Consumers Union
Nonprofit Publisher of Consumer Reports

"Modernizing Bank Supervision and Regulation"

Testimony
of

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Before the

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Committee on Banking, Housing & Urban Affairs

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Chairman Dodd, Ranking Member Shelby, and members of the Committee, I appreciate the opportunity to testify on behalf of Consumers Union, the nonprofit publisher of *Consumer Reports*,[1] on the important topic of reforming and modernizing the regulation and oversight of financial institutions and financial markets in the U.S.

Introduction and summary

The job of modernizing the U.S. system of financial markets oversight and financial products regulation will involve much more than the addition of a layer of systemic risk oversight. The regulatory system must provide for effective household risk regulation as well as systemic risk regulation. Regulators must exercise their existing and any new powers more vigorously, so that routine, day to day supervision becomes much more effective. Gaps that allow unregulated financial products and sectors must be closed. This includes an end to unregulated status for the "shadow" financial sector. Regulators must place a much higher value on the prevention of harm to consumers. This new infrastructure, and the public servants who staff it, must protect individuals as consumers, workers, small business owners, investors, and taxpayers.

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[1] Consumers Union of United States, Inc., publisher of *Consumer Reports* and *Consumer Reports Online,* is a nonprofit membership organization chartered in 1936 to provide consumers with information, education, and counsel about goods, services, health and personal finance. Consumers Union's print and online publications have a combined paid circulation of approximately 8.5 million. These publications regularly carry articles on Consumers Union's own product testing; on health, product safety, financial products and services, and marketplace economics; and on legislative, judicial, and regulatory actions that affect consumer welfare. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and services, and noncommercial contributions, grants, and fees. Consumers Union's publications and services carry no outside advertising and receive no commercial support. Consumers Union's mission is "to work for a fair, just, and safe marketplace for all consumers and to empower consumers to protect themselves." Our Financial Services Campaign engages with consumers and policymakers to seek strong consumer protection, vigorous law enforcement, and an end to practices that impede capital formation for low and moderate income households.

A reformed financial regulatory structure must include:

- Strong consumer protections to reduce household risk;
- A changed regulatory culture;
- A federal agency independent of the banking industry that focuses on the safety of consumer financial products;
- An active role for state consumer protection;
- Credit reform leading to suitable and sustainable credit;
- An approach to systemic risk that includes systemic oversight addressing more than large financial institutions, stronger prudential regulation for risk, and closing regulatory gaps; and
- Increased accountability by all who offer financial products.

1. Strong, effective, preventative consumer protection can reduce systemic risk

Proactive, affirmative consumer protection is essential to modernizing financial system oversight and to reducing risk. The current crisis illustrates the high costs of a failure to provide effective consumer protection. The complex financial instruments that sparked the financial crisis were based on home loans that were poorly underwritten; unsuitable to the borrower; arranged by persons not bound to act in the best interest of the borrower; or contained terms so complex that many individual homeowners had little opportunity to fully understand the nature or magnitude of the risks of these loans. The crisis was magnified by highly leveraged, largely unregulated financial instruments and inadequate risk management. The resulting crisis of confidence led to reduced credibility for the U.S. financial system, gridlocked credit markets, loss of equity for homeowners who accepted nonprime mortgages and for their neighbors who did not, empty houses, declining neighborhoods and reduced property tax revenue. All of this started with a failure to protect consumers.

Effective consumer protection is a key part of a safe and sound financial system. As FDIC Chairman Bair testified before this Committee, "There can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy."[2]

Effective consumer protection will require:

- Changing the regulatory culture so that every existing federal financial regulatory agency places a high priority on consumer protection and the prevention of consumer harm;
- Creating an agency charged with requiring safety in financial products across all types of financial services providers (holding concurrent jurisdiction with the existing banking agencies); and
- Restoring to the states the full ability to develop and enforce consumer protection standards in financial services.

2. A change in federal regulatory culture is essential

Consumer advocates have long noted that federal banking agencies give insufficient attention to achieving effective consumer protection.[3] Perhaps this stems partly from undue

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[2] Bair, Sheila C., Chairman, Federal Deposit Insurance Corporation, *Testimony before the Senate Committee on Banking, Housing and Urban Affairs on Modernizing Bank Supervision and Regulation*, March 19, 2009, http://www.fdic.gov/news/news/speeches/chairman/spmar0319.html.

[3] *Improving Federal Consumer Protections in Financial Services*, Testimony of Travis Plunkett, before the Committee on Financial Services of the U.S. House of Representatives, July 25, 2007, available at http://www.consumerfed.org/pdfs/Financial_Services_Regulation_House_Testimony_072507.pdf.

confidence in the regulated industry or an assumption that problems for consumers are created by just a few "bad apples." One federal bank regulator has even attempted to weaken efforts by another federal agency to protect consumers from increases in credit card interest rates on funds already borrowed.[4] Consumers Union believes that federal banking regulators have placed too much confidence in the private choices of bank management and too much unquestioning faith in the benefits of financial innovation. Too often, the perceived value of financial innovation has not been weighed against the value of preventing harm to individuals. The Option ARM, as sold to a broad swathe of ordinary homeowners, has shown that the harm from some types and uses of financial services innovation can far outweigh the benefits.

We need a fundamental change in regulatory culture at most of the federal banking regulatory agencies. Financial regulators must place a much higher value on preventing harm to individuals and to the public. Comptroller Dugan's testimony to this Committee on March 19, 2009, may have unintentionally illustrated the regulatory culture problem when he described the "sole mission" of the OCC as "bank supervision."[5]

The purpose of this hearing is to build for a better future, not to assign blame for the current crisis. However, the missed opportunities to slow or stop the products and practices that led to the current crisis should inform the decisions about the types of changes needed in future

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[4] The OCC unsuccessfully asked the Federal Reserve Board to add significant exemptions to the Fed's proposed rule to limit the raising of interest rates on existing credit card balances. See the OCC's comment letter: http://www.occ.treas.gov/foia/OCC%20Reg%20AA%20Comment%20Letter%20to%20FRB_8%2018%2008.pdf.

[5] The Comptroller stated: "Most important, moving all supervision to the Board would lose the very real benefit of having an agency whose sole mission is bank supervision. That is, of course, the sole mission of the OCC…." Dugan, John C., Comptroller of the Currency, *Testimony before the Senate Committee on Banking, Housing and Urban Affairs on Modernizing Bank Supervision and Regulation*, March 19, 2009, p.11, available at: http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=494666d8-9660-439f-82fa-b4e012fe9c0f&Witness_ID=845ef046-9190-4996-8214-949f47a096bd. Other parts of the testimony indicate that the Comptroller was including compliance with existing consumer laws within "supervision."

regulatory oversight. Consumer groups warned federal banking agencies about the harms of predatory practices in subprime lending long before it exploded in volume. For example, Consumers Union asked the Federal Reserve Board in 2000 to reinterpret the triggers for the application of the Home Ownership and Equity Protection Act (HOEPA) in a variety of ways that would have expanded its coverage.[6] Other consumer groups, such as the National Consumer Law Center, had been seeking similar reforms for some time. In the year 2000, the New York Times reported on how securitization was fueling the growth in subprime loans with abusive features.[7] While the current mortgage meltdown involves practices in loan types beyond subprime and high cost mortgages, we will never know if stamping out some of the abusive practices that consumer advocates sought to end in 2000 would have prevented more of those practices from spreading.

Some have claimed that poor quality loans and abusive lender practices were primarily an issue only for state-chartered, solely state-overseen lenders, but the GAO found that a significant volume of nonprime loans were originated by banks and by subsidiaries of nationally chartered banks, thrifts or holding companies. The GAO analyzed nonprime originations for 2006. That report covers the top 25 originators of nonprime loans, who had 90% of the volume. The GAO report shows that the combined nonprime home mortgage volume of all banks and of

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[6] Garcia, Norma Paz, Senior Attorney, Consumers Union, *Testimony before the Federal Reserve Board of Governors regarding Predatory Lending Practices*, Docket No. R-1075, San Francisco, CA, September 7, 2000, available at: www.defendyourdollars.org/2000/09/cus_history_of_against_predato.html. In that testimony, Consumers Union asked the Federal Reserve Board to adjust the HOEPA triggers to include additional costs within the points and fees calculation, which would have brought more loans under the basic HOEPA prohibition on a pattern or practice of extending credit based on the collateral – that is, that the consumer is not expected to be able to repay from income. We also asked the Board to issue a maximum debt to income guideline to further shape industry practice in complying with the affordability standard.

[7] Henriques, D and Bergman, L, Mortgaged Lives: *A Special Report.; Profiting from Fine Print with Wall Street's Help*, New York Times, March 20, 2000, available at: http://www.nytimes.com/2000/03/15/business/mortgaged-lives-special-report-profiting-fine-print-with-wall-street-s-help.html.

subsidiaries of federally chartered banks, thrifts, and bank holding companies actually exceeded the nonprime origination volume of independent lenders subject only to state oversight. The GAO reported these volumes for nonprime originations: $102 billion for all banks, $203 billion for subsidiaries of nationally chartered entities, and $239 billion for independent lenders. Banks had a significant presence, and subsidiaries of federally chartered entities had a volume of nonprime originations nearly as high as the volume for state-only-supervised lenders.[8]

It is too easy for a bank regulator to see its job as complete if the bank is solvent and no laws are being violated. The current crisis doesn't seem to have brought about a fundamental change in this regulatory perspective. Comptroller Dugan told this Committee just last week: "Finally, I do not agree that the banking agencies have failed to give adequate attention to the consumer protection laws that they have been charged with implementing."[9] Clearly, the public thinks that bank regulation has failed. Homeowners in distress, as well as their neighbors who are suffering a loss in home values, think that bank regulation has failed. Taxpayers who are footing the bill for the purchase of bank capital think that bank regulation has failed.

3. Consumers need a Financial Product Safety Commission (FPSC)

The bank supervision model lends itself to the view that the regulator's job is finished if existing laws are followed. Unfortunately, a compliance-focused mentality leaves no one with the primary job of thinking about how evolving, perhaps currently legal, business practices and

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[8] *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO 09-216, January 2009, at 24, available at: http://www.gao.gov/new.items/d09216.pdf.

[9] Dugan, John C., Comptroller of the Currency, *Testimony before the Senate Committee on Banking, Housing, and Urban Affairs*. U.S. Senate, March 19, 2009. p 11, available at: http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=494666d8-9660-439f-82fa-b4e012fe9c0f&Witness_ID=845ef046-9190-4996-8214-949f47a096bd.

product features may pose undue harm to consumers. A strong Financial Product Safety Commission can fill the gap left by compliance-focused bank regulators. The Financial Product Safety Commission would set a federal floor for consumer protection without displacing stronger state laws. It would essentially be an "unfair practices regulator" for consumer credit, deposit and payment products.[10] Investor protection would remain elsewhere.[11]

The Financial Product Safety Commission would not remove the obligation on existing regulators to ensure compliance with current laws and regulations. Instead, the Commission would promulgate rules that would apply regardless of the chartering status of the product provider. This would insulate consumers from some of the harmful effects of "charter choice," because chartering would be irrelevant to the application of rules designed to minimize unreasonable risks to consumers. Only across the board standards can eliminate a "race to the bottom" in consumer protection.

Without endorsing the FPSC, FDIC Chairman Bair has emphasized the need for standards that apply across types of providers of financial products, stating:

> Whether or not Congress creates a new commission, it is essential that there be uniform standards for financial products whether they are offered by banks or non-banks. These

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[10] Payment products include prepaid cards, which increasingly are marketed as account substitutes, including to the unbanked. For a discussion of the holes in current consumer law with respect to these cards, see: G. Hillebrand, *Before the Grand Rethinking*, 83 Chicago-Kent L. Rev. No. 2, 769 (2008), available at: http://www.consumersunion.org/pdf/WhereisMyMoney08.pdf. Consumers Union and other consumer and community groups asked the Federal Reserve Board to expand Regulation E to more clearly cover these cards, including cards on which unemployment benefits are delivered, in 2004. Consumer Comment letter to Federal Reserve Board in Docket R-1210, October 24, 2004, available at: http://www.consumersunion.org/pdf/payroll1004.pdf. That protection is still lacking. In February 2009, the Associated Press reported on consumer difficulties with the use of prepaid cards to deliver unemployment benefits. Leonard, C., *Jobless Hit with Bank Fees on Benefits*, Associated Press, Feb. 19, 2009.

[11] Investor protection has long been important to Consumers Union. In May 1939, *Consumer Reports* said: "I know it is quite impossible for the average investor to examine and judge the real security that stands behind mere promises of security, and that unless one has expert knowledge and disinterested judgment available, he must shun all such plans, no matter how attractive they seem. We cannot wait for the next depression to tell us that these financial plans—appealing and reasonable in print—failed and created such widespread havoc, not because of the depression, but because they were not safeguarded to weather a depression."

> standards must apply across all jurisdictions and issuers, otherwise gaps create competitive pressures to reduce standards, as we saw with mortgage lending standards. Clear standards also permit consistent enforcement that protects consumers and the broader financial system.[12]

The Financial Product Safety Commission is part of a larger shift we must make in consumer protection to move away from failed "disclosure-only" approaches. Financial products which are too complex for the intended consumer carry special risks that no amount of additional disclosure or information will fix. Many of the homeowners who accepted predatory mortgages did not understand the nature of their loan terms. The over 60,000 individuals who filed comments in the Federal Reserve Board's Regulation AA docket on unfair or deceptive credit card practices described many instances in which they experienced unfair surprise because the fine print details of the credit arrangement did not match their understanding of the product that they were currently using. The Financial Product Safety Commission can pay special attention to practices that make financial products difficult for consumers to use safely.

4. State power to protect financial services consumers, regardless of the chartering of the financial services provider, must be fully restored

The Financial Product Safety Commission would set a federal floor, not a federal cap, on consumer protection in financial services products. No agency can foresee all of the potentially harmful consequences of new practices and products. A strong concurrent role for state law and state agencies is essential to provide more and earlier enforcement of existing standards and to provide places to develop new standards for addressing emerging practices. Harmful financial practices often start in one region or are first targeted to one subgroup of consumers. When

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[12] Bair, Sheila C., Chairman, Federal Deposit Insurance Corporation, *Testimony before the Committee on Banking, Housing and Urban Affairs on Modernizing Bank Supervision and Regulation*, March 19, 2009.

those practices go unchallenged, others feel a competitive pressure to adopt similar practices. State legislatures should be in a unique position to spot and stop bad practices before they spread. However, federal preemption has seriously compromised the ability of states to play this role.

Some might ask why states can't just regulate state-chartered entities, while federal regulators address the conduct of federally chartered entities. There are several reasons. First, federal bank regulators aren't well-suited to address conduct issues of operating subsidiaries of national banks in local and state markets. Second, assertions of federal preemption for nationally chartered entities and their subsidiaries interfere with the ability of states to restrict the conduct of state-chartered entities. The reason for this is simple: if national financial institutions or their operating subsidiaries have a sizable percentage of any market, this creates a barrier to state reforms applicable only to state-only entities. The state-chartered entities argue strongly against the reforms on the grounds that their direct competitors would be exempt.

As FDIC Chairman Bair told the Committee on March 19, 2009:

> Finally, in the on-going process to improve consumer protections, it is time to examine curtailing federal preemption of state consumer protection laws. Federal preemption of state laws was seen as a way to improve efficiencies for financial firms who argued that it lowered costs for consumers. While that may have been true in the short run, it has now become clear that abrogating sound state laws, particularly regarding consumer protection, created an opportunity for regulatory arbitrage that frankly resulted in a "race-to-the-bottom" mentality. Creating a "floor" for consumer protection, based on either appropriate state or federal law, rather than the current system that establishes a ceiling on protections would significantly improve consumer protection.[13]

The Home Owners' Loan Act stymies application of state consumer protection laws to federally chartered thrifts due to its field preemption, which should be changed by statute. State standards for lender conduct and state enforcement against national banks and their operating

[13] Bair, Sheila C., Chairman, Federal Deposit Insurance Corporation. *Testimony before the Senate Committee on Banking, Housing and Urban Affairs on Modernizing Bank Supervision and Regulation,* March 19, 2009.

subsidiaries have been severely compromised by the OCC's preemption rules and operating subsidiary rule.[14] The OCC has even taken the position that state law enforcement cannot investigate violations of non-preempted state laws against a national bank or its operating subsidiaries.[15] That latter issue is now pending in the U.S. Supreme Court.

The OCC is an agency under the U.S. Treasury Department. The Administration should take immediate steps to repeal the OCC's package of preemption and visitorial powers rules.[16] This would remove the agency's thumb from the scale as courts determine the meaning of the National Bank Act. Further, because the OCC's broad view of preemption has influenced the Courts' views on the scope of preemption under the National Bank Act, Congress should amend the National Bank Act to make it crystal clear that state laws requiring stronger consumer

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[14] In 2004, the Office of the Comptroller of the Currency promulgated regulations to preempt state laws, state oversight, and consumer enforcement in the broad areas of deposits, real-estate loans, non-real estate loans, and the oversight of operating subsidiaries of national banks. 12 CFR sections 7.4000, 7.4007, 7.4008, 7.4009, and 34.4. These regulations interpret portions of the National Bank Act that consumer advocates believe were designed to prevent states from imposing harsher conditions on national banks than on state banks, not to give national banks an exemption from state laws governing financial products and services.

The OCC has repeatedly sided in court with banks seeking to invalidate state consumer protection laws. One example is the case of Linda A. Watters, Commissioner, Michigan Office of Insurance and Financial Services v. Wachovia Bank, N.A., 550 U.S. 1 (2007). The OCC filed an amicus brief in support of Wachovia in the United States Supreme Court to prevent Michigan from regulating the practices of a Wachovia mortgage subsidiary. The OCC argued that its regulations and the National Bank Act preempt state oversight and enforcement and prevented state mortgage lending protections from applying to a national bank's operating subsidiary. The Supreme Court then held that Michigan's licensing, reporting, and investigative powers were preempted. Wachovia is no longer in business, and many observers attribute that to its mortgage business.

[15] In Office of the Comptroller of the Currency v. Spitzer, 396 F. Supp. 2d 383 (S.D.N.Y., 2005), aff'd in part, vacated in part on other grounds & remanded in part on other grounds sub nom. The Clearing House Ass'n v. Cuomo, 510 F.3d 105 (2d Cir., 2007), cert. granted, Case No. 08-453, New York's Attorney General sought to investigate whether the residential mortgage lending practices of several national banks doing business in New York were racially discriminatory because the banks were issuing high-interest home mortgage loans in significantly higher percentages to African-American and Latino borrowers than to White borrowers. The OCC and a consortium of national banks sued to prevent the Attorney General from investigating and enforcing the anti-discrimination and fair lending laws against national banks. The OCC claimed that only it could enforce these state laws against a national bank. The district court granted declaratory and injunctive relief, and the Second Circuit affirmed. (See http://www.ca2.uscourts.gov:8080/isysnative/RDpcT3BpbnNcT1BOXDA1LTU5OTYtY3Zfb3BuLnBkZg==/05-5996-cv_opn.pdf.) The case is now being briefed in the United States Supreme Court.

[16] Those rules are 12 CFR sections 7.4000, 7.4007, 7.4008, 7.4009, and 34.4.

protections for financial services consumers are not preempted; state law enforcement is not "visitation" of a national bank; and any visitorial limitation has no application to operating subsidiaries of national banks.

Once the preemption barrier is removed, state legislation can provide an early remedy for problems that are serious for one subgroup of consumers or region of the country. State legislation can also develop solutions that may later be adopted at the federal level. Prior to the overbroad preemption rules, as well as in the regulation of credit reporting agencies which falls outside of OCC preemption, states have pioneered such consumer protections as mandatory limits on check hold times, the free credit report, the right to see the credit score, and the security freeze for use by consumers to stop the opening of new accounts by identity thieves.[17] Congress later adopted three of these four developments into statute for the benefit of consumers nationwide.

5. Credit reform can provide access to suitable and sustainable credit

Attempts to protect consumers in financial services are often met with assertions that protections will cause a reduction in access to credit. Consumers Union disputes the accuracy of those assertions in many contexts. However, we also note that not every type of credit is of net positive value to consumers. For example, the homeowner with a zero interest Habitat for Humanity loan who was refinanced into a high cost subprime mortgage would have been much

[17] The first two of these developments were described by Consumers Union in its comment letter to the OCC opposing its broad preemption rule before adoption. Consumers Union letter of Oct. 1, 2003, in OCC Docket 03-16, available at: http://www.consumersunion.org/pub/core_financial_services/000770.html. The free credit report and the right to a free credit score if the score is used in a home-secured loan application process were both made part of the FACT Act. For information on the security freeze, which is available in 46 states by statute and the remaining states through an industry program, see: http://www.consumersunion.org/campaigns//learn_more/003484indiv.html.

better off without that subprime loan.[18] The same is true for countless other homeowners with fixed rate, fully amortizing home loans who were persuaded to refinance into loans that contained rate resets, balloon payments, Option ARMs, and other adverse features of variable rate subprime loans.

Creating access to sustainable credit will require substantial credit reform. This will have to include steps such as: outlawing pricing structures that mislead; requiring underwriting to the highest rate the loan payment may reach; requiring that the "shelter rule" which ends purchaser responsibility for problems with the loan be waived by the purchaser of any federally-related mortgage loan; requiring borrower income to be verified; ending complex pricing structures that obscure the true cost of the loan; requiring suitability and fiduciary duties; and ending steering payments and negative amortization abuses.

6. Systemic risk regulation, prudential risk regulation, and closing regulatory gaps

A. Scope of systemic risk regulation

There has been discussion about whether the systemic risk regulator should focus on institutions which are "too big to fail." Federal Reserve Board Chairman Bernanke has noted that the incentives, capital requirements, and other risk management requirements must be tight for any institution so large that its failure would pose a systemic risk.[19]

FDIC Chairman Bair's recent testimony posed the larger question about whether any value to the economy of extremely large and complex financial institutions outweighs the risk to

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[18] Center for Responsible Lending founder Martin Eakes described this homeowner as the reason he become involved in anti-predatory lending work in a speech to the CFA Consumer Assembly.

[19] Bernanke, Ben S., Chairman, Federal Reserve Board. *Speech to the Council on Foreign Relations.* Washington, D.C. March 10, 2009, available at: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm#f4.

the system should such institutions fail, or the cost to the taxpayer if policymakers decide that these institutions cannot be permitted to fail. Consumers Union suggests that one goal of systemic risk regulation should be to internalize to large and complex financial market participants the costs to the system that the risks created by their size and complexity impose on the financial system. "Too big to fail" institutions either have to become "smaller and less complex" or they have to become "too strong to fail" despite their size and complexity - without future expectations of public assistance.

There are many ideas in development with respect to what a systemic risk oversight function would entail, who should perform it, and what powers it should have. Systemic risk oversight should focus on protecting the markets, not specific financial institutions. Systemic risk oversight probably cannot be limited to the largest firms. It will have to also focus on practices used by bank and non-bank entities that create or magnify risk through interdependencies with both insured depository institutions and with other entities which hold important funds such as retirement savings and the money to fund future pensions**.**

The mortgage crisis has shown that a non-financial institution, such as a rating agency or a bond insurer, can adopt a practice that has consequences throughout the entire financial system. Toxic mortgage securitizations which initially received solid gold ratings are an example of the widespread consequences of practices of non-financial institutions.

B. Who should undertake the job of systemic risk regulation?

There are many technical questions about the exact structure for a systemic risk regulator and its powers. Like other groups, Consumers Union looks forward to learning from the debate. Accordingly we do not offer a recommendation as between giving the job to the Federal Reserve

Board, the Treasury, the FDIC, a new agency, or to a panel, committee, or college of regulators. However, we offer the following comments on some of the proposal. We agree with the proposition put forth by the AFL-CIO that the systemic risk regulator should not be governed by, or do its work through, any body that is industry-dominated or uses a self-regulatory model. We question whether the same agency should be responsible for both ongoing prudential oversight of bank holding companies and systemic risk oversight involving those same companies. If part of the idea of the systemic risk regulator is a second pair of eyes, that can't be accomplished if one regulator has both duties for a key segment of the risk-producers.

The panel or committee approach has other problems. A panel made up of multiple regulators would be composed of persons who have a shared allegiance to the systemic risk regulator and to another agency. It could become a forum for time-wasting turf battles. In addition, systemic risk oversight should not be a part-time job. We also are concerned with the proposal made by some industry groups that the systemic risk regulator be limited in most cases to acting through or with the primary regulator. This could recreate the type of cumbersome and slow interagency process that the GAO discussed in the context of mortgage regulation.[20]

Consumers Union supports a clear, predictable, rules-based process for overseeing the orderly resolution of non-depository institutions. However, it is not clear that the systemic risk regulator should oversee the unwinding. That job could be given to the FDIC, which has deep experience in resolving banks. Assigning the resolution job to the FDIC might leave the systemic risk regulator more energy to focus on risk, rather than the many important details in a well-run resolution.

[20] Government Accountability Office. *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,* January 2009, GAO 09-216, p. 43, available at: http://www.gao.gov/new.items/d09314t.pdf.

C. Relationship of systemic risk regulation to stronger across the board prudential regulation and to closing regulatory gaps

Federal financial regulators must have new powers and new obligations. How much of the job is assigned to the systemic risk regulator may depend in part on how effectively Congress and the regulators close existing loopholes and by how much the regulators improve the quality and sophistication of day to day prudential regulation. For example, if the primary regulator sees and considers all liabilities, including those now treated as off-balance sheet, that will change what remains to the done by the systemic oversight body. Thus, each of the powers described in the next subsection for a systemic risk regulator should also be held, and used, by primary prudential regulators. The more effectively they do so, the more the systemic risk regulator will be able to focus on new and emerging practices and risks.

Closing the gaps that have allowed some entities to offer financial products, impose counterparty risk on insured institutions, engage in bank-like activities, or otherwise impinge on the health of the financial system without regulation is at least as important, if not more important, than the creation and powers of a systemic risk regulator. Gaps in regulation must be closed and kept closed. Gaps can permit small corners of the law to become safe harbors from the types of oversight applicable to similar practices and products.

The theory that some investors don't require protection, due to their level of sophistication, has been proved tragically wrong for those investors, with adverse consequences for millions of ordinary people. The conduct of sophisticated investors and the shadow market sector contributed to the crisis of confidence and thus to the credit crunch. The costs of that crunch are being paid, in part, by individuals facing tighter credit limits and loss of jobs as their employers are unable to get needed business credit.

D. Powers of a systemic risk regulator

Consumers Union suggests these powers for a systemic risk regulator. Other powers may also be needed. As already discussed, we also believe that the primary regulator should be exercising all or most of these powers in its routine prudential supervision.

Power to set capital, liquidity, and other regulatory requirements directly related to risk and risk management: It is essential to ensuring that all the players whose interconnections create risk for others in the financial system are well capitalized and well-managed for risk.

Power to act by rule, corrective action, information, examination, and enforcement: The systemic risk regulator must have the power to act with respect to entities or practices that pose systemic risk, including emerging practices that could fall in this category if they remain unchecked. This should include the power to require information, take corrective action, examine, order a halt to specific practices by a single entity, define specific practices as inappropriate using a generally applicable rule, and engage in enforcement.

Power to publicize: The recent bailout will be paid for by U.S. taxpayers. Even if some types of risks might have to be handled quietly at some stages of the process, the systemic risk regulator must have the power and the obligation to make public the nature of too-risky practices, and the identities of those who use those practices.

Power and obligation to evaluate emerging practices, predict risks, and recommend changes in law: Even the best-designed set of regulations can develop unintended loopholes as financial products, practices and industry structure change. Part of the failure of the existing regulatory structure has been that financial products and practices regularly outpace existing legal requirements, so that new products fit into regulatory gaps. For this reason, every financial services regulator, including the systemic risk regulator, should be required to make an annual, public evaluation of emerging practices, the risks that those emerging practices may pose, and any recommendations for legislation or regulation to address those practices and risks.

Power to impose receivership, conservatorship, or liquidation on an entity which is systemically important, for orderly resolution: Consumers Union agrees with many others who have endorsed developing a method for predictable, orderly resolution of certain types of non-bank entities. There will have to be a required insurance premium, paid in advance, for the costs of resolution. Such an insurance program is unlikely to work if it is voluntary, since those engaged in the riskiest practices might also be those least likely to choose to opt in to a voluntary insurance system.

Undermining of confidence from a power to modify or suspend accounting requirements: Some have recommended that the systemic risk regulator be given the power to suspend, or modify the implementation of, accounting standards. Consumers Union believes that this could lead to a serious undermining of confidence. As the past year has shown, confidence is an essential element in sustaining financial markets.

7. Promoting increased accountability

Consumers Union strongly agrees with President Obama's statement that market players must be held accountable for their actions, starting at the top.[21] There are many elements to accountability. Here is a nonexclusive list.

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[21] Overhaul, post to the White House blog on Feb. 25, 2009, available at http://www.whitehouse.gov/blog/09/02/25/Overhaul/.

Consumers Union believes that accountability must include making every entity receiving a fee in connection with a financial instrument responsible for future problems with that instrument. This would help to end the "keep the fee, pass the risk" phenomenon which helped to fuel poor underwriting of nonprime mortgages. Moreover, everyone who sells a financial product to an individual should have an enforceable legal obligation to ensure that the product is suitable. Likewise, everyone who advises individuals about financial products should have an enforceable fiduciary duty to those individuals.

Executive compensation structures should be changed to avoid overemphasis on short term returns rather than the long term health and stability of the financial institution. We also agree with the recommendation which has been made by regulators that they should engage in a thorough review of regulatory rules to identify any rules which may permit or encourage over-reliance on ratings or risk modeling.

Consumers Union also supports more accountability for financial institutions who receive public support. Companies that choose to accept taxpayer funds or the benefit of taxpayer-backed programs or guarantees should be required to abandon anti-consumer practices and be held to a high standard of conduct.[22]

A stronger role for state law and state law enforcement also will enhance accountability. Regulatory oversight and strict enforcement at all levels of government can stop harmful products and practices before they spread. "All hands on deck," including state legislatures, state

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[22] For example, in connection with the Consumer and Business Lending Initiative, which is to be managed through the Term Asset Backed Securities Facility (TALF), Consumers Union and 26 other groups asked Secretary Geithner on Jan. 29, 2009, to impose eligibility restrictions on program participants to ensure that the TALF would not support the taxpayer financed purchase of credit card debt with unfair terms. That request was made before the program's size was increased from $200 billion to $1 trillion. http://www.consumersunion.org/pdf/TALF.pdf.

Attorneys General and state banking supervisors, will help to enforce existing standards, identify problems, and develop new solutions.

Conclusion

Even the best possible regulatory structure will be inadequate unless we also achieve a change in regulatory culture, better day to day regulation, an end to gaps in regulation, real credit reform, accountability, and effective consumer protection. Creating a systemic risk regulator without reducing household risk through effective consumer protection would be like replacing the plumbing of our financial system with all new pipes and then still allowing poisoned water into those new pipes. The challenges in regulatory reform and modernization are formidable and the stakes are high. We look forward to working with you toward reforming the oversight of financial markets and financial products.

List of Appendices

1. General Accountability Office figure showing 2006 nonprime mortgage volume of banks ($102 billion), subsidiaries of nationally chartered financial institutions ($203 billion) and independent lenders ($239 billion).

2. Consumers Union's Principles for Regulatory Reform in Consumer Financial Services.

3. Consumers Union's Platform on Mortgage Reform

APPENDIX ONE

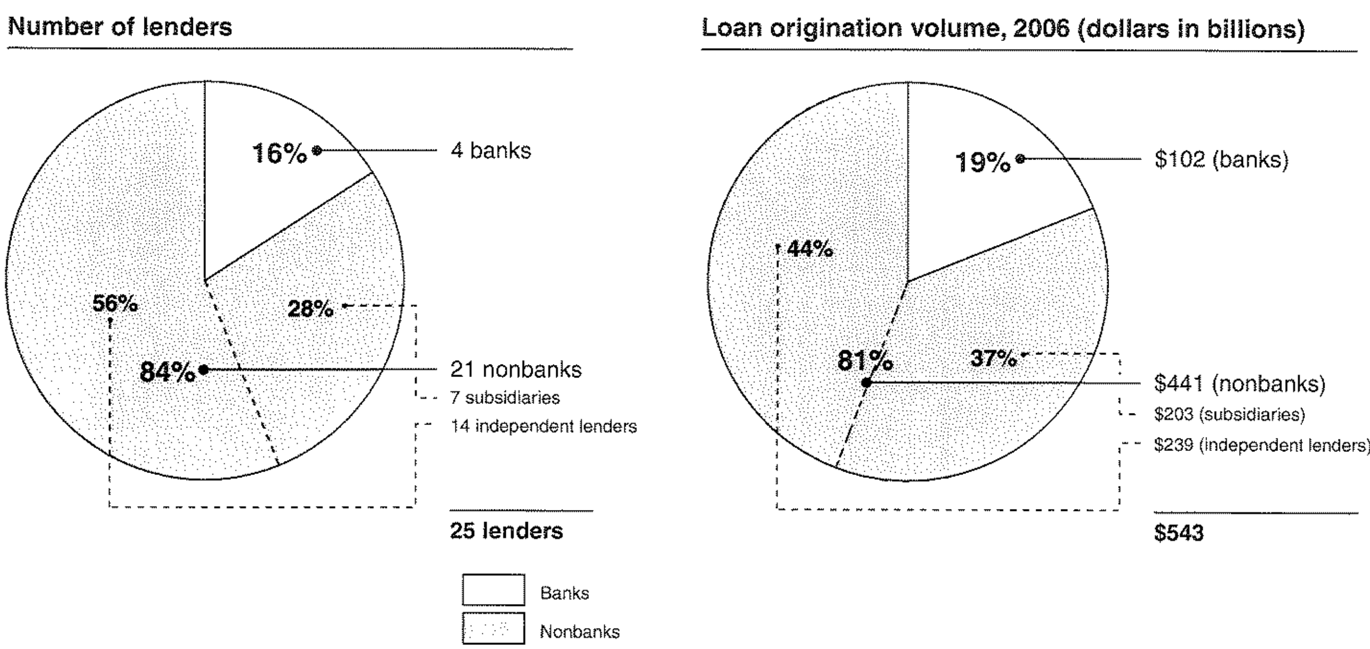
Page 24 from GAO Report, GAO 09-0216, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

PDF follows

Also found at: http://www.gao.gov/new.items/d09216.pdf.

originations), all but 4 were nonbank lenders, accounting for 81 percent of origination by dollar volume.[39]

Figure 3: Status of Top 25 Subprime and Nonprime Mortgage Lenders (2006)



Source: GAO.

Although these lenders were subject to certain federal consumer protection and fair lending laws, they were generally not subject to the same routine monitoring and oversight by federal agencies that their bank counterparts were. From 2003 to 2006, subprime lending grew from about 9 percent to 24 percent of mortgage originations (excluding home equity loans), and Alt-A lending (nonprime loans considered less risky than subprime) grew from about 2 percent to almost 16 percent, according to data from the trade publication *Inside Mortgage Finance*. The resulting sharp rise in defaults and foreclosures that occurred as subprime and other homeowners were unable to make mortgage payments led to the collapse of the subprime mortgage market and set off a series of events that led to today's financial turmoil.

[39]Of the 21 nonbank lenders, 7 were subsidiaries of national banks, thrifts, or holding companies.

APPENDIX TWO

Consumers Union Principles for Regulatory Reform in Consumer Financial Services

1. Every financial regulatory agency must make consumer protection as important as safety and soundness. The crisis shows how closely linked they are.

2. Consumers must have the additional protection of a Financial Product Safety agency whose sole job is their protection, and whose rules create baseline federal standards that apply regardless of the nature of the provider. This agency would have dual jurisdiction along with the functional regulator. States would remain free to set higher standards.

3. State innovation in financial services consumer protection and state enforcement of both federal and state laws must be honored and encouraged. This will require repeal of the OCC's preemption regulations and its rule exempting operating subsidiaries of national banks from state supervision. The OCC should also immediately cease to intervene in cases, or to file amicus briefs, against the enforceability of state consumer protection laws.

4. Every financial services regulator must have: a proactive attitude to find and stop risky, harmful, or unfair practices; prompt, robust, effective complaint handling for individuals; and an active and public enforcement program.

5. Financial restructuring will be incomplete without real credit reform, including: outlawing pricing structures that mislead; requiring underwriting for the ability to repay the loan at the highest interest rate and highest payment that the loan may reach; a requirement that the "shelter rule" that ends most purchaser responsibility for problems with a loan be waived by the purchaser of any federally-related mortgage loan; a requirement that borrower income be verified; an end to complex pricing structures that obscure the true cost of credit; suitability and fiduciary duties on credit sellers and credit advisors; and an end to steering payments and negative amortization abuses.

APPENDIX THREE

Consumers Union Mortgage Reform Platform

We need strong new laws to make all loans fair. This should include these requirements for every home mortgage:

- Require underwriting: Every lender should be required to decide if the borrower will be able to repay the loan and all related housing costs at the highest interest rate and the highest payment allowed under the loan.
- Lenders should be required to verify all income on the loan application.
- End complex pricing structures that obscure the true cost of the loan.
- Brokers and lenders should be required to offer only those types of loans that are suitable to the borrower.
- Brokers and lenders should have a fiduciary obligation to act in the best interest of the borrower.
- Stop payments to brokers to place consumers in higher cost loans.
- End the use of negative amortization to hide the real cost of a loan.
- Require translation of loan documents into the language in which the loan was negotiated.
- Hold investors accountable through assignee liability for the loans they purchase.
- Require that everyone who gets a fee for making or arranging a loan is responsible later if something goes wrong with that loan.
- Adopt extra protections for higher-cost loans.
- Restore state powers to develop and enforce consumer protections that apply to all consumers and all providers.
- For more information, see: http://www.defendyourdollars.org/topic/mortgages/