S. HRG. 111–59

# CONSUMER PROTECTIONS IN FINANCIAL SERVICES: PAST PROBLEMS, FUTURE SOLUTIONS

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

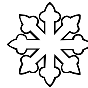
FIRST SESSION

ON

ESTABLISHING STRONG CONSUMER PROTECTIONS WHILE ENSURING A SAFE AND SOUND FINANCIAL SYSTEM IN THE UNITED STATES

MARCH 3, 2009

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

51–290 PDF WASHINGTON : 2009

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

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CHRISTOPHER J. DODD, Connecticut, *Chairman*

TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
ROBERT MENENDEZ, New Jersey
DANIEL K. AKAKA, Hawaii
SHERROD BROWN, Ohio
JON TESTER, Montana
HERB KOHL, Wisconsin
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
MICHAEL F. BENNET, Colorado

RICHARD C. SHELBY, Alabama
ROBERT F. BENNETT, Utah
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
MEL MARTINEZ, Florida
BOB CORKER, Tennessee
JIM DEMINT, South Carolina
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
KAY BAILEY HUTCHISON, Texas

COLIN MCGINNIS, *Acting Staff Director*
WILLIAM D. DUHNKE, *Republican Staff Director and Counsel*

AMY FRIEND, *Chief Counsel*
LYNSEY GRAHAM REA, *Counsel*
JULIE CHON, *Senior International Adviser*
JONATHAN MILLER, *Professional Staff Member*
MATTHEW PIPPIN, *Professional Staff Member*
TAMARA FUCILE, *Professional Staff Member*

MARK OESTERLE, *Republican Chief Counsel*
JIM JOHNSON, *Republican Counsel*
MARK CALABRIA, *Republican Senior Professional Staff Member*

DAWN RATLIFF, *Chief Clerk*
DEVIN HARTLEY, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

# CONTENTS

## TUESDAY, MARCH 3, 2009


| | Page |
|---|---|
| Opening statement of Senator Dodd | 1 |
| Opening statements, comments, or prepared statements of: | |
| Senator Shelby | 4 |
| Senator Akaka | 6 |
| Senator Merkley | 6 |
| Senator Schumer | 23 |


## WITNESSES


| | |
|---|---|
| Steve Bartlett, President and Chief Executive Officer, Financial Services Roundtable | 7 |
| Prepared statement | 37 |
| Response to written question of Senator Vitter | 73 |
| Ellen Seidman, Senior Fellow, New America Foundation, and Executive Vice President ShoreBank Corporation | 9 |
| Prepared statement | 48 |
| Response to written question of Senator Vitter | 74 |
| Patricia A. McCoy, George J. and Helen M. England Professor of Law, University of Connecticut School of Law | 11 |
| Prepared statement | 52 |
| Response to written question of Senator Vitter | 75 |

# CONSUMER PROTECTIONS IN FINANCIAL SERVICES: PAST PROBLEMS, FUTURE SOLUTIONS

---

**TUESDAY, MARCH 3, 2009**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:06 a.m., in room 538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. The Committee will come to order. Let me welcome those of you here in the room, my colleagues and our witnesses, who will spend a few moments with us as we discuss "Consumer Protections in Financial Services: Past Problems and Future Solutions."

Let me begin by commending all three of our witnesses. I went over your testimony yesterday and I found it very, very interesting, with different perspectives on this issue, not so much on how we got where we are, but where we need to go from here. I found it very, very worthwhile, very enlightening and interesting. And really, what I liked about it is, given we have spent a lot of time over the last year talking about it in general terms, it talks specifically about where we go, and all three of you really have offered some very specific ideas on how to move forward. That is what we need to be doing in the coming days.

And, of course, I am delighted to be with my friend and colleague here from Alabama, who was the former Chairman of the Committee. We have had some great times working together over the last 2 years, some difficult times, but he has been a great partner and a good Senator. We have our differences from time to time, but we try to minimize those and do whatever we can to work together.

And this is a subject matter where I am determined, and I believe he is determined, as I hope our colleagues are, too, to come together and do something historic in light of all the problems that we face in our country. You need only to pick up our morning newspapers to appreciate what people are going through. We read the numbers, but, obviously, out there behind all of those numbers are people watching their jobs disappear, their retirements evaporate, and they are losing their homes, and their children's future and education are in question. And that is what has to motivate us and drive us. We keep them in mind through all of this.

So this morning, we continue the conversation we have been having about how we can make our economy stronger, our institutions more stable and reliable, and of course, in the final analysis, to make sure that the consumers of all of these products are going to receive the protection that they deserve.

So today, the Banking Committee meets for another time in a series of hearings to discuss ways to modernize our financial architecture to help our nation grow, to prosper, and to lead our nation into the 21st century. This hearing will focus on critical consumer, investor, and shareholder protections in financial services.

For the past year, as I have traveled in my home State of Connecticut, along, I am sure, with my colleagues in their own respective States, and our constituents have underscored the importance of rebuilding our financial system by injecting tough new consumer investor protections that have been missing or overlooked for far too long. They are literally banking on change in this area, and I believe we must give it to them this year, and our common hope is to do just that, because efficient and effective markets only work when all actors have good information.

It also means increased accountability, disclosure and transparency to ensure that consumers and investors understand the rules of the road regarding their transactions. And it means doing these things in a way which doesn't unduly cramp the vitality, innovation, and creativity, which is the source of genius in our financial system. Striking that balance is a tall order, but that must be our charge.

The President has now made clear that regulatory modernization, which will protect consumers and investors in this way, is a top priority for him. Senator Shelby and I, joined by Chairman Barney Frank and Ranking Member Spencer Baucus, met last week met at the White House, and we agreed to work toward that goal, informed by key principles outlined by the President in that meeting.

It is an historic undertaking, one of the most important debates in which we have engaged here in a long time, maybe the most important debate that members of this Committee may ever engage in, considering the significance of what we are about to undertake. It will be challenging, and no doubt it will take twists and turns in the coming months. But I hope and expect that the process will culminate in a comprehensive regulatory modernization bill at its end.

Senator Shelby and his colleagues have been partners in many such legislative efforts over the past couple of years that I have chaired this Committee, and I am very grateful to him specifically and to my colleagues as well, for the fine work they have done with us on this Committee.

In the last Congress, this Committee and its subcommittees held 30 hearings to identify the causes and consequences of the financial crisis, which is at the root of our economic troubles. We looked at everything from predatory lending and foreclosures to the risks of derivatives in the banking system, and security and insurance industries. What we found at the heart of the problem in these areas was a single fundamental breakdown, an almost total failure to protect consumers, investors, and shareholders.

By no means is this problem exclusive to financial services. Whether it is poisoned toys imported from China or meat with deadly pathogens knowingly sold to supermarkets, some for too long have been willing to cross the bright lines of basic business operations, and fair treatment of the consumer to bolster their bottom lines.

Nowhere was that failure starker or more catastrophic for our economy than the housing market, where lenders, brokers, and banks offered or financed an array of unsuitable mortgage products without regard to the borrower's ability to repay. For too long, many in the industry focused solely on large profits and ignored the major risks that accompanied them. They were willing to gamble with not only their own futures, but those of their customers, who were encouraged to take on more and more risk.

And the result is clear. With unemployment now at its highest in 16 years, 8 million homes in danger of foreclosure, and some of our largest financial institutions either in ruins or at the risk of being such, this house of cards has collapsed, and today the Committee meets to continue our discussion on how to rebuild a stronger and more stable structure.

I pledge personally over the coming months that we will rebuild the nation's financial architecture from the bottom up and put the needs of consumers, investors, and shareholders who own these firms not at the margins of our financial service system, but at its very center. Just as failure to protect the American people was the cause of our financial collapse, so too must our efforts to rebuild be premised on a strong foundation of consumer and investor protections.

Certainly, we have a ways to go, as we all know, when mortgage brokers can charge yield spread premiums for directing customers into riskier, costlier mortgages, and when credit card companies can raise rates on customers who have always paid their bills on time.

Recently, I learned of a woman named Samantha Moore from Guilford, Connecticut, a paralegal whose husband owns a small business. Not long ago, she was 3 days late on a credit card payment, the first late payment in 18 years. For that seemingly minor transgression, she had her interest rate raised from 12 percent to 27 percent and her credit line slashed from $31,400 a year to $4,500. What is a middle-class family like the Moores supposed to do if they were counting on that credit line to help them through a medical crisis? That single decision could mean the difference between scraping by during a recession and a lifetime of financial catastrophe, all because a single payment after 18 years was 3 days late.

With the average household carrying more than $10,000 in revolving debt on their credit cards and millions trapped in home loans with exploding interest rates, sweeping reform of abusive credit card and mortgage lending practices will be an essential component of this Committee's financial modernization efforts.

Today, we will discuss broader regulatory reform questions that focus on how we treat customers of financial institutions. For instance, should bank regulators continue to have that authority? In 1994, Congress gave the Fed authority to ban abusive home mort-

gages and it failed miserably. Is it time to create a new regulator whose sole function is the fair treatment of individual customers?

Certainly, we need strong cops on the beat in every neighborhood. Fifty-two percent of subprime mortgages originated with companies like stand-alone mortgage brokers and others that have no Federal supervision whatsoever. Who should be charged with consumer protection for these financial institutions? Some have suggested that we set up an entity modeled on the Consumer Product Safety Commission, which protects the public from products used in the home, the school, and for recreation. In this day and age, financial products are just as commonplace and some can be equally as dangerous.

No one suggests that the buyer is to blame for a dangerous toaster that catches fire or a toy for a child that is contaminated with lead. Should it be any different for a borrower who takes out a mortgage or signs up for a credit card? I think it is a fair thing to ask, and one thing is clear: These complex financial transactions, including mortgages, can be much more dangerous than a family toaster.

We are talking about huge financial decisions, often the most significant in a family's life, on which they stake their life's savings. We must do everything we can to make sure that they understand precisely the terms of those transactions and their implications and that they are protected from the kinds of abuses we have seen in recent years. These protections must be comprehensive and consistent over our regulatory architecture.

For too long, we have allowed a misguided belief to persist, that when you protect a consumer, you stifle innovation and growth. That is truly a false choice. Efficient, dynamic marketplaces don't function in spite of people like Samantha Moore, they function because of people like her and millions of others who work, invest, and save to send their children to school, to buy homes, and to live the often-spoken-of American dream.

If we are going to grow a more sensible economy, a sustainable economy, with a safe and sound financial architecture that supports it, we need to protect and nurture and invest in our most precious resource, the American people. That starts with the work of this Committee.

With that, let me turn to my colleague, Senator Shelby, and then I will ask my colleagues who are here if they would like to make any opening comments, and then we will turn to our witnesses. Richard?

## STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

There is no question that many home buyers were sold inappropriate mortgages over the past several years. We have heard their stories. We have heard some of those stories right here. There is also no question that many home buyers were willing parties to contracts that stretched them far beyond their financial means. Some of these home buyers were even willing to commit fraud to buy a new home. We have heard their stories, as well.

As with any contract, there must be at least two parties to each mortgage. If either party chooses not to participate, there is no

agreement. Unfortunately, during the real estate boom, willing participants were in abundance all along the transaction chain, from buyers to bankers, from Fannie and Freddie to investment banks, and from pension funds to international investors. There appeared to be no end to the demand for mortgage-backed securities. Underwriting standards seemed to go from relaxed to nonexistent as the model of lending known as originate to distribute proliferated the mortgage markets. The motto in industry seemed to be risk passed, risk avoided.

However, as the risk was then passed around our financial markets like a hot potato, everyone taking their piece along the way, some of the risk was transferred back onto the balance sheets of regulated financial institutions. In many cases, banks were permitted to hold securities backed by loans that they were proscribed from originating. Interesting. How did our regulators allow this to happen? This is just one of the many facets of this crisis that this Committee will be examining over the months ahead.

A key issue going forward is how do we establish good consumer protections while also ensuring the safety and soundness of our financial system? In many respects, consumer protection and safety and soundness go hand in hand. Poorly underwritten loans that consumers cannot afford are much more likely to go bad and inflict losses on our banks. In addition, an essential element of consumer protection is making sure that a financial institution has the capital necessary to fulfill its obligations to its customers.

This close relationship between consumer protection and safety and soundness argues in favor of a unified approach to financial regulation. Moreover, the ongoing financial crisis has shown that fractured regulation creates loopholes and blind spots that can, over time, pose serious questions to our financial system.

It is regulatory loopholes that have also spawned many of the worst consumer abuses. Therefore, we should be cautious about establishing more regulatory agencies just to create the appearance of improving consumer protections.

We should also be mindful of the limits of regulation. Our regulators cannot protect consumers better than they can protect themselves. We should be careful not to construct a regulatory regime that gives consumers a false sense of security. The last thing we need to do is lead consumers to believe that they don't have to do their own due diligence. If this crisis teaches us anything, it should be that everyone, from the big banks and pension funds to small community banks and the average consumer, has to do a better job of doing their own due diligence before entering into any financial transactions. At the end of the day, self-reliance may prove to be the best consumer protection.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Akaka, any opening comments?

## STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I want you to know that I appreciate your conducting this hearing and also appreciate your advocacy on behalf of consumers, Mr. Chairman and Ranking Member, Senator Shelby.

I also want to welcome our witnesses this morning to this hearing.

Well before the current economic crisis, our financial regulatory system was failing to adequately protect working families, home buyers, individuals from predatory practices and exploitations. Prospective home buyers were steered into mortgage products with risks and costs that they could not afford. Working families were being exploited by high-cost fringe financial service providers, such as payday lenders and check cashers. Low-income taxpayers had their Earned Income Tax Credit benefits unnecessarily diminished by refund anticipation loans. Individuals trying to cope with their debt burdens were pushed into inappropriate debt management plans by disreputable credit counselors.

We must increase consumer education so that individuals are able to make better informed decisions. However, although it is essential, education is not enough. We must also restrict predatory policies, ensure that consumers' interests are better represented in the regulatory process, and increase effective oversight of financial services.

Mr. Chairman, you mentioned this in your opening statement and I will certainly work with you on these measures. I appreciate the witnesses today and I look forward with all of you to educate, protect, and empower consumers.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you.

Senator Merkley, any opening thoughts?

## STATEMENT OF SENATOR MERKLEY

Senator MERKLEY. Thank you very much, Mr. Chair, and welcome to the experts testifying before us.

I will say just simply that too often, the failure of regulation has turned the American dream of home ownership into an American nightmare of home ownership, and that the failure of regulation on Wall Street has created the situation where these same mortgages have contributed enormously to the meltdown of our economy, and just not our economy, but now to the world economy.

So this is incredibly important to the success of our families that we get this right, and to the success of our economy and the world economy. I look forward to your testimony.

Thank you very much, Mr. Chair.

Chairman DODD. Thank you very much, as well, Senator. I appreciate your opening comments.

Let me just introduce our witnesses so we can get to them. As I said at the outset, I was very impressed with your testimony. It is very thorough and, in fact, my constituent is extremely thorough. His testimony was 28 pages. We are going to try and limit you this morning. I am going to challenge my colleagues to read all of it, but we will try and keep it down to about somewhere between five and 8 minutes or so, so that we can get to some questions with you.

Our first witness is truth in advertising. He is a good friend of mine, Steve Bartlett. Steve is CEO of the Financial Services Roundtable, previously served as the Mayor of Dallas, a former Member of the Congress. In fact, he served on the Financial Services Committee when he served in the House, and so he has a familiarity with these issues as a chief executive of a city, as a Member of the Congress serving on the counterpart Committee to this Committee, and, of course, as the CEO of the Financial Services Roundtable. Steve, we thank you immensely for joining us today and being with us.

Ellen Seidman is the former Director of the Office of Thrift Supervision and currently Senior Fellow of the New America Foundation and Executive Vice President on National Policy and Partnership Development at ShoreBank Corporation. We thank you very much once again for being before the Committee.

And I am proud to introduce Professor Patricia McCoy, a nationally recognized authority on consumer finance law and subprime lending. She is the George J. and Helen M. England Professor of Law at the University of Connecticut. She was a partner of Mayer, Brown, Rowe and Maw in Washington, D.C., where she specialized in complex securities banking and commercial constitutional litigation. It is a pleasure to have you. I hope you are enjoying your tenure in Connecticut.

Ms. McCoy. Very much so, Senator.

Chairman DODD. That is good.

We will begin with you, Steve, and again, thank you all for your excellent testimony.

**STATEMENT OF STEVE BARTLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL SERVICES ROUNDTABLE**

Mr. BARTLETT. Thank you, Chairman Dodd and Ranking Member Shelby and members of the Committee.

To start with the obvious, it is true that many consumers were harmed by the mortgage-lending practices that led to the current crisis, but what is even more true is that even more have been harmed by the crisis itself. The root causes of the crisis, to overly simplify, are twofold: One, mistaken policies and practices by many, but not all, not even most, financial services firms; and two, the failure of our fragmented financial regulatory system to identify and to prevent those practices and the systemic failures that resulted.

This crisis illustrates the nexus, then, between consumer protection regulation and safety and soundness regulation. Safety and soundness, or prudential regulation, is the first line of defense for protecting consumers. It ensures that financial services firms are financially sound and further loans that borrowers can repay with their own income are healthy both for the borrower and for the lender. In turn, consumer protection regulation ensures that consumers are treated fairly. Put another way, safety and soundness and consumer protection are self-reinforcing, each strengthening the other.

Given this nexus, we do not support, indeed, we oppose proposals to separate consumer protection regulation from safety and sound-

ness regulation. Such a separation would significantly weaken both.

An example, Mr. Chairman, in real time, today, a provision in the pending omnibus appropriations bill that would give State attorneys general the authority to enforce compliance with the Federal Truth in Lending Act illustrates this problem. It would create additional fragmented regulation, and attempting to separate safety and soundness and consumer protection would harm both.

My testimony has been divided into two parts. First, I address what went wrong, and second, I address how to fix the problem.

What went wrong? The proximate cause of the current financial crisis was the nationwide collapse of housing values. The root cause of the crisis are twofold. The first was a breakdown, as I said, in policies, practices, and processes at many, but not all financial services firms. Since 2007, admittedly long after all the horses were out of the barn and running around in the pasture, the industry identified and corrected those practices. Underwriting standards have been upgraded. Credit practices have been reviewed and recalibrated. Leverage has been reduced as firms were rebuilt. Capital incentives have been realigned. And some management teams have been replaced.

The second underlying cause, though, is our overly complex and fragmented financial regulatory structure which still exists today as it existed during the ramp-up to the crisis. There are significant gaps in the financial regulatory system in which no one has regulatory jurisdiction. The system does not provide for sufficient coordination and cooperation among regulators and does not adequately monitor the potential for market failures or high-risk activities.

So how to fix the problem? The Roundtable has developed over the course, literally, of 3 years a draft financial regulatory architecture that is intended to close those gaps, and our proposed architecture, which I submit for the record, has six key features.

First, we propose to expand the membership of the President's Working Group on Financial Markets and rename it the Financial Markets Coordinating Council, but key, to give it statutory authority rather than merely executive branch authority.

Second, to address systemic risk, we propose that the Federal Reserve Board be authorized as a market stability regulator. The Fed would be responsible for looking across the entire financial services sector to identify interconnections that could pose a risk to the entire financial system.

Third, to reduce the gaps in regulation, we propose a consolidation of several existing Federal agencies, such as OCC and OTS, into a single national financial institutions regulator. The new agency would be a consolidated prudential and consumer protection agency for three broad sectors: Banking, securities, and insurance. The agency would issue national prudential and consumer protection standards for mortgage origination. Mortgage lenders, regardless of how they are organized, would be required to retain some of the risk for the loans they originate, also known as keeping some skin in the game, and likewise, mortgage borrowers, regardless of where they live or who their lender is, would be protected by the same safety and soundness and consumer standards.

Fourth, we propose the creation of a national capital markets agency with the merger of the SEC and the Commodities Futures Trading Commission.

And fifth, to protect depositors, policy holders, and investors, we propose that the Federal Deposit Insurance Corporation would be renamed the National Insurance Resolution Authority and that it manage insurance mechanisms for banking, depository institutions, but also federally chartered insurance companies and federally licensed broker dealers.

Before I close, Mr. Chairman, I have also included in my testimony two other issues of importance to this Committee and the policymakers and the industry. One, lending by institutions that have received TARP funds is a subject of great comment around this table. And second, the impact of fair value accounting in illiquid markets.

I have attached to my statement a series of tables that the Roundtable has compiled on lending by some of the nation's largest institutions. These tables are designed to set the record straight. The fact is that large financial services firms have increased their lending as a result of TARP capital.

And second, fair value accounting continues to be of gargantuan concerns for the industry and should be for the public in general. We believe that the pro-cyclical effects of existing and past policies, which have not been changed, are unnecessarily exacerbating the crisis. We urge the Committee to take up this subject and deal with it.

We thank you again for the opportunity to appear. I yield back.

Chairman DODD. Thank you, Steve, very, very much. I appreciate the testimony. You laid out, as well, rather specifically the structure of an architecture, which I found very interesting and appreciate the detailed proposal and worthy of our consideration.

Mr. BARTLETT. Thank you.

Chairman DODD. Ms. Seidman, thank you for being with us.

**STATEMENT OF ELLEN SEIDMAN, SENIOR FELLOW, NEW AMERICA FOUNDATION, AND EXECUTIVE VICE PRESIDENT, SHOREBANK CORPORATION**

Ms. SEIDMAN. Thank you very much, Chairman Dodd, Ranking Member Shelby, and members of the Committee. I appreciate your inviting me here this morning. As the Chairman mentioned, my name is Ellen Seidman. I am a Senior Fellow at the New America Foundation as well as Executive Vice President at ShoreBank.

My views are informed by my current experience, although they are mine alone, not those of New America or ShoreBank, as well as by my years at the Treasury Department, Fannie Mae, the National Economic Council, and as Director of the Office of Thrift Supervision.

In quick summary, I believe the time has come to create a single well-funded Federal entity with the responsibility and authority to receive and act on consumer complaints about financial services and to adopt consumer protection regulations that with respect to specific products would be applicable to all and would be preemptive. However, I believe that prudential supervisors, and particularly the Federal and State banking regulatory agencies, should re-

tain primary enforcement jurisdiction over the entities they regulate.

Based on my OTS experience, I believe the bank regulators, given proper guidance from Congress and the will to act, are fully capable of effectively enforcing consumer protection laws. Moreover, because of the system of prudential supervision with its onsite examinations, they are ultimately in an extremely good position to do so and to do it in a manner that benefits both consumers and the safety and soundness of the regulated institutions.

In three particular cases during my OTS tenure, concern about consumer issues led directly to safety and soundness improvements. However, I think the time has come to consider whether the consolidation of both the function of writing regulations and the receipt of complaints would make the system more effective.

The current crisis has many causes, including an over reliance on finance to solve many of the problems of our citizens. Those needs require broader social and fiscal solutions, not financial engineering. Nevertheless, there were three basic regulatory problems.

First, there was a lack of attention and sometimes unwillingness to effectively regulate products and practices, even where regulatory authority existed. The clearest example of this is the Federal Reserve's unwillingness to regulate predatory mortgage lending under HOEPA.

Second, there were and are holes in the regulatory system, both in terms of unregulated entities and products and in terms of insufficient statutory authority.

Finally, there was and is confusion for both regulated entities and consumers and those who work with them.

The solutions are neither obvious nor easy. Financial products, even the good ones, can be extremely complex. Many, especially loans and investments, involve both uncertainty and difficult math over a long period of time. The differences between a good product and a bad one can be subtle, especially if the consumer doesn't know where to look. And different consumers legitimately have different needs.

The regulatory framework, of course, involves both how to regulate and who does it. With respect to how, I suggest three guiding principles.

First, products that perform similar functions should be regulated similarly, no matter what they are called or what kind of entity sells them.

Second, we should stop relying on consumer disclosure as the primary method of protecting consumers. While such disclosures can be helpful, they are least helpful where they are needed the most, when products and features are complex.

Third, enforcement is at least as important as writing the rules. Rules that are not enforced or are not enforced equally across providers generate both false comfort and confusion and tend to drive through market forces all providers to the practices of the least well regulated.

As I mentioned at the start, I believe the bank regulators, given guidance from Congress to elevate consumer protection to the same level of concern of safety and soundness, can be highly effective in enforcing consumer protection laws. Nevertheless, I think it is time

to give consideration to unifying the writing of regulations as to major consumer financial products, starting with credit products, and also to establish a single national repository for the receipt of consumer complaints.

A single entity dedicated to the development of consumer protection regulations, if properly funded and staffed, will be more likely to focus on problems that are developing and to propose and potentially take action before the problems get out of hand. In addition, centralizing the complaint function in such an entity will give consumers and those who work with them a single point of contact and the regulatory body early warning of trouble. Such a body will also have the opportunity to become expert in consumer understanding and behavior, so as to regulate effectively without necessarily having a heavy hand. It could also become the focus for the myriad of Federal activities surrounding financial education.

The single regulator concept is not, however, a panacea. Three issues are paramount.

How will the regulator be funded, and at what level? It is essential that this entity be well funded. If it is not, it will do more harm than good as those relying on it will not be able to count on it.

What will be the regulator's enforcement authority? My opinion is that regulators who engage in prudential supervision, whether Federal or State, with onsite examinations, should have primary regulatory authority with the new entity having the power to bring an enforcement action if it believes the regulations are not being effectively enforced, and having primary authority where there is no prudential supervision.

And finally, will the regulations written by the new entity preempt both regulations and guidance of other Federal and State regulators? This is a difficult issue, both ideologically and because there will be disagreements about whether the regulator has set a high enough standard. Nevertheless, my opinion is that where the new entity acts with respect to specific products, their regulations should be preemptive. We have a single national marketplace for most consumer financial products. Where a dedicated Federal regulator has acted, both producers and consumers should be able to rely on those rules.

The current state of affairs provides a golden opportunity to make significant improvements in the regulatory system to the benefit of consumers, financial institutions, and the economy. If we don't act now, what will compel us to act?

Thank you, and I would be pleased to respond to questions.

Chairman DODD. Thank you very much, Ms. Seidman.

Ms. McCoy?

**STATEMENT OF PATRICIA A. MCCOY, GEORGE J. AND HELEN M. ENGLAND PROFESSOR OF LAW, UNIVERSITY OF CONNECTICUT SCHOOL OF LAW**

Ms. MCCOY. Chairman Dodd and members of the Committee, thank you for inviting me here today to discuss restructuring financial regulation. My name is Patricia McCoy and I am a law professor at the University of Connecticut. I also had the pleasure of living in Alabama where I clerked for Judge Vance some years ago.

I applaud the Committee for exploring bold new approaches to this issue. In my remarks today, I propose transferring consumer protection for consumer credit from Federal banking regulators to one agency whose sole mission is consumer protection. We need this to fix three problems.

First, during the housing bubble, fragmented regulation drove lenders to shop for the easiest regulators and laws.

Second, this put pressure on banking regulators, State and Federal, to relax credit standards.

Finally, banking regulators often dismiss consumer protection in favor of the short-term profitability of banks.

During the housing bubble, risky subprime mortgages and nontraditional mortgages crowded out safer, fixed-rate loans. Between 2003 and 2005, the market share of non-prime loans tripled, from 11 percent to 33 percent. Over half of them were interest-only loans and option payment ARMs. These loans seemed appealing to many borrowers because their initial monthly payments were often lower than fixed-rate loans, but they had many hidden risks that many borrowers did not suspect. So borrowers flocked to the loans with the lower monthly payments, causing dangerous loans to crowd out the safer loans. Conventional lenders then decided, well, if we can't beat them, let us join them, and they expanded into dangerous loans, as well.

Meanwhile, lenders were able to shop for the easiest laws and regulators. There was one set of laws that applied to federally chartered depository institutions and their subsidiaries. There is a wholly different set of laws that applied to independent non-bank lenders and mortgage brokers. At the Federal level, of course, we all know that we have four banking regulators plus the Federal Trade Commission. The States add another 50 jurisdictions on top. Because lenders could threaten to change charters, they were able to play off regulators against one another. This put pressure on regulators to relax their standards in enforcement.

For example, in 2007, Countrywide turned in its charters in order to drop the Federal Reserve and the OCC as its regulators and to switch to OTS. The result was a regulatory race to the bottom.

We can see evidence of regulatory failure by the Federal Reserve, the OTS, and OCC. As the Committee knows, the Federal Reserve refused to exercise its authority under HOEPA to regulate unfair and deceptive mortgages under Chairman Greenspan. The Fed did not change its mind until last summer under the leadership of Chairman Ben Bernanke.

Meanwhile, OTS allowed thrifts to expand aggressively into option payment ARMs and other risky loans. In 2007 and 2008, five of the seven largest depository failures were regulated by OTS, including IndyMac and WaMu. In addition, Wachovia Mortgage FSB and Countrywide Bank FSB were forced into shotgun marriages to avoid receivership. By the way, none of this happened on my colleague Ellen Seidman's watch. She was a leader in fighting mortgage abuses when she was Director of OTS.

Finally, how about the OCC? During the housing boom, the OCC allowed all five of the largest banks—Bank of America, JPMorgan Chase, CitiBank, Wachovia, and Wells Fargo—to expand aggres-

sively into low-doc and no-doc loans. The results were predictable. Today, as a result, the country is struggling with how to handle banks that are too big to fail as a result.

Bottom line, when you look at all types of depository charters, State banks and thrifts had the best default rates. Federal thrifts had the worst, and national banks had the second worst. Placing consumer protection with bank regulators turned out to be no guarantee of safety and soundness. Having it in a separate agency would counteract the over-optimism of Federal banking regulators at the top of the credit cycle.

To fix these problems, we need three reforms. First, Congress should adopt uniform minimum safety standards for all providers of consumer credit, regardless of the type of entity or charter. This should be a floor, not a ceiling. First of all, that is necessary to make sure that the entity, the regulator, does not have too weak of a standard. And second, we have seen that States are closer to people at home and more responsive to their problems.

Second, the authority for administering these standards should be housed in one Federal agency whose sole mission is consumer protection. This agency could either be a new agency or the Federal Trade Commission. All responsibility for oversight of consumer credit should be transferred from Federal banking regulators to this agency.

And then finally, to avoid the risk of agency inaction, Congress should give parallel enforcement authority to the States and allow consumers to bring private causes of action to recover for injuries they sustain.

I would be glad to take any questions. Thank you.

Chairman DODD. Well, again, I thank our witnesses for their very excellent testimony and thoughts this morning.

We have been joined by Senator Bennet of Colorado, as well. Michael, thank you for being here with us this morning.

I have a series of questions. I will put a 5-minute clock on each of us up here. Actually, given the numbers we have, we can engage, and I would invite, by the way, if I raise a question with one of you and the other two would like to comment on it, that you please do. This is a very important discussion we are in the process of undertaking. In many ways, while we have had obviously a number of witnesses before us, including Paul Volcker and others, in many ways, today, the three of you are representing some ideas that really are far more specific than things we have heard, so I would invite the kind of conversation back and forth that could help us, even in a formal hearing like this, which is always a little more difficult.

Let me begin, if I can, with you, Ms. Seidman. You note that while you were at OTC, there were situations when, I am quoting, "a concern about consumer issues led directly to safety and soundness improvements." You also note that compliance has always had a hard time competing with safety and soundness for the attention of regulators. If we do not create a separate consumer protection regulator, how do we ensure that consumer protection will be given equal standing and attention?

Ms. SEIDMAN. I appreciate that dichotomy and I obviously put it in the testimony on purpose. I believe that there is a difference be-

tween writing the rules and enforcing them, and with respect to enforcement, I think that not only is it extremely valuable for the banking regulators to have responsibility for enforcing consumer protection laws, but as Mr. Bartlett has said, that can lead to safety and soundness improvements and it certainly did during my tenure at OTS.

On the other hand, I will say that the writing of regulations on consumer protection issues is something that I found incredibly difficult when I was at OTS. There were any number of times where we wanted to move and we couldn't get the other three, or the other four regulators—either three or four, depending on whether the credit unions were in or out—to move with us. There were times when we wanted to take action and it was really hard to find the statutory authority on the consumer protection side because many of the consumer protection laws are written very, very specifically. They are sort of "thou shalt not" rules. Payday lending was a major example of that.

And so I think that we need three things. One, I think it really would be useful to establish a separate regulator to write the rules, and whether it is the FTC expanded or a new agency I think is definitely worth a serious conversation.

But I do think that we will benefit on both the safety and soundness side and the consumer protection side by leaving the initial enforcement authority, the primary enforcement authority, with the bank regulators where they have prudential supervision. The results of prudential supervision may not be perfect, but they are better than a complaint-based system where there has to be a lot of bad acting by a single entity with a lot of consumers who realize they have a problem and take the time to complain in order to get cases going. So I think we shouldn't throw away the prudential system.

But the final piece is, I think if Congress is serious about consumer protection, and certainly this Committee is, it is time to amend the National Banking Act, amend HOLA, change the basic banking laws to say that consumer protection and making the financial system work for consumers is a critical element of our banking system.

Chairman DODD. Yes. Steve, let me say, you in effect are positioned here on the table, ironically, in a way in which you represent three different models that we are talking about. Ellen was the middle model. The question for you is, you heard me say in my previous question that compliance has always had a hard time competing with safety and soundness for the attention of regulators. I don't think there is much debate about that.

I think most would probably agree with that statement, and history over the last 5 years certainly underscores that point. The Federal regulators clearly put consumer protection on the back burner, acting only well after it was too late to avoid a catastrophe, and even then, I might add, over the objections of many that we do anything at all.

In the face of all the evidence, how do you conclude that keeping prudential and consumer regulation together won't simply result in consumer regulation continuing to be on the back bench here, as we have seen in the last 5 years?

Mr. BARTLETT. Mr. Chairman, Lyndon Johnson used to have a saying when he was Senate Majority Leader, and I will paraphrase it for this Committee: "Grab them by the throats and their hearts and minds will follow."

[Laughter.]

Mr. BARTLETT. The fact is the prudential regulators, it is the supervisors that have them by the throats, that have the ability to get the attention with a cease and desist order and a requirement, and worse, in a receivership. So if you separate the power and the mandate to protect the consumers away from the grabbing them by the throat, well, at best, it will be the two different sets of regulators will give conflicting goals and one of them will be advice, the other one will be the throat. Or at worst, we would continue to have the system in which the consumer protection is ignored and it is only safety and soundness.

I have to say that we are not advocating the status quo. We are not at all advocating that we just continue what we have been doing. We are, by contrary, advocating that we provide the specific and clear mandates for consumer protection, the mandates for enforcement, and then to consolidate the agencies so that these agencies that have them by the throats have the ability to enforce those, all of the sets of regulations.

And then I guess last is safety and soundness and consumer protection are mirror images of the same thing. The ability to repay or documentation is both a consumer protection and it is also a safety and soundness protection.

Chairman DODD. Ms. McCoy, that is a pretty good argument. You are a law professor and have debates like this in your law school. We have had similar debates over the years in Congress on matters not relating to financial services, but in the area of consumer protection. There has been a strong argument that because the traditional regulators were not doing their job, there should be a Consumer Protection Agency in place to insist they do their job.

The counter-argument was, well, they already should be doing their job. The fact that they were not doing it doesn't mean they shouldn't be, and therefore we ought to empower them to do it rather than creating yet a separate agency that would end up with the kind of potential conflicts that Steve just talked about. What is the answer to that?

Ms. MCCOY. Well, for the most part, they are empowered to do it, and what we saw over the past six or 8 years was a prolonged failure to exercise that power. I have been spending the last few months looking at the enforcement record of the three agencies I described, and I found with the OCC, the Federal Reserve, and OTS a distinct reluctance to bring formal cease and desist orders or anything stricter. In fact, in autopsies of failed institutions, generally what the regulators were doing at most—at most—was negotiating some sort of voluntary agreement with the banks' management. There were usually protracted delays in negotiating that agreement and over that period more lax lending happened and the banks slid toward insolvency. So while the regulators have the ability to hold the banks by the throats, they are distinctly reluctant to exercise it.

With respect to Ms. Seidman's proposal, she and I, I think, are 95 percent in agreement. The two places where we have some difference are whether the enforcement authority should be consolidated strictly in this separately consumer product regulator or should be parceled out between the Federal banking regulators and this other regulator.

My one concern there is if we parcel out the compliance examinations and other enforcement, leaving enforcement with Federal banking regulators for banks, that there still will be this opportunity to shop for the agency with the weakest, most accommodating enforcement posture.

Now, one way, if we go with that model, to try to counteract that is to give this separate consumer protection agency the independent ability to institute enforcement if it feels that a Federal banking regulator is lax, so that it would not have to wait for the regulator to act.

Chairman DODD. Well, those are great answers and I appreciate it very, very much. It took a long time just on that one, but let me turn to Senator Shelby because I have overrun my time already.

Senator SHELBY. Thank you, Mr. Chairman.

Professor McCoy, I know you had not only good leadership under Robert S. Vance, the late judge who was tragically murdered——

Ms. MCCOY. He was my hero.

Senator SHELBY. That is right, but he was also very exacting, was he not?

Ms. MCCOY. Yes. I can attest to that.

Senator SHELBY. Sure. Enforcement failures—I will ask you this first question—many have suggested, Professor McCoy, that the Federal Reserve should have acted much sooner under its Home Ownership Equity Protection Act rulemaking authority to regulate the conduct of all parties originating mortgage products. Are there other areas where you believe that the Federal banking regulators could have acted but failed to act to either draft rules or appropriately enforce rules that it promulgated?

Ms. MCCOY. Yes. So first of all, also with respect to the Federal Reserve, the Federal Reserve, of course, has jurisdiction over the Truth in Lending Act and it still astonishes me that to this day, the Fed has not updated its TILA rules on closed-end mortgages. It turns out that TILA disclosures just didn't work well for risk-based pricing. The Federal Reserve issued a report——

Chairman DODD. "TILA" is Truth in Lending, just so the record is clear.

Ms. MCCOY. Yes. My apologies. It is lawyer lingo. The Federal Reserve actually wrote a report in 1998 diagnosing this problem, but here we are 11 years later. It hasn't fixed it. That is one thing.

The other Federal banking regulators also had authority under Section 5 of the Federal Trade Commission Act to regulate unfair and deceptive acts and practices. Their rulemaking authority was somewhat limited. I think that needs to be addressed. But they had full enforcement authority, and again, as I mentioned, they failed to exercise it.

Senator SHELBY. Well, that is troubling to me and I think to Senator Dodd, too, as we look toward a regulatory process that will work. The role of the Fed seems to have been a role of failure in

a lot of instances as far as the regulation. They have been the regulator of a lot of things, especially our largest banks, and I think the question arises, where were they? Did they know what the banks were doing? Did they know the risk they were taking? Obviously, they didn't.

Competition among regulators—the OCC and the OTS are funded by assessments on the institution that they regulate. Professor McCoy raises the possibility of regulators lowering their enforcement standards in order to attract more institutions to their specific charter. Specifically mentioned in her testimony is the long-term decline in the number of thrift institutions.

Ms. Seidman, during your tenure as the OTS Director, did the OTS lower enforcement standards in order to maintain or increase the number of financial institutions that you supervised, and do you believe it is appropriate for financial regulators to be funded by assessments on the institutions that they regulate?

Ms. SEIDMAN. First of all, the answer to the first question is no, and I——

Senator SHELBY. OK. How about the second question?

Ms. SEIDMAN. I worked very hard to discourage charter shopping.

Senator SHELBY. OK.

Ms. SEIDMAN. As to the second question, Jerry Hawke, who was the Comptroller part of the time that I was at OTS, and I spent quite a while attempting to shop the notion that OTS and the OCC should not, in fact, be funded by the industries and that instead there should be some way of funding them through the Deposit Insurance System as the FDIC is funded.

I think the issue of the industry funding government agencies is a difficult one under all circumstances, but it is an especially difficult one where there is not a monopoly. You know, we do have the agriculture industry to some extent funding the agriculture inspections and the pharmaceutical industry to some extent funding the FDA. But there is only one FDA. There is only one Department of Agriculture.

Senator SHELBY. The role of securitization in consumer protection generally—many argue that the securitization market lessens the incentive for financial institutions to make prudent loans based on a borrower's ability to repay. The rationale was simple. So long as the loans did not sit on the balance sheet, then the financial institution no longer carried the risk.

Do you believe that realigning the incentive structure to give everyone within the securitization chain a stake in the loans' performance would greatly enhance consumer protection, or would it compound it? I want to ask Professor McCoy first.

Ms. MCCOY. Senator Shelby, thank you. This is a really critical question and the answer is yes. The basic problem which you put your finger on was the ability to shift risk to entities down the line, and so we need to make sure that every participant in the securitization process has skin in the game, and that can be through capital and also prudential regulation. In the end, we need to make sure that investors have an incentive to put pressure on investment banks to do proper due diligence and to have full, honest disclosures.

My proposal for doing that is carefully crafted assignee liability that gives the investors incentives to put pressure on the investment banks to do their job right. We have seen from the State experience that this does not reduce loan volumes. I am working with economists. We have empirically tested that. It does not reduce access to credit because if it is carefully crafted, it can be priced into the loan. So it is eminently doable and a very good idea.

Senator SHELBY. Ms. Seidman, do you have any comment on that?

Ms. SEIDMAN. I also agree that one of the critical elements is that people need to have skin in the game, and Pat's assignee liability proposal is one that I have looked at and I would support.

I would point out two other things. Pat mentioned this really briefly, but the capital rules are also absolutely critical here. To the extent that institutions were not required to hold capital against loans that they thought they had gotten rid of but, in fact, came back to them, that just encouraged more of that kind of origination for sale. We need to deal with that issue. And as Steve mentioned, we need to deal with it in a manner that is counter cyclical, not pro cyclical.

And finally, I think that this is where the very tough issue of compensation also comes into play.

Senator SHELBY. Steve, do you have any comments?

Mr. BARTLETT. I think skin in the game or risk retention is an essential part of the set of reforms, not the only part, of course, but it is essential. It has to be combined with systemic risk regulation, which is currently done *de facto* but not *de jure,* so the Federal Reserve has sort of assumed authority, but not necessarily statutory authority. So we think that systemic risk regulation ought to be combined with risk retention in some form.

Senator SHELBY. Mr. Bartlett, in your draft financial regulatory architecture, you envision giving the Federal Reserve veto power over pro cyclical actions by FASB. Wouldn't giving the Federal Reserve this sort of power undermine the function of accounting standards, which are intended to provide investors with transparency? How do you explain?

Mr. BARTLETT. We think that accounting standard should give the investors transparency and strength and we think that is not happening right now in the case of fair value accounting. So in some part, our call for the Fed to help is out of desperation because all of the Federal agencies at this point, individually and collectively, are telling us that it is somebody else's problem and yet it is that misapplication of fair value accounting that is a large source of the current liquidity crisis portion of the crisis. So perhaps my call for the Fed to do it is just simply knowing that somebody has to do it and so we are looking for help.

Ms. SEIDMAN. Can I respond briefly to that, too?

Chairman DODD. Certainly.

Ms. SEIDMAN. I think that calling for counter cyclical capital regulations now turns into a conversation about fair value accounting. But 6 or 8 years ago—8 years ago, the question being asked was about loan loss reserves. In Spain, where their banking system has gone through a bubble and not been in as much trouble as ours, the loan loss reserves are required without particular reference to

historical conditions. The banking regulators worked really hard to try to get the SEC to understand that bankers make more loans in good times and then those loans go bad in bad times and that we really need to have far greater loan loss reserves than historic experience, particularly with untested products, which is what the subprime mortgages were.

Senator SHELBY. By loan loss reserves, you talking about capital, aren't you?

Ms. SEIDMAN. Well, you know, loan loss reserves are the first line of defense and capital is the second, and frankly, if we can increase the loan loss reserves to the point where the combination is counter cyclical, that will do.

Chairman DODD. Those are good points, good questions by the former Chairman, as well.

Let me turn now to Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and I appreciate the diversity of models that you are presenting for us to wrestle with.

I wanted to present one specific issue and see how you might view that issue and how it might fit into the different models you are presenting, and that is the issue of steering payments. It has been an item of concern to me that consumers by and large have enormous protection in terms of conflict of interest when they go to a real estate agent. It is very clearly declared whether that agent is working for the buyer or for the seller, all kinds of disclosure. When they turn around and go to a broker, very few consumers realize that that broker whom they are paying and who is giving them advice that they think they are paying for is also being paid secretly, that is not on the settlement sheet, to provide—paid different amounts according to what type of loan they sell, and often the incentives are all for the broker to sell an expensive loan that is not in the interest of the consumer. But it is really a consumer, a lamb to the slaughter, if you will, because they aren't aware of this fundamental conflict of interest in that transaction.

This is an issue States have tried to wrestle with but really have been prohibited from dealing with except with State-chartered institutions, which creates a distinction at the State level between State and federally chartered groups. So there is always the advocacy to do it at the Federal level.

So if each of you could take your model and say, one, do you consider steering payments to be a problem? Second, how do you envision that the regulatory regime you are proposing would tackle such an item? And maybe we will just start in the order that the testimony was given.

Mr. BARTLETT. Thank you, Senator. Senator, we have long called for the national licensing and regulation of mortgage brokers, not as a way of casting blame, but just simply to say that they are the front end of it.

Second is we believe that there should be a system within that national license for some type of a retention of risk by the brokers. Currently, the system of payment is that brokers get paid—and they should get paid, but they get paid for creating a loan or selling a loan, whether it is a good loan or a bad loan, and we think that is a misguided compensation.

Third is that we believe that the originators, as the Chairman said, I believe it is 58 percent of all subprime loans were originated by non-regulated entities, but the originators, regulated and unregulated, should accept the responsibility for accepting a good loan and then should they sell those loans in a securitized model, the securitizers should accept the responsibility for those being good loans. So it is responsibility up and down the chain, but beginning with the brokers when that is appropriate.

Senator MERKLEY. Just before I go on, would you envision, then, all the power occurring at the Federal level in this framework or giving any alternative power to the States to enhance——

Mr. BARTLETT. No. We believe in the dual banking system in the sense that there should be State-chartered banks. But the power of actually insisting that the system be regarded as a system has to come from the Federal level, of which the States have a big role. But the system itself, it is an interstate system. It is a national system, so it should be thought of as a national system with uniform standards.

Senator MERKLEY. Thank you.

Ellen?

Ms. SEIDMAN. By steering payments, I assume among other things you mean yield spread premiums. I believe, having wrestled with the problem of yield spread premiums, that the right answer really is to get rid of them, that disclosure isn't sufficient. There have been proposals that say, well, you should just disclose it. The Fed actually tried that and then backed off because they came to the conclusion that no consumer could understand the disclosure. They, of course, then didn't take the next step, which would have been to ban them.

An alternative which I think is a partial solution but probably not the full solution here, but a good solution in general, is that it is time to put a fiduciary responsibility on brokers. At the very least, that creates the legal responsibility to behave in the best interest of the consumer. I think Steve's point and the point we have all made about skin in the game with respect to compensation is also important.

In terms of how this would work in the system that I proposed, the single regulator would face the issue and make a decision about whether these payments should be banned or should be disclosed or make the relevant decision, and then the enforcement would be in the case of the banks with their prudential supervisors, in the case of mortgage bankers in Massachusetts, who are subject to prudential supervision with the Massachusetts regulator, and otherwise the primary jurisdiction would be with the single Federal entity.

Senator MERKLEY. Thank you.

Ms. McCoy?

Ms. MCCOY. Senator, I have personal experience with this. Back in 2003, when I applied for a mortgage to buy my house in Connecticut, I walked in with complete copies of my pay stubs, tax returns, my new contract, my job contract, and the broker said, oh no, we will put you in a no-doc loan. So I walked out. But I later got the rate sheet from the lender which showed that the no-doc

loan would have paid a higher YSP, yield spread premium, to that broker.

So in my mind, this is a legalized kickback and we need to ban it. Probably broker compensation needs to be a percentage of loan principal and also the full payout of that commission should probably be linked and to urge appending good performances alone.

I agree that a fiduciary duty should be placed on brokers and we need to seriously think about higher capital requirements for brokers because they have very, very little skin in the game today.

Finally, the responsibility for administering this under my plan would be with the consumer credit regulator. Thank you.

Senator MERKLEY. Thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Bennet?

Senator BENNET. Thank you, Mr. Chairman. I appreciate it.

Ms. Seidman, you mentioned earlier in passing that even good products are complex or can be complex, which is true in these markets, and good products being ones that actually are collateralized, that actually have some value. When we are thinking about how to create a regulatory structure and a bureaucratic structure that makes sense, on the one hand, there is the issue of wanting the capital markets to be inventive, wanting to be able to lower costs for people that are in their homes and borrowing money or other kinds of things, and on the other hand we find ourselves in a place where we securitized—we didn't, but all these loans were securitized. The bad products became very complex as well as good products and it inspired lots of, or incentivized a lot of behavior that probably wouldn't have happened otherwise because the market in some sense was insatiable and people started to say, well, we don't need to do 70 percent loan to value anymore, let us do 100 percent, just to create a take-up, or a product for that take-up.

And I wonder what the implications of all of that are for thinking about the bureaucratic design here so that we can allow the markets to continue to invent, on the one hand, but on the other hand say, is there a degree of complexity that we simply can't sustain or that the regulators will never catch up to, or—I am sorry for the long-winded question—or does it imply something about who needs to be in the room to pass on whether these structures actually make sense or not, these structures being these products?

Ms. SEIDMAN. I think that this current situation is really forcing us to take another look at the question of whether innovation and complexity in consumer financial products is something that we ought to value. It is not to say that everybody should have a 30-year fixed-rate mortgage. There are certainly situations in which a 30-year fixed-rate mortgage is not the best instrument for the consumer. And it is not to say that some good products like savings bonds aren't inherently complex. They are. They are extremely complex. But I do think that the notion that allowing continuous redesign and complexity is a good thing needs to be reevaluated.

I do think that there are some suggestions that have been made recently about how to sort of come in the middle. The default product suggestion that I mentioned in my testimony is one of them. There would be a standard, relatively simple product that was the product that needed to be offered first in all situations, to avoid the

situation that Pat's broker tried to get her into. If a consumer nevertheless decided to buy one of the non-default products, the seller's ability to enforce the contract would be subject to the seller having to prove that whatever disclosures they made initially were understandable to a reasonable man, which is your classic legal standard.

I would prefer a system of standardized contracts, but I think that at least in certain areas like mortgages, we probably need multiple standardized contracts in order to cover the waterfront.

Senator BENNET. Does anybody else have a comment on that?

Mr. BARTLETT. Well, Senator, it is awfully tempting, given the crisis that we are in now, to sit around this table and say, well, let us design the financial products and we will have three of them, but that would be a disaster for the American people, if not in the short-run, at least in the medium-run. Innovation does help consumers. That is why it is innovative.

That is not to say that nothing should happen. In fact, I am calling for some massive additional more effective regulation to regulate the standards, responsibility, accepting the responsibility and accountability both by the agencies and by the companies, uniform national standards, and a system of enforcement. But the idea to then convert over to a system where the government simply in whatever form designs what a financial product should look like, I think would do a great disservice, both in the near-term and the long-term.

Senator BENNET. Mr. Chairman, that is not what I am suggesting, but I think that even the most simple products, in some respects, at the consumer level, I think what we are seeing now is that in their aggregation and in the secondary markets into which they are sold, there is a level of complexity at that point that has, at the very least, created a lack of transparency about what is going on on the balance sheets of our major banks, and in the worst cases helped contribute to where we are. I think I am just trying to, with the other Committee members, figure out what we can do to redesign things so that we don't find ourselves here again, not to rewrite these rules.

Professor McCoy, just one question. You mentioned this in your testimony, both written and spoken. I just wanted to come back to it. Tell us a little more about—and you proposed setting up a separate agency for consumer protection. But one of the reasons for that is your observation that you think there has been a reluctance on the part of the existing regulatory agencies to exercise their enforcement authority. Can you talk more about where you think that reluctance springs from?

Ms. MCCOY. I think there are various sources. One is this longstanding bank regulatory culture of dialog and cooperation with regulated banks. It may, in fact, be that the reluctance to bring formal enforcement action is part of a longstanding tradition of secrecy, lack of transparency in bank regulation due to fears about possible runs on deposit. But what we have ended up with is an enforcement system that is entirely opaque. It is very, very difficult to see what is happening behind the curtain.

One other thing I failed to mention was that the late Governor Gramlich in 2007 stated that the Federal Reserve had not been

doing routine examinations of the mortgage lending subsidiaries that were under its watch. It was not going in and examining at all except in emergency situations. Thank you.

Senator BENNET. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator. Very good.

Senator Schumer?

**STATEMENT OF SENATOR SCHUMER**

Senator SCHUMER. Thank you, Mr. Chairman. Thank you for holding this hearing, and unfortunately I got here a little late, so I am going to take a little bit of my time and read my opening statement, if you don't mind.

And I want to thank you and Senator Shelby for holding this hearing. I think this hearing is really important. We have a great economic crisis in our country and it extends from one end to the other. We have had an explosion of consumer debt. Now we have 12 million households that owe more on their mortgages than their house is worth. The average American family has over $8,000 in credit card debt. Mortgages and credit cards are ordinary features of middle-class life and now they are at the heart of our financial crisis. Something went awry, seriously awry.

During the 1980s, I worked to pass legislation that would require disclosure on credit card terms, the "Schumer box," and it had a real effect. But it doesn't do enough now, because disclosure isn't enough, and when you hear of banking institutions just raising the rates, boom, for some small almost induced mistake, you say, well, we need more, and I know that Senator Dodd, Senator Menendez, and I have been working on credit card legislation.

But the deceptive practices, the predatory practices, we have seen them in the mortgage industry. The Federal Reserve was in charge of all this and did nothing. Home buyers were enticed and misled, sometimes by banks, sometimes by independent mortgage brokers, more often by the latter, but there is a serious problem.

And so I would say complexity ultimately stacks the deck in favor of the financial experts who peddle the products at the expense of the consumer. So again, I am not trying to point fingers of blame here. I am trying to correct the situation.

In the early 1900s, Congress created the Food and Drug Administration to protect consumers from peddlers of medicinal concoctions whose miracle elixirs did more harm than good. In today's world, we need a comparable response to peddlers of unfair and deceptive financial practices and services.

And I would just say to Mr. Bartlett that all too often, they don't come only from major banking institutions or financial institutions. They come from everywhere.

So this week Senator Durbin and I plan to introduce legislation to create a new regulator to provide consumers with stronger protection from excessively costly and predatory financial products and practices. The idea for a Financial Product Safety Commission was first proposed by Elizabeth Warren, professor at Harvard, in 2007. She recognized that substantial changes in the credit markets have made debt far riskier for consumers today than a generation ago and that ordinary credit transactions have become complex undertakings. Consumers are at the mercy of those who write the con-

tracts, and simple disclosure—it is never simple anymore because the terms are so complicated—it doesn't do the job.

So consumers deserve to have someone on their side, a regulator that will watch out for the average American, who will review financial products and services to ensure they work without any hidden dangers or unreasonable tricks. So the time is right for a financial services regulator with consumer focus. Professor Warren and consumer groups—CFA, Consumers Union, Public Citizen, Center for Responsible Lending—have been instrumental in helping develop the objectives and responsibilities of such a regulator and I appreciate their efforts.

I also think we have got to think beyond regulatory reform of the financial system. We need to think about a new way to live, because what has happened basically over the last decade and a half is we became a country that consumed more than we produced, borrowed more than we saved, and imported more than we exported. Something has to give. And I would say the greatest challenge President Obama has after he gets us out of this financial mess is to figure out how we get back to those traditional values.

We have seen it up and down the line. There are the CEOs and their salaries. We all know about that, excessive, huge, based on the short-term. We have seen it here in government with all the deficits. And we have seen it with individuals who get into debt far beyond their means. So it has been a whole societal problem that we have to do something about.

The proposal that Senator Durbin and I are making is one part of that, but there are lots of other parts, and I thank you all for listening. I particularly want to thank both Ellen Seidman and Professor McCoy for arguing for this kind of thing.

Do I have time for one question, Mr. Chairman? Is that OK?

Chairman DODD. Yes.

Senator SCHUMER. OK. My question is to both Ms. Seidman and Professor McCoy about this new agency. How would you propose it be funded? Should there be some kind of user fee, whether on the lender or the borrower? And how do you think enforcement ought to be done? Should it be done by the agency itself, by attorneys general, by the Justice Department? I will let Ellen Seidman answer first, and then Professor McCoy. And I won't ask Steve Bartlett because he probably does not support such an agency.

Ms. SEIDMAN. Thank you, Senator Schumer. As I said in my testimony, I think the critical thing is that this entity be well funded. My preference, just because I think it has something to do with honesty in budgeting, is that it be funded through appropriations rather than by user fees. If it were funded by user fees, it would be very good to be able to come up with a system something like the SEC's—actually, not the way the SEC is, the way the SEC brings in money. As we all know, it only gets a part of that to use.

Senator SCHUMER. Yes.

Ms. SEIDMAN. But an automatic, very small tax on transactions rather than by an entity kind of funding.

In terms of enforcement, I believe that where there is prudential supervision, it would be a mistake to throw it away with respect to consumers. So I think where there is prudential supervision, the primary enforcement entity should be the prudential supervisor. I

think where there is not, the new entity ought to have the primary jurisdiction and it should have the back-up jurisdiction on its own motion. I mean, it would just have to make a finding with respect to the situations where there is prudential supervision.

Senator SCHUMER. Right. Sort of like the FTC a little bit?

Ms. SEIDMAN. A little bit.

Senator SCHUMER. Professor McCoy?

Ms. MCCOY. Thank you. The key thing that we are trying to fix here is regulatory arbitrage, this ability to shop for lax enforcement. If we consolidate both rulemaking and enforcement in this one agency, then I am comfortable with the funding model that Ms. Seidman proposed. If we parcel out enforcement among Federal banking regulators plus this other agency, we are going to have this same shopping phenomenon go on and then funding through assessments is going to become problematic and we will have to look at an appropriations model. So I think the two are linked. If you consolidate it in one agency, you stop the shopping problem and then you can have a user fee approach.

Senator SCHUMER. Thank you, Mr. Chairman. Thank you both.

Chairman DODD. Thank you, Senator, very much.

Let me say, if I can, and some of these questions have been asked, that we have talked a lot about the brokers and the lack of regulation at that level of the chain. In fact, I remember at a hearing we had here, I think Senator Shelby and Senator Schumer will remember, we had displayed the Web site of the brokers at the time—this was back about 2 years ago—and on the Web site, the first rule was, convince the borrower you are their financial advisor. That was the first rule. And, of course, that was fairly easy to do in Committee ways. You are talking about people who are relatively unaccustomed to all of this.

I was with a group of bankers not long ago and I asked them a question I suppose all of us ask ourselves any time we have been to a closing. How many times do we find ourselves with the lawyers there with the tabs and sign the tabs and we don't find ourselves reading everything. We assume that these things are pretty boilerplate, standardized stuff and accept it for what it is.

And so the idea that there is this level playing field between the borrower and the lender, any more than there is between the patient and a physician in cases of medical malpractice, is questionable. Obviously, the borrower and the patient have responsibilities. That is not to suggest they don't have any, but the suggestion somehow that they are both equal in terms of that moment of bargaining is, I think, something that most of us—all of us—would recognize as being unrealistic.

I am interested in, and this is a point that Professor McCoy made, why we have focused largely on the problem at origination. Professor McCoy, you lay out in your testimony the role played by Wall Street. Essentially, you argue that it was the demand for product to securitize that drove the lending standards down, not the other way around. And I wonder whether or not you, Ms. Seidman, would agree with that and how you feel about that, Steve.

Ms. SEIDMAN. I think both work. The collapse of the subprime market was the trigger here, but the fact that there was a gigantic

bubble to break happened because of the investment side demand. Who knows what other products would have been created to fill that demand if the mortgage products hadn't. The mortgage products had a big advantage. They were regarded as extremely safe and producing rates of return that were significantly higher than Treasuries. And, of course, back in the 1990s, mortgage products were extremely safe and produced higher returns than Treasuries.

So I think both were definitely part of the problem and that if we had just had lax consumer protection without the investment side, we would have had a problem for a lot of consumers, but we probably wouldn't have had a global international crisis.

Chairman DODD. Steve, how do you——

Mr. BARTLETT. Mr. Chairman, I am here to posit for systemic reform and systemic regulation and for comprehensive reform. So to use your example in the case of the mortgage base, yes, the mortgage brokers were a significant part of the problem, but that doesn't eliminate the responsibility from the other parts.

Then the originators, say what you will, the originators originated the loans, and they originated in many cases in the subprime markets bad loans for them and bad loans for the borrower. But at that point, some of those originators had regulators, 42 percent. Those regulators in many cases noticed that those were, quote, "bad loans," what you and I would call bad loans, but they either didn't have or didn't believe they had the authority to say, therefore, you cannot originate those loans. They believe they only had the authority to say you couldn't own them, and so the originators said, OK, we won't own them. We will sell them upstream.

And then there was no nexus, or there was a huge gap in the regulatory structure of no one from the originator, or supervising their originator, had any ability to talk to anyone on Wall Street who was buying the loans to say, that is a pool of bad loans, and yet it was sort of—it was clear. I mean, it was not as opaque as we like to make it out to be. There was transparency within those pools. So the pools were formed consisting of some number of bad loans and then sold to buyers, unregulated, and then those buyers then relied on mortgage insurance backed by the State insurance commissioners, both unregulated and not talking to each other.

So there were literally hundreds—are, not were—are, in real time today, are literally hundreds of regulatory agencies that are each regulating individual toenails of the elephant while the elephant is stomping all over us. So the problem is the lack of systemic regulation. I have heard some talk about a twin peaks theory, and it is not twin peaks. It is multiple flagpoles, if you will, where people are sitting on the top of the flagpoles and there are more gaps between the flagpoles than there are the pillars of the regulation of the flagpoles.

So it requires systemic, uniform national standards among them, and each of the pillars taking responsibility for their piece, but also a systemic regulation taking responsibility for the entire system.

Chairman DODD. That is a good point.

Ms. McCoy, in your testimony, you raised a subject that I find interesting and I would like to get your co-panelists to respond to this. You called a light touch regulation by the OTS and the OCC, whereby most enforcement actions are done behind closed doors,

privately through negotiations without any public knowledge. Would you describe the process to us and why you find this informal process inadequate, and would public disclosure of such actions create more accountability for regulators and give other institutions a signal of what kind of behavior is unacceptable?

And the other side obviously is that you have got to have some gradation, I suppose, in all of this between what may be a minor infraction of some kind and a larger. But that debate about the light touch, the privacy, if you will, and not the public accountability, which can have its own—if you know something else has gone on, then other institutions start taking a closer look at what they are doing themselves. So that is an interesting point I thought you raised.

Ms. MCCOY. Sure. So with the light touch regulation, it had two major components. One was a preference for guidances rather than binding rules. Now, the banks were supposed to follow the guidances, but what I have been doing is going into securities filings of major banks after the issuance of each guidance to see if they are reporting continuing making loans that violate the guidances, and with most of the major five banks, I did find disclosures showing violations. And in some cases, they continued all the way until 2007. So apparently regulated banks, including "too big to fail" banks, felt that they could ignore guidances. So part of light touch is avoiding rules, guidances, and in my mind, it doesn't work.

The enforcement side is relying on examinations and informal enforcement, which usually consists of these negotiated agreements and which are done on a confidential basis so that it is impossible on a real-time basis for me or any other researcher outside to know what is happening. I can only find that out if there are inadvertent press releases or if an institution fails afterwards.

And we saw that, at least with the Federal Reserve, that it didn't do the examinations at all. We saw with the three agencies I mentioned that they were extremely reluctant to take any public formal enforcement action, and whatever informal action they took was really delayed, in some cases literally just days before the FDIC seized the institution, because the negotiations were drawn out.

And I will just close by saying we saw this exact same pattern during the S&L crisis. It is not new. Thank you.

Chairman DODD. But is the complaint-driven process better?

Ms. MCCOY. The complaint-driven process, I think needs to be augmented with registration of all market actors and regular reporting. One of the problems that the FTC has in its complaint-driven process is a lack of information on a periodic basis from regulated institutions about what they are doing. And it seems to me that I would prefer to go with the SEC model, where you have registration, you have periodic reporting, and you have the ability based on that reporting to go in at any time to do an examination.

One thing that I left out of my voluminous written testimony was I would also have a self-regulatory organization for the industry akin to FINRA. I think FINRA is an excellent supplement to the SEC's enforcement power and I would strongly urge the Committee to look at a model that includes a mandatory SRO.

Chairman DODD. Thank you very much.

Senator Shelby?

Senator SHELBY. Thank you.

If we make bad loans and they are securitized, you don't have bad securities. That is a given, is it not? And that is where we are today, isn't it?

Ms. Seidman, the suitability standard for credit products, in your written testimony, you state, quote, "the difference between a good product and a bad one can be subtle, especially if the consumer doesn't know where to look." You then suggested that perhaps a suitability standard such as the one used in the securities arena should be fashioned for consumer credit transactions. Who would be the person charged with carrying out that standard? Would it be the loan officers in a bank? How would this apply to credit card transactions and so forth? And how would the regulators enforce this provision?

Ms. SEIDMAN. I think—first of all, with respect to mortgage lending, most mortgage lending, particularly purchase money mortgages, is still done on a face-to-face basis and I see no difference in terms of the responsibility that a loan officer or a broker or somebody else would have with respect to the suitability of a mortgage product compared to the securities side. In fact, it is probably the case that the originator of the mortgage should be acquiring at least as much information as the broker acquires in order to understand what product is right.

The credit card situation is somewhat more difficult, but I do think that in general, or in the old days, at least, one actually had to fill out a fairly extensive form in order to be able to get a credit card. I think that there are ways of determining from that kind of information—what is my income source, what other kinds of debts do I have—whether a credit card of one type or another is the most appropriate for that consumer.

You know, we would have to work it through. There would be uncertainty, but this is not rocket science. This is really not very far away from the ability to pay standard. It just says, not only should you look at whether in the worst possible circumstances the borrower could pay, but also try to figure out what is good for that borrower.

Senator SHELBY. Professor McCoy, the subject would be the GSE affordable lending practices. You explain in your testimony, Professor McCoy, why you believe reckless lenders will crowd out good lenders. A variety of Federal efforts are aimed at providing borrowers alternatives. For instance, Fannie Mae and Freddie Mac have often claimed as their mission right here in this Committee the expansion of responsible home ownership, which we have supported—responsible home ownership.

Do you believe that Fannie Mae and Freddie Mac's purchase of private-label subprime mortgage-backed securities added to borrowers' options for responsible home ownership?

Ms. MCCOY. Senator Shelby, first of all, while Fannie and Freddie starting around 2005 joined the party with respect to origination standards, they didn't start the party. They were one of these conventional good guys who——

Senator SHELBY. They got on the truck, didn't they?

Ms. MCCOY. They got on the truck, but they didn't start it and it is really the private-label market that started it.

I did find it highly problematic that Fannie and Freddie purchased as part of their investment portfolios subprime mortgage-backed securities. They were among many other global investors, part of the glut of money that drove the securitization crisis and the drop in lending standards, but they do not deserve sole blame.

Senator SHELBY. Sure. So the rationale for the GSEs providing liquidity to the subprime market, although later, rather than focusing on the purchase of whole loans, exacerbated that problem, did it not?

Ms. MCCOY. Yes, I think that is right. But the purchase of loans by Fannie and Freddie is a very, very important device and I wouldn't want that to be compromised in the efforts to remove the investment portfolio authority.

Senator SHELBY. Absolutely. I agree with that. But on the other hand, they should purchase good loans or responsible loans, shouldn't they?

Ms. MCCOY. Yes. Yes. And they were doing that around 2000. They were——

Senator SHELBY. Oh, they were doing great for a while.

Ms. MCCOY. Right.

Senator SHELBY. But——

Ms. MCCOY. Things changed.

Senator SHELBY. They got on the truck. Sure.

Mr. Bartlett, you would suppose that financial institutions have strong incentives well beyond legal compliance to treat their customers well, treat them fairly, and to maintain long-term relationships. In other words, you take care of your customers and your customers will be around. In other words, consumer protection should amount to consumer retention, is what people try to do, I hope. Yet it seems that financial institutions sometimes have not chosen to pursue this course. How can we realign the incentives so that they will be realigned in the future?

Mr. BARTLETT. Senator, first of all, I believe firmly that that is what financial institutions do because that is their goal in life, is to help their customers and to keep their healthy customers. We got away from that during the subprime market, or many companies did, and those companies have taken action——

Senator SHELBY. Then there is no loyalty to your bank that way, is there?

Mr. BARTLETT. No. I think both the banks and the other financial institutions create a loyalty to their bank and with customer retention, so I think your proposition of your question is exactly correct. That is not to say that we don't need some more effective regulation to be certain that all of the sides of the bank talk to each other. There were banks that didn't participate in the subprime market because they believed those were bad loans, but their Wall Street affiliates purchased those same bad loans from their competitors so you didn't have the connection between the two, even within the same bank.

Senator SHELBY. What, Ms. Seidman——

Ms. SEIDMAN. Can I just add that one of the things that we sometimes lose sight of is that there are a lot of different kinds of banks and there are about 8,000 banks that have under a billion dollars in assets. There are Community Development Financial In-

stitution banks, like ShoreBank. And those banks, in general, really did keep contact with their customers, not only their consumer customers, but their small business customers.

I do think that one of the things that we need to be a little careful about in this rush to consolidation that we seem to be going through right now is retaining the best of the banking system.

Senator SHELBY. I hope we will not rush to consolidate all the bank regulatory systems. But I do believe that we need to go down that road and we need to do it right. Senator Dodd alluded to it earlier. We have seen gaps, big gaps out there in the regulation of institutions. We have seen sometimes, and I am going to bring up the Fed again, the Fed is the central bank, supposed to be the lender of last resort. Now it has become the lender of first resort, it seems to me. The big banks that they have regulated, gosh, so many of them are in trouble. So you have to ask from this podium up here, why? Where were they? And so forth.

So we have to have, I believe, a comprehensive regulator, and along those same lines, look at AIG. Who were they regulated by basically? Their primary regulator was the New York State Insurance Commission, because under McCarran-Ferguson, there are a lot of things the Fed even to this day doesn't have the power over. It assumed a lot of power over AIG because of systemic risk that Steve talks about. But I believe that whatever we do, we are going to have to be comprehensive and we are going to have to do it right, and I believe we are not going to rush to it, but we are really going to focus on it. We have no other choice.

Ms. SEIDMAN. My concern, let me just clarify, is the consolidation of the institutions, of the banking institutions, not the regulatory issue.

Senator SHELBY. OK.

Chairman DODD. Well, I am going to turn to Senator Merkley for any additional questions he has, but I want to thank you, Ms. Seidman, for making the point. I try to make it at every hearing we have on this subject matter and I didn't do it today and I should have at the outset.

You are absolutely correct. There are 8,000 banks in the country. My community banks in Connecticut made choices, obviously, more conservative choices, thank goodness, and as a result, they get drawn into the pejorative, and I think we need to be very careful. There are so many different institutions that have the label of "bank" and there are very, very huge differences that exist within that universe of banks, and these differences have been rightly raised with me, as I am sure they have with my other colleagues. When we talk about banks, we ought to take a moment to make sure we are distinguishing between those who engage in some of these practices we are talking about and have accumulated many of these bad assets and the vast majority that have not.

In fact, there are only a handful of banks—I forget the exact number, and one of you may correct me here—I think it is around 18 to 20 banks that have 80 or 85 percent of the assets in the country out of the 8,000 we are talking about. We too often draw everyone else into this discussion, so it is important to differentiate. And I appreciate your point about making sure that as we move forward with this we keep that in mind.

I will have some closing thoughts in a minute, but let me turn to Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Thank you for all of your responses related to steering payments. It sounded like there was a consensus that there is a real problem there that needs to be fixed and I appreciated the range of remedies you mentioned, from fiduciary responsibility to an outright ban to a fixed-fee arrangement that doesn't depend on the type of the loan.

I wanted to turn to another piece of this puzzle which are prepayment penalties combined with teaser rates. Very often, brokers have been able to say, hey, you don't want a fully amortizing 30-year loan. You want to have a discount for a couple of years. Your family can save up money. Your house will increase in value. You can refinance. And the teaser rates have been kind of the bait on the front end and the prepayment penalty has been the steel trap that captures families on the back end. Is this product inherently flawed and should it be banned?

Mr. BARTLETT. Senator, my sense is the market has spoken to that. Most of our companies don't have prepayment penalties. There was a value to them, but in some cases they were abused and the value, in essence, is you could give someone a lower rate if they planned to stay in that house and keep that mortgage for a longer period of time because you could lock in the rate. Having said that, the value has sort of long since been overcome by the abuses, so most of our banks—as far as I know, all of them—don't have the prepayment penalties anymore, I believe.

Senator MERKLEY. Would it be appropriate to back up what the market has done with a specific ban on teaser rates and prepayment penalties?

Mr. BARTLETT. You know, it never strikes me as appropriate to go out and lock the barn door after the horses are out, but it wouldn't do any harm in the near term. The difficulty is any time that you create some kind of a Federal ban for something that somebody used to do, well, then 5 years from now, you will discover that it is getting in the way of something that consumers want. It wouldn't do any harm. It just doesn't strike me as being all that useful at this point.

Senator MERKLEY. Ellen Seidman?

Ms. SEIDMAN. I think that the combination of teaser rates and a prepayment penalty is a combination that has no redeeming social value. I would ban it. And I am pleased to hear that Steve says that, in general, prepayment penalties are disappearing. I think they are pernicious and if they are to exist, they should be limited to a very short period of time, certainly as the Fed has done, no longer than the initial adjustment. They should come off before the initial adjustment in the mortgage rate.

Senator MERKLEY. Thank you, and Professor?

Ms. MCCOY. I have nothing more to add with Ms. Seidman. I totally agree with her.

Senator MERKLEY. There are those who have argued that, really, if you get rid of the prepayment penalty, teaser rates take care of themselves because obviously you are only going to get a slight discount. A finance lender is not going to offer you a big discount if

you could go ahead and refinance 2 years later into another low discount. Do you all share that opinion, that really the focus is on the prepayment penalty? If you take care of that, the teaser rate issue takes care of itself?

Ms. SEIDMAN. That is probably right in logic. However, I think the problem on the teaser rates is that when you are dealing with a population that doesn't have a fiduciary looking out for them and is not really familiar with how mortgages work, it is too easy to sell the low monthly payment.

Mr. BARTLETT. Senator, our group concluded about 2 years ago, and I am joined here with the President of the Housing Policy Council that led this, we concluded about 2 years ago that the focus should be on the ability to repay, that a mortgage should have the ability to repay. There are a lot of ingredients to that, of which teaser rates and prepayments is part of it, but that should be the focus. It should be the ability to repay for the life of the loan. We adopted it ourselves for our companies, which is about 80 percent of the mortgage market, but then equally important, we then recommended it to the Fed, which they adopted it in perhaps a slightly less fulsome form than we did, but the same thing.

Ms. MCCOY. The problem with focusing just on the prepayment penalty is that assumes the consumer has the ability to refinance during the introductory period, and we have seen that that may not be true for a couple of reasons. First of all, their credit scores may be sinking. And second, house prices may fall.

Now, we are in a very unusual situation now, but in the 1990s, I lived in Cleveland, where housing price appreciation was pretty fragile. It was going up in other parts of the country, but you were never quite sure if you could sell your house for what you bought it at.

Senator MERKLEY. Thank you. I think that is a very good point, and if I could just restate and make sure that we are on the save wavelength here, that even without a prepayment penalty, you may be locked into a loan, if it has a short teaser rate followed by high interest, but you may be locked in because the value of your house falls and you no longer have the equity to be able to refinance in a prime loan.

Ms. MCCOY. Correct.

Senator MERKLEY. Thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator. Those are good questions and ones we have spent a lot of time on over the last 2 years on going through the predatory lending practices. The yield spread premium issue is one that consumed a lot of attention of this Committee, as did teaser rates and prepayment penalties, so I am very appreciative of you raising it again here in today's discussion as we look down the road our work on predatory lending as well as credit cards.

I wanted to make note, as well, that on Thursday, we will have a hearing on AIG before this Committee and a very interesting group of panelists to come, particularly in light of the decisions in the last 24 hours or so—36 hours—and so there will be a lot of interest, I presume, in hearing where that stands and where we are going with all of it.

Let me underscore the point that Senator Shelby has made and I attempted to make at the outset. This is a large task we have in front of us and our common determination here is to get this right. I am very grateful to have a partner in this in Senator Shelby, who has sat in the chair that I am sitting in as Chair of this Committee and has a good understanding of these issues, as you have witnessed by his questions here today and his interest in the subject matter.

And so it is our common determination to try and, as the Chair and Vice Chair or Co-Chair or Ranking Member of this Committee here, to work closely together with people like yourselves who are very, very informative and have a lot to offer in this discussion. This is a formal hearing today, but our intention is to have informal conversations and discussions with people as well, so we can have the kind of give and take as we move forward and start to build that architecture. So I am very grateful to all three of you for your participation today.

Richard, do you have something else?

Senator SHELBY. Yes. I just want to follow up on the number of banks. You were talking about 8,000, more or less, smaller banks. And then we have the top 19 banks they are going to apply the stress test to if they can find the pulse and so forth.

Steve, if you put the 19 banks that they are going to do a stress test on together, roughly how much of the deposits in the United States is that, roughly?

Mr. BARTLETT. Senator Shelby, I don't have the exact numbers——

Senator SHELBY. I know that.

Mr. BARTLETT. It is a significant portion——

Senator SHELBY. Would it be 80 percent?

Mr. BARTLETT. No, it wouldn't be 80 percent, but it perhaps could be around 70 percent——

Senator SHELBY. Seventy percent.

Mr. BARTLETT.——so you were closer than I was.

Senator SHELBY. You have got some good help back here.

Mr. BARTLETT. Yes, I do.

Senator SHELBY. Seventy percent, so say 19 banks in the United States have approximately 70 percent of all the deposits. Then you say every other bank, the 8,000 banks have 30 percent. But a lot of those 30 percent, a lot of those banks, although small, are very important to their communities and a lot of them have stayed with the fundamentals of banking and are relatively, as I understand Professor McCoy, in relatively good shape, considering the plight of some of the bigger ones. Is that fair?

Ms. MCCOY. Yes. Yes. When I looked at the smaller banks, for the most part, they were not into these mortgages.

Senator SHELBY. They weren't buying credit default swaps and all this from AIG, were they?

Ms. MCCOY. No. They had pretty simple balance sheets.

Senator SHELBY. Balanced.

Ms. SEIDMAN. Let me just say, though, that while in general the small banks are doing better than the very big ones, it would be hard to do a lot worse. But even though they didn't participate in the kind of lending we are talking about, some smaller banks, par-

ticularly those that are in communities that have been devastated by that kind of lending——

Senator SHELBY. Sure.

Ms. SEIDMAN.——are running into trouble because the value of their loans is declining, and where you also have unemployment, the borrowers, even the prime borrowers, are in trouble. This is a big issue for some smaller banks.

Senator SHELBY. So a lot of that—I know it is everywhere to some extent, but a lot of the things you are referencing are in California, Florida, Nevada——

Ms. SEIDMAN. And in the Upper Midwest.

Senator SHELBY. In the Upper Midwest, the Rust Belt.

Mr. BARTLETT. Senator, Mr. Chairman, if I could take 30 seconds, I think it is, though, fair to say that it is too broad a brush to say, well, the small banks are good and the big banks are bad——

Senator SHELBY. Sure.

Mr. BARTLETT.——because that is simply not accurate.

Senator SHELBY. That is what she was saying.

Mr. BARTLETT. I think that regions, being there in Birmingham, and BBVA in Birmingham and Webster Financial in Connecticut, Sun Trust in Atlanta, and others are banks that serve their communities quite well, make good decisions, good loans, have increased their lending as a result of TARP participation, and, in fact, we have an economic decline with unemployment and with frozen liquidity markets, but it is not a matter of those individual banks having made bad decisions. There are lots of bad decisions that have been made by all kinds—and lots of good decisions. Now the issue is how do we build out of it. So I think the banks I cited and others made quite good decisions. They are a big part of the solution.

Chairman DODD. No, no, you are right, absolutely right. Go ahead.

Senator SHELBY. Ms. Seidman, a lot of the smaller banks—and large ones, too—bought mortgage-backed securities that were rated investment grade, you know, were packaged and sold back. In other words, they came right around the merry-go-round. But they weren't allowed to hold those loans individually on their banking sheets, I understand it. Do you understand what I am getting at? Professor McCoy, do you want to comment?

Ms. MCCOY. Yes, I certainly do. First of all, there was a way to get around that, which was to make it on a low-doc or no-doc basis, so a seemingly safe loan actually didn't have the proper documentation. We did see that a lot among regulated depositories.

But apart from that, yes. Banks were allowed to invest in investment grade subprime mortgage-backed securities under the standard rules that we have. I had a very interesting conversation with a regulator at the Bank of Italy who said that several years ago, the Bank of Italy called up all the banks in Italy and said, you shall not invest in these bonds. I don't care if they are investment grade. We forbid you from doing it.

Senator SHELBY. Deemed investment grade by a rating agency?

Ms. MCCOY. Correct.

Senator SHELBY. After they bought insurance and were wrapped and everything, is that correct?

Ms. MCCOY. Correct.

Senator SHELBY. Because anybody that was doing real due diligence knew there was a risk there, did they not?

Ms. MCCOY. That is right. That is right. Or they knew they couldn't tell what the risk was.

Senator SHELBY. OK. Thank you.

Chairman DODD. Let me just—one point I wanted to make before the conclusion, we are allowing the words "subprime" and "predatory lending" to become interchangeable and that is dangerous, in my view. If you have good underwriting standards, subprime lending can work, provided you don't have a lot of bells and whistles on it. This has been one of the great wealth creators for people who are moving up economically to be able to acquire a home and to watch equity build up. It becomes a great stabilizer, not to mention it does a lot for families and neighborhoods. Equity interest in homes is, I think, one of the great benefits. I think we are one of the few countries in the world that ever had a 30-year fixed-rate mortgage for people. Now, that is not always the best vehicle, I understand that, as well.

But I wonder if you would agree with me or disagree with me. I just worry about this idea that we are going to exclude the possibility of poorer people becoming home owners. They have to meet standards, obviously. I think you pointed out where Community Investment Act requirements are in place, I think only 6 percent of those institutions ended up in some kind of problems. There has been an assumption that the Community Reinvestment Act gave mortgages to a lot of poor people who couldn't afford them. But, in fact, the evidence I have seen is quite the contrary. Where institutions followed CRA guidelines here and insisted upon those underwriting standards, there were very few problems, in fact. I wonder if you might comment on those two points.

Ms. MCCOY. If I may, Senator Dodd, the performance of CRA loans has, in fact, been much better. That turned out to be a viable model for doing subprime lending, and there are two other viable models. One are FHA guaranteed loans. That works pretty well. And then the activities, the lending activities of CDFIs such as ShoreBank are an excellent model to look at, as well.

Ms. SEIDMAN. Let me just add, first of all, you are certainly right that subprime used to mean a borrower with less than stellar credit.

Chairman DODD. Right.

Ms. SEIDMAN. It did not mean an ugly loan. And one has, unfortunately, morphed into the other.

I think we did lending to borrowers with lower incomes and lower wealth extremely well during the 1990s because we worked on the notion that the borrower and the instrument should match and that the borrower should be well counseled. And I commend to the Committee and would ask you to put into the record a recent study by the Center for Community Capital at the University of North Carolina, who looked at essentially matched pairs of borrowers, one who had gotten a CRA loan and one who had gotten brokered loans with various other gizmos, ARMs or prepayment

penalties. For the 2004 originations, the ARM-brokered loans with prepayment penalties defaulted at 5.3 times the rate of the low-downpayment loans made to lower-income borrowers under CRA programs.

Chairman DODD. In fact, I think that—I forget which publication it was, it may have been the Wall Street Journal, and I may be a little bit off on this—somewhere around 60 percent of the subprime loans to borrowers actually would have qualified for conventional mortgages.

Ms. SEIDMAN. That is right. Governor Kroszner, former Fed Governor Kroszner, has cited a study by Glenn Canner at the Fed that only 6 percent of the high-cost loans to low-income people were made by CRA-regulated institutions in their assessment areas.

Chairman DODD. Steve, do you want to comment on that at all before I call——

Mr. BARTLETT. Yes, I do, Mr. Chairman. Mr. Chairman, lending decisions should not be made by political correctness or by government fiat or by a law or by regulation. Those lending decisions should be based on safety and soundness, good underwriting standards and consumer protection, and every time we get into an attempt to have that, then we sort of skew the outcome. So subprime lending is in and of itself not bad. It is a good thing. We had a large number of terrible abuses, but it shouldn't be therefore outlawed.

Second, loans, though, and mortgages should be made for the benefit of consumers by a competitive marketplace where 8,000 lenders or 15,000 lenders compete against each other for the consumers' business. And then those lenders should be regulated for safety and soundness and for consumer protection. But the regulation should not be to design the exact terms and conditions of the loan, as in, well, I think this is what a good loan should be and somebody else says, I think this. The marketplace will do the best job.

And then last, and I have some considerable experience with CRA as both a mayor and as a member of the other body, the purpose of CRA has worked quite well. It can be clumsy and so there are exceptions to that, but CRA is the government's requirement that regulated lenders, depository institutions, figure out how they should be making good loans in low-income neighborhoods because that was not occurring prior to CRA in large part, I regret to say, but it was not. So that is the purpose of CRA. That should be kept. It shouldn't be expanded to some other purpose or contracted for other purposes. But that was the underlying purpose and I think that is why the CRA debate is outside this debate that we are having today.

Chairman DODD. Very worthwhile, all of you. I can't thank you enough and thank my colleagues here. We will leave the record open for additional questions. By unanimous consent, we will accept that article you suggested to us from the University of North Carolina.

With that, the hearing stands adjourned.

[Whereupon, at 12:07 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

**STATEMENT OF STEVE BARTLETT**

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
FINANCIAL SERVICES ROUNDTABLE

MARCH 3, 2009

Chairman Dodd, Ranking Member Shelby and Members of the Senate Banking Committee. I am Steve Bartlett, President and Chief Executive Officer of the Financial Services Roundtable. The Roundtable is a national trade association composed of the nation's largest banking, securities, and insurance companies. Our members provide a full range of financial products and services to consumers and businesses. Roundtable member companies provide fuel for America's economic engine, accounting directly for $85.5 trillion in managed assets, $965 billion in revenue, and 2.3 million jobs.

On behalf of the members of the Roundtable, I wish to thank you for the opportunity to participate in this hearing on the role of consumer protection regulation in the on-going financial crisis. Many consumers have been harmed by this crisis, especially mortgage borrowers and investors. Yet, the scope and depth of this crisis is not simply a failure of consumer protection regulation. As I will explain in a moment, the root causes of this crisis are found in basic failures in many, but not all financial services firms, and the failure of our fragmented financial regulatory system.

I also believe that this crisis illustrates the nexus between consumer protection regulation and safety and soundness regulation. Consumer protection and safety and soundness are intertwined. Prudential regulation and supervision of financial institutions is the first line of defense for protecting the interests of all consumers of financial products and services. For example, mortgage underwriting standards not only help to ensure that loans are made to qualified borrowers, but they also help to ensure that the lender gets repaid and can remain solvent.

Given the nexus between the goals of consumer protection and safety and soundness, we do not support proposals to separate consumer protection regulation and safety and soundness regulation. Instead, we believe that the appropriate response to this crisis is the establishment of a better balance between these two goals within a reformed and more modern financial regulatory structure.

Moreover, I would like to take this opportunity to express the Roundtable's concerns with the provision in the Omnibus Appropriations bill that would give State attorneys generals the authority to enforce compliance with the Truth-in-Lending Act (TILA) and would direct the Federal Trade Commission to write regulations related to mortgage lending. As I will explain further, we believe that one of the fundamental problems with our existing financial regulatory system is its fragmented structure. This provision goes in the opposite direction. It creates overlap and the potential for conflict between the Federal banking agencies, which already enforce compliance with TILA, and State AGs. It also creates overlap and the potential conflict between the Federal banking agencies, which are responsible for mortgage lending activities, and the Federal Trade Commission. While it may be argued that more "cops on the beat" can enhance compliance, more "cops" that are not required to act in any coordinated fashion will simply exacerbate the regulatory structural problems that contributed to the current crisis.

My testimony is divided into three parts. First, I address "What Went Wrong." Second, I address "How to Fix the Problem." Finally, I take this opportunity to comment on the lending activities of TARP-assisted firms, and the Roundtable's continuing concerns over the impact of fair value accounting.

*What Went Wrong*

The proximate cause of the current financial crisis was the nation-wide collapse of housing values, and the impact of that collapse on individual homeowners and the holders of mortgage-backed securities. The crisis has since been exacerbated by a serious recession.

The root causes of the crisis are twofold. The first was a clear breakdown in policies, practices, and processes at many, but not all, financial services firms. Poor loan underwriting standards and credit practices, excessive leverage, misaligned incentives, less than robust risk management and corporate governance are now well known and fully documented. Corrective actions are well underway in the private sector as underwriting standards are upgraded, credit practices reviewed and recalibrated, leverage is reduced as firms rebuild capital, incentives are being realigned, and some management teams have been replaced, while whole institutions have been intervened by supervisors or merged into other institutions. So needed corrective actions are being taken by the firms themselves.

More immediately, we need to correct the failures that the crisis exposed in our complex and fragmented financial regulatory structure. Crises have a way of revealing structural flaws in regulation, supervision, and our regulatory architecture that have long-existed, but were little noticed until the crisis exposed the underlying weaknesses and fatal gaps in regulation and supervision. This one is no different. It has revealed significant gaps in the financial regulatory system. It also revealed that the system does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk and result in panics like we saw last year and the crisis that lingers today.

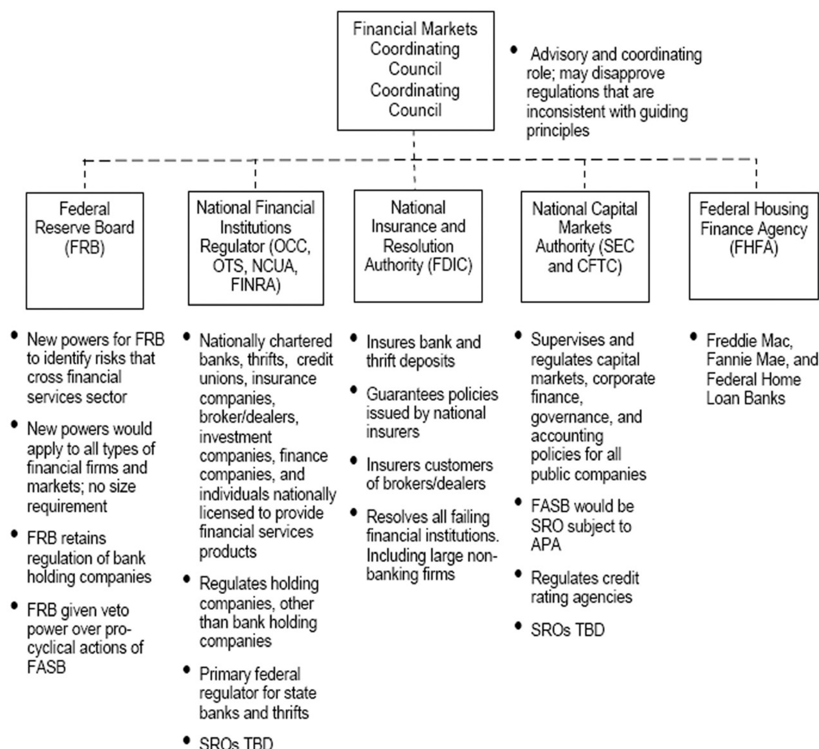
The regulation of mortgage finance illustrates these structural flaws in both regulation and supervision. Many of the firms and individuals involved in the origination of mortgage were not subject to supervision or regulation by any prudential regulator. No single regulator was held accountable for identifying and recommending corrective actions across the activity known as mortgage lending to consumers. Many mortgage brokers are organized under State law, and operated outside of the regulated banking industry. They had no contractual or fiduciary obligations to brokers who referred loans to them. Likewise, many brokers were not subject to any licensing qualifications and had no continuing obligations to individual borrowers. Most were not supervised in a prudential manner like depository institutions engaged in the same business line.

The Federal banking regulators recognized many of these problems and took actions—belatedly—to address the institutions within their jurisdiction, but they lacked to power to reach all lenders. Eventually, the Federal Reserve Board's HOEPA regulations did extend some consumer protections to a broader range of lenders, but the Board does not have the authority to ensure that those lenders are engaged in safe and sound underwriting practices or risk management.

The process of securitization suffered from a similar lack of systemic oversight and prudential regulation. No one was responsible for addressing the over-reliance investors placed upon the credit rating agencies to rate mortgage-backed securities, or the risks posed to the entire financial system by the development of instruments to transfer that risk worldwide.

*How to Fix the Problem*

How do we fix this problem? Like others in the financial services industry, the members of the Financial Services Roundtable have been engaged in a lively debate over how to better protect consumers by addressing the structural flaws in our current financial regulatory system. While our internal deliberations continue, we have developed a set of guiding principles and a "Draft Financial Regulatory Architecture" that is intended to close the gaps in our existing financial regulatory system. We are pleased that the set of regulatory reform principles that President Obama announced last week are broadly consistent and compatible with the Roundtable's principles for much needed reforms. Our first principle in our 2007 *Blueprint for U.S. Financial Modernization* was to "treat consumers fairly." Our current principles for regulatory reform this year build on that guiding principle and call for: 1) a new regulatory architecture; 2) common prudential and consumer and investor protection standards; 3) balanced and effective regulation; 4) international cooperation and national treatment; 5) failure resolution; and 6) accounting standards. Our plan also seeks to encourage greater coordination and cooperation among financial regulators, and to identify systemic risks before they materialize. We also seek to rationalize and simplify the existing regulatory architecture in ways that make more sense in our modern, global economy. The key features of our proposed regulatory architecture are as follows.




*Financial Markets Coordinating Council*

To enhance coordination and cooperation among the many and various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it as the Financial Markets Coordinating Council (FMCC). We believe that this Council should be established by law, in contrast to the existing PWG, which has operated under a Presidential Executive Order since 1988. This would permit Congress to oversee the Council's activities on a regular and ongoing basis. We also believe that the Council should include representatives from all major Federal financial agencies, as well as individuals who can represent State banking, insurance, and securities regulation.

This Council could serve as a forum for national and State financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections. In other words, it could help to better coordinate policies within our still fragmented regulatory system. We do not believe that the Council should have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of Federal and State financial agencies, and thereby ensure that they are consistent.

*Federal Reserve Board*

To address systemic risk, we believe the Federal Reserve Board (Board) should be authorized to act as a market stability regulator. As a market stability regulator, the Board should be responsible for looking across the entire financial services sector to identify interconnections that could pose a risk to our financial system. To perform this function, the Board should be empowered to collect information on financial markets and financial services firms, to participate in joint examinations with other regulators, and to recommend actions to other regulators that address

practices that pose a significant risk to the stability and integrity of the U.S. financial services system.

The Board's authority to collection information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (*e.g.,* transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk.

*National Financial Institutions Regulator*

To reduce gaps in regulation, we propose the consolidation of several existing Federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for banking, securities and insurance.

More specifically, it would charter, regulate and supervise (i) banks, thrifts, and credit unions, currently supervised by the Office of the Thrift Supervision, the Office of the Comptroller of the Currency, and the National Credit Union Administration; (ii) licensed broker/dealers, investment advisors, investment companies, futures commission merchants, commodity pool operators, and other similar intermediaries currently supervised by the Securities and Exchange Commission or the Commodities Futures Trading Commission; and (iii) insurance companies and insurance producers that select a Federal charter. The AIG case illustrates the need for the Federal Government to have the capacity to supervise insurance companies. Also, with the exception of holding companies for banks, the NFIR would be the regulator for all companies that control broker/dealers or national chartered insurance companies.

The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these of nationally chartered or licensed entities. For example, national banks, Federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards.

In the area of mortgage origination, we believe that the NFIR's prudential and consumer protection standards should apply to both national and State lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate (keep some "skin-in-the-game"). Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

As noted above, we believe that is it important for this agency to combine both safety and soundness (prudential) regulation and consumer protection regulation. Both functions can be informed, and enhanced, by the other. Prudential regulation can identify practices that could harm consumers, and can ensure that a firm can continue to provide products and services to consumers. The key is not to separate the two, but to find an appropriate balance between the two.

*National Capital Markets Agency*

To focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency through the merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as broker/dealers, investment companies, investment advisors, and futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

*National Insurance Resolution Authority*

To protect depositors, policyholders, and investors, we propose that the Federal Deposit Insurance Corporation (FDIC) would be renamed the National Insurance and Resolution Authority (NIRA), and that this agency act not only as an insurer of bank deposits, but also as the guarantor of retail insurance policies written by nationally chartered insurance companies, and a financial backstop for investors who have claims against broker/dealers. These three insurance systems would be legally and functionally separated. Additionally, this agency should be authorized to act as the receiver for large non-bank financial services firms. The failure of Leh-

man Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

*Federal Housing Finance Agency*

Finally, to supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing GSEs in our economy.

*TARP Lending and Fair Value Accounting*

Before I close I would like to address two other issues of importance to policymakers and our financial services industry: lending by institutions that have received TARP funds, and the impact of fair value accounting in illiquid markets. Lending by institutions that have received TARP funds has become a concern, especially given the recessionary pressures facing the economy. I have attached to this statement a series of tables that the Roundtable has compiled on this issue. Those tables show the continued commitment of the nation's largest financial services firms to lending.

Fair value accounting also is a major concern for the members of the Roundtable. We continue to believe that the pro-cyclical effects of existing policies are unnecessarily exacerbating this crisis. We urge this Committee to direct financial regulators to adjust current accounting standards to reduce the pro-cyclical effects of fair value accounting in illiquid markets. We also urge the U.S. and international financial regulators coordinate and harmonize regulatory policies to development accounting standards that achieve the goals of transparency, understandability, and comparability.

*Conclusion*

Thank you again for the opportunity to appear today to address the connection between consumer protection regulation and this on-going financial crisis. The Roundtable believes that the reforms to our financial regulatory system we have developed would substantially improve the protection of consumers by reducing existing gaps in regulation, enhancing coordination and cooperation among regulators, and identifying systemic risks. We also call on Congress to address the continuing pro-cyclical effects of fair value accounting.

Broader regulatory reform is important not only to ensure that financial institutions continue to meet the needs of all consumers but to restart economic growth and much needed job creation. Financial reform and ending the recession soon are inextricably linked—we need both. We need a financial system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy. We need better, more effective regulation and a modern financial regulatory system that is unrivaled anywhere in the world. We deserve no less.

At the Roundtable, we are poised and ready to work with you on these initiatives. As John F. Kennedy once cited French Marshall Lyautey, who asked his gardener to plant a tree. The gardener objected that the tree was slow growing and would not reach maturity for 100 years. The Marshall replied, "In that case, there is no time to lose; plant it this afternoon!" The same is true with regard to the future of the United States in global financial services—there is no time to lose; let's all start this afternoon.

**Treasury Monthly Bank Lending Survey - Average Loan Balances (Millions) From October thru December 2008**

***Bold Indicates Increase**

| Name | First Mortgage | | | Home Equity | | | US Card Managed | | | Other Consumer | | | C&I | | | Commercial Real Estate | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Average Loan Balance | | | Average Loan Balance | | | Average Loan Balance | | | Average Loan Balance | | | Average Loan & Lease Balance | | | Average Loan & Lease Balance | | | Total Average Loan Balance | | |
| | October | November | December | October | November | December | October | November | December | October | November | December | October | November | December | October | November | December | October | November | December |
| Bank of America | $255,343 | $253,344 | $251,712 | $152,434 | $152,904 | $150,794 | **$161,122** | **$161,119** | **$163,348** | $75,623 | $76,363 | $76,355 | $263,551 | $262,398 | $259,474 | **$64,092** | **$64,917** | **$64,693** | $972,165 | $971,045 | $966,376 |
| Bank of NY Mellon | **$4,637** | **$4,672** | **$4,694** | $331 | $335 | $341 | $0 | $0 | $0 | $789 | $765 | $757 | **$10,445** | **$10,709** | **$10,809** | $3,086 | $3,100 | $3,074 | **$19,288** | **$19,581** | **$19,675** |
| BB&T | $18,477 | $18,362 | $18,219 | **$5,645** | **$5,718** | **$5,809** | **$1,930** | **$1,934** | **$1,966** | $18,877 | $18,766 | $18,653 | **$32,470** | **$32,947** | **$33,531** | **$19,366** | **$19,383** | **$19,614** | **$96,765** | **$97,110** | **$97,792** |
| Capital One | $7,339 | $7,255 | $7,204 | $3,476 | $3,449 | $3,466 | **$51,883** | **$52,327** | **$53,568** | $33,781 | $33,363 | $32,850 | **$23,516** | **$23,722** | **$23,921** | **$17,355** | **$17,421** | **$17,439** | **$137,350** | **$137,537** | **$138,448** |
| CIT | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $12,776 | $12,692 | $12,604 | $57,085 | $56,224 | $55,075 | $882 | $880 | $866 | $70,743 | $69,796 | $68,545 |
| Citigroup | $158,562 | $155,438 | $152,369 | $68,986 | $68,829 | $68,717 | **$148,344** | **$147,449** | **$149,138** | $62,515 | $62,243 | $61,863 | $41,740 | $42,820 | $42,104 | $25,162 | $21,329 | $21,169 | $505,309 | $498,108 | $495,360 |
| Comerica | $1,858 | $1,853 | $1,843 | **$1,710** | **$1,749** | **$1,774** | $61 | $59 | $52 | $878 | $830 | $805 | $32,028 | $31,697 | $31,373 | $15,202 | $15,160 | $15,085 | $51,737 | $51,348 | $50,932 |
| Fifth Third | $12,448 | $12,347 | $12,332 | **$12,001** | **$12,034** | **$12,067** | **$1,999** | **$2,041** | **$2,081** | $9,966 | **$9,364** | **$9,487** | $31,345 | $31,312 | $30,906 | $20,542 | $20,372 | $19,883 | $88,301 | $87,470 | $86,756 |
| Goldman Sachs | **$4,445** | **$4,631** | **$5,040** | $0 | $75 | $151 | $0 | $0 | $0 | $1,438 | **$1,531** | **$1,584** | $98,861 | $91,618 | $86,907 | $29,359 | **$28,735** | **$29,271** | $134,103 | $126,590 | $122,953 |
| JPMorgan Chase | $55,257 | $54,669 | $54,163 | $94,713 | $94,553 | $94,434 | **$156,454** | **$156,419** | **$158,989** | $78,497 | **$78,299** | **$78,426** | $173,465 | $171,019 | $167,795 | $23,145 | $22,955 | $22,534 | $581,531 | $577,914 | $576,341 |
| KeyCorp | $3,663 | $3,667 | $3,630 | **$7,773** | **$7,852** | **$7,941** | $6 | $6 | $6 | $8,396 | $8,354 | $8,313 | $37,491 | $37,100 | $36,506 | $19,332 | $19,359 | $19,224 | $76,661 | $76,338 | $75,620 |
| Marshall & Ilsley | $8,111 | **$8,089** | **$8,092** | **$2,616** | **$2,648** | **$2,682** | **$266** | **$266** | **$275** | $1,794 | **$1,819** | **$1,847** | $15,656 | $15,358 | $15,251 | **$21,938** | **$22,009** | **$22,020** | $50,381 | $50,189 | $50,167 |
| Morgan Stanley | $4,748 | $4,692 | $4,581 | $2,625 | $2,601 | $2,500 | $0 | $0 | $0 | **$5,861** | **$5,845** | **$5,874** | **$71,433** | **$75,287** | **$73,078** | $13,260 | $13,205 | $12,954 | **$97,927** | **$101,630** | **$98,987** |
| Northern Trust | **$8,088** | **$8,154** | **$8,184** | **$2,157** | **$2,238** | **$2,315** | $0 | $0 | $0 | $2,212 | **$2,161** | **$2,180** | **$12,611** | **$12,449** | **$12,794** | **$2,970** | **$3,023** | **$3,040** | **$28,038** | **$28,025** | **$28,513** |
| PNC | $8,700 | $8,616 | $8,475 | $14,916 | $14,956 | $14,991 | **$290** | **$301** | **$321** | **$6,370** | **$6,444** | **$6,511** | **$35,261** | **$35,356** | **$35,429** | $9,645 | **$9,503** | **$9,596** | **$75,182** | **$75,176** | **$75,323** |
| Regions | $16,551 | $16,374 | $16,257 | **$15,953** | **$16,046** | **$16,109** | $0 | $0 | $0 | $6,243 | $5,656 | $5,463 | $24,655 | $24,065 | $23,643 | $37,658 | $37,638 | $37,555 | $101,060 | $99,779 | $99,027 |
| State Street | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $15,198 | $10,873 | $10,538 | **$797** | **$800** | **$800** | $15,995 | $11,673 | $11,338 |
| SunTrust | **$34,040** | **$33,317** | **$32,603** | **$18,728** | **$18,767** | **$18,778** | **$995** | **$1,007** | **$996** | **$12,610** | **$12,612** | **$12,633** | **$40,423** | **$40,797** | **$40,477** | $25,522 | $25,279 | $25,153 | $132,318 | $131,779 | $130,640 |
| U.S.Bancorp | **$26,337** | **$29,480** | **$35,066** | $18,327 | $18,640 | $19,105 | **$12,674** | **$12,849** | **$13,399** | **$28,376** | **$28,433** | **$28,611** | **$52,997** | **$54,057** | **$54,831** | **$35,181** | **$35,649** | **$36,530** | **$173,892** | **$179,108** | **$187,542** |
| Wells Fargo | $90,444 | $93,629 | $89,489 | **$85,523** | **$85,791** | **$85,921** | **$20,400** | **$20,541** | **$20,934** | $48,151 | $47,589 | $46,984 | **$99,295** | **$100,570** | **$99,838** | **$62,368** | **$63,127** | **$63,988** | **$406,181** | **$411,247** | **$407,154** |
| Total | $719,048 | $718,589 | $713,953 | $507,914 | $509,185 | $507,895 | **$556,424** | **$556,318** | **$565,073** | $415,153 | $413,129 | $411,800 | $1,169,526 | $1,160,378 | $1,144,280 | $446,862 | **$443,844** | **$444,488** | $3,814,927 | $3,801,443 | $3,787,489 |

February 12, 2009

Mr. Robert Herz
Chairman
Financial Accounting Standards
Board 401 Merritt 7
P.O. Box 5116
Norwalk, Conn. 06856-5116

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Mr. Herz and Sir David:

Our business organizations and institutions represent companies and firms from all sectors of the economy and areas of the financial services arena. We write to you today regarding the second meeting of the Financial Crisis Advisory Group ("FCAG") being held at Baruch College in New York. City. The agenda of the FCAG's meeting includes deliberations regarding the possibility of changes to fair value accounting and the potential issuance of further guidance thereof. We believe that changes to fair value accounting and additional guidance should be issued with all dispatch.

The ramification of the continuing financial crisis continues to spread throughout the global economy. More rather than less transparency around the valuation of assets is a fundamental pre-condition for economic recovery. This is why we are concerned that the current regime of fair value accounting rules is continuing to make it difficult to accurately reflect the value of assets. No one need look no further than the inability to value assets under the U.S. Treasury Troubled Asset Relief Program ("TARP") to understand the complexity of establishing fair valuations in the current environment. Accounting rules have unintentionally become both a barrier to improved transparency and a catalyst of additional economic pain.

This continued uncertainty has frozen the credit markets, endangered the soundness of financial institutions and cut off the lifeline to businesses. The delay in

Mr. Robert Herz
Sir David Tweedie
February 12, 2009
Page Two

addressing these issues is compounding current problems and causing additional long-term adverse consequences and market dislocations.

We would respectfully request that the FASB and IASB issue additional guidance to determine fair value for accounting purposes and we would further recommend the following for immediate action:

**Separate and report the credit loss portion of the periodic changes in fair value. The credit losses are, to be reflected in earnings, while all other losses are to be reflected in accumulated other comprehensive income (loss) until the related asset is sold or matures.**

U.S. GAAP guidance around the recognition and measurement of impairment losses for loans differs from U.S. GAAP guidance for recognizing and measuring impairments related to investments in debt securities, even though the cash flows for both types of assets are often similar. In accordance with FAS 5 and FAS 114, the loan impairment model is based on incurred credit losses at the measurement date. However, in accordance with FAS 115 and EITF 99-20, the latter model is based on comparing the securities fair value versus it's the current carrying value at the measurement date. This difference between these two models should be addressed by modifying the latter model to be consistent with the loan impairment model. Additionally, the periodic changes in fair value should be separated and reported in two components: (1) through earnings, and (2) in accumulated other comprehensive income (loss). For other than temporary impairment ("OTTI") in securities, this would mean recognizing: (1) probable credit losses currently through earnings (i.e., only those impairments representing probable losses of contractual cash flows) and (2) all other portions of the loss (such as from liquidity discounts) in accumulated other comprehensive income (loss) until it becomes probable that the instrument will be sold or matures.

We recommend that these changes be transparent on the appropriate financial statements to allow investors, users and regulators a full and accurate disclosure of financial information.

Mr. Robert Herz
Sir David Tweedie
February 12, 2009
Page Three

**Conclusion**

Requests for additional guidance and suggested changes to fair value accounting were contained in last August's report by the Securities and Exchange Commission's ("SEC") Advisory Committee on Improvements to Financial Reporting, last December's SEC Study on Mark to Market Accounting, as well as numerous comment letters by businesses, organizations and practitioners. With the continued worsening financial crisis, the changes discussed herein should be implemented as quickly as possible.

We stand by to assist you in any manner with this process.

Sincerely,

Richard Murray
Chairman
U.S. Chamber of Commerce
Center for Capital Markets
Competitiveness

Michael Monahan
Director, Accounting Policy
American Council of Life Insurers

John A. Courson
Chief Operating Officer
Mortgage Bankers Association

Steve Bartlett
President and Chief Executive Officer
Financial Services Roundtable

Rob Nichols
President and Chief Operating Officer
Financial Services Forum

William P. Kilmer
Group Executive Vice President
Advocacy Group
National Association of Homebuilders

Robert Gordon
Senior Vice President
Property Casualty Insurers Association of America

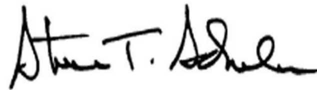
Camden R. Fine
President and Chief Executive Officer
Independent Community Bankers of America

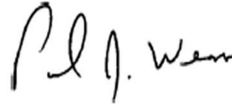
John von Seggern
President and Chief Executive Officer
Council of Federal Home Loan Banks

Michael Simms
Senior Vice President and Chief Financial Officers
Federal Home Loan Bank of Dallas

Roger D. Lundstrom
Executive Vice President and Chief Financial Officer
Federal Home Loan Bank of Chicago

Steven J. Goldstein
Chief Financial Officer
Federal Home Loan Bank Atlanta





Steven T. Schuyler
Executive Vice President and
Chief Financial Officer
Federal Home Loan Bank of Des
Moines

Paul J. Weaver
Senior Vice President and Chief
Accounting Officer
Federal Home Loan Bank of
Indianapolis

Patrick A. Morgan
Senior Vice President and Chief
Financial Officer
Federal Home Loan Bank of New
York

Richard M. Riccobono
President and Chief Executive
Officer
Federal Home Loan Bank of Seattle

Kristina K. Williams
Chief Financial Officer
Federal Home Loan Bank of
Pittsburgh

cc: Mr. Harvey Goldschmid, Co-Chairman of the Financial Crisis Advisory Group
Mr. Hans Hoogervorst, Co-Chairman of the Financial Crisis Advisory Group

**PREPARED STATEMENT OF ELLEN SEIDMAN**

SENIOR FELLOW, NEW AMERICA FOUNDATION AND
SENIOR VICE PRESIDENT, SHOREBANK CORPORATION

MARCH 3, 2009

Chairman Dodd, Ranking Member Shelby and members of the Committee. I appreciate your inviting me here this morning to discuss consumer protection and oversight in the financial services industry in the context of the current economic crisis, and to provide my thoughts on how the regulatory system should be restructured to enhance consumer protection in the future. In quick summary, I believe that the time has come to create a well-funded single Federal entity with the responsibility and authority to receive and act on consumer complaints about financial services and to adopt consumer protection regulations that would be applicable to all and would be preemptive. However, I believe that prudential supervisors, in particular the Federal and State banking regulatory agencies, should retain primary enforcement jurisdiction over the entities they regulate.

My name is Ellen Seidman, and I am a Senior Fellow at the New America Foundation as well as Executive Vice President, National Program and Partnership Development at ShoreBank Corporation, the nation's first and leading community development bank holding company, based in Chicago. My views are informed by my current experience—although they are mine alone, not those of New America or ShoreBank—as well as by my years at the Treasury Department, at Fannie Mae, at the National Economic Council under President Clinton, and as Director of the Office of Thrift Supervision from 1997 to 2001.

During my tenure at OTS, we placed significant emphasis on both consumer and compliance issues and on the responsibility of the institutions we regulated to serve the communities in which they were chartered, both because of their obligations under the Community Reinvestment Act and because it was good business. We paid particular attention to compliance, building up our staff and examination capability, establishing a special award (done away with by my successor) to honor the best performer in compliance and community affairs, reaching out to consumers and communities, and enhancing our complaint function. We were by no means perfect, but we worked to put compliance on an equal footing with safety and soundness.

Since I left OTS, I have spent much of my time working on issues relating to asset building and banking the underbanked, in which context the importance of consumer protection, for both credit and other products, is plainly apparent. Finally, my years at Fannie Mae and at ShoreBank and the community development work I have been doing have made me both conscious of and extremely sad about what has happened in the mortgage market and the effects it is having on both households and communities.

Based on my OTS experience, I believe the bank regulators, given the proper guidance from Congress and the will to act, are fully capable of effectively enforcing consumer protection laws. Moreover, because of the system of prudential supervision, with its onsite examinations, they are also in an extremely good position to do so and to do it in a manner that benefits both consumers and the safety and soundness of the regulated institutions. In three particular cases during my OTS tenure, concern about consumer issues led directly to safety and soundness improvements. Two involved guidance that got thrifts out of sub-prime monoline credit card lending (just months before that industry got into serious trouble) and payday lending. In another case involving a specific institution, through our compliance examiners' concern about bad credit card practices, we uncovered serious fair lending and safety and soundness issues. Consumer protection can be the canary that gives early warning of safety and soundness issues—but only if someone is paying attention to dying birds.

We also sounded the alarm on predatory lending. Sub-prime guidance issued in 1998 by all the bank regulators warned of both safety and soundness and consumer protection issues. In speeches and testimony I gave in 2000, concerns about predatory lending and discussion about what we were doing to respond were a consistent theme. Nevertheless, as I will discuss below, I think it is time to consider whether consolidation of both the function of writing regulations and the receipt of complaints would make the system more effective for consumers, for financial institutions and for the economy.

*The Current Crisis*

The current crisis has many causes, including an over-reliance on finance to "solve" many of the needs of our citizens. When real incomes stagnate while the cost of housing, health care and education skyrocket, there are really only two possible

results: people do without or they become more and more overleveraged. Financial engineering and cheap investor funding, largely from abroad, enabled the overleveraging, but a lack of adequate attention to the manner in which the financial services system interacted with consumers certainly kept the process going and caused consumers and the economy to fall harder when it ended. There were really two parallel problems: the proliferation of bad products and practices and the sale of hard-to-understand credit and investment products to consumers for whom they were not suitable; and the lack of high quality products that meet consumer needs, well priced and effectively marketed, especially in lower income communities.

I believe that there where three basic regulatory problems. First, there was a lack of attention, and sometimes unwillingness, to effectively regulate products and practices even where regulatory authority existed. The clearest example of this is the Federal Reserve's unwillingness to regulate mortgage lending under HOEPA. However, as the recent actions by the Federal Reserve, OTS and NCUA have demonstrated, there was also authority under the FTC Act that went unused. It is important to understand that this is not only an issue of not issuing regulations or guidance; it is perhaps even more importantly a lack of effective enforcement.

Compliance has always had a hard time competing with safety and soundness for the attention of regulators—which is one reason I spent a good deal of my tenure at OTS emphasizing its importance—but there was a deliberate downgrading of the compliance function at the Federal level at the start of the Bush Administration. Moreover, neither the Federal Reserve nor the OTS—at least until fairly recently—has seriously probed the consumer practices of non-depository subsidiaries of the holding companies they regulate. This is not just an issue at the Federal level. While there are certain states—North Carolina, Maryland and Massachusetts prominent among them—that have consistently engaged in effective enforcement of consumer protection laws with respect to the entities under their regulation, others, including California, the home of many of the most aggressive mortgage lenders, were even less aggressive than the Federal regulators. Moreover, ineffective enforcement is not just an issue of consumer protection regulation per se; the ability to move badly underwritten products completely off the balance sheet, earning fees for originating them, but holding no responsibility for them and no capital against them, only encouraged the proliferation of such activities.

Second, we need to acknowledge that there were, and are, holes in the regulatory system, both in terms of unregulated entities and products, and in terms of insufficient statutory authority. The clearest case relates to mortgage brokers, where there was no Federal regulation at all, no regulation beyond simple registration in many states, and ineffective regulation even in most of the states that actually asserted some regulatory authority. But there are other examples—payday lending is prohibited in some states, regulated more or less effectively in others, and pretty much allowed without restriction in still others. And then of course there is the question of what kind of responsibility sellers of non-investment financial products have to customers. We know we have not imposed a fiduciary duty on them, but does that mean there is no responsibility to match customer with product?

Finally, there is and was confusion, for both the regulated entities and consumers and those who work with them. Consumer protection comes in many forms, from substantive prohibitions like usury ceilings and payday lending prohibitions, through required terms and practices, to disclosures and marketing rules. I would assert it also includes the affirmative mandate of the Community Reinvestment Act; recent experience has demonstrated that where well-regulated entities do not provide quality services that meet needs and are well marketed, expensive and sometimes predatory substitutes will move in.

Multiple regulators and enforcement channels exacerbate the confusion. At the Federal level, there are multiple bank regulators, not to mention the NCUA, the FTC and HUD, and their jurisdiction is frequently overlapping. States and even localities also regulate consumer protection, again often through multiple agencies. And of course, sometimes the Federal and State laws overlap. The enforcement mechanisms are just as confusing, involving examinations, complaints, collateral consequences such as limitations on municipal deposits or procurement, and both public and private lawsuits.

The system clearly could be improved. But as we do so, we should not be lulled into thing the solutions are obvious or easy. In general they're not, and I would assert that they are harder and more subtle than is the case with manufactured consumer products. The products, even the good ones, can be extremely complex. Just try describing the lifetime interest rate on a Savings Bond or how a capped ARM works. Or for that matter whether a payday loan or a bounced check is more expensive. Many products, especially loans and investments, involve both uncertainty and difficult math over a long period of time, which is hard for even the most educated

consumer. And the differences between a good product and a bad one can be subtle, especially if the consumer doesn't know where to look. An experienced homeowner knows the importance of escrowing insurance and taxes, but the dire consequences of the lack of an escrow are easy for a first-time homebuyer to miss. And a relatively safe ARM can turn into a risky one when caps are removed or a prepayment penalty added.

Finally, different consumers legitimately have different needs. To take the example economists love, when there is a normal, upward sloping yield curve, most homebuyers are better off with a 5-year ARM than with a 30-year fixed rate mortgage, because with the long-term loan they are paying a higher interest rate for an option they are unlikely ever to use, since they will likely move, prepay or refinance long before 30 years are up. But for a consumer whose income is unlikely to increase, who has few other resources, or who has difficulty budgeting—or who is just plain risk-averse—the certainty of the fixed rate mortgage may well be worth the additional cost.

*Looking Forward*

Before turning to regulatory issues, I suggest there is a broader social context of change that we need to consider. To what extent can we turn some of the complex, long-term financial obligations that we have foisted on individual consumers—most clearly retirement and health care—back to more collective management? We also should recognize that there is some level of interest and some level of financial engineering at which "availability of credit" is an excuse for both not having sufficient income and collateral supports (such as health care) and an insufficient level of financial understanding—it's not a way of life. We need to educate our children from day one about what money means, how interest rates work, and who to get help from, and we need to create systems of helpers, which can include the internet and things like overdraft alarms, but which also requires low-cost access to people who are competent to give advice and have a fiduciary duty to the consumer.

In this period when consumers are being forced to deleverage and cut back, and are actually beginning to save more on their own accord, we should once again make saving easy and an expected part of life. Having an account at a bank or credit union helps encourage saving, although the account needs to be designed so consumers have the liquidity they need without paying for it through excessive overdraft fees. Tying savings to credit, such as by requiring part of a mortgage payment to go into a savings account for emergencies like repairs or temporary inability to make a payment, can also help. And so would moving toward more savings opt-outs, like payroll deductions for non-restricted savings accounts that can be used in an emergency (as well as for retirement accounts), a concept we are testing at the New America Foundation as AutoSave.

*Principles for Regulation*

The regulatory framework, of course, involves both how to regulate and who does it. With respect to how, I suggest three guiding principles. First, to the maximum extent possible, products that perform similar functions should be regulated similarly, no matter what they are called or what kind of entity sells them. For example, we know that many people regarded money market mutual funds and federally insured deposit accounts as interchangeable. Either they are, and both the products and—to the extent the regulation has to do with making sure the money is there when the customer wants it—the regulation should be similar, or they are not and they should not be treated as such, including by regulators who are assessing capital requirements. To take another example, payday loans and bounced check protection have a good deal in common, and probably should be regulated in a similar manner. This also means that a mortgage sold directly through a bank should be subject to the same regulatory scheme and requirements as one sold through a broker.

Second, we should stop relying on consumer disclosure as the primary method of protecting consumers. While such disclosures can be helpful, they are least helpful where they are needed the most, when products and features are complex. The Federal Reserve's recognition of this with respect to double cycle credit card billing was a critical breakthrough: by working with consumers, they came to understand that no amount of disclosure was going to enable consumers to understand the practice. The same is true of very complex mortgage products. The "one page disclosure" is great for simple mortgage products, but where there are multiple difficult-to-understand concepts in a single mortgage—indexes and margins, caps on rate increases and on payments, per adjustment and over the loan's lifetime, escrows or not, prepayment penalties that change over time, option payments and negative amortiza-

tion, and many different fees—the likelihood is low that any disclosure will enable those for whom these issues really make a difference to understand them.

In the last few years, several academics have suggested some potential substitutes for disclosure that go beyond the traditional type of prohibitory consumer protection rules. For example, Professor Ronald Mann has suggested that credit card contracts be standardized, with competition allowed on only a few easily understood terms, such as annual fees and interest rates.[1] In some ways, this is what the situation was with mortgages well into the 1990s. Professors Michael Barr, Eldar Shafir and Sendil Mullainathan have suggested the development of high quality, easily understood "default" products such as mortgages, credit cards and bank accounts, allowing other products to be sold, but with more negative consequences for sellers if the products go bad, such as requiring the seller to prove that the disclosures were reasonable as a condition to enforcing the contract, including in a mortgage foreclosure action.[2]

Third, enforcement is at least as important as writing the rules. Rules that are not enforced, or not enforced equally across providers, generate both false comfort and confusion, and tend to drive, through market forces, all providers to the practices of the least well regulated. This is in many ways what we have seen with respect to mortgages; it is not just that some entities were not subject to the same rules as others, but also that the rules were not enforced consistently across entities.

*Who Should Regulate*

As discussed above, that there are currently a myriad of regulators both making the rules and enforcing them. This situation makes accomplishment of the substantive principles discussed above very difficult. To a substantial extent, both the Federal Reserve and the FTC have broad jurisdiction already; whether they take action to write rules depends to some extent on capacity, will and priorities. But even where they have such authority and take it, significant problems remain concerning both enforcement and to what extent their rules trump State rules. The bank regulators, both together when they can agree and separately when they can't, also write rules and guidance that is often as effective as rules, but those apply only to entities under their jurisdiction, and generate very substantial controversy concerning the extent to which regulations of the OCC and OTS preempt State laws and regulations.

As I mentioned at the start, I believe the bank regulators, given the guidance from Congress to elevate consumer protection to the same level of concern as safety and soundness, can be highly effective in enforcing consumer protection laws. Nevertheless, I think it is time to give consideration to unifying the writing of regulations as to major consumer financial products—starting with credit products—and also to establish a single national repository for the receipt of consumer complaints.

The mortgage situation has shown that a single set of regulations that governs all parties is a precondition to keeping the market at the level of those engaged in best practices—or at least the practices condoned by the regulators—not the worst. The situation with payday lending, especially in multi-State metropolitan areas, is similar. And among regulators with similar jurisdictions, whether the Federal bank regulators or State regulators, having major consumer products governed by a single set of regulations will reduce the opportunity for regulatory arbitrage.

A single entity dedicated to the development of consumer protection regulations, if properly funded and staffed—unfortunately the experience of both the FTC and CPSC over the last 8 years, but in fact for many more years suggests that's a big "if"—will be more likely to focus on problems that are developing and to propose, and potentially, take action before they get out of hand. In addition, centralizing the complaint function in such an entity will give consumers and those who work with them a single point of contact and the regulatory body the early warning of trouble that consumer complaints provide.

Such a body will also have the opportunity to become expert in consumer understanding and behavior. This will enable it to use the theories and practices being developed about consumer understanding and how to maximize positive consumer behavior—the learnings of behavioral economics—to regulate effectively without

---

[1] Ronald Mann, "'Contracting' for Credit," 104 Mich LR 899 (2006) at 927–28.

[2] Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "A One-Size-Fits-All Solution," *New York Times,* December 26, 2007, available at *http://www.nytimes.com/2007/12/26/opinion/26barr.html?scp=1&sq=michael percent20barr percent20mortgage&st=cse. See* also Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Financial Services Regulation" (Washington, DC: New America Foundation, October 2008), available at *http://www.newamerica.net/files/naf__behavioral__v5.pdf.*

necessarily having a heavy hand. The regulator could also become the focus for the myriad of scattered and inefficient Federal efforts surrounding financial education.

The single regulator concept is not, however, a panacea. Three major issues that could stymie such a regulator's effectiveness are funding, preemption, and the extent of its enforcement authority.

How will the new regulator be funded, and at what level? It is tempting to think that annual appropriations will be sufficient, but is that really the case? Political winds and priorities change, and experience suggests that consumer regulatory agencies are at risk of reduced funding. Is this a place for user fees—a prospect more palatable if there is a single regulator covering all those in the business rather than multiple regulatory bodies for whom lower fees can become a marketing tool? In any event, it is essential that this entity be well funded; if it is not, it will do more harm than good, as those relying on it will not be able to count on its being effective.

What will be the regulator's enforcement authority? Will it have primary authority over any group of entities? Will the authority be secondary to other regulatory bodies that license or charter those providing financial services? My opinion is that regulators who engage in prudential supervision (Federal and State), with onsite examinations, should have primary regulatory authority, with the new entity empowered to bring an enforcement action if it believes the regulations are not being effectively enforced. Coupled with Congressional direction to the prudential supervisors to place additional emphasis on consumer protection, the supplemental authority of the consumer protection regulator to act should limit the number of situations in which the new regulator is forced to take action.

And finally, will the regulations written by the new entity preempt both regulations and guidance of other Federal regulators and State regulation? My opinion is that where the new entity acts, their regulations should be preemptive. We have a single national marketplace for most consumer financial products. Whereas in the past the argument that providers can't be expected to respond to a myriad of rules held sway, as technology has advanced this argument has lost its potency. But consumers are entitled to a consistent level of protection no matter where they live and with whom they deal. Yes, there may be times when the agency does not work as fast or as broadly as some advocates would like. But the point of having a single agency with responsibility in this area is to create a single focal point for action that will benefit all Americans. Where the agency does take action, it should fill the field. But preemption may well be the most difficult issue of all, not only because preemption is ideologically difficult, but also because the uniformity that a single regulator can provide will always be in tension with the attempts of some actors to get around the regulations and of regulators and other parties to move in to respond.

*Conclusion*

While the current crisis has many causes, the triggering event was almost certainly the collapse of the sub-prime mortgage market. That is an event that need never have happened if both our regulatory system and regulators had been more completely and effectively focused on protecting consumers. For many years, many of us have been pointing out that bad consumer practices are also bad economic practices. Not only because of the damage it does to consumers, but also because when the music stops, we all get hurt. The current state of affairs provides a golden opportunity to make significant improvements in the regulatory system. If not now, when?

---

## PREPARED STATEMENT OF PATRICIA A. McCOY

GEORGE J. AND HELEN M. ENGLAND PROFESSOR OF LAW
UNIVERSITY OF CONNECTICUT SCHOOL OF LAW

MARCH 3, 2009

Chairman Dodd and Members of the Committee: Thank you for inviting me here today to discuss the problem of restructuring the financial regulatory system. I applaud the Committee for exploring bold new approaches to financial regulation on the scale needed to address our nation's economic challenges.

In my remarks today, I propose transferring consumer protection responsibilities in the area of consumer credit from Federal banking regulators to a single, dedicated agency whose sole mission is consumer protection. This step is essential for three reasons. First, during the housing bubble, our current system of fragmented regulation drove lenders to shop for the easiest legal regime. Second, the ability of lenders to switch charters put pressure on banking regulators—both State and Fed-

eral—to relax credit standards. Finally, banking regulators have routinely sacrificed consumer protection for short-term profitability of banks. Creating one, dedicated consumer credit regulator charged with consumer protection would establish uniform standards and enforcement for all lenders and help eliminate another death spiral in lending. Although I examine this issue through the lens of mortgage regulation, my discussion is equally relevant to other forms of consumer credit, such as credit cards and payday lending.

The reasons for the breakdown of the home mortgage market and the private-label market for mortgage-backed securities are well known by now. Today, I wish to focus on lax lending standards for residential mortgages, which were a leading cause of today's credit crisis and recession. Our broken system of mortgage finance and the private actors in that system—ranging from mortgage brokers, lenders, and appraisers to the rating agencies and securitizers—bear direct responsibility for this breakdown in standards.

There is more to the story, however. In 2006, depository institutions and their affiliates, which were regulated by Federal banking regulators, originated about 54 percent of all higher-priced home loans. In 2007, that percentage rose to 79.6 percent.[1] In some states, mortgages originated by State banks and thrifts and independent nonbank lenders were regulated under State anti-predatory lending laws. In other states, however, mortgages were not subject to meaningful regulation at all. Consequently, the credit crisis resulted from regulatory failure as well as broken private risk management. That regulatory failure was not confined to states, moreover, but pervaded Federal banking regulation as well.

Neither of these phenomena—the collapse in lending criteria and the regulatory failure that accompanied it—was an accident. Rather, they occurred because mortgage originators and regulators became locked in a competitive race to the bottom to relax loan underwriting and risk management. The fragmented U.S. system of financial services regulation exacerbated this race to the bottom by allowing lenders to shop for the easiest regulators and laws.

During the housing bubble, consumers could not police originators because too many loan products had hidden risks. As we now know, these risks were ticking time bombs. Lenders did not take reasonable precautions against default because they able to shift that to investors through securitization. Similarly, regulators failed to clamp down on hazardous loans in a myopic attempt to boost the short-term profitability of banks and thrifts.

I open by examining why reckless lenders were able to take market share away from good lenders and good products. Next, I describe our fragmented financial regulatory system and how it encouraged lenders to shop for lenient regulators. In part three of my remarks, I document regulatory failure by Federal banking regulators. Finally, I end with a proposal for a separate consumer credit regulator.

**I. Why Reckless Lenders Were Able To Crowd Out the Good**

During the housing boom, the residential mortgage market was relatively unconcentrated, with thousands of mortgage originators. Normally, we would expect an unconcentrated market to provide vibrant competition benefiting consumers. To the contrary, however, however, highly risky loan products containing hidden risks—such as hybrid adjustable-rate mortgages (ARMs), interest-only ARMs, and option payment ARMs—gained market share at the expense of safer products such as standard fixed-rate mortgages and FHA-guaranteed loans.[2]

These nontraditional mortgages and subprime loans inflicted incalculable harm on borrowers, their neighbors, and ultimately the global economy. As of September 30, 2008, almost 10 percent of U.S. residential mortgages were 1 month past due or

---

[1] Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *The 2007 HMDA Data,* FED. RES. BULL. A107, A124 (Dec. 2008), available at *http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf.*

[2] A hybrid ARM offers a 2- or 3-year fixed introductory rate followed by a floating rate at the end of the introductory period with substantial increases in the rate and payment (so-called "2-28" and "3-27" mortgages). Federal Reserve System, *Truth in Lending, Part II: Proposed rule; request for public comment,* 73 Fed. Reg. 1672, 1674 (January 9, 2008). An interest-only mortgage allows borrowers to defer principal payments for an initial period. An option payment ARM combines a floating rate feature with a variety of payment options, including the option to pay no principal and less than the interest due every month, for an initial period. Choosing that option results in negative amortization. Department of the Treasury *et al., Interagency Guidance on Nontraditional Mortgage Product Risks: Final guidance,* 71 Fed. Reg. 58609, 58613 (Oct. 4, 2006).

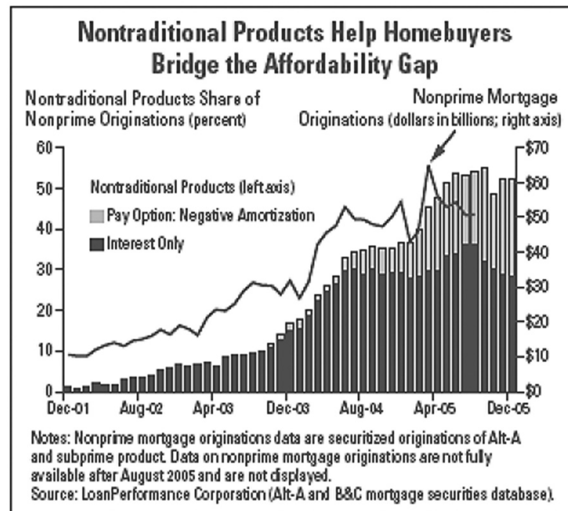
more.[3] By year-end 2008, every sixth borrower owed more than his or her home was worth.[4] The proliferation of toxic loans was the direct result of the ability to confuse borrowers and to shop for the laxest regulatory regime.[5]

**A. The Growth in Dangerous Mortgage Products**

During the housing boom, hybrid subprime ARMs, interest-only mortgages, and option payment ARMs captured a growing part of the market. We can see this from the growth in nonprime mortgages.[6] Between 2003 and 2005, nonprime loans tripled from 11 percent of all home loans to 33 percent.[7]

If we unpack these numbers, it turns out that hybrid ARMs, interest-only mortgages, and option payment ARMs accounted for a growing share of nonprime loans over this period. Option payment ARMs and interest-only mortgages went from 3 percent of all nonprime originations in 2002 to well over 50 percent by 2005. (*See* Figure 1). Low- and no-documentation loans increased from 25 percent to slightly over 40 percent of subprime loans over the same period. By 2004 and continuing through 2006, about three-fourths of the loans in subprime securitizations consisted of hybrid ARMs.[8]

Figure 1. Growth in Nontraditional Mortgages, 2002–2005[9]




[3] *See* Mortgage Bankers Association, *Delinquencies Increase, Foreclosure Starts Flat in Latest MBA National Delinquency Survey* (Dec. 5, 2008), available at *www.mbaa.org/NewsandMedia/PressCenter/66626.htm.*

[4] Michael Corkery, *Mortgage 'Cram-Downs' Loom as Foreclosures Mount,* WALL ST. J., Dec. 31, 2008.

[5] The discussion in this section was drawn, in part, from Patricia A. McCoy, Andrey D. Pavlov, & Susan M. Wachter, *Systemic Risk through Securitization: The Result of Deregulation and Regulatory Failure,* ___ CONN. L. REV. ___ (forthcoming 2009) and Oren Bar-Gill & Elizabeth Warren, Making Credit Safer, ___ U. PENN. L. REV. ___ (forthcoming 2009).

[6] I use the term "nonprime" to refer to subprime loans plus other nontraditional mortgages. Subprime mortgages carry higher interest rates and fees and are designed for borrowers with impaired credit. Nontraditional mortgages encompass a variety of risky mortgage products, including option payment ARMs, interest-only mortgages, and reduced documentation loans. Originally, these nontraditional products were offered primarily in the "Alt-A" market to people with near-prime credit scores but intermittent or undocumented income sources. Eventually, interest-only ARMs and reduced documentation loans penetrated the subprime market as well.

[7] FDIC Outlook, *Breaking New Ground in U.S. Mortgage Lending* (Summer 2006), available at *www.fdic.gov/bank/analytical/regional/ro20062q/na/2006__summer04.html.*

[8] *See* generally McCoy, Pavlov & Wachter, *supra* note 5; FDIC Outlook, *Breaking New Ground in U.S. Mortgage Lending* (Summer 2006), available at *www.fdic.gov/bank/analytical/regional/ro20062q/na/2006__summer04.html.*

[9] FDIC Outlook, *Breaking New Ground in U.S. Mortgage Lending* (Summer 2006), available at *www.fdic.gov/bank/analytical/regional/ro20062q/na/2006__summer04.html.*

As the product mix of nonprime loans became riskier and riskier, two default indicators for nonprime loans also increased substantially. Loan-to-value ratios went up and so did the percentage of loans with combined loan-to-value ratios of over 80 percent. This occurred even though the credit scores of borrowers with those loans remained relatively unchanged between 2002 and 2006. At the same time, the spreads of rates over the bank cost of capital tightened. To make matters worse, originators layered risk upon risk, with borrowers who were the most at risk obtaining low equity, no-amortization, reduced documentation loans. (*See* Figure 2).

Figure 2. Underwriting Criteria for Adjustable-Rate Mortgages, 2002–2006

| | | ARMS | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Orig Yr | CLTV | CLTV>80 | Seconds | Full Doc | IO% | DTI | FICO<700 | Investor | WAC | SpdtoWAC |
| Prime | 2002 | 66.4 | 4.1 | 1.9 | 56.0 | 46 | 31.0 | 20.7 | 0.7 | 5.5 | - |
| | 2003 | 68.2 | 10.1 | 10.9 | 48.6 | 53 | 31.8 | 21.8 | 1.6 | 4.6 | - |
| | 2004 | 73.5 | 20.7 | 23.1 | 51.2 | 71 | 33.5 | 22.0 | 2.1 | 4.5 | - |
| | 2005 | 74.1 | 21.7 | 26.8 | 47.3 | 81 | 33.6 | 18.9 | 1.9 | 5.4 | - |
| | 2006 | 75.3 | 26.2 | 35.3 | 33.6 | 91 | 37.2 | 19.5 | 2.3 | 6.2 | - |
| Alt A | 2002 | 74.3 | 20.8 | 2.7 | 29.3 | 26 | 35.4 | 46.4 | 9.9 | 6.3 | 0.8 |
| | 2003 | 78.0 | 33.3 | 23.4 | 28.1 | 56 | 35.3 | 44.7 | 12.9 | 5.6 | 1.0 |
| | 2004 | 82.6 | 46.9 | 39.1 | 32.6 | 75 | 36.2 | 44.3 | 15.3 | 5.5 | 1.0 |
| | 2005 | 83.5 | 49.6 | 46.9 | 28.3 | 83 | 37.0 | 40.5 | 16.5 | 6.0 | 0.6 |
| | 2006 | 85.0 | 55.4 | 55.4 | 19.0 | 87 | 38.3 | 44.2 | 13.5 | 6.8 | 0.6 |
| Subprime | 2002 | 81.2 | 46.8 | 3.7 | 66.9 | 1 | 40.0 | 93.4 | 4.7 | 8.5 | 3.0 |
| | 2003 | 83.5 | 55.6 | 9.9 | 63.5 | 5 | 40.2 | 91.6 | 4.9 | 7.5 | 2.9 |
| | 2004 | 85.3 | 61.1 | 19.1 | 59.9 | 20 | 40.6 | 90.6 | 5.3 | 7.1 | 2.6 |
| | 2005 | 86.6 | 64.4 | 28.1 | 55.9 | 32 | 41.2 | 89.7 | 5.4 | 7.3 | 1.9 |
| | 2006 | 86.7 | 64.0 | 31.0 | 54.6 | 20 | 42.1 | 91.8 | 5.7 | 8.2 | 2.0 |

Source: Loan Performance data as of November 2006. UBS, April 16, 2007, Thomas Zimmerman, "How Did We Get Here and What Lies Ahead"

Spreads declined

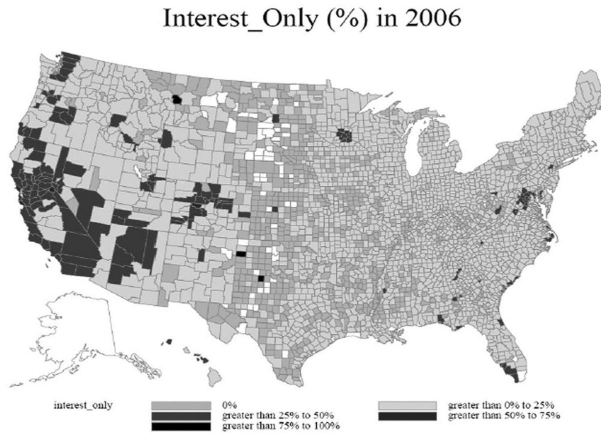
% Full Doc declined

Not much change in FICO or DTI

**Legend:**
*CLTV:* Combined loan-to value ratio
*Full Doc*: Full documentation loans
*IO*: Interest-only loans
*DTI*: Average debt-to-income ratios
*FICO*: Fair Isaac Company credit score
*WAC*: Weighted average coupon (measuring spread)

Many of these risky mortgage instruments were made in areas where housing was least affordable, such as California, Florida and Arizona, leading to concentrated areas of unsustainable housing values. (*See* Figures 3 and 4). This concentration of risky loans put the entire local markets at risk, due to the sudden and extreme withdrawal of credit in the aftermath of a bubble.[10]

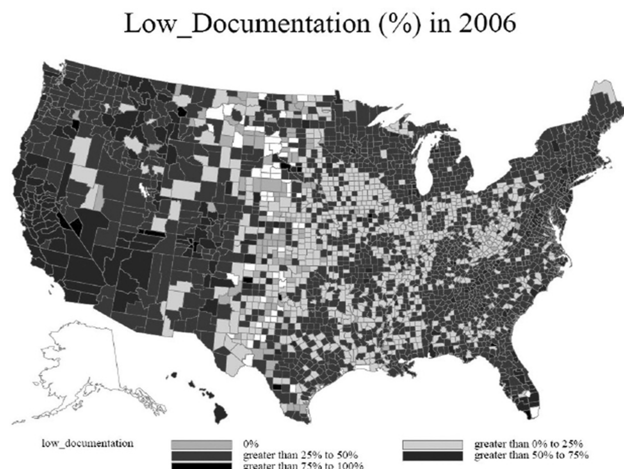
Figure 3. Geographic Distribution of Interest-Only Loans, 2006.[11]




[10] *See* Susan M. Wachter, Andrey D. Pavlov & Zoltan Pozsar, *Subprime Lending and Real Estate Markets,* in MORTGAGE AND REAL ESTATE FINANCE____(Stefania Perrucci, ed., Risk Books 2008).

[11] Anthony Pennington-Cross, Mortgage Product Substitution and State Predatory Lending Laws, Presentation at the 2008 Mid-Year Meeting of the American Real Estate and Urban Economics Association, Washington, D.C., May 27, 2008.

Figure 4. Geographic Distribution of Low-Documentation Loans, 2006[12]




The combination of easing credit standards and a growing economy resulted in a sharp increase in homeownership rates through 2004. As the credit quality of loans steadily grew worse over 2005 through 2007,[13] however, the volume of unsustainable loans grew and homeownership rates dropped.[14] (*See* Table 1).

Table 1. U.S. Homeownership Rates, by Year (U.S. Census Bureau)

| Period | U.S. Total, % | Non-Hispanic, % | | | | Hispanic% |
|---|---|---|---|---|---|---|
| | | White Alone | Black Alone | Other race alone | Two or more races | |
| 1983 | 64.9 | 69.1 | 45.6 | 53.3 | NA | 41.2 |
| 1984 | 64.5 | 69 | 46 | 50.9 | NA | 40.1 |
| 1985 | 64.3 | 69 | 44.4 | 50.7 | NA | 41.1 |
| 1986 | 63.8 | 68.4 | 44.8 | 49.7 | NA | 40.6 |
| 1987 | 64 | 68.7 | 45.8 | 48.7 | NA | 40.6 |
| 1988 | 64 | 69.1 | 42.9 | 49.7 | NA | 40.6 |
| 1989 | 64 | 69.3 | 42.1 | 50.6 | NA | 41.6 |
| 1990 | 64.1 | 69.4 | 42.6 | 49.2 | NA | 41.2 |
| 1991 | 64 | 69.5 | 42.7 | 51.3 | NA | 39 |
| 1992 | 64.1 | 69.6 | 42.6 | 52.5 | NA | 39.9 |
| 1993 | 64.1 | 70.2 | 42 | 50.6 | NA | 39.4 |
| 1994 | 64 | 70 | 42.5 | 50.8 | NA | 41.2 |
| 1995 | 64.7 | 70.9 | 42.9 | 51.5 | NA | 42 |
| 1996 | 65.4 | 71.7 | 44.5 | 51.5 | NA | 42.8 |
| 1997 | 65.7 | 72 | 45.4 | 53.3 | NA | 43.3 |
| 1998 | 66.3 | 72.6 | 46.1 | 53.7 | NA | 44.7 |
| 1999 | 66.8 | 73.2 | 46.7 | 54.1 | NA | 45.5 |
| 2000 | 67.4 | 73.8 | 47.6 | 53.9 | NA | 46.3 |
| 2001 | 67.8 | 74.3 | 48.4 | 54.7 | NA | 47.3 |
| 2002 | 67.9 | 74.7 | 48.2 | 55 | NA | 47 |
| 2003 | 68.3 | 75.4 | 48.8 | 56.7 | 58 | 46.7 |
| 2004 | 69 | 76 | 49.7 | 59.6 | 60.4 | 48.1 |
| 2005 | 68.9 | 75.8 | 48.8 | 60.4 | 59.8 | 49.5 |
| 2006 | 68.8 | 75.8 | 48.4 | 61.1 | 59.9 | 49.7 |
| 2007 | 68.1 | 75.2 | 47.8 | 60.3 | 59 | 49.7 |

[12] *Id.*

[13] Subprime mortgage originated in 2005, 2006 and 2007 had successively worse default experiences than vintages in prior years. *See* Freddie Mac, *Freddie Mac Update* 19 (December 2008), available at *www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.*

[14] *See* Jesse M. Abraham, Andrey Pavlov & Susan Wachter, *Explaining the United States' Uniquely Bad Housing Market,* XII WHARTON REAL ESTATE REV. 24 (2008).

The explosion of nontraditional mortgage lending was timed to maintain securitization deal flows after traditional refinancings weakened in 2003. The major take-off in these products occurred in 2002, which coincided with the winding down of the huge increase in demand for mortgage securities through the refinance process. Coming out of the recession of 2001, interest rates fell and there was a massive securitization boom through refinancing that was fueled by low interest rates. The private-label securitization industry had grown in capacity and profits.

But in 2003, rising interest rates ended the potential for refinancing at ever lower interest rates, leading to an increased need for another source of mortgages to maintain and grow the rate of securitization and the fees it generated. The "solution" was the expansion of the market through nontraditional mortgages, especially interest-only loans and option payment ARMs offering negative amortization. (*See* Figure 1 *supra*). This expansion of credit swept a larger portion of the population into the potential homeowner pool, driving up housing demand and prices, and consumer indebtedness. Indeed, consumer indebtedness grew so rapidly that between 1975 and 2007, total household debt soared from around 43 percent to nearly 100 percent of gross domestic product.[15]

The growth in nonprime mortgages was accomplished through market expansion of nontraditional mortgages and by qualifying more borrowing through easing of traditional lending terms. For example, while subprime mortgages were initially made as "hard money" loans with low loan-to-value ratios, by the height of their growth, combined loan-to-value ratios exceeded that of the far less risky prime market. (*See* Figure 3 *supra*). While the demand for riskier mortgages grew fueled by the need for product to securitize, the potential risk due to deteriorating lending standards also grew.

**B. Consumer Confusion**

If borrowers had been able to distinguish safe loans from highly risky loans, risky loans would not have crowded out the market. But numerous borrowers were not able to do so, for three distinct reasons. First, hybrid subprime ARMs, interest-only mortgages, and option payment ARMs were baffling in their complexity. Second, it was impossible to obtain binding price quotes early enough to permit meaningful comparison shopping in the nonprime market. Finally, borrowers usually did not know that mortgage brokers got higher compensation for steering them into risky loans.

*Hidden Risks*—The arcane nature of hybrid ARMs, interest-only loans, and option payment ARMs often made informed consumer choice impossible. These products were highly complex instruments that presented an assortment of hidden risks to borrowers. Chief among those risks was payment shock—in other words, the risk that monthly payments would rise dramatically upon rate reset. These products presented greater potential payment shock than conventional ARMs, which had lower reset rates and manageable lifetime caps. Indeed, with these exotic ARMs, the only way interest rates could go *was* up. Many late vintage subprime hybrid ARMs had initial rate resets of 3 percentage points, resulting in increased monthly payments of 50 percent to 100 percent or more.[16]

For a borrower to grasp the potential payment shock on a hybrid, interest-only, or option payment ARM, he or she would need to understand all the moving parts of the mortgage, including the index, rate spread, initial rate cap, and lifetime rate cap. On top of that, the borrower would need to predict future interest rate movements and translate expected rate changes into changes in monthly payments. Interest-only ARMs and option payment ARMs had the added complication of potential deferred or negative amortization, which could cause the principal payments to grow. Finally, these loans were more likely to carry large prepayment penalties. To understand the effect of such a prepayment penalty, the borrower would have to use a formula to compute the penalty's size and then assess the likelihood of moving

[15] U.S. Federal Reserve Board, Bureau of Economic Analysis.

[16] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, *www.fdic.gov/news/news/speeches/chairman/spjan3108.html.*

or refinancing during the penalty period.[17] Truth-in-Lending Act disclosures did not require easy-to-understand disclosures about any of these risks.[18]

*Inability to Do Meaningful Comparison Shopping*—The lack of binding rate quotes also hindered informed comparison-shopping in the nonprime market. Nonprime loans had many rates, not one, which varied according to the borrower's risk, the originator's compensation, the documentation level of the loan, and the naivety of the borrower. Between their complicated price structure and the wide variety of products, subprime loans were not standardized. Furthermore, it was impossible to obtain a binding price quote in the subprime market before submitting a loan application and paying a non-refundable fee. Rate locks were also a rarity in the subprime market. In too many cases, subprime lenders waited until the closing to unveil the true product and price for the loan, a practice that the Truth in Lending Act rules countenanced. These rules, promulgated by the Federal Reserve Board, helped foster rampant "bait-and-switch" schemes in the subprime market.[19]

As a result, deceptive advertising became a stock-in-trade of the nonprime market. Nonprime lenders and brokers did not advertise their prices to permit meaningful comparison-shopping. To the contrary, lenders treated their rate sheets—which listed their price points and pricing criteria—as proprietary secrets that were not to be disclosed to the mass consumer market. Subprime advertisements generally focused on fast approval and low initial monthly payments or interest rates, not on accurate prices.

While the Federal Reserve exhorted people to comparison-shop for nonprime loans,[20] in reality, comparison-shopping was futile. Nonprime lenders did not post prices, did not provide consumers with firm price quotes, and did not offer lock-in commitments as a general rule. Anyone who attempted to comparison-shop had to pay multiple application fees for the privilege and, even then, might not learn the actual price until the closing if the lender engaged in a bait-and-switch.

As early as 1998, the Federal Reserve Board and the Department of Housing and Urban Development were aware that Truth in Lending Act disclosures did not come early enough in the nonprime market to allow meaningful comparison shopping. That year, the two agencies issued a report diagnosing the problem. In the report, HUD recommended changes to the Truth in Lending Act to require mortgage originators to provide binding price quotes before taking loan applications. The Federal Reserve Board dissented from the proposal, however, and it was never adopted.[21] To this day, the Board has still not revamped Truth in Lending disclosures for closed-end mortgages.

*Perverse Fee Incentives*—Finally, many consumers were not aware that the compensation structure rewarded mortgage brokers for riskier loan products and higher interest rates. Mortgage brokers only got paid if they closed a loan. Furthermore, they were paid solely through upfront fees at closing, meaning that if a loan went bad, the losses would fall on the lender or investors, not the broker. In the most pernicious practice, lenders paid brokers thousands of dollars per loan in fees known as yield spread premiums (or YSPs) in exchange for loans saddling borrowers with steep prepayment penalties and higher interest rates than the borrowers qualified for, based on their incomes and credit scores.

In sum, these three features—the ability to hide risk, thwart meaningful comparison-shopping, and reward steering—allowed lenders to entice unsuspecting borrowers into needlessly hazardous loans.

### C. The Crowd-Out Effect

The ability to bury risky product features in fine print allowed irresponsible lenders to out-compete safe lenders. Low initial monthly payments were the most visible feature of hybrid ARMs, interest-only loans, and option payment ARMs. During the

---

[17] Federal Reserve System, *Truth in Lending, Part III: Final rule, official staff commentary,* 73 Fed. Reg. 44522, 44524–25 (July 30, 2008); Federal Reserve System, *Truth in Lending, Part II: Proposed rule; request for public comment,* 73 Fed. Reg. 1672, 1674 (January 9, 2008).

[18] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing,* 44 HARV. J. LEGIS. 123 (2007), available at *http://www.law.harvard.edu/students/orgs/jol/vol44_1/mccoy.pdf.*

[19] *Id.;* Federal Reserve System, Truth in Lending—Proposed rule; request for public comment, 73 Fed. Reg. 1672, 1675 (Jan. 9, 2008).

[20] *See, e.g.,* Federal Reserve Board, Looking for the Best Mortgage, *www.federalreserve.gov/pubs/mortgage/mortb_11.htm.*

[21] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS. & DEP'T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS, CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, at 28–29, 39–42 (1998), available at *www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.*

housing boom, lenders commonly touted these products based on low initial monthly payments while obscuring the back-end risks of those loans.[22]

The ability to hide risks made it easy to out-compete lenders offered fixed-rate, fully amortizing loans. Other things being equal, the initial monthly payments on exotic ARMs were lower than on fixed-rate, amortizing loans. Furthermore, some nonprime lenders qualified borrowers solely at the low initial rate alone until the Federal Reserve Board finally banned that practice in July 2008.[23]

Of course, many sophisticated customers recognized the dangers of these loans. That did not deter lenders from offering hazardous nontraditional ARMs, however. Instead, the "one-sizefits-one" nature of nonprime loans permitted lenders to discriminate by selling safer products to discerning customers and more lucrative, dangerous products to naive customers. Sadly, the consumers who were least well equipped in terms of experience and education to grasp arcane loan terms[24] ended up with the most dangerous loans.

In the meantime, lenders who offered safe products—such as fixed-rate prime loans—lost market share to lenders who peddled exotic ARMs with low starting payments. As conventional lenders came to realize that it didn't pay to compete on good products, those lenders expanded into the nonprime market as well.

### II. The Regulatory Story: Race to the Bottom

Federal banking regulators added fuel to the crisis by allowing reckless loans to flourish. It is a basic tenet of banking law that banks should not extend credit without proof of ability to repay. Federal banking regulators[25] had ample authority to enforce this tenet through safety and soundness supervision and through Federal consumer protection laws. Nevertheless, they refused to exercise their substantial powers of rulemaking, formal enforcement, and sanctions to crack down on the proliferation of poorly underwritten loans until it was too late. Their abdication allowed irresponsible loans to multiply. Furthermore, their green light to banks to invest in investment-grade subprime mortgage-backed securities and CDOs left the nation's largest banks struggling with toxic assets. These problems were a direct result of the country's fragmented system of financial regulation, which caused regulators to compete for turf.

### A. The Fragmented U.S. System of Mortgage Regulation

In the United States, the home mortgage lending industry operates under a fragmented regulatory structure which varies according to entity.[26] Banks and thrift institutions are regulated under Federal banking laws and a subset of those institutions—namely, national banks, Federal savings associations, and their subsidiaries—are exempt from State anti-predatory lending and credit laws by virtue of Federal preemption. In contrast, mortgage brokers and independent non-depository mortgage lenders escape Federal banking regulation but have to comply with all State laws in effect. Only State-chartered banks and thrifts in some states (a dwindling group) are subject to both sets of laws.

Under this dual system of regulation, depository institutions are subject to a variety of Federal examinations, including fair lending, Community Reinvestment Act, and safety and soundness examinations, but independent nondepository lenders are not. Similarly, banks and thrifts must comply with other provisions of the Community Reinvestment Act, including reporting requirements and merger review. Federally insured depository institutions must also meet minimum risk-based capital re-

---

[22] *See, e.g.,* Julie Haviv & Emily Kaiser, *Web lenders woo subprime borrowers despite crisis,* REUTERS (Apr. 22, 2007); E. Scott Reckard, Refinance pitches in sub-prime tone, LOS ANGELES TIMES, October 29, 2007.

[23] In fall 2006, Federal regulators issued an interagency guidance advising option ARM lenders to qualify borrowers solely at the fully indexed rate. Nevertheless, Washington Mutual (WaMu) apparently continued to qualify applicants for option ARMs at the low, introductory rate alone until mid-2007. It was not until July 30, 2007 that WaMu finally updated its "Bulk Seller Guide" to require its correspondents to underwrite option ARMs and other ARMs at the fully indexed rate.

[24] Howard Lax, Michael Manti, Paul Raca & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency,* 15 HOUSING POL'Y DEBATE 533, 552–554 (2004), *http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Lax.pdf.*

[25] The four Federal banking regulators include the Federal Reserve System, which serves as the central bank and supervises State member banks; the Office of the Comptroller of the Currency, which oversees national banks; the Federal Deposit Insurance Corporation, which operates the Deposit Insurance Fund and regulates State nonmember banks; and the Office of Thrift Supervision, which supervises savings associations.

[26] This discussion is drawn from Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending,* in BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 110 (Nicolas P. Retsinas & Eric S. Belsky eds., Joint Center for Housing Studies of Harvard University & Brookings Institution Press, 2008).

quirements and reserve requirements, unlike their independent non-depository counterparts.

Some Federal laws applied to all mortgage originators. Otherwise, lenders could change their charter and form to shop for the friendliest regulatory scheme.

**B. Applicable Law**

Despite these differences in regulatory regimes, the Federal Reserve Board did have the power to prohibit reckless mortgages across the entire mortgage industry. The Board had this power by virtue of its authority to administer a Federal anti-predatory lending law known as "HOEPA."

**1. Federal Law**

Following deregulation of home mortgages in the early 1980's, disclosure became the most important type of Federal mortgage regulation. The Federal Truth in Lending Act (TILA),[27] passed in 1968, mandates uniform disclosures regarding cost for home loans. Its companion law, the Federal Real Estate Settlement Procedures Act of 1974 (RESPA),[28] requires similar standardized disclosures for settlement costs. Congress charged the Federal Reserve with administering TILA and the Department of Housing and Urban Development with administering RESPA.

In 1994, Congress augmented TILA and RESPA by enacting the Home Ownership and Equity Protection Act (HOEPA).[29] HOEPA was an early Federal anti-predatory lending law and prohibits specific abuses in the subprime mortgage market. HOEPA applies to all residential mortgage lenders and mortgage brokers, regardless of the type of entity.

HOEPA has two important provisions. The first consists of HOEPA's high-cost loan provision,[30] which regulates the high-cost refinance market. This provision seeks to eliminate abuses consisting of "equity stripping." It is hobbled, however, by its extremely limited reach—covering only the most exorbitant subprime mortgages—and its inapplicability to home purchase loans, reverse mortgages, and open-end home equity lines of credit.[31] Lenders learned to evade the high-cost loan provisions rather easily by slightly lowering the interest rates and fees on subprime loans below HOEPA's thresholds and by expanding into subprime purchase loans.

HOEPA also has a second major provision, which gives the Federal Reserve Board the authority to prohibit unfair or deceptive lending practices and refinance loans involving practices that are abusive or against the interest of the borrower.[32] This provision is potentially broader than the high-cost loan provision, because it allows regulation of both the purchase and refinance markets, without regard to interest rates or fees. However, it was not self-activating. Instead, it depended on action by the Federal Reserve Board to implement the provision, which the Board did not take until July 2008.

**2. State Law**

Before 2008, only the high-cost loan provision of HOEPA was in effect as a practical matter. This provision had a serious Achilles heel, consisting of its narrow coverage. Even though the Federal Reserve Board lowered the high-cost triggers of HOEPA effective in 2002, that provision still only applied to 1 percent of all subprime home loans.[33]

After 1994, it increasingly became evident that HOEPA was incapable of halting equity stripping and other sorts of subprime abuses. By the late 1990s, some cities and states were contending with rising foreclosures and some jurisdictions were contemplating regulating subprime loans on their own. Many states already had older statutes on the books regulating prepayment penalties and occasionally balloon clauses. These laws were relatively narrow, however, and did not address other types of new abuses that were surfacing in subprime loans.

Consequently, in 1999, North Carolina became the first State to enact a comprehensive anti-predatory lending law.[34] Soon, other states followed suit and passed anti-predatory lending laws of their own. These newer State laws implemented HOEPA's design but frequently expanded coverage or imposed stricter regulation on subprime loans. By year-end 2005, 29 States and the District of Columbia had en-

---

[27] 15 U.S.C. §§ 1601–1693r (2000).

[28] 12 U.S.C. §§ 2601–2617 (2000).

[29] 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b).

[30] 15 U.S.C. § 1602(aa)(1)–(4); 12 C.F.R. § 226.32(a)(1), (b)(1).

[31] 15 U.S.C. § 1602(i), (w), (bb); 12 C.F.R. § 226.32(a)(2) (1997); EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).

[32] 15 U.S.C. § 1639(*l*)(2).

[33] Gramlich, *supra* note 31 (2007, p. 28).

[34] N.C. GEN STAT. § 24–1.1E (2000).

acted one of these "mini-HOEPA" laws. Some States also passed stricter disclosure laws or laws regulating mortgage brokers. By the end of 2005, only six States—Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota—lacked laws regulating prepayment penalties, balloon clauses, or mandatory arbitration clauses, all of which were associated with exploitative subprime loans.[35]

Critics, including some Federal banking regulators, have blamed the states for igniting the credit crisis through lax regulation. Certainly, there were states that were largely unregulated and there were states where mortgage regulation was weak. Mortgage brokers were loosely regulated in too many states. Similarly, the states never agreed on an effective, uniform system of mortgage regulation.

Nevertheless, this criticism of the states disregards the hard-fought efforts by a growing number of states—which eventually grew to include the majority of states—to regulate abusive subprime loans within their borders. State attorneys general and State banking commissioners spearheaded some of the most important enforcement actions against deceptive mortgage lenders.[36]

**C. The Ability to Shop For Hospitable Laws and Regulators**

State-chartered banks and thrifts and their subsidiaries had to comply with the State anti-predatory lending laws. So did independent nonbank lenders and mortgage brokers. For the better part of the housing boom, however, national banks, Federal savings associations, and their mortgage lending subsidiaries did not have to comply with the State anti-predatory lending laws due to Federal preemption rulings by their Federal regulators. This became a problem because Federal regulators did not replace the preempted State laws with strong Federal underwriting rules.

**1. Federal Preemption**

The states that enacted anti-predatory lending laws did not legislate in a vacuum. In 1996, the Federal regulator for thrift institutions—the Office of Thrift Supervision or OTS—promulgated a sweeping preemption rule declaring that henceforth Federal savings associations did not have to observe State lending laws.[37] Initially, this rule had little practical effect because any State anti-predatory lending provisions on the books then were fairly narrow.[38]

Following adoption of the OTS preemption rule, Federal thrift institutions and their subsidiaries were relieved from having to comply with State consumer protection laws. That was not true, however, for national banks, State banks, State thrifts, and independent nonbank mortgage lenders and brokers.

The stakes rose considerably starting in 1999, when North Carolina passed the first comprehensive State anti-predatory lending law. As State mini-HOEPA laws proliferated, national banks lobbied their regulator—a Federal agency known as the Office of the Comptroller of the Currency or OCC—to clothe them with the same Federal preemption as Federal savings associations. They succeeded and, in 2004, the OCC issued its own preemption rule banning the states from enforcing their laws impinging on real estate lending by national banks and their subsidiaries.[39] In a companion rule, the OCC denied permission to the states to enforce their own laws that were *not* federally preempted—state lending discrimination laws are one example—against national banks and their subsidiaries. After a protracted court

---

[35] *See* Raphael Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan Wachter, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms,* 60 J. ECON. & BUS. 47–66 (2008), full working paper version available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005423.*

[36] For instance, in 2002, State authorities in 44 states struck a settlement with Household Finance Corp. for $484 million in consumer restitution and changes in its lending practices following enforcement actions to redress alleged abusive subprime loans. Iowa Attorney General, *States Settle With Household Finance: Up to $484 Million for Consumers* (Oct. 11, 2002), available at *www.iowa.gov/government/ag/latest_news/releases/oct_2002/Household_Chicago.html.* In 2006, forty-nine states and the District of Columbia reached a $325 million settlement with Ameriquest Mortgage Company over alleged predatory lending practices. *See, e.g.,* Press Release, Iowa Dep't of Justice, Miller: Ameriquest Will Pay $325 Million and Reform its Lending Practices (Jan. 23, 2006), available at *http://www.state.ia.us/government/ag/latest_news/releases/jan_2006/Ameriquest_Iowa.html.*

[37] 12 C.F.R. §§ 559.3(h), 560.2.

[38] Bostic *et al., supra* note 35; Office of Thrift Supervision, *Responsible Alternative Mortgage Lending: Advance notice of proposed rulemaking,* 65 Fed. Reg. 17811, 17814–16 (2000).

[39] Office of the Comptroller of the Currency, *Bank Activities and Operations; Final rule,* 69 FED. REG. 1895 (2004) (codified at 12 C.F.R. § 7.4000); Office of the Comptroller of the Currency, *Bank Activities and Operations; Real Estate Lending and Appraisals; Final rule,* 69 FED. REG. 1904 (2004) (codified at 12 C.F.R. §§ 7.4007–7.4009, 34.4). National City Corporation, the parent of National City Bank, N.A., and a major subprime lender, spearheaded the campaign for OCC preemption. *Predatory lending laws neutered,* ATLANTA JOURNAL CONSTITUTION, Aug. 6, 2003.

battle, the controversy ended up in the U.S. Supreme Court, which upheld the OCC preemption rule.[40]

OTS and the OCC had institutional motives to grant Federal preemption to the institutions that they regulated. Both agencies depend almost exclusively on fees from their regulated entities for their operating budgets. Both were also eager to persuade State-chartered depository institutions to convert to a Federal charter. In addition, the OCC was aware that if national banks wanted Federal preemption badly enough, they might defect to the thrift charter to get it. Thus, the OCC had reason to placate national banks to keep them in its fold. Similarly, the OTS was concerned about the steady decline in thrift institutions. Federal preemption provided an inducement to thrift institutions to retain the Federal savings association charter.

**2. The Ability to Shop for the Most Permissive Laws**

As a result of Federal preemption, State anti-predatory lending laws applied to State-chartered depository institutions and independent nonbank lenders, but not to national banks, Federal savings associations, or their mortgage lending subsidiaries. The only anti-predatory lending provisions that national banks and federally chartered thrifts had to obey were HOEPA and agency pronouncements on subprime and nontraditional mortgage loans.[41] Of these, HOEPA had extremely narrow scope. Meanwhile, agency guidances lacked the binding effect of rules and their content was not as strict as the stronger State laws.

This dual regulatory system allowed mortgage lender to play regulators off one another by threatening to change charters. Mortgage lenders are free to operate with or without depository institution charters. Similarly, depository institutions can choose between a State and Federal charter and between a thrift charter and a commercial bank charter. Each of these choices allows a lender to change regulators.

A lender could escape a strict State law by switching to a Federal bank or thrift charter or by shifting its operations to a less regulated State. Similarly, a lender could escape a strict regulator by converting its charter to one with a more accommodating regulator.

Countrywide, the nation's largest mortgage lender and a major subprime presence, took advantage of this system to change its regulator. One of its subsidiaries, Countrywide Home Loans, was supervised by the Federal Reserve. This subsidiary switched and became an OTS-regulated entity as of March 2007. That same month, Countrywide Bank, N.A., converted its charter from a national bank charter under OCC supervision to a Federal thrift charter under OTS supervision. Reportedly, OTS promised Countrywide's executives to be a "less antagonistic" regulator if Countrywide switched charters to OTS. Six months later, the regional deputy director of the OTS West Region, where Countrywide was headquartered, was promoted to division director. Some observers considered it a reward.[42]

The result was a system in which lenders could shop for the loosest laws and enforcement. This shopping process, in turn, put pressure on regulators at all levels—

[40] Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007); Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System,* 23 ANN. REV. BANKING & FINANCE LAW 225 (2004). The Supreme Court recently granted certiorari to review the legality of the OCC visitorial powers rule. Cuomo v. Clearing House Ass'n, L.L.C.,____U.S.____, 129 S. Ct. 987 (2009).

The OCC and the OTS left some areas of State law untouched, namely, State criminal law and State law regulating contracts, torts, homestead rights, debt collection, property, taxation, and zoning. Both agencies, though, reserved the right to declare that any State laws in those areas are preempted in the future. For fuller discussion, see. McCoy & Renuart, *supra* note 26.

[41] Board of Governors of the Federal Reserve System *et al.,* Interagency Guidance on Subprime Lending (March 1, 1999); OCC, Abusive Lending Practices, Advisory Letter 2000–7 (July 25, 2000); OCC *et al.,* Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001); OCC, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans, Advisory Letter 2003–3 (Feb. 21, 2003); OCC, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, Advisory Letter 2003–2 (Feb. 21, 2003); OCC, OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices, 70 Fed. Reg. 6329 (2005); Department of the Treasury *et al.,* Interagency Guidance on Nontraditional Mortgage Product Risks; Final guidance, 71 Fed. Reg. 58609 (2006); Department of the Treasury *et al.,* Statement on Subprime Mortgage Lending; Final guidance, 72 Fed. Reg. 37569 (2007). Of course, these lenders, like all lenders, are subject to prosecution in cases of fraud. Lenders are also subject to the Federal Trade Commission Act, which prohibits unfair and deceptive acts and practices (UDAPs). However, Federal banking regulators were slow to propose rules to define and punish UDAP violations by banking companies in the mortgage lending area.

[42] Richard B. Schmitt, *Regulator takes heat over IndyMac,* LOS ANGELES TIMES, Oct. 6, 2008; see also Binyamin Appelbaum & Ellen Nakashima, *Regulator Played Advocate Over Enforcer,* WASHINGTON POST, November 23, 2008.

state and local—to lower their standards or relax enforcement. What ensued was a regulatory race to the bottom.

**III. Regulatory Failure**

Federal preemption would not have been such a problem if Federal banking regulators had replaced State laws with tough rules and enforcement of their own. Those regulators had ample power to stop the deterioration in mortgage underwriting standards that mushroomed into a full-blown crisis. However, they refused to intervene in disastrous lending practices until it was too late. As a result, federally regulated lenders—as well as all lenders operating in states with weak regulation—were given *carte blanche* to loosen their lending standards free from meaningful regulatory intervention.

**A. The Federal Reserve Board**

The Federal Reserve Board had the statutory power, starting in 1994, to curb lax lending not only for depository institutions, but for all lenders across-the-board. It declined to exercise that power in any meaningful respect, however, until after the nonprime mortgage market collapsed.

In the mortgage lending area, the Fed's supervisory process has three major parts and breakdowns were apparent in two out of the three. The only part that appeared to work well was the Fed's role as the primary Federal regulator for State-chartered banks that are members of the Federal Reserve System.[43]

As the second part of its supervisory duties, the Fed regulates nonbank mortgage lenders owned by bank holding companies but not owned directly or indirectly by banks or thrifts. During the housing boom, some of the largest subprime and Alt-A lenders were regulated by the Fed, including the top- and third-ranked subprime lenders in 2006, HSBC Finance and Countrywide Financial Corporation, and Wells Fargo Financial, Inc.[44] The Fed's supervisory record with regard to these lenders was mixed. On one notable occasion, in 2004, the Fed levied a $70 million civil money penalty against CitiFinancial Credit Company and its parent holding company, Citigroup Inc., for subprime lending abuses.[45] Apart from that, the Fed did not take public enforcement action against the nonbank lenders that it regulated. That may be because the Federal Reserve did not routinely examine the nonbank mortgage lending subsidiaries under its supervision, which the late Federal Reserve Board Governor Edward Gramlich revealed in 2007. Only then did the Fed kick off a "pilot project" to examine the nonbank lenders under its jurisdiction on a routine basis for loose underwriting and compliance with Federal consumer protection laws.[46]

Finally, the Board is responsible for administering most Federal consumer credit protection laws, including HOEPA. When former Governor Edward Gramlich served on the Fed, he urged then-Chairman Alan Greenspan to exercise the Fed's power to address unfair and deceptive loans under HOEPA. Greenspan refused, preferring instead to rely on non-binding statements and guidances.[47] This reliance on state-

[43] In general, these are community banks on the small side. In 2007 and 2008, only one failed bank—the tiny First Georgia Community Bank in Jackson, Georgia, with only $237.5 million in assets—was regulated by the Federal Reserve System. It is not clear whether the Fed's performance is explained by the strength of its examination process, the limited role of member banks in risky lending, the fact that State banks had to comply with State anti-predatory lending laws, or all three.

In the following discussion on regulatory failure by the Federal Reserve Board, the OTS, and the OCC, the data regarding failed and near-failed banks and thrifts come from Federal bank regulatory and S.E.C. statistics, disclosures, press releases, and orders; rating agency reports; press releases and other web materials by the companies mentioned; statistics compiled by the *American Banker;* and financial press reports.

[44] Data provided by *American Banker,* available at *www.americanbanker.com.*

[45] Federal Reserve, Citigroup Inc. New York, New York and Citifinancial Credit Company Baltimore, Maryland: Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent, May 27, 2004.

[46] Edward M. Gramlich, Boom and Busts, The Case of Subprime Mortgages, Speech given August 31, 2007, Jackson Hole, Wyo., at symposium titled "Housing, Housing Finance & Monetary Policy," sponsored by the Federal Reserve Bank of Kansas City, pp. 8–9, available at *www.kansascityfed.org/publicat/sympos/2007/pdf/2007.09.04.gramlich.pdf;* Speech by Governor Randall S. Kroszner At the National Bankers Association 80th Annual convention, Durham, North Carolina, October 11, 2007.

[47] House of Representatives, Committee on Oversight and Government Reform, "The Financial Crisis and the Role of Federal Regulators, Preliminary Transcript" 35, 37–38 (Oct. 23, 2008), available at *http://oversight.house.gov/documents/20081024163819.pdf.* Greenspan told the House Oversight Committee in 2008:

> Well, let's take the issue of unfair and deceptive practices, which is a fundamental concept

Continued

ments and guidances had two disadvantages: one, major lenders routinely dismissed the guidances as mere "suggestions" and, two, guidances did not apply to independent nonbank mortgage lenders.

The Federal Reserve did not relent until July 2008, when under Chairman Ben Bernanke's leadership, it finally promulgated binding HOEPA regulations banning specific types of lax and abusive loans. Even then, the regulations were mostly limited to higher-priced mortgages, which the Board confined to first-lien loans of 1.5 percentage points or more above the average prime offer rate for a comparable transaction, and 3.5 percentage points for second-lien loans. Although shoddy nontraditional mortgages below those triggers had also contributed to the credit crisis, the rule left those loans—plus prime loans—mostly untouched.[48]

The rules, while badly needed, were too little and too late. On October 23, 2008, in testimony before the U.S. House of Representatives Oversight Committee, Greenspan admitted that "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief." House Oversight Committee Chairman Henry Waxman asked Greenspan whether "your ideology pushed you to make decisions that you wish you had not made?" Greenspan replied:[49]

> Mr. GREENSPAN. . . . [Y]es, I found a flaw, I don't know how significant or permanent it is, but I have been very distressed by that fact . . .
> Chairman WAXMAN. You found a flaw?
>
> Mr. GREENSPAN. I found a flaw in the model that defines how the world works, so to speak.
>
> Chairman WAXMAN. In other words, you found that your view of the world, your ideology, was not right, it was not working.
>
> Mr. GREENSPAN. Precisely. That's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well.[50]

**B. Regulatory Lapses by the OCC and OTS**

Federal preemption might not have devolved into a banking crisis of systemic proportions had OTS and the OCC replaced State regulation for their regulated entities with a comprehensive set of binding rules prohibiting lax underwriting of home mortgages. Generally, in lieu of binding rules, Federal banking regulators, including the OCC and OTS, issued a series of "soft law" advisory letters and guidelines against predatory or unfair mortgage lending practices by insured depository institutions.[51] Federal regulators disavowed binding rules during the run-up to the subprime crisis on grounds that the guidelines were more flexible and that the agencies enforced those guidelines through bank examinations and informal enforcement actions.[52] Informal enforcement actions were usually limited to negotiated, voluntary agreements between regulators and the entities that they supervised, which made it easy for management to drag out negotiations to soften any restrictions and to bid for more time. Furthermore, examinations and informal enforcement are highly confidential, making it easy for a lax regulator to hide its tracks.

**1. The Office of Thrift Supervision**

Although OTS was the first agency to adopt Federal preemption, it managed to fly under the radar during the subprime boom, overshadowed by its larger sister agency, the OCC. After 2003, while commentators were busy berating the OCC pre-

---

> to the whole predatory lending issue.
>
> The staff of the Federal Reserve . . . say[ ] how do they determine as a regulatory group what is unfair and deceptive? And the problem that they were concluding . . . was the issue of maybe 10 percent or so are self-evidently unfair and deceptive, but the vast majority would require a jury trial or other means to deal with it . . .

*Id.* at 89.

[48] Federal Reserve System, *Truth in Lending: Final rule; official staff commentary,* 73 FED. REG. 44522, 44536 (July 30, 2008). The Board set those triggers with the intention of covering the subprime market, but not the prime market. *See id.* at 44536–37.

[49] House of Representatives, Committee on Oversight and Government Reform, "The Financial Crisis and the Role of Federal Regulators, Preliminary Transcript" 36–37 (Oct. 23, 2008), available at *http://oversight.house.gov/documents/20081024163819.pdf.*

[50] Testimony of Dr. Alan Greenspan before the House of Representatives Committee of Government Oversight and Reform, October 23, 2008, available at *http://oversight.house.gov/documents/20081023100438.pdf.*

[51] *See* note 41 *supra.*

[52] Office of the Comptroller of the Currency, *Bank Activities and Operations; Real Estate Lending and Appraisals; Final rule,* 69 FED. REG. 1904 (2004).

emption rule, OTS allowed the largest Federal savings associations to embark on an aggressive campaign of expansion through option payment ARMs, subprime loans, and low-documentation and no-documentation loans.

Autopsies of failed depository institutions in 2007 and 2008 show that five of the seven biggest failures were OTS-regulated thrifts. Two other enormous thrifts during that period—Wachovia Mortgage, FSB and Countrywide Bank, FSB—were forced to arrange hasty takeovers by large bank holding companies to avoid failing. By December 31, 2008, thrifts totaling $355 billion in assets had failed in the previous sixteen months on OTS' watch.

The reasons for the collapse of these thrifts evidence fundamental regulatory lapses by OTS. Almost all of the thrifts that failed in 2007 and 2008—and all of the larger ones—succumbed to massive levels of imprudent home loans. IndyMac Bank, FSB, which became the first major thrift institution to fail during the current crisis in July 2008, manufactured its demise by becoming the nation's top originator of low-documentation and no-documentation loans. These loans, which became known as "liar's loans," infected both the subprime market and credit to borrowers with higher credit scores. By 2006 and 2007, over half of IndyMac's home purchase loans were subprime loans and IndyMac Bank approved up to half of those loans based on low or no documentation.

Washington Mutual Bank, popularly known as "WaMu," was the nation's largest thrift institution in 2008, with over $300 billion in assets. WaMu became the biggest U.S. depository institution in history to fail on September 25, 2008, in the wake of the Lehman Brothers bankruptcy. WaMu was so large that OTS examiners were stationed there permanently onsite. Nevertheless, from 2004 through 2006, despite the daily presence of the resident OTS inspectors, risky option ARMs, second mortgages, and subprime loans constituted over half of WaMu's real estate loans each year. By June 30, 2008, over one fourth of the subprime loans that WaMu originated in 2006 and 2007 were at least thirty days past due. Eventually, it came to light that WaMu's management had pressured its loan underwriters relentlessly to approve more and more exceptions to WaMu's underwriting standards in order to increase its fee revenue from loans.[53]

Downey Savings & Loan became the third largest depository institution to fail in 2008. Like WaMu, Downey had loaded up on option ARMs and subprime loans. When OTS finally had to put it into receivership, over half of Downey's total assets consisted of option ARMs and nonperforming loans accounted for over 15 percent of the thrift's total assets.

In short, the three largest depository institution failures in 2007 and 2008 resulted from high concentrations of poorly underwritten loans, including low- and no-documentation ARMs (in the case of IndyMac) and option ARMs (in the case of WaMu and Downey) that were often only underwritten to the introductory rate instead of the fully indexed rate. During the housing bubble, OTS issued no binding rules to halt the proliferation by its largest regulated thrifts of option ARMs, subprime loans, and low- and no-documentation mortgages. Instead, OTS relied on oversight through guidances. IndyMac, WaMu, and Downey apparently treated the guidances as solely advisory, however, as evidenced by the fact that all three made substantial numbers of hazardous loans in late 2006 and in 2007 in direct disregard of an interagency guidance on nontraditional mortgages issued in the fall of 2006 and subscribed to by OTS that prescribed underwriting ARMs to the fully indexed rate.[54]

The fact that all three institutions continued to make loans in violation of the guidance suggests that OTS examinations failed to result in enforcement of the guidance. Similarly, OTS fact sheets on the failures of all three institutions show that the agency consistently declined to institute timely formal enforcement proceedings against those thrifts prohibiting the lending practices that resulted in their demise. In sum, OTS supervision of residential mortgage risks was confined to "light touch" regulation in the form of examinations, nonbinding guidances, and occasional informal agreements that ultimately did not work.

**2. The Office of the Comptroller of the Currency**

The OCC has asserted that national banks made only 10 percent of subprime loans in 2006. But this assertion fails to mention that national banks moved aggressively into Alt-A low-documentation and no-documentation loans during the housing

[53] Peter S. Goodman & Gretchen Morgenson, *Saying Yes, WaMu Built Empire on Shaky Loans,* N.Y. TIMES, Dec. 28, 2008.

[54] Department of the Treasury *et al., Interagency Guidance on Nontraditional Mortgage Product Risks; Final guidance,* 71 FED. REG. 58609 (2006).

boom.[55] This mattered a lot, because the biggest national banks are considered "too big to fail" and pose systemic risk on a scale unmatched by independent nonbank lenders. We might not be debating the nationalization of Citibank and Bank of America today had the OCC stopped them from expanding into toxic mortgages, bonds, and SIVs.

Like OTS, "light touch" regulation was apparent at the OCC. Unlike OTS, the OCC did promulgate one rule, in 2004, prohibiting mortgages to borrower who could not afford to repay. However, the rule was vague in design and execution, allowing lax lending to proliferate at national banks and their mortgage lending subsidiaries through 2007.

Despite the 2004 rule, through 2007, large national banks continued to make large quantities of poorly underwritten subprime loans and low- and no-documentation loans. In 2006, for example, fully 62.6 percent of the first-lien home purchase mortgages made by National City Bank, N.A., and its subsidiary, First Franklin Mortgage, were higher-priced subprime loans. Starting in the third quarter of 2007, National City Corporation reported five straight quarters of net losses, largely due to those subprime loans. Just as with WaMu, the Lehman Brothers bankruptcy ignited a silent run by depositors and pushed National City Bank to the brink of collapse. Only a shotgun marriage with PNC Financial Services Group in October 2008 saved the bank from FDIC receivership.

The five largest U.S. banks in 2005 were all national banks and too big to fail. They too made heavy inroads into low- and no-documentation loans. The top-ranked Bank of America, N.A., had a thriving stated-income and no-documentation loan program which it only halted in August 2007, when the market for private-label mortgage-backed securities dried up. Bank of America securitized most of those loans, which may be why the OCC tolerated such lax underwriting practices.

Similarly, in 2006, the OCC overrode public protests about a "substantial volume" of no-documentation loans by JPMorgan Chase Bank, N.A., the second largest bank in 2005, on grounds that the bank had adequate "checks and balances" in place to manage those loans.

Citibank, N.A., was the third largest U.S. bank in 2005. In September 2007, the OCC approved Citibank's purchase of the disreputable subprime lender Argent Mortgage, even though subprime securitizations had slowed to a trickle. Citibank thereupon announced to the press that its new subsidiary—christened "Citi Residential Lending"—would specialize in nonprime loans, including reduced documentation loans. But not long after, by early May 2008 after Bear Stearns narrowly escaped failure, Citibank was forced to admit defeat and dismantle Citi Residential's lending operations.

The fourth largest U.S. bank in 2005, Wachovia Bank, N.A., originated low- and no-documentation loans through its two mortgage subsidiaries. Wachovia Bank originated such large quantities of these loans—termed Alt-A loans—that by the first half of 2007, Wachovia Bank was the twelfth largest Alt-A lender in the country. These loans performed so poorly that between December 31, 2006 and September 30, 2008, the bank's ratio of net write-offs on its closed-end home loans to its total outstanding loans jumped 2400 percent. Concomitantly, the bank's parent company, Wachovia Corporation, was reported its first quarterly loss in years due to rising defaults on option ARMs made by Wachovia Mortgage, FSB, and its Golden West predecessor. Public concern over Wachovia's loan losses triggered a silent run on Wachovia Bank in late September 2008, following Lehman Brothers' failure. To avoid receivership, the FDIC brokered a hasty sale of Wachovia to Wells Fargo after Wells Fargo outbid Citigroup for the privilege.

Wells Fargo Bank, N.A., was in better financial shape than Wachovia, but it too made large quantities of subprime and reduced documentation loans. In 2006, over 23 percent of the bank's first-lien refinance mortgages were high-cost subprime loans. Wells Fargo Bank also securitized substantial numbers of low- and no-documentation mortgages in its Alt-A pools. In 2007, a Wells Fargo prospectus for one of those pools stated that Wells Fargo had relaxed its underwriting standards in mid-2005 and did not verify whether the mortgage brokers who had originated the weakest loans in that loan pool complied with its underwriting standards before closing. Not long after, as of July 25, 2008, 22.77 percent of the loans in that loan pool were past due or in default.

As the Wells Fargo story suggests, the OCC depended on voluntary risk management by national banks, not regulation of loan terms and practices, to contain the risk of improvident loans. A speech by the then-Acting Comptroller, Julie Williams, confirmed as much. In 2005, Comptroller Williams, in a speech to risk managers

[55] Testimony by John C. Dugan, Comptroller, before the Senate Committee on Banking, Housing, and Urban Affairs, March 4, 2008.

at banks, coached them on how to "manage" the risks of no-doc loans through debt collection, higher reserves, and prompt loss recognition. Securitization was another risk management device favored by the OCC.

Three years later, in 2008, the Treasury Department's Inspector General issued a report that was critical of the OCC's supervision of risky loans.[56] Among other things, the Inspector General criticized the OCC for not instituting formal enforcement actions while lending problems were still manageable in size. In his written response to the Inspector General, the Comptroller, John Dugan, conceded that "there were shortcomings in our execution of our supervisory process" and ordered OCC examiners to start initiating formal enforcement actions on a timely basis.[57]

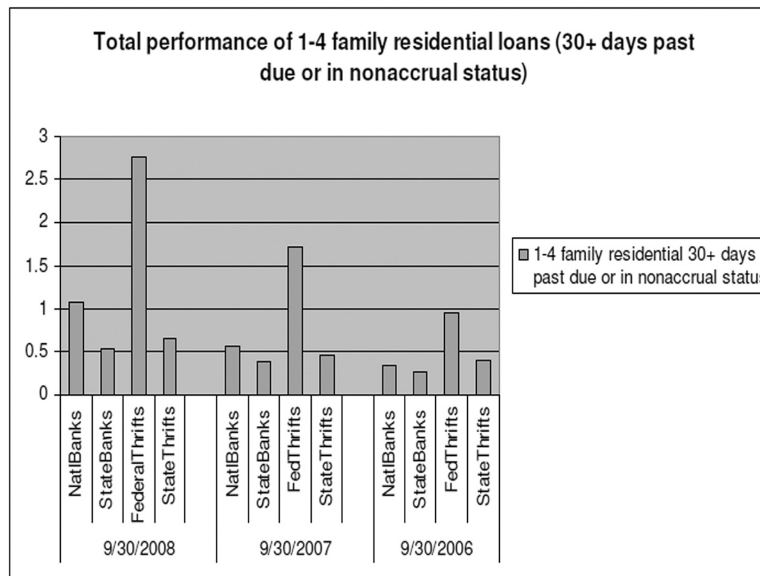
The OCC's record of supervision and enforcement during the subprime boom reveals many of the same problems that culminated in regulatory failure by OTS. Like OTS, the OCC usually shunned formal enforcement actions in favor of examinations and informal enforcement. Neither of these supervisory tools obtained compliance with the OCC's 2004 rule prohibiting loans to borrowers who could not repay. Although the OCC supplemented that rule later on with more detailed guidances, some of the largest national banks and their subsidiaries apparently decided that they could ignore the guidances, judging from their lax lending in late 2006 and in 2007. The OCC's emphasis on managing credit risk through securitization, reserves, and loss recognition, instead of through product regulation, likely encouraged that *laissez faire* attitude by national banks.

**C. Judging by the Results: Loan Performance By Charter**

OCC and OTS regulators have argued that their agencies offer "comprehensive" supervision resulting in lower default rates on residential mortgages. The evidence shows otherwise.

Data from the Federal Deposit Insurance Corporation show that among depository institutions, Federal thrift institutions had the worst default rate for one-to-four family residential mortgages from 2006 through 2008. (*See* Figure 5).

Figure 5. Total Performance of Residential Mortgages by Depository Institution Lenders




Source: FDIC Statistics on Depository Institutions

[56] Office of Inspector General, Department of the Treasury, "Safety and Soundness: Material Loss Review of ANB Financial, National Association" (OIG–09–013, Nov. 25, 2008).
[57] *Id.*

The second-worst performance record among depository institution lenders went to national banks. State thrifts had better default rates than either type of federally chartered institution in 2007 and 2008. State banks consistently had the lowest default rates of all.

Among these charter types, the only ones that enjoy Federal preemption are national banks regulated by the OCC and Federal thrift institutions regulated by the OTS. State banks and State thrift institutions do not. Thus it appears, at least among depository institutions, that Federal preemption was associated with higher default rates, not lower rates, during 2006 through 2008, when credit standards hit bottom and the mortgage market imploded.

These data do not address whether that independent nonbank lenders have even higher default rates in some states and that may in fact be the case. Nevertheless, the data undercut the assertion that Federal preemption reduces default rates among mortgages by depository institution lenders. To the contrary, the lowest default rates were at State banks and thrifts, which are subject both to State and Federal regulation.

**IV. What to Do**

Dual regulation and the resulting crazy quilt of laws encouraged lenders to shop for the lightest rules. In turn, this pressured regulators to weaken their standards and to relax enforcement of safety and soundness and consumer protection laws.

Casting underwriting standards to the wind in a seemingly obscure corner of the consumer credit market ended up triggering a global recession. This crisis shows that the United States ignores consumer protection at its peril. If it was not clear before, we now know that systemic stability and consumer protection are inextricably linked.

To correct the regulatory lapses that I have described, our financial regulatory system needs to adopt three reforms:

- *First,* Congress should adopt uniform minimum safety standards for all providers of consumer credit, regardless of the type of entity or charter.
- *Second,* the authority for administering and enforcing these standards should be housed in one Federal agency whose sole mission is consumer protection.
- *Third,* to avoid the risk of agency inaction, Congress should give parallel enforcement authority to the states and allow consumers to bring private causes of action to recover for injuries they sustain.

I expand on these proposals below.

**A. Uniform Federal Safety Standards For Consumer Credit**

The downward spiral in underwriting standards drove home the need for minimum, uniform consumer credit safety standards. Adopting a uniform Federal floor would prevent lenders and brokers from seeking safe havens in legal regimes that do little or nothing to protect consumers.

The purpose of these uniform Federal standards is three-fold. First, the standards should ensure proper loan underwriting based on the consumer's ability to repay. Second, the standards should prohibit unfair or deceptive practices in consumer credit products and transactions. Finally, the standards should promote transparency through improved consumer disclosures, product simplification and product standardization. Bottom-line, Federal standards should make it possible for consumers to engage in meaningful comparison shopping, with no hidden surprises.

The experience with the high-cost loan provisions of HOEPA reveals that a detailed regulatory statute limited to specific loan terms is not an effective approach. HOEPA has proven too rigid and has failed to address new abuses as they appeared in the mortgage market. Instead, Congress should authorize a broad statutory mandate to give the implementing agency the flexibility to respond promptly to industry innovations (both good and bad) in the consumer credit industry. This broad statutory model would be akin to the open-ended provisions found in Section 5 of the Federal Trade Commission Act and Section 10(b) of the Securities Exchange Act of 1934, instead of the highly detailed prohibitions found in HOEPA. Congress should then delegate broad authority to the implementing agency to promulgate rules—preferably objective ones—to implement the statute.

The uniform standards should constitute a floor, in which weaker State laws are federally preempted. Under the statute, however, states should remain free to enact stricter consumer protections so long as those protections are consistent with the Federal statute.

A minimum Federal floor, instead of a ceiling, is critical for three reasons. First, states are closer to local conditions and often more responsive to emerging problems at home. A Federal floor would preserve the states' ability to protect their citizens.

Second, giving latitude to states to adopt stricter standards would preserve the states' important role as laboratories of experimentation. Finally, a Federal floor, not a ceiling, would provide an important safeguard against the possibility that the implementing agency might adopt weak rules or fail to update the rules.

As part of or in addition to creating the uniform Federal standards just outlined, Congress should transfer the authority to administer other existing Federal consumer credit laws to the implementing agency. At a minimum, oversight for the Truth in Lending Act, HOEPA, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the fair lending laws, the Fair Credit Billing Act, and the Home Mortgage Disclosure Act should be transferred to this agency.[58] Responsibility for administering Section 5 of the Federal Trade Commission Act as it applies to all providers of consumer credit should also be consolidated in this agency.

### B. A Dedicated Federal Agency Whose Sole Mission is Consumer Protection

#### 1. Federal Regulators Cannot Serve Two Masters

The housing bubble and hazardous mortgages by federally regulated depository institutions show that we cannot expect consumer protection to be paramount to Federal banking regulators. Recent history has shown that the safety and soundness mandate of Federal banking regulators regularly eclipses concern for consumer protection. For this reason, the consumer protection function should be removed from Federal banking regulators and housed in its own agency whose sole mission is consumer protection.

The bank regulatory agencies' own mission statements make it clear that consumer protection is a low priority. For example, the Federal Reserve Board divides its duties into four general areas:[59]

- "conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- "supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- "providing financial services to depository institutions, the U.S. Government, and foreign official institutions, including playing a major role in operating the nation's payments system."

In the Fed's description, monetary policy comes first, followed by banking supervision. Consumer protection does not even merit its own bullet point.

Similarly, safety and soundness regulation is the paramount mission of the OCC and OTS. The OCC describes its mission as having four objectives, the last of which is consumer protection:[60]

- "To ensure the safety and soundness of the national banking system.
- "To foster competition by allowing banks to offer new products and services.
- "To improve the efficiency and effectiveness of OCC supervision, including reducing regulatory burden.
- "To ensure fair and equal access to financial services for all Americans."

Like the OCC, OTS describes safety and soundness as its principal job:[61]

> To supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs.

---

[58] This agency should also receive sole responsibility for administering the Consumer Leasing Act, the Right to Financial Privacy Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Women's Business Ownership Act, the Fair Credit and Charge Card Disclosure Act, the Home Equity Loan Consumer Protection Act, the Truth in Savings Act, title V of the Gramm-Leach-Bliley Act, and the Fair and Accurate Credit Transaction Act.

[59] The FEDERAL RESERVE SYSTEM, PURPOSES & FUNCTIONS 1 (9th ed. 2005).

[60] Comptroller of the Currency, *About the OCC* (viewed February 28, 2009), available at *http://www.occ.treas.gov/aboutocc.htm.*

[61] Office of Thrift Supervision, *Mission and Goals* (viewed February 28, 2009), available at *http://www.ots.treas.gov/?p=MissionGoal.*

In theory, safety and soundness should serve consumer protection. In practice, it has not, as recent experience shows. During the housing boom, Federal banking regulators too often mistook short-term profitability, including profits from excessive fees on consumers,[62] with safety and soundness. In their effort to protect the short-term profitability of banks and thrifts, Federal regulators often dismissed consumer protection as conflicting with that mission. When agencies derive most of their operating budgets from assessments on the entities they regulate—as do the OCC and OTS—the pressure to sacrifice consumer protection for profit maximization by those entities can be overwhelming.[63]

I served on the Federal Reserve Board's Consumer Advisory Council from 2002 through 2004 and saw firsthand how resistant Federal banking regulators were to instituting basic consumer protections during the run-up to the current crisis. Repeatedly over that period, I and other members of that Council warned the Federal Reserve's staff and Governors about rising foreclosures and other dangers associated with reckless subprime loans. We urged the Board to exercise its powers under HOEPA to strengthen protections for subprime and nontraditional mortgages, but to no avail. During my tenure on the Council, the late Governor Gramlich told me during a break at one of the Council's public meetings that there was not enough support on the Board to expand HOEPA's protections. These experiences confirmed my belief that banking regulators often dismiss the consumer protection piece of their mission.

Some critics argue that removing consumer protection responsibilities from Federal banking regulators and housing them in their own dedicated agency would undercut the safety and soundness of banks. As the current crisis shows, however, entrusting consumer protection to the Federal banking agencies is no guarantee of bank safety and soundness. Indeed, having a separate Federal watchdog for consumer credit would help place healthy, countercyclical constraints on the tendency of Federal banking regulators to sacrifice long-term safety for short-term profits at the top of the credit cycle. It would also encourage forward-looking regulation as new problems arise, instead of laggard, backward-looking regulation of the type recently issued by the Federal Reserve.

Congress could institute mechanisms to avoid agency conflicts or to resolve them if they occur. Such mechanisms could include formal or informal consultation with Federal banking regulators or judicial dispute resolution.

**2. A Separate Federal Consumer Credit Agency Offers Other Strong Advantages**

A wide range of experts across the political spectrum, from the Treasury Department under former Secretary Paulson to the Congressional Oversight Panel, have recommended housing consumer credit protection in its own separate agency.[64] A separate Federal agency dedicated to consumer protection for all consumer credit would offer several distinct advantages. First, it would consolidate industry-wide enforcement in one agency, which would mean that all providers of credit would be subject to the same level of enforcement. Under the current regime, even though the

---

[62] Examples include regulators' slow response to curtailing large prepayment penalties and their continued indecision on costly overdraft protection.

[63] For instance, the OCC derives 95 percent of its budget from assessments on national banks. The twenty largest national banks contribute almost 60 percent of those assessments. *See, e.g.,* Bar-Gill & Warren, *supra* note 5, at 193–94 (working draft version); Testimony of Arthur E. Wilmarth, Jr., Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (Apr. 26, 2007).

[64] THE DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 170–74 (March 2008) (proposing a Conduct of Business Regulatory Agency), available at *www.treasury.gov;* CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM 30–37 (Jan. 2009), available at *http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.* The Committee on Capital Markets Regulation recommended an independent consumer protection agency as one alternative. Committee on Capital Markets Regulation, Recommendations for Reorganizing the U.S. Financial Regulatory Structure 5 (Jan. 14, 2009), available at *http://www.capmktsreg.org.* While the Government Accountability Office has not taken a position, last month it advised that "[c]onsumer protection should be viewed from the perspective of the consumer rather than through the various and sometimes divergent perspectives of the multitude of Federal regulators that currently have responsibilities in this area." GENERAL ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 18 (GAO–09–349T Feb. 4, 2009), available at *www.gao.gov. See* also Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit,* 18 LOYOLA CONSUMER L. REV. 43, 77–78, 82 (2005) ("while there are benefits to combining prudential regulation and consumer protection, serious doubt remains as to whether it is the best arrangement"; "[t]he most sensible approach to correcting the structural defect in the current regime would be to eliminate entirely the Federal banking regulators' role in consumer protection").

Federal Reserve Board administers most Federal consumer credit laws, compliance examinations and enforcement are divided among Federal banking regulators and sometimes other agencies. Other Federal consumer protection laws—such as Section 5 of the Federal Trade Commission Act and the Community Reinvestment Act—are individually implemented by the four Federal banking regulators with respect to their regulated entities. Each agency can make its own choice about the extent to which it enforces or does not enforce the law. Ending this fragmentation of enforcement would discourage lenders from switching charters in search of the easiest regulator.

Transferring consumer credit laws to one agency whose sole mission is consumer protection would also provide regulators with a complete overview of the entire consumer credit market, its structure, and emerging issues. Right now, consumer credit regulation suffers from a silo mentality because it is parceled out among so many agencies. Consolidating consumer credit oversight would overcome this silo mentality. In addition, consolidation would have the benefit of concentrating expertise for consumer credit products in one agency.

### 3. Agency Responsibilities and Oversight

In assigning consumer credit protection to its own separate agency, it is necessary to ask whether the agency should adopt a supervisory model based on routine examinations akin to banking regulation or an enforcement model akin to that used by the Security and Exchange Commission or the Federal Trade Commission.

Banking regulators are supposed to examine all of their regulated entities for consumer compliance on a routine basis. Requiring regular examinations of all credit providers and related entities, from depository institutions and nonbank lenders to mortgage brokers and payday lenders, would be extremely costly and not the best use of tax dollars.

Given the large number of participants in the consumer credit market, it would make more sense to adopt an enforcement model similar to that used by the Securities and Exchange Commission.[65] Under that model, market participants would be required to register with the agency and obtain licenses. Regular reporting would provide the agency with a steady flow of needed information to pinpoint possible violations and identify new problems. Under its broad statutory mandate, the agency would issue binding rules and interpretations to prohibit unfair and deceptive acts and practices. The agency's research arm would conduct empirical tests of the effects of new financial products and proposed regulations. Finally, the agency should have strong enforcement authority, including the power to conduct special examinations and issue subpoenas; the power to take agency enforcement action and levy restitution and sanctions; and criminal and civil enforcement authority.

### 4. Should Congress Create a New Agency or Transfer All Consumer Credit Oversight to the Federal Trade Commission?

In removing consumer credit oversight from Federal banking regulators and transferring it to a dedicated agency, Congress must decide where to house it. There are two obvious choices. One would be to create a new agency for consumer credit oversight. The other would be to transfer this responsibility to the Federal Trade Commission.

Each approach has advantages and disadvantages. Unlike the FTC, a brand new agency would be solely responsible for consumer credit products and would not be distracted by other duties, such as policing antitrust violations or the marketing of home appliances, over-the-counter drugs, dietary supplements, computer software, and other products, that fall under the FTC's purview.

A new agency would also have the benefit of starting on a clean slate. If, as I recommend, the model for consumer protection is based on the SEC's registration and reporting scheme, the FTC would have to transform itself away from its current consumer complaint enforcement model. The FTC, like any other agency, has a bias toward the status quo that could make it hard to implement a new enforcement model and otherwise change the way the agency functions. A new agency would not suffer under this handicap.

On the other hand, creating a new Federal agency would be costly and entail substantial startup time. The FTC already has the institutional expertise and single-minded commitment to consumer protection to regulate consumer credit industry-wide. This is particularly true within the FTC's Division of Financial Practices and the Division of Privacy and Identity Protection, which fall in the FTC's Bureau of

---

[65] A consumer complaint model alone, such as that employed by the FTC, would not provide an oversight agency with enough information or authority to keep abreast of the rapid pace of financial innovation.

Consumer Protection. In 2008, the Division of Financial Practices specifically ramped up its staff and in-house training in anticipation of heightened enforcement activity.

Of course, for the FTC to succeed as the consumer protection enforcer, the agency would need dramatic increases in funding. A new agency would also need a substantial commitment of resources to properly do its job. Presumably, some of this cost could be defrayed by transferring resources from the consumer compliance operations of Federal banking regulators.

Consolidating oversight in one Federal agency—whether that agency is new or the FTC—poses a final concern about agency capture and inaction. The FTC, for example, had a vigorous enforcement record regarding mortgage abuses during the Clinton Administration but a lackluster record during the George W. Bush Administration until recently. Whether consumer credit protection is consolidated in a new agency or the FTC, the best antidote to agency inaction is outside enforcement. Accordingly, Congress should give parallel enforcement authority for Federal consumer credit laws to State regulators and private causes of action (including carefully crafted assignee liability) to injured consumers. Congress could also set target consumer protection goals, such as maximum default rates, and require the implementing agency to report to Congress on its performance. Finally, that agency should be funded through congressional appropriations instead of assessments on regulated entities to assure that the agency remains independent.

## RESPONSE TO WRITTEN QUESTION OF SENATOR VITTER FOR STEVE BARTLETT BY IRVING E. DANIELS

**Q.1.** In my experience, TILA violations are small, technical violations related to the TILA mortgage disclosure. In the past, they have been used by the trial lawyers to file numerous class action law suits that were frivolous in nature, but very serious for the industry—and consumers that would ultimately bear the burden of any costs of litigation. Some of my colleagues may recall the infamous "Rodash" decision that was rendered in Florida in the mid-1990s. Mrs. Rodash was a sympathetic complainant who could not afford to repay the mortgage she took out. Her attorney claimed that the disclosures of the Federal Express charge and the taxes imposed by the State of Florida were disclosed on the wrong lines on the form. There was no doubt that she owed the money, but the attorney alleged that the charges were simply disclosed on the wrong line of the forms. The judge felt sorry for her and ruled in favor of Mrs. Rodash. The tolerance for error at that time was $10 and both the Federal Express charge and the Florida State taxes exceeded that $10 tolerance. The "Rodash" decision spawned more than 250 class action law suits and would have cost the mortgage industry more than $1.3 ***trillion*** in liability had Congress not intervened and passed retroactive legislation to right this wrong.

The issue of mortgage disclosures is a thorny one.

There are two Federal laws that govern the disclosures in the mortgage transactions—RESPA and TILA. Last year, HUD finalized a rule to revise the RESPA disclosures. Currently, the Fed is currently working on revamping the TILA disclosure. Neither HUD nor the Fed have worked to combine and coordinate their disclosures so the result is going to be that the consumer is going to get more disclosures that are even more confusing—and that will not conflict—than the disclosures they currently receive. I doubt that anyone in this room thinks that the pile of paper you get in the mortgage process is not confusing.

So, now that the Feds are working to confuse consumers even more with their "new and improved" disclosures, we are going to turn the enforcement of this mess over to the State AGs. This will, undoubtedly, result in an enormous increase in litigation.

This Committee has heard testimony recommending that it should work to close regulatory gaps. The TILA provisions inserted in the Omnibus spending bill allows State attorneys general to enforce consumer issues. Therefore, adding more duplication to a fragmented system. Why are we doing this? We have enough of a mess on our hands without creating a new one.

**A.1.** The Financial Services Roundtable has regularly urged the agencies to work together in crafting regulations that overlap practices and activities in the economy. Most recently, The Roundtable, its Housing Policy Council and other industry groups spent considerable time explaining to Congress and to HUD and the Federal Reserve that the RESPA regulations HUD was creating would overlap the broader jurisdiction of the Federal Reserve and its TILA responsibilities. In addition, we pointed out that the TILA revision project of the Federal Reserve was underway at the time HUD staff was drafting. The staff of the Federal Reserve also commented directly to HUD on that same point.

HUD issued its RESPA rules anyway without coordinating with the Federal Reserve. Now lenders are faced with the responsibility of making major changes in our RESPA practices, technology and training only to likely face the need to make additional ones in the same areas as the Federal Reserve announces its regulations under TILA. Most likely there will be irreconcilable conflicts between the two.

To the Roundtable, it is a further demonstration of the harm that the regulatory silo effect can have in conducting business, and the confusion that it sews in the minds of consumers who, in the case we are discussing, will have yet more mortgage disclosures that will be confusing. We urge Congress to look closely at the Blueprint for regulatory reform that the Roundtable has published where we have proposed solutions to some of these issues. We strongly support agency coordination on issues such as mortgage term disclosures.

---

**RESPONSE TO WRITTEN QUESTION OF SENATOR VITTER FROM ELLEN SEIDMAN**

**Q.1.** In my experience, TILA violations are small, technical violations related to the TILA mortgage disclosure. In the past, they have been used by the trial lawyers to file numerous class action law suits that were frivolous in nature, but very serious for the industry—and consumers that would ultimately bear the burden of any costs of litigation. Some of my colleagues may recall the infamous "Rodash" decision that was rendered in Florida in the mid-1990s. Mrs. Rodash was a sympathetic complainant who could not afford to repay the mortgage she took out. Her attorney claimed that the disclosures of the Federal Express charge and the taxes imposed by the State of Florida were disclosed on the wrong lines on the form. There was no doubt that she owed the money, but the attorney alleged that the charges were simply disclosed on the wrong line of the forms. The judge felt sorry for her and ruled in favor of Mrs. Rodash. The tolerance for error at that time was $10 and both the Federal Express charge and the Florida State taxes exceeded that $10 tolerance. The "Rodash" decision spawned more than 250 class action law suits and would have cost the mortgage industry more than $1.3 ***trillion*** in liability had Congress not intervened and passed retroactive legislation to right this wrong.

The issue of mortgage disclosures is a thorny one.

There are two Federal laws that govern the disclosures in the mortgage transactions—RESPA and TILA. Last year, HUD finalized a rule to revise the RESPA disclosures. Currently, the Fed is currently working on revamping the TILA disclosure. Neither HUD nor the Fed have worked to combine and coordinate their disclosures so the result is going to be that the consumer is going to get more disclosures that are even more confusing—and that will not conflict—than the disclosures they currently receive. I doubt that anyone in this room thinks that the pile of paper you get in the mortgage process is not confusing.

So, now that the Feds are working to confuse consumers even more with their "new and improved" disclosures, we are going to

turn the enforcement of this mess over to the State AGs. This will, undoubtedly, result in an enormous increase in litigation.

This Committee has heard testimony recommending that it should work to close regulatory gaps. The TILA provisions inserted in the Omnibus spending bill allows State attorneys general to enforce consumer issues. Therefore, adding more duplication to a fragmented system. Why are we doing this? We have enough of a mess on our hands without creating a new one.

**A.1.** I completely agree with the Senator that greater coordination between government agencies who are working to the same end is highly desirable; consumers have enough difficulty understanding mortgage documents without having to attempt to decipher documents that are written for different purposes with potentially different outcomes. With respect to the role of State attorneys general, in the current mortgage crisis, State attorneys general were early movers in uncovering, litigating, and recovering for plaintiffs damages from abusive mortgage practices. The Ameriquest and Countrywide cases stand out—serious, non-duplicative cases that generated major changes in practice, albeit too late. There is no reason to believe the AGs would not hold themselves to a similar standard with respect to TILA litigation.

---

## RESPONSE TO WRITTEN QUESTION OF SENATOR VITTER FROM PATRICIA A. McCOY

**Q.1.** In my experience, TILA violations are small, technical violations related to the TILA mortgage disclosure. In the past, they have been used by the trial lawyers to file numerous class action law suits that were frivolous in nature, but very serious for the industry—and consumers that would ultimately bear the burden of any costs of litigation. Some of my colleagues may recall the infamous "Rodash" decision that was rendered in Florida in the mid-1990s. Mrs. Rodash was a sympathetic complainant who could not afford to repay the mortgage she took out. Her attorney claimed that the disclosures of the Federal Express charge and the taxes imposed by the State of Florida were disclosed on the wrong lines on the form. There was no doubt that she owed the money, but the attorney alleged that the charges were simply disclosed on the wrong line of the forms. The judge felt sorry for her and ruled in favor of Mrs. Rodash. The tolerance for error at that time was $10 and both the Federal Express charge and the Florida State taxes exceeded that $10 tolerance. The "Rodash" decision spawned more than 250 class action law suits and would have cost the mortgage industry more than $1.3 ***trillion*** in liability had Congress not intervened and passed retroactive legislation to right this wrong.

The issue of mortgage disclosures is a thorny one.

There are two Federal laws that govern the disclosures in the mortgage transactions—RESPA and TILA. Last year, HUD finalized a rule to revise the RESPA disclosures. Currently, the Fed is currently working on revamping the TILA disclosure. Neither HUD nor the Fed have worked to combine and coordinate their disclosures so the result is going to be that the consumer is going to get more disclosures that are even more confusing—and that will not conflict—than the disclosures they currently receive. I doubt that

anyone in this room thinks that the pile of paper you get in the mortgage process is not confusing.

So, now that the Feds are working to confuse consumers even more with their "new and improved" disclosures, we are going to turn the enforcement of this mess over to the State AGs. This will, undoubtedly, result in an enormous increase in litigation.

This Committee has heard testimony recommending that it should work to close regulatory gaps. The TILA provisions inserted in the Omnibus spending bill allows State attorneys general to enforce consumer issues. Therefore, adding more duplication to a fragmented system. Why are we doing this? We have enough of a mess on our hands without creating a new one.

**A.1.** Did not respond by publication deadline.