task force of state regulators is currently studying supplemental capital for credit unions with the National Credit Union Administration (NCUA). This group is researching the appropriate regulatory parameters for supplemental capital for credit unions. In December 2008, NCUA Board member Gigi Hyland announced that after conversations with NASCUS and state

regulators she was convinced that discussion on supplemental capital was appropriate given the economic climate for credit unions.

As the Committee addresses regulatory reform and other legislation this fall, NASCUS encourages consideration of access to supplemental capital for credit unions.

Summary

In this Committee's deliberations on regulatory reform legislation, NASCUS asks you to reaffirm the important role state regulators fulfill in the U.S. financial services system and to draw on the state system's expertise and strengths. We also ask that dual chartering is maintained, and state regulators are involved in consumer protection enhancements and systemic risk mitigation. Lastly, NASCUS encourages the Committee to consider capital enhancements for credit unions.

NASCUS would be pleased to provide any information you deem appropriate as you work through these matters. Thank you for your attention.

QUESTIONS FOR REGULATORS
HOUSE FINANCIAL SERVICES COMMITTEE
SEPTEMBER 23, 2009

(Examples of Regulatory Accounting Interpretations)

- "Our examiners have made us charge off percentages of principal on loans that are current and that have always been performing simply because the loan collateral is real estate. In some cases, the appraisals are coming in at "fire sale" values (50-60% discounted). In other cases, particularly with respect to vacant properties, the appraisers are telling us that there are no comparables and no current market (thus 100% discounted). Obviously, appraised values are going to be depressed in the current economic environment, but we are talking about properties where the borrowers have absolutely no intention to sell until the market comes back, and meanwhile, they are completely current on their loan repayments. This is creating huge write-downs for our bank and putting major stress on our capital levels."

- "We recently went through an exam. We had two participation loans with another bank, both of which had recent appraisals that still justified our loan-to-value positions. We were not told to charge either loan down. Having said that, while our lead field examiner recommended a top rating for us, she was overruled by her supervisor because of these two loans. We had no charge-offs and no write-downs at all in this exam. We had comparable capital, better liquidity, better risk management and better income ratios than our peers. We were criticized for having increased commercial loans over the past FIVE years (mainly due to these two loans), but even accepting this 20-20 hindsight, WE ARE STILL WAY BELOW OUR PEER GROUP. Nonetheless, our composite CAMELS rating was dropped due to these two loans, the only result being that now we have to pay more in FDIC assessment fees. It is the belief of our entire organization that the exam result was manipulated by a supervisor who had an apparent agenda. It is inexplicable to us."

- "I would need several hours to compose an e-mail that addresses all of the problems we have experienced with our examiners during the past several years. However, I would like to express some initial thoughts. Our bank is regulated by the Office of the Comptroller of the Currency. I worked for the OCC for 10 years, and since then, I have had 20 years of experience as President & CEO of this bank. When I left the OCC to take my current position, I was a seasoned field examiner who was involved with the oversight of many problem banks during the 1980's.

In addition to my oversight of problem financial institutions, I was involved with many special assignments to help provide oversight and direction of bank supervision. I also served as a training team leader for several groups of young or new examiners hired by the agency. I also was involved in the development of loans used in the test for commissioned national bank examiners. During my tenure with the OCC, I was considered by many personnel in our field and district offices as a major resource person with expertise in the fields of funds management and interest rate risk, investments, loan portfolio management, and taxes. I truly believe that my skills in these areas have been enhanced while serving in my present capacity as President/CEO of the bank.

I bring your attention to my background so that you may have some insight into my insights. My point is that in all my years of working in the banking industry, I have never felt more insulted, belittled and ridiculed by any one examiner or group of examiners, all with much less experience than me. Realistically, I have given up on having any form of meaningful discussions with the examiners on various banking-related issues that pertain to our bank. My background and experience means very little to them and even possibly threatens them. We have held what I considered civil discussions, exit meetings, etc. when meeting "face to face," only to receive a written report of examination or letter that criticized me personally for lack of objectivity and challenged my integrity. Overall, I am "old school" when it comes to criticism and can handle it well. However, in this environment, it has become more personal.

To give you a specific example, I will discuss the issue of Other Than Temporary Impairment (OTTI) as it pertains to the bank's investment portfolio. Last fall, I spent countless hours studying the matter and consulted

with various experts in the field. At the time, we owned a large volume of whole loan CMOs, so this was critical to the bank. Our initial due diligence and supporting documentation that went into the purchase of each of these investments was significant and initially provided critical support for our investment decisions. All of our bank's purchases were of high-end tranches. However, credit quality in some of the issues had deteriorated, therefore requiring an OTTI analysis.

The examiners and I held several discussions on how each OTTI analysis should be performed for each security impacted. During our conversations, the examiners specifically stated that they had a lack of direction from their superiors on this matter. In the meantime, I was working on my OTTI analysis of each bond that potentially could be impacted. I want to specifically mention that an OTTI analysis is an estimate of potential loss at some future date based on the facts and circumstances available at the time. It is a tool used to predict a potential loss. It does not mean the loss will actually occur, but that it could occur based on the current information available combined with present expectations. This leaves a lot of room for subjectivity. If an OTTI analysis is performed only once, it would require significantly more accuracy. However, the estimate is performed quarterly as new facts present themselves.

I believe the OCC examiners wanted us to be 100% accurate "out of the box" on the first OTTI analysis, yet neither they nor we (nor the industry) had any guidance or experience on how to do so. On the other hand, my approach was to analyze each bond with respect to its overall performance and develop 3 scenarios for each: best case, worse case, and most likely. Basically, CMOs can be analyzed based on 3 performance criteria: prepayment speeds (e.g. CPR), loss rates (CDR), and loss severity (dollar percentage of loss when the asset or property is sold).

The factors that pertain to each of these criteria as applied to each security, and their impact on each security, will be unique for a multitude of reasons. They cannot and should not be standardized. However, that is exactly what the examiners wanted us to use – one single, homogenous standard. They had no interest in the most likely or best case scenarios, despite any meaningful rationale that we discussed. Their interest was only in the worse case scenario for each bond. In addition, if the worse case scenario did not produce the results they wanted to see – in other words, a loss – the examiners wanted us to run even more severe rates until a loss was produced. The worse case scenarios that we were required to run in our models included the lowest CPR rates experienced in the prior 3 to 6 months, combined with the highest CDR and loss severity rates in the prior 3 to 6 months. I tried to explain to the examiners how this would not realistically be possible. High CDR and loss severity rates will produce high CPR rates as well. However, they did not understand and expressed no interest in this rationale. (Hence their criticism for our lack of objectivity.)

It is important to note that we have taken a little over $400,000 in OTTI charges in 2009. HOWEVER, WE HAVE YET TO EXPERIENCE ANY ACTUAL LOSSES. We began 2008 with $383 million (gross invested value) in our investment portfolio. As of September 30, 2009, our gross invested value will be roughly $183 million, representing a net reduction of $200 million, or 52%. This reduction has occurred through a combination of payments received on CMOs, calls, maturities or sales. Overall, we have not experienced any loss from this activity. In fact, we have recognized roughly $140,000 more in income through $90,000 in security gains and $50,000 in additional accretion income. In addition, our current payment stream on the bonds has not been disrupted. Still, we are being required to run exclusively worse case scenarios on our remaining investment portfolio and to take OTTI losses when these forced scenarios necessarily exhibit them.

This is just one of many frustrating examples that we are currently experiencing in this environment. However, it may be the most compelling. Thank you for your time."

Provided by Illinois Bankers Association, September 23, 2009

GBA
GEORGIA BANKERS ASSOCIATION
the resource that empowers

Key Regulatory Issues Facing Georgia's Banks

Summary: There are several key economic and regulatory issues that continue to be of concern to many Georgia banks. They include:

Real-estate marketplace

- Continued weakness in the broad housing construction and purchase market is slowing inventory reductions and hurting borrowers' ability to pay back construction and development loans.
- Difficulty in obtaining reasonable and consistent property appraisals continues to put downward pressure on property and collateral values.

Regulatory policies

- Regulatory interpretations of accounting guidelines/FAS 114/5; fair value of real estate are causing banks to use real capital to account for theoretical real estate losses, putting further stress on bank capital levels.
- Downward pressure on asset prices caused by market forces and unintended consequences of government stability programs hurt borrowers' collateral values and bank capital levels.
- New rules for determining deposit-product rate caps for many Georgia banks limit liquidity, funding sources and ability to retain customers.
- Strict requirements prohibiting banks that are considered to be less than "well capitalized" from renewing brokered deposits or seeking new brokered deposits are creating immediate funding and liquidity problems for banks that can least afford them.
- The FDIC special assessment of 5 basis points on assets minus tier-1 capital paid in September; the pending $45 billion in liquidity that will be lost to the industry when banks prepay three years of deposit insurance premiums in December have negative effects on bank capital.
- Disallowance of more than $1.8 billion of capital in Georgia banks (Loan Loss Reserve capital above 1.25%) artificially lowers regulatory capital ratios.
- Certain traditional bank mortgage loans can no longer be made because of regulatory overreaction to abuses in the mortgage market that traditional banks had little to do with.

Capital markets

- Access to private capital continues to be limited, stressing some banks' stability and lending opportunities.
- More open bank assistance for troubled institutions could bring additional private capital investment.
- Many community banks who were interested in the TARP/CPP program were denied access.

Regulatory flexibility, time and actions that lead to more market certainty and consumer confidence are the key factors to encourage economic recovery and a return to profit for many of our state's banks.

Appraisals: difficulty in obtaining reasonable, consistent valuations

Obtaining good appraisals in the current market is extremely difficult. Our recommendation is that all appraisers should be allowed to consider the environment for improved sales in the future when determining market values. Otherwise, they are appraising the value of the collateral at the lowest point of the business cycle with little regard for the realistic expectation that the supply and demand equation calls for improvement in the not too distant future. Furthermore, regulatory field examiners are applying their own appraisal methodology in evaluating the validity of independent appraisals if they believe the current appraisal is inadequate. We fully acknowledge that field examiners must review appraisals with a critical eye. However, we suggest further discussion about whether it is within the scope of the regulators' work to override independent appraisals using their own methodology. We encourage our regulators to continue to support rational methodologies for valuations.

Regulatory interpretations of accounting guidelines/FAS 114/5; fair value of real estate

Regulatory methods for applying certain accounting guidelines, primarily FAS 114 and FAS 5, need to be reviewed. The major ongoing concerns and frustration banks are having with these methods are related to how regulators are interpreting the rules for determining how loans are classified and how much capital banks should be required to reserve for losses or potential losses against those assets. In some cases, bank regulators are taking more aggressive positions than the guidelines require. These interpretations are causing banks to use real capital for theoretical real estate losses, putting further stress on bank capital levels. In the past, certain loans would have been charged off only at the time of foreclosure after all payment opportunities had been exhausted, not while the bank was still working with borrowers and payments were still being made. And, in some instances, regulators have required banks to use extremely short timeframes, three-to-six months instead of three-to-five years, to set historical loss ratios used to evaluate loans and determine appropriate reserves.

Downward pressure on property and collateral values

We are seeing extreme discounting on many poor-performing loans and bank-owned or FDIC-controlled assets. The FDIC's process of rapidly disposing of some of the earlier failed bank assets at extremely low prices contributed to further market-price deterioration. It is reasonable to expect this will be less of an FDIC issue going forward with FDIC's approach of entering loss-sharing agreements with purchasers of closed banks. The effects of overly aggressive discounting also hurts borrowers when the value of their real estate pledged collateral is artificially devalued, resulting in their struggling to meet either loan covenants requiring specific levels of collateral or selling properties at these lower values to repay or pay down loans. Banks are also being required to write down their real estate portfolios to these new values, which are unnecessary hits to capital. With market forces as well as government programs and actions, even well-intended ones, driving asset prices and valuations downward this quickly, there may not be enough capital in the marketplace to sustain many banks located in the most troubled geographic areas. These factors are causing banks to burn through capital at an alarming rate at a time when the private capital markets remain constrained. And with the deep discounts FDIC is willing to take in disposing of assets through online auctions, the FDIC fund is taking devastating losses that the banking industry now has to replenish.

Deposit rate caps

Beginning Jan. 1, 2010, banks that are below the threshold for being considered "well capitalized" or that are operating under certain regulatory orders have a new hurdle to clear in raising important core deposits. These institutions must adhere to certain interest-rate restrictions that are not new. However under a new FDIC rule, these interest-rate restrictions are now to be determined by a national average interest rate rather than relying on calculations of prevailing rates in local markets. We are already hearing from some banks that the published FDIC national rates are significantly lower than the average in their markets. Because these institutions will be required to offer deposit rates that are below the going local market rate, there is no reasonable way to assume they'll even be able to retain current core deposits, much less attract new deposits necessary to stabilize their funding or meet regulatory requirements to reduce their reliance on brokered deposits (see below for a discussion of that issue). We

view the formula determining the local rate to be flawed. As we understand it, the formula requires the use of rates offered by each bank *branch* in a market. If a bank has multiple branches in the market, each branch routinely offers the same deposit rate. To count these branches as if they were stand-alone institutions unfairly over-weights the formula toward the rate paid by the bank with multiple branches. We suggest the formula be changed to count multiple branches of one bank as a single bank to restore fair treatment to the banks with fewer branches in that same market. And we strongly encourage a clearly-defined and quick decision process for banks wanting to appeal the usage of the national rate in their market.

Brokered deposits

Requirements prohibiting banks that are considered to be less than "well capitalized" from renewing brokered deposits or seeking new brokered deposits creates immediate funding and liquidity problems for banks that can least afford them. There are reasonable ways to lessen the impact without increasing risk to the deposit insurance fund or artificially distorting the local deposit market. One possible helpful easing of the regulation would allow "adequately capitalized" banks to renew maturing brokered deposits but continue to prohibit them from acquiring new brokered deposits. This would allow some funding stability for the bank without increasing the potential cost to the deposit insurance fund. If the statute cannot be changed regarding brokered deposits, banks having to shed those deposits should be allowed to reduce their reliance over a longer period of time than simply upon renewal. If the FDIC could require an orderly reduction of brokered deposits of perhaps 10% per quarter or some other reasonable number, the impact would less.

FDIC deposit insurance assessments

The FDIC recently levied a special insurance premium assessment due September 30, 2009 on banks of 5 basis points based on total assets minus tier-1 capital. Our estimate of that assessment's cost to Georgia banks was $133 million. Additionally, the FDIC Board recently proposed a new Deposit Insurance Fund restoration plan that would require banks to prepay their estimated quarterly assessment for the fourth quarter of 2009 and for all of 2010-2012, due Dec. 30, 2009. This method is not as harmful as another special assessment, but we encourage FDIC to consider other options such as tapping into the recently expanded line of credit with the Treasury Department on a temporary basis or borrowing from the better capitalized banks that have the resources necessary. The banking industry fully supports the industry paying to maintain the fund if all other non-cash options prove not to be viable.

Loan-Loss Reserve effect on regulatory capital – artificial disallowance of $1.86 billion of capital from Georgia banks

The current regulatory threshold states loan loss reserves above 1.25 percent of risk-weighted assets cannot be included in calculations for meeting regulatory capital guidelines. This is real capital that banks have on hand and is available. Current calculation rules on Total Risk-Based Capital as of June 30, 2009, artificially disallow $1.86 billion of valid capital in Georgia banks. By removing or raising the cap, banks will have stronger capital ratios without affecting the safety of the system. John Dugan, Comptroller of the Currency, has suggested removing this arbitrary cap and allowing 100% of the bank's allowance for loan losses to count towards regulatory capital. We would ask the other regulatory agency heads to consider the same.

Regulation Z/Truth in Lending Act (TILA) amendments

The Federal Reserve TILA amendments that went into effect on October 1, 2009, are having an extreme and negative effect on home mortgage lending from many Georgia banks. The amendments create an unwinnable situation for consumers and community banks by throwing many prime loans into a higher-priced loan category that puts the bank in danger of noncompliance and prevents many borrowers from passing the required test for such loans. Furthermore, many mortgages made by community banks are 3 and 5 year balloon notes amortized over 30 years for customers whose mortgage would not otherwise qualify for sale in the secondary market. This category of loans is prohibited in the new rule and is the perfect example of regulatory overreaction on a segment of the lending

industry that had little to do with the current crises. And further, the new regulation has caused consumers' credit options to dwindle. The regulation needs to be reworked to restore this viable source of credit to potential homeowners.

Access to capital and sources of liquidity remain limited; regulatory deadlines for raising capital are too short

We are seeing a growing number banks being placed under severe regulatory orders that require significantly higher capital levels beyond the current definitions for a bank being well-capitalized. In an environment when private capital is extremely difficult to attract to the industry, the capital requirements in these orders are proving insurmountable. We encourage the regulators to consider the bank's longer-term plans for raising capital rather than imposing such short timelines, sometimes as short as 60 days. With regard to private equity investors, on Aug. 26, 2009, the FDIC adopted new guidelines for private equity investors interested in purchasing failed banks. The proposals would impose higher capital requirements for non-bank equity investors as well as requirements for guaranteeing ownership for three years. The FDIC is aiming to balance the need for new investors in banks as well as the need to ensure long-term safety and soundness and protection of the Deposit Insurance Fund. We appreciate that the board adopted a less-restrictive capital requirement (10%) than originally proposed (15%), and are hopeful this will drive new investment.

Open Bank Assistance for Troubled Institutions

One possible helpful approach that would encourage more private capital and reduce the cost of failed banks to the deposit insurance fund is for the FDIC to make use of open bank assistance arrangements for failing institutions rather than insisting on closing the banks and placing them into receivership. With the current closure and receivership philosophy, investors who may normally be interested in acquiring a bank and its assets are sitting on the sidelines waiting on closures so they can bid on and buy assets from the FDIC for pennies on the dollar. There are investors or other financial institutions who would buy such banks and all of their assets without a bank having to be closed provided there was an appropriate loss-sharing arrangement with the FDIC. This approach would also reduce the negative stigma that a closed bank has on the local community and the employees of such a bank. Part of this approach would also need to include a change in the rule that requires bidders of a failed bank to have an existing bank charter. Some recent bank closures have had no bidders for the failed banks' deposits, due to the FDIC limiting bidders only to holders of existing bank charters. One example of positive regulatory response to address this issue is a shelf charter that was approved by the Comptroller of the Currency last fall for an investor group which expanded the pool of bidders for troubled institutions.

TARP/CPP Investments and Sources of Private Capital

The TARP/CPP process has been frustrating for most Georgia banks that have chosen to apply to participate. Only 25 Georgia banks have been funded for TARP/CPP investment. Private capital has essentially dried up for most banks because of uncertainly and mixed messages on federal capital investments. The TARP/CPP program needs to be revisited to determine if more viable community banks can qualify for investment.

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September 22, 2009

The Honorable Timothy F. Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Secretary Geithner,

On behalf of the of the Retail Industry Leaders Association ("RILA"), I am writing to express our concern regarding a recent action by the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS") to eliminate critical "No Interest, No Payments" retail-financing programs. We request that you review this decision and its impact on consumer choice and retail sales during this period of challenging economic growth in the United States.

By way of background, RILA promotes consumer choice and economic freedom through public policy and industry operational excellence. Our members include the largest and fastest growing companies in the retail industry – retailers, product manufacturers and service suppliers – which together account for more than $1.5 trillion in annual sales. RILA member provide millions of jobs and operate more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

Recently RILA learned through its members that partner with certain banks to offer retail financing to their customers, that the OCC and OTS have issued guidance to their regulated banks that after February 22, 2010, "No Interest, No Payment" financing would no longer be allowed. Any "No Interest" or deferred-financing promotion would consequently require monthly payments. RILA is deeply concerned that no formal rulemaking procedure has been followed in issuing this guidance. Moreover, neither OCC nor OTS has been able to present any concrete evidence that No Interest, No Payment promotions have an impact on the safety and soundness of their regulated banks or their credit card programs.

No Interest, No Payment Financing Gives Consumers Flexibility and Choice.

No Interest, No Payment financing is a deferred-interest financing program that allows consumers to incur no interest on purchases if paid off within a certain period of time (usually 3 to 12 months, depending on the offer). During that time, the consumer is not required to make monthly payments but is free to pay any or all of the promotional balance, which provide the consumer with flexibility in budgeting. Quite often, this type of financing is used for emergency-type appliance purchases (i.e., broken refrigerator, washer/dryer or water heater) and allows consumers the chance to obtain the needed goods. For example, some consumers might

use tax refunds that they will receive in a few months to pay for these goods during the promotional period. This method of financing allows consumers to make needed purchases while still giving them the maximum flexibility in controlling their own repayment budgets.

These deferred financing promotions provide consumers with a cost-effective means for purchasing large-ticket, hard goods (e.g., refrigerators, clothes washers and dryers, water heaters, heating and air-conditioning systems) that often wear out or require replacement at unexpected or inconvenient times. Hence, these promotions are critical tools that enable consumers to buy what they need when they need it. They also support tens of billions of dollars in consumer purchases annually among our members, which helps generate economic growth on a national scale. We have received data showing that deferred-interest financing may represent 15 to 20 percent of total sales (on an annualized basis).

Retailers Have A Vested Interest In Providing Financing Programs That Are Helpful To Our Customers

Retailers place customers' needs at the forefront of our decision making, and we offer goods and services that they desire, not the least of which are flexible-financing options. We take great effort to provide credit card and other financing programs that are helpful and promote a good customer experience. Our members' customer-satisfaction surveys show high levels of satisfaction with No Interest, No Payment financing programs, and many customers avail themselves of these programs repeatedly. Clearly, retailers are providing a needed and desired benefit to their customers when they promote deferred-interest financing programs.

No Interest, No Payment Promotions Demonstrate Low Credit Risk and Responsible Consumer Behavior

Our members' experience with these transactions does not suggest that the types of deferred-interest financing programs they offer today cause consumers to buy more than they can afford. We have received data that shows a 7.5-percent gross write-off rate in 2008 for these promotional deferred-interest sales, and over a 14-percent gross write-off rate in 2008 for non-promotional sales. We see no demonstrable evidence that No Interest, No Payment financing creates any more risk to the safety and soundness of bank lending than non-promotional financing.

Importantly, aggregate member company data shows that the vast majority of customers pay off their promotional balances within the promotional period, and in some instances the pay-off rate may reach as high as 87 percent (i.e., the percent of customers who pay off within the time allowed and do not get assessed any accrued interest charges). This demonstrates that the vast majority of customers do not make purchases they could not otherwise afford, and that they use these deferred-interest programs to help them manage unexpected expenses in the way that best suits them.

Further, we have received credit score statistics (FICO scores) about customers from our members' banking partners that support the position that customers who take advantage of deferred-interest financing programs are good customers with strong credit performance and can and do handle their purchases responsibly:

	12/07	3/08	6/08	9/08	12/08
Deferred Interest Sales FICO	716	719	719	723	720
Regular Non-Deferred Interest Sales FICO	710	713	715	715	

This Proposed Action By The OCC and OTS Alters The Playing Field – Favoring Some Retailers Over Others Based Solely On Their Banking Partner Regulator

Not all of our retailer members offer consumer-financing programs through banks regulated by the OCC and OTS. Some partner with state chartered banks regulated by state banking officials and the Federal Deposit Insurance Corporation (FDIC). While the OCC and OTS have taken this unnecessary step of banning No Interest, No Payment financing, the FDIC has remained silent on this subject. No agency has gone through any rulemaking process that would allow organizations like RILA and the individual retailers affected by such sweeping decisions to comment and present a full picture for consideration. In fact, the OCC and OTS appear to be working off of guidance issued in 2003 that is not particularly relevant today and should be updated through a complete and open rulemaking process. If the FDIC and other lenders do not require similar restrictions on retail financing for their regulated banks, the OCC and OTS will have created an unequal playing field that will have devastating consequences to our member retailers.

Depending on the bank with which the retailer has partnered to offer consumer financing, the retailer may or may not be allowed to offer No Interest, No Payment deferred-financing programs. Subsequently, financing offers to consumers would vary depending on the partner bank's regulator. This would shift sales from one merchant to another without any perceived benefit to the banking system as a whole. But, the effects on sales at the merchants who happen to have financing programs through banks regulated by the OCC and OTS would be devastating. With the variety of banking institutions that partner with retail merchants to offer consumer financing, we do not believe that allowing different lending standards that would shift consumer purchasing to different retailers depending on that merchant's banking partner serves any purpose to the banking industry as a whole, and ultimately works to the detriment of consumers.

Given the dramatic consequences to some retailers that banning No Interest, No Payment financing programs present, and the fact that there has been no demonstration that these types of financing programs cause any increased risk to the banks themselves, or to the consumers who use them to finance the goods they need (often urgently), we request that you review the guidance issued by the OCC and OTS and request the financial justification for issuing that guidance under the guise of "safety and soundness" or "consumer protection." At the very least,

we request that should such a dramatic shift in financing plans be perceived as necessary, the various banking agencies should be unified and go through the formal rulemaking process to allow other organizations to present the complete and accurate picture of what such a proposal would mean, both to the consumers and retailers, as well as to the economy as a whole.

In closing, RILA appreciates the opportunity to bring to your attention our strong concerns regarding actions to eliminate popular No Interest, No Payment promotions, and we would welcome the opportunity to provide you with additional information. We look forward to continuing to work with you and your colleagues to enable our members and the broader retail community to continue to improve customer satisfaction with this important financing tool that well serves American consumers and benefits our nation's economy. Should you have any questions or need additional information regarding this issue, please contact me or Andrew Szente, director, government affairs, at (703) 600-2033 or by email at andrew.szente@rila.org.

Sincerely,

John G. Emling,
Senior Vice President, Government Affairs

Honorable Representative Bean

Question: I've heard from a number of retailers that the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) are moving to end "No Interest, No Payments" financing promotions offered by retailers which offer no interest and no financing for a fixed period of time that allow consumers to purchase large ticket items such as dishwashers, refrigerators and water heaters, and defer making payment on them for a specified period of time.

Why are OCC and OTS moving forward with this proposal at this time? And in particular, can you share evidence that led you to believe No Interest, No Payment promotions pose a risk to lending institutions?

Answer: Recent examination reviews of OTS supervised savings associations that offer "no interest - no payment" credit card programs revealed increasing delinquencies and losses related to these accounts.

OTS examination staff noted that:

> No payment promotions presents substantially higher credit risk (unexpected loss) to banks than regular revolving accounts. This is not necessarily because the accounts/customers themselves are riskier but because the structure of the promotion results in an inability to adequately monitor and assess risk. These promotions also present problems for customers who are less adept at managing their finances. The best way to address these problems is to require some level of minimum monthly payments.

Examiners also noted that:

> No payment promotions are most prevalent on big ticket purchases such as furniture and big-screen televisions. These types of purchases often result in balances of $5,000 or more. Many view promotional programs that offer no payments until next year as being designed to entice customers into making a large purchase that they may not otherwise have considered or thought they couldn't afford. It allows customers to acquire these items without worrying about paying for them for a long period of time. For those customers who are not as adept at managing their finances, it may be very difficult to make a $5,000 payment at the end of the promotion – at which time they will incur high financing costs, in some cases (back-billing) all of the costs they thought they were avoiding.

On September 24, 2009, OTS issued CEO Letter 321 – "No Interest, No Payment" Credit Card Programs to remind savings associations of certain guidance contained in the 2003 interagency "Account Management and Loss Allowance Guidance for Credit Card Lending." That guidance articulated sound account management, risk management, and loss allowance practices for all institutions engaged in credit card lending. CEO Letter 321 reminds savings associations of OTS's longstanding position that minimum payments should be required on credit card accounts. CEO Letter 321 neither prohibits nor discourages the practice of "no interest" credit card promotions, but stresses the importance of monthly minimum payment requirements that promotes safe and sound

lending. Over the past year, OTS and OCC have worked closely to develop the respective policy statements, which are substantially identical.

CEO Letter 321 states:

> Regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact with the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment and mask true portfolio performance and quality.

Minimum regular monthly payments requirements are not onerous. Since May 2006, OTS policy had stated that minimum monthly payments on credit card accounts should include all interest and fees, plus a 1 percent principal reduction. (See OTS Examination Handbook Section 218, page 13, issued May 8, 2006. (http://files.ots.treas.gov/422064.pdf).) Thus the minimum monthly payment on a $5,000 purchase would be $50, on a no interest account, and $150, on a 24% deferred interest account.

Finally, the CEO Letter states that savings associations will be given a reasonable time to implement any changes to their existing programs as a result of the policy clarification. All savings associations are expected to be in full compliance for all new credit card transactions no later than February 22, 2010.

To summarize:

- OTS issued a policy statement (CEO Letter 321) on "no interest, no payment" credit card programs on September 24, 2009.
- CEO Letter 321 is not new guidance and only clarifies expectations as to minimum monthly payments contained in both the 2003 interagency account management guidance and OTS Handbook Section 218.
- OTS does not restrict "no interest" promotions.
- Examination data shows increased delinquency and credit risk for programs that do not require regular monthly payments from borrowers.
- Savings associations will be given a reasonable period of time to make any necessary changes to their existing programs.

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Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, DC 20552 • (202) 906-5666

Timothy T. Ward
Deputy Director, Examinations, Supervision, and Consumer Protection

September 24, 2009

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Timothy T. Ward
Deputy Director
Examinations, Supervision, and Consumer Protection

SUBJECT: "No Interest, No Payment" Credit Card Programs

On January 8, 2003, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation jointly issued the "Account Management and Loss Allowance Guidance for Credit Card Lending ("AMG"). That guidance articulated sound account management, risk management, and loss allowance practices for all institutions engaged in credit card lending. This memorandum reminds savings associations of some of the specific requirements of that guidance.

One key tenet of safe and sound retail lending is the monthly minimum payment requirement. Regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact with the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment and mask true portfolio performance and quality.

Recent examinations have identified increasing use of "no interest, no payment" programs that allow borrowers to defer making payments for extended periods. These deferral periods often range from three- to twelve-months or longer, and are most commonly associated with private label marketing agreements for retailers such as electronics and furniture companies.

The AMG states that OTS expects lenders to require minimum payments that will amortize the current balance over a reasonable period of time consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. As indicated in the OTS Examination Handbook Section 218, as revised in May 2006, the minimum monthly payment should cover at least a one percent principal balance reduction plus all

assessed monthly interest and finance charges. Savings associations are thus reminded they should require a minimum payment from the borrower each month for all credit card programs, including private label arrangements with retailers. While savings associations (or their retail partners) may offer "no interest" promotions, they should have a policy of a minimum monthly payment even during the promotional period. The minimum payment should be consistent with the issuer's standard principal reduction for the product or program, but in no event less than one percent of the principal balance owed.

In recognition of the time needed to revise marketing campaigns and materials, savings associations will be allowed a reasonable amount of time to comply with the minimum payment expectations described in this memorandum for all new credit transactions. Nonetheless, full compliance should be no later than February 22, 2010, which is also the implementation deadline for most of the new requirements contained in the Credit Card Act of 2009. (See OTS CEO Memorandum #308, issued June 25, 2009, "Credit Card Act of 2009: Effective Dates.")

For further information, contact William Magrini, Senior Project Manager, Credit Policy, at (202) 906-5744.

Follow up Questions Submitted to
John E. Bowman, Acting Director,
Office of Thrift Supervision
From the Hearing Entitled: "Financial Regulatory Perspectives on
Financial Regulatory Reform Proposals"
September 23, 2009

Honorable Representative Manzullo

Question: I've heard from retailers that the Office of the Comptroller of the Currency and the Office of Thrift Supervision intend to end financing promotions that offer no interest and/or no payments for a specific period of time. These promotions are intended to enable retailers to competitively offer products to consumers. I am requesting data to verify that these promotions present a "safety and soundness" concern to the lending banks. Some suggest that FICO data shows that consumers who use these programs appear to be better at meeting their obligations than those who do not.

Please tell us why you are pursuing this action. Additionally, please describe the timeframe in which you expect to carry out this course of action. If it is your intent to prohibit these promotional programs, please provide the Committee with the data or other evidence you are using to justify that action.

Answer: In arriving at the decision to issue a letter on these programs to the savings association we regulate, we considered, among other things, the following:

Recent examination reviews of OTS supervised savings associations that offer "no interest - no payment" credit card programs revealed increasing delinquencies and losses related to these accounts.

OTS examination staff noted that:

> No payment promotions present substantially higher credit risk (unexpected loss) to banks than regular revolving accounts. This is not necessarily because the accounts/customers themselves are riskier, but because the structure of the promotion results in an inability to adequately monitor and assess risk. These promotions also present problems for customers who are less adept at managing their finances. The best way to address these problems is to require some level of minimum monthly payments.

Examiners also noted that:

> No payment promotions are most prevalent on big ticket purchases such as furniture and big-screen televisions. These types of purchases often result in balances of $5,000 or more. Many view promotional programs that offer no payments until next year as being designed

> to entice customers into making a large purchase that they may not otherwise have considered or thought they couldn't afford. It allows customers to acquire these items without worrying about paying for them for a long period of time. For those customers who are not as adept at managing their finances, it may be very difficult to make a $5,000 payment at the end of the promotion – at which time they will incur high financing costs, in some cases (back-billing) all of the costs they thought they were avoiding.

On September 24, 2009, OTS issued CEO Letter 321 - "No Interest, No Payment" Credit Card Programs to remind savings associations of certain guidance contained in the 2003 interagency "Account Management and Loss Allowance Guidance for Credit Card Lending." That guidance articulated sound account management, risk management and loss allowance practices for all institutions engaged in credit card lending. CEO Letter 321 reminds savings associations of OTS's longstanding position that minimum payments should be required on credit card accounts. CEO Letter 321 neither prohibits nor discourages the practice of "no interest" credit card promotions, but stresses the importance of monthly minimum payment requirements that promotes safe and sound lending. Over the past year, OTS and OCC have worked closely to develop the respective policy statements, which are substantially identical.

CEO Letter 321 states:

> Regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact with the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment and mask true portfolio performance and quality.

Minimum regular monthly payments requirements are not onerous. Since May 2006, OTS policy had stated that minimum monthly payments on credit card accounts should include all interest and fees, plus a 1 percent principal reduction. (See OTS Examination Handbook Section 218, page 13, issued May 8, 2006. (http://files.ots.treas.gov/422064.pdf).) Thus the minimum monthly payment on a $5,000 purchase would be $50, on a no interest account, and $150, on a 24% deferred interest account.

Finally, the CEO Letter states that savings associations will be given a reasonable time to implement any changes to their existing programs as a result of the policy clarification. All savings associations are expected to be in full compliance for all new credit card transactions no later than February 22, 2010.

To summarize:

- OTS issued a policy statement (CEO Letter 321) on "no interest, no payment" credit card programs on September 24, 2009.
- CEO Letter 321 is not new guidance and only clarifies expectations as to minimum monthly payments contained in both the 2003 interagency account management guidance and OTS Handbook Section 218.
- OTS does not restrict "no interest" promotions.

- Examination data shows increased delinquency and credit risk for programs that do not require regular monthly payments from borrowers.
- Savings associations will be given a reasonable period of time to make any necessary changes to their existing programs.

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September 24, 2009

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Timothy T. Ward
Deputy Director
Examinations, Supervision, and Consumer Protection

SUBJECT: "No Interest, No Payment" Credit Card Programs

On January 8, 2003, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation jointly issued the "Account Management and Loss Allowance Guidance for Credit Card Lending ("AMG"). That guidance articulated sound account management, risk management, and loss allowance practices for all institutions engaged in credit card lending. This memorandum reminds savings associations of some of the specific requirements of that guidance.

One key tenet of safe and sound retail lending is the monthly minimum payment requirement. Regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact with the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment and mask true portfolio performance and quality.

Recent examinations have identified increasing use of "no interest, no payment" programs that allow borrowers to defer making payments for extended periods. These deferral periods often range from three- to twelve-months or longer, and are most commonly associated with private label marketing agreements for retailers such as electronics and furniture companies.

The AMG states that OTS expects lenders to require minimum payments that will amortize the current balance over a reasonable period of time consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. As indicated in the OTS Examination Handbook Section 218, as revised in May 2006, the minimum monthly payment should cover at least a one percent principal balance reduction plus all

assessed monthly interest and finance charges. Savings associations are thus reminded they should require a minimum payment from the borrower each month for all credit card programs, including private label arrangements with retailers. While savings associations (or their retail partners) may offer "no interest" promotions, they should have a policy of a minimum monthly payment even during the promotional period. The minimum payment should be consistent with the issuer's standard principal reduction for the product or program, but in no event less than one percent of the principal balance owed.

In recognition of the time needed to revise marketing campaigns and materials, savings associations will be allowed a reasonable amount of time to comply with the minimum payment expectations described in this memorandum for all new credit transactions. Nonetheless, full compliance should be no later than February 22, 2010, which is also the implementation deadline for most of the new requirements contained in the Credit Card Act of 2009. (See OTS CEO Memorandum #308, issued June 25, 2009, "Credit Card Act of 2009: Effective Dates.")

For further information, contact William Magrini, Senior Project Manager, Credit Policy, at (202) 906-5744.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

November 6, 2009

The Honorable Barney Frank
Chairman
Committee on Financial Services
US House of Representatives
Washington, DC 20215

Dear Chairman Frank:

Enclosed please find my response to the questions submitted for the record following the September 23, 2009, hearing on "Federal Regulator Perspectives on Financial Regulatory Reform Proposals."

Representatives Foster, Bean, and Manzullo submitted similar questions relating to recent supervisory guidance issued by the OCC that reminded bank examiners that the increased use of "No Payment" programs was not consistent with OCC Account Management Guidance issued in 2003. Because the Members' questions were very similar, I have provided a single response to their questions.

I hope this information is helpful. If you have any questions or need additional information, please feel free to contact John Hardage, Director, Congressional Liaison, at (202) 874-1881.

Sincerely,

John C. Dugan
Comptroller of the Currency

Enclosure

Questions for the Record

Representative Foster:
We have heard that the OCC is taking action to eliminate "No Interest, No Payment" retail financing programs early next year. Is this true and, if so, what is the rationale? Please provide any and all information used to justify this decision.

Representative Bean:
I've heard from a number of retailers that the OCC and the OTS are moving to end "No Interest, No Payment" financing promotions offered by retailers, which offer no interest and no financing for a fixed period of time that allows consumers to purchase large ticket items such as dishwashers, refrigerators and water heaters, and defer making payments on them for a specified period of time. Why are the OCC and OTS moving forward with this proposal at this time? And in particular, can you share evidence that led you to believe "No Interest, No Payment" promotions pose a risk to lending institutions?

Representative Manzullo:
I've heard from a number of retailers that the OCC and the OTS intend to end financing promotions that offer no interest and/or no payments for a specific period of time. These promotions are intended to enable retailers to competitively offer products to consumers. I am requesting data to verify that these promotions present a safety and soundness concern to the lending banks. Some suggest that FICO data shows that consumers who use these programs appear to be better at meeting their obligations than those who do not. Please tell us why you are pursuing this action. Additionally, please describe the timeframe in which you expect to carry out this course of action. If it is your intent to prohibit these promotional programs, please provide the Committee with the data or other evidence you are using to justify that action.

The OCC believes that the receipt of regular monthly payments is important in consumer lending for several reasons. For borrowers, well-designed payment structures promote a fundamental understanding of their debt burden in terms of monthly cash flow and total income. Regular, budgeted payments help avoid the potential pitfalls associated with payment shock when payments begin or significantly increase under the loan amortization schedule. Regular payments also allow borrowers to demonstrate to existing and prospective lenders the willingness and capacity to repay their debts while systematically reducing those debts.

For lenders, regular payments are an efficient way to monitor borrowers' willingness and ability to repay without the operational expense associated with requiring ongoing payment capacity information. Regular payment streams also allow the identification of early warning measurements such as delinquencies, roll rates, payment rates, and credit scores to be effective. Furthermore, they help lenders manage portfolio risk by providing important inputs into the determination of adequate capital and reserve levels.

For these reasons, the OCC, the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation ("the Agencies"), issued the Credit Card Account Management and Loss Allowance Guidance ("AMG") in January 2003. This guidance addressed regulatory concerns with the easing of minimum payment requirements as well as concerns with other account management practices. The AMG states, in part, that the Agencies expect lenders to require minimum payments that will amortize the current balance of the account over a reasonable period. The guidance does not differentiate between general purpose and private label card programs. Consequently, we issued a Supervisory Memorandum on June 18, 2009, to remind our examiners that the increased use of "No Payment" programs being offered by banks, and their retail partners, are not consistent with the AMG. We asked our examiners to ensure that national banks cease any "No Payment" programs by February 22, 2010. This gives national banks, and their retail partners, time to make necessary changes and coincides with the implementation date for other changes dictated by the Credit CARD Act.

As a matter of clarification, the OCC does not object to "No Interest" programs. These promotions are very attractive to consumers and often provide real, tangible benefits. However, the OCC believes that any benefits associated with "No Payment" programs are outweighed by the negative impacts, including the loss of discipline associated with a regular payment stream, potential payment shock, a prolonged repayment schedule, and bank safety and soundness concerns.