Hearing on "Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve" before the Subcommittee on Domestic Monetary Policy and Technology of the U.S. House Committee on Financial Services

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2:00 p.m., Thursday, July 16, 2009 – 2128 Rayburn House Building

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Chairman Watt, Ranking Member Paul, and Members of the Subcommittee: Thank you for inviting me here today to discuss restructuring the financial regulatory system. I applaud the subcommittee for exploring bold new approaches to financial regulation needed to address our nation's economic challenges.

In my remarks today, I testify in support of the Consumer Financial Protection Agency Act of 2009, proposed by the Administration. The Act would transfer many of the consumer financial protection responsibilities of federal banking regulators to a single, dedicated agency whose sole mission is consumer protection. This step is essential for three reasons. First, during the housing bubble, our current system of fragmented regulation drove lenders to shop for the easiest legal regime. Second, the ability of lenders to switch charters put pressure on regulators – both state and federal – to relax credit standards. Finally, federal banking regulators have routinely sacrificed consumer protection for the short-term profitability of banks. Creating one, dedicated regulator charged solely with consumer financial protection would establish uniform standards and enforcement for all lenders and help eliminate another death spiral in lending. Although I examine this issue through the lens of mortgage regulation, my discussion is equally relevant to other forms of consumer credit, such as credit cards and payday loans.

The reasons for the breakdown of the home mortgage market and the private-label market for mortgage-backed securities are well known by now. Our broken system of mortgage finance and the private actors in that system – ranging from mortgage brokers, lenders, and appraisers to the rating agencies and securitizers – bear direct responsibility for this breakdown in standards.

There is more to the story, however. In 2006, depository institutions and their affiliates, which were regulated by federal banking regulators, originated about 54% of all higher-priced home loans. In 2007, that percentage rose to 79.6%.[1] In some states, mortgages originated by state banks and thrifts and independent nonbank lenders were regulated under state anti-predatory lending laws. In other states, however, mortgages had no meaningful state regulation. Consequently, regulatory failure was to blame as well as reckless business practices. That failure was not confined to states, but pervaded federal banking regulation as well.

Neither of these phenomena – the collapse in lending criteria nor the regulatory failure that accompanied it – was an accident. Rather, they occurred because mortgage originators and

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

regulators became locked in a competitive race to the bottom to relax loan underwriting and risk management. The fragmented U.S. system of financial services regulation exacerbated this race to the bottom by allowing lenders to shop for the easiest regulators and laws.

I open by describing how our fragmented regulatory system encouraged lenders to shop for lenient regulators. Then I document regulatory failure by federal banking regulators. Finally, I discuss how the Consumer Financial Protection Agency Act of 2009 solves these problems.

I. The Regulatory Story: Race to the Bottom

It is a basic tenet of banking law that banks should not extend credit without proof of ability to repay. Federal banking regulators[2] had ample authority to enforce principle through safety and soundness and federal consumer protection laws. Nevertheless, they refused to exercise their substantial powers of rule-making, formal enforcement, and sanctions to crack down on poorly underwritten loans until it was too late. Their abdication allowed irresponsible loans to multiply. Furthermore, their green light to banks to invest in investment-grade subprime mortgage-backed securities and CDOs left the nation's largest banks struggling with toxic assets. These problems were a direct result of the country's fragmented system of financial regulation, which caused regulators to compete for turf.

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

In the United States, the home mortgage industry operates under a fragmented regulatory structure which varies according to entity.[3] Banks and thrift institutions are regulated under federal banking laws and a subset of those institutions – namely, national banks, federal savings associations, and their subsidiaries – are exempt from state anti-predatory lending and credit laws due to federal preemption. In contrast, mortgage brokers and independent non-depository mortgage lenders escape federal banking regulation but have to comply with state laws. Only state banks and thrifts in some states (a dwindling group) are subject to both sets of laws.

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

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

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

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

B. Applicable Law

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

1. Federal Law

Following deregulation of home mortgages in the early 1980s, disclosure became the prevailing form of federal mortgage regulation. The federal Truth in Lending Act (TILA),[4] passed in 1968, mandates uniform disclosures regarding cost for home loans. Its companion law, the federal Real Estate Settlement Procedures Act of 1974 (RESPA),[5] requires similar standardized disclosures for settlement costs. Congress charged the Federal Reserve with administering TILA and the Department of Housing and Urban Development with administering RESPA.

In 1994, Congress augmented TILA and RESPA by enacting the Home Ownership and Equity Protection Act (HOEPA).[6] HOEPA was an early federal anti-predatory lending law and prohibits specific abuses in the subprime mortgage market. HOEPA applies to all residential mortgage lenders and mortgage brokers, regardless of the type of entity.

HOEPA has two important provisions. The first consists of HOEPA's high-cost loan provision,[7] which regulates the high-cost refinance market. This provision seeks to eliminate abuses consisting of "equity stripping." It is hobbled, however, by its extremely limited reach – covering only the most exorbitant subprime mortgages – and its inapplicability to home purchase loans, reverse mortgages, and open-end home equity lines of credit.[8] Lenders learned to evade the high-cost loan provisions easily by slightly lowering the interest rates and fees on subprime loans below HOEPA's thresholds and by expanding into subprime purchase loans.

HOEPA also has a second major provision, which gives the Federal Reserve Board the authority to prohibit unfair or deceptive lending practices and refinance loans involving practices that are abusive or against the interest of the borrower.[9] This provision is potentially broader than the high-cost loan provision, because it allows regulation of both the purchase and refinance markets, without regard to interest rates or fees. However, it was not self-activating. Instead, it depended on action by the Federal Reserve Board to implement the provision, which the Board did not take until July 2008.

2. State Law

Before 2008, only the high-cost loan provision of HOEPA was in effect as a practical matter. This provision had a serious Achilles heel, consisting of its narrow coverage. Even though the

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4 15 U.S.C. §§ 1601–1693r.
5 12 U.S.C. §§ 2601–2617.
6 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b).
7 15 U.S.C. § 1602(aa)(1)–(4); 12 C.F.R. § 226.32(a)(1), (b)(1).
8 15 U.S.C. § 1602(i), (w), (bb); 12 C.F.R. § 226.32(a)(2) (1997); EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).
9 15 U.S.C. § 1639(*l*)(2).

Federal Reserve Board lowered the high-cost triggers of HOEPA effective in 2002, that provision still only applied to 1% of all subprime home loans.[10]

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

Consequently, in 1999, North Carolina became the first state to enact a comprehensive anti-predatory lending law.[11] Soon, other states followed suit and passed anti-predatory lending laws of their own. These newer state laws implemented HOEPA's design but frequently expanded coverage or imposed stricter regulation on subprime loans. By year-end 2005, twenty-nine states and the District of Columbia had enacted one of these "mini-HOEPA" laws. Some states also passed stricter disclosure laws or laws regulating mortgage brokers. By the end of 2005, only six states – Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota – lacked laws regulating prepayment penalties, balloon clauses, or mandatory arbitration clauses, all of which were associated with exploitative subprime loans.[12]

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

Nevertheless, this criticism of the states disregards the hard-fought efforts by a growing number of states – which eventually grew to include the majority of states – to regulate abusive subprime loans within their borders. State attorneys general and state banking commissioners spearheaded some of the most important enforcement actions against deceptive mortgage lenders.[13]

C. The Ability to Shop For Lax Laws and Regulators

State-chartered banks and thrifts and their subsidiaries had to comply with the state anti-predatory lending laws. So did independent nonbank lenders and mortgage brokers.

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10 EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).

11 N.C. GEN STAT. § 24-1.1E.

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

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

For the better part of the housing boom, however, national banks, federal savings associations, and their mortgage lending subsidiaries did not have to comply with the state anti-predatory lending laws due to federal preemption rulings by their federal regulators. This became a problem because federal regulators did not replace the preempted state laws with strong federal underwriting rules.

1. Federal Preemption

The states that enacted anti-predatory lending laws did not legislate in a vacuum. In 1996, the federal regulator for thrift institutions – the Office of Thrift Supervision or OTS – promulgated a sweeping preemption rule declaring that henceforth federal savings associations did not have to observe state lending laws.[14] Initially, this rule had little practical effect because any state anti-predatory lending provisions on the books back then were fairly narrow.[15]

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

The stakes rose considerably starting in 1999, when North Carolina passed the first comprehensive state anti-predatory lending law. As state mini-HOEPA laws proliferated, national banks lobbied their regulator – a federal agency known as the Office of the Comptroller of the Currency or OCC – to clothe them with the same federal preemption as federal savings associations. They succeeded and, in 2004, the OCC issued its own preemption rule banning the states from enforcing their laws impinging on real estate lending by national banks and their subsidiaries.[16] In a companion rule, the OCC denied permission to the states to enforce their own laws that were *not* federally preempted – state lending discrimination laws are one example – against national banks and their subsidiaries. After a protracted court battle, the controversy ended up in the U.S. Supreme Court, which upheld the OCC preemption rule.[17]

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14 12 C.F.R. §§ 559.3(h), 560.2.

15 Bostic et al., *supra* note 12; Office of Thrift Supervision, *Responsible Alternative Mortgage Lending: Advance notice of proposed rulemaking*, 65 Fed. Reg. 17811, 17814-16 (2000).

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

17 Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007); Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System*, 23 ANN. REV. BANKING & FINANCE LAW 225 (2004). The Supreme Court later overturned part of the OCC visitorial powers rule. Cuomo v. Clearing House Ass'n, L.L.C., ___ U.S. ___ (2009). The OCC and the OTS left some areas of state law untouched, namely, state criminal law and state law regulating contracts, torts, homestead rights, debt collection, property, taxation, and zoning. Both agencies, though, reserved the right to declare that any state laws in those areas are preempted in the future. For fuller discussion, see. McCoy & Renuart, *supra* note 3.

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

2. The Ability to Shop for the Most Permissive Laws

As a result of federal preemption, state anti-predatory lending laws applied to state-chartered depository institutions and independent nonbank lenders, but not to national banks, federal savings associations, or their mortgage lending subsidiaries. The only anti-predatory lending provisions that national banks and federally chartered thrifts had to obey were HOEPA and agency pronouncements on subprime and nontraditional mortgage loans.[18] Of these, HOEPA had extremely narrow scope. Meanwhile, agency guidances lacked the binding effect of rules and their content was not as strict as the stronger state laws.

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

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

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

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

director of the OTS West Region, where Countrywide was headquartered, was promoted to division director. Some observers considered it a reward.[19]

The result was a system in which lenders could shop for the loosest laws and enforcement. This shopping process, in turn, put pressure on regulators at all levels – state and local – to lower their standards or relax enforcement. What ensued was a regulatory race to the bottom.

II. Regulatory Failure

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

A. The Federal Reserve Board

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

In the mortgage lending area, the Fed's supervisory process has three major parts and breakdowns were apparent in two out of the three. The only part that appeared to work well was the Fed's role as the primary federal regulator for state-chartered banks that are members of the Federal Reserve System.[20]

As the second part of its supervisory duties, the Fed regulates nonbank mortgage lenders owned by bank holding companies but not owned directly or indirectly by banks or thrifts. During the housing boom, some of the largest subprime and Alt-A lenders were regulated by the Fed, including the top- and third-ranked subprime lenders in 2006, HSBC Finance and Countrywide Financial Corporation, and Wells Fargo Financial, Inc.[21]

The Fed's supervisory record with regard to these lenders was mixed. On one notable occasion, in 2004, the Fed levied a $70 million civil money penalty against CitiFinancial Credit Company

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19 Richard B. Schmitt, *Regulator takes heat over IndyMac*, LOS ANGELES TIMES, Oct. 6, 2008; see also Binyamin Appelbaum & Ellen Nakashima, *Regulator Played Advocate Over Enforcer*, WASHINGTON POST, November 23, 2008. The official later retired following a capital contribution backdating scandal.

20 In general, these are community banks on the small side. In 2007 and 2008, only one failed bank – the tiny First Georgia Community Bank in Jackson, Georgia, with only $237.5 million in assets – was regulated by the Federal Reserve System. It is not clear whether the Fed's performance is explained by the strength of its examination process, the limited role of member banks in risky lending, the fact that state banks had to comply with state anti-predatory lending laws, or all three. While more state member banks have since failed, the deepening recession was likely a contributing factor to their failure.

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

21 Data provided by *American Banker*, available at www.americanbanker.com.

and its parent holding company, Citigroup Inc., for subprime lending abuses.[22] Apart from that, the Fed did not take public enforcement action against the nonbank lenders that it regulated. That may be because the Federal Reserve did not routinely examine the nonbank mortgage lending subsidiaries under its jurisdiction. The late Federal Reserve Board Governor Edward Gramlich stated as much in a speech in 2007. Only then did the Fed kick off a "pilot project" to examine the nonbank lenders under its jurisdiction on a routine basis for loose underwriting and compliance with federal consumer protection laws.[23]

Finally, the Board is responsible for administering most federal consumer credit protection laws, including HOEPA. When former Governor Edward Gramlich served on the Fed, he urged then-Chairman Alan Greenspan to exercise the Fed's power to address unfair and deceptive loans under HOEPA. Greenspan refused, preferring instead to rely on non-binding statements and guidances.[24] This reliance on statements and guidances had two disadvantages: one, major lenders routinely dismissed the guidances as mere "suggestions" and, two, guidances did not apply to independent nonbank mortgage lenders.

The Federal Reserve did not relent until July 2008, when under Chairman Ben Bernanke's leadership, it finally promulgated binding HOEPA regulations banning specific types of lax and abusive loans. Even then, the regulations were mostly limited to higher-priced mortgages, which the Board confined to first-lien loans of 1.5 percentage points or more above the average prime offer rate for a comparable transaction, and 3.5 percentage points for second-lien loans. Although shoddy nontraditional mortgages below those triggers had also contributed to the credit crisis, the rule left those loans – plus prime loans – mostly untouched.[25] While badly needed, the rules were too little and too late.

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

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

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

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

Id. at 89.

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

In the home mortgage area, the Board also abdicated its authority to keep Truth-in-Lending Act disclosures up-to-date. The last time the Board did a major overhaul of the TILA rules was in 1981. These TILA disclosures worked tolerably well under the old market conditions featuring fixed-rate mortgages. In the 1990s, however, the market changed with the introduction of risk-based pricing. By that time, the Fed's sorely outdated Truth-in-Lending Act disclosures were not equipped to produce accurate, timely disclosures for subprime loans and exotic adjustable-rate mortgages.[26] Nevertheless, the Fed dragged its feet on issuing new rules. It did not get around to issuing a narrow new rule under TILA on bait-and-switch tactics and payment shock disclosures until July 30, 2008 and when it did, Congress immediately passed legislation declaring the rule insufficient.[27] As for comprehensive reform, the Board did not even initiate a full review of its TILA rules for closed-end mortgages until 2007. It still has not completed that review.[28]

On October 23, 2008, in testimony before the U.S. House of Representatives Oversight Committee, Greenspan admitted that "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief." House Oversight Committee Chairman Henry Waxman asked Greenspan whether "your ideology pushed you to make decisions that you wish you had not made?" Greenspan replied:[29]

> Mr. GREENSPAN. . . . [Y]es, I found a flaw, I don't know how significant or permanent it is, but I have been very distressed by that fact. . . .
>
> Chairman WAXMAN. You found a flaw?
>
> Mr. GREENSPAN. I found a flaw in the model that defines how the world works, so to speak.
>
> Chairman WAXMAN. In other words, you found that your view of the world, your ideology, was not right, it was not working.

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[26] As early as 1998, the Federal Reserve Board and the Department of Housing and Urban Development were aware that Truth in Lending Act disclosures did not come early enough in the nonprime market to allow meaningful comparison shopping. That year, the two agencies issued a report diagnosing the problem. In the report, HUD recommended changes to the Truth in Lending Act to require mortgage originators to provide binding price quotes before taking loan applications. The Federal Reserve Board dissented from the proposal, however, and it was never adopted. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & DEP'T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS, CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, at 28 - 29, 39 - 42 (1998), *available at* www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

[27] *Compare* Federal Reserve System, *Truth in Lending: Final rule; official staff commentary*, 73 Fed. Reg. 44522 (July 30, 2008) w*ith* Mortgage Disclosure Improvement Act of 2008 (MDIA), Pub. L. No. 110-289, tit. V, § 2502(a)(6), 122 Stat. 2855-2856 (July 30, 2008). In the MDIA, Congress issued a rebuke to the Federal Reserve by mandating stronger payment shock disclosures and notice of any interest rate hikes before the loan closing. Congress further amended these provisions of the MDIA in the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, enacted on October 3, 2008.

[28] The Board also seriously delayed revamping TILA disclosures for credit cards, but did issue a comprehensive new final rule on credit card disclosures in January 2009. Federal Reserve System, *Truth in Lending: Final rule*, 74 FR 5244 (Jan. 29, 2009).

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

Mr. GREENSPAN. Precisely. That's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well.[30]

B. Regulatory Lapses by the OCC and OTS

Federal preemption might not have devolved into a banking crisis of systemic proportions had OTS and the OCC replaced state regulation for their regulated entities with a comprehensive set of binding rules prohibiting lax underwriting of home mortgages. Instead, federal banking regulators, including the OCC and OTS, issued a series of "soft law" advisory letters and guidelines against predatory or unfair mortgage lending practices by insured depository institutions.[31] Federal regulators disavowed binding rules during the run-up to the subprime crisis saying that guidelines were more flexible and the agencies enforced those guidelines through bank examinations and informal enforcement actions.[32] Informal enforcement was usually limited to negotiated, voluntary agreements between regulators and the entities that they supervised, making it easy for management to drag out negotiations to soften any restrictions and bid for more time. Furthermore, examinations and informal enforcement are highly confidential, making it easy for a lax regulator to hide its tracks.

1. The Office of Thrift Supervision

Although OTS was the first agency to adopt federal preemption, it managed to fly under the radar during the subprime boom, overshadowed by its larger sister agency, the OCC. After 2003, while commentators were busy berating the OCC preemption rule, OTS allowed the largest federal savings associations to embark on an aggressive campaign of expansion through option payment ARMs, subprime loans, and low-documentation and no-documentation loans.

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

The reasons for these thrift failures evince fundamental regulatory lapses by OTS. Almost all of the thrifts that failed in 2007 and 2008 – and all of the larger ones -- succumbed to massive levels of imprudent home loans. IndyMac Bank, FSB, which became the first major thrift institution to fail during this crisis, in July 2008, manufactured its demise by becoming the top originator of low-documentation and no-documentation loans. These loans, which became known as "liar's loans," infected both the subprime market and credit to borrowers with higher

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

[31] See note 18 *supra.*

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

credit scores. By 2006 and 2007, over half of IndyMac's home purchase loans were subprime loans and IndyMac Bank approved up to half of those loans based on low or no documentation.

Washington Mutual Bank, popularly known as "WaMu," was the nation's largest thrift institution in 2008, with over $300 billion in assets. WaMu became the biggest U.S. depository institution in history to fail on September 25, 2008, in the wake of the Lehman Brothers bankruptcy. WaMu was so large that OTS examiners were stationed there permanently onsite. Nevertheless, from 2004 through 2006, despite the daily presence of the resident OTS inspectors, risky option ARMs, second mortgages, and subprime loans constituted over half of WaMu's real estate loans each year. By June 30, 2008, over one fourth of the subprime loans that WaMu originated in 2006 and 2007 were at least thirty days past due. Eventually, it came to light that WaMu's management had pressured its loan underwriters relentlessly to approve more and more exceptions to WaMu's underwriting standards in order to increase its fee revenue from loans.[33]

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

In short, the three largest depository institution failures in 2007 and 2008 resulted from high concentrations of poorly underwritten loans, including low- and no-documentation ARMs (in the case of IndyMac) and option ARMs (in the case of WaMu and Downey) that were often only underwritten to the introductory rate instead of the fully indexed rate. During the housing bubble, OTS issued no binding rules to halt the proliferation by its largest regulated thrifts of option ARMs, subprime loans, and low- and no-documentation mortgages. Instead, OTS relied on oversight through guidances. IndyMac, WaMu, and Downey apparently treated the guidances as solely advisory, however, as evidenced by the fact that all three made substantial numbers of hazardous loans in late 2006 and in 2007 in direct disregard of an interagency guidance on nontraditional mortgages issued in the fall of 2006 and subscribed to by OTS that prescribed underwriting ARMs to the fully indexed rate.[34]

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

2. The Office of the Comptroller of the Currency

The OCC has asserted that national banks made only 10% of subprime loans in 2006. But this assertion fails to mention that national banks moved aggressively into Alt-A low-documentation

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

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

and no-documentation loans during the housing boom.[35] This mattered a lot, because the biggest national banks are considered "too big to fail" and pose systemic risk on a scale unmatched by independent nonbank lenders. We might not be debating bailouts of Citibank and Bank of America today had the OCC stopped them from expanding into toxic mortgages and bonds.

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

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

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

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

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

The fourth largest U.S. bank in 2005, Wachovia Bank, N.A., originated low- and no-documentation loans through its two mortgage subsidiaries. Wachovia Bank originated such large quantities of these loans – termed Alt-A loans – that by the first half of 2007, Wachovia Bank was the twelfth largest Alt-A lender. These loans performed so poorly that between December 31, 2006 and September 30, 2008, the bank's ratio of net write-offs on its closed-end home loans to its total outstanding loans jumped 2400%. Concomitantly, the bank's parent company, Wachovia Corporation, was reported its first quarterly loss in years due to rising

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

defaults on option ARMs made by Wachovia Mortgage, FSB, and its Golden West predecessor. Public concern over Wachovia's loan losses triggered a silent run on Wachovia Bank in late September 2008, following Lehman Brothers' failure. To avoid receivership, the FDIC brokered a hasty sale of Wachovia to Wells Fargo after Wells Fargo outbid Citigroup for the privilege.

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

As the Wells Fargo story suggests, the OCC depended on voluntary risk management by national banks, not regulation of loan terms and practices, to contain the risk of improvident loans. A speech by the then-Acting Comptroller, Julie Williams, confirmed as much. In 2005, Comptroller Williams, in a speech to risk managers at banks, coached them on how to "manage" the risks of no-doc loans through debt collection, higher reserves, and prompt loss recognition. Securitization was another risk management device favored by the OCC.

Three years later, in 2008, the Treasury Department's Inspector General issued a report that was critical of the OCC's supervision of risky loans. Among other things, the Inspector General criticized the OCC for not instituting formal enforcement actions while lending problems were still manageable in size. In his written response to the Inspector General, the Comptroller, John Dugan, conceded that "there were shortcomings in our execution of our supervisory process" and ordered OCC examiners to start initiating formal enforcement actions on a timely basis.[36]

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

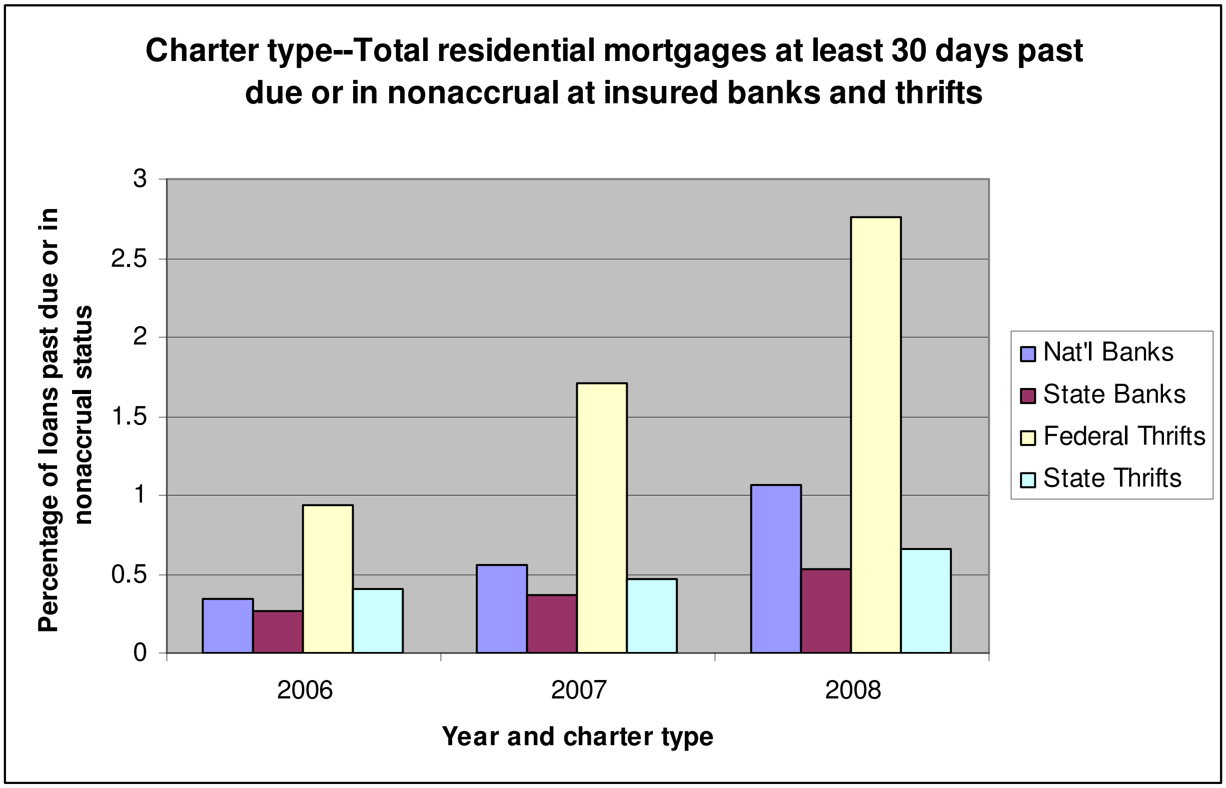
C. Judging by the Results: Loan Performance By Charter

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

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

Data from the Federal Deposit Insurance Corporation show that among depository institutions, federal thrift institutions had the worst default rate for one-to-four family residential mortgages from 2006 through 2008. (See Figure 1).

Figure 1. Total Performance of Residential Mortgages by Depository Institution Charter



Source: FDIC Statistics on Depository Institutions

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

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

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

III. The Consumer Financial Protection Agency Act of 2009

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

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

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

- *First*, Congress should adopt uniform minimum consumer protection standards for all financial services providers nationwide, regardless of entity, charter, or location.

- *Second,* the authority for administering and enforcing these standards should be housed in one federal agency whose sole mission is consumer protection.

- *Third,* to avoid the risk of agency inaction, Congress should give parallel enforcement authority to federal banking regulators and the states.

The Consumer Financial Protection Agency Act of 2009 accomplishes all three objectives.

A. Uniform Federal Safety Standards For Consumer Credit

The downward spiral in underwriting standards drove home the need for uniform consumer protection standards that apply to all financial services providers. Adopting a uniform federal floor would prevent lenders, brokers and other financial providers from seeking safe havens in legal regimes that do little to protect consumers.

The Consumer Financial Protection Agency Act of 2008 ("the Act") solves this problem by creating one set of uniform federal laws that apply to all financial services providers across the country, regardless of entity, charter, or geographic location. To prevent regulators from competing to relax the interpretation of those laws, furthermore, the Act consolidates the authority to administer those laws in one agency. That agency is the new Consumer Financial Protection Agency ("Agency").

The Act would give the Agency jurisdiction over the following types of consumer financial protection laws and apply almost all of these laws to all financial services providers:

- *Unfair Practices:* First, in Section 1031 of the bill, the Agency would have authority to define and prevent unfair or deceptive acts and practices in consumer financial services. While federal banking regulators have this power, they resisted using it until far too late, after the mortgage market melted down. Section 1031 also represents an improvement over the high-cost loan provisions in HOEPA, which proved too narrow and rigid and failed to address new abuses as they appeared in the mortgage market.

- *Deceptive Marketing*: Second, Section 1033 of the bill would authorize the Agency to write rules banning unfair sales practices in consumer financial services. The bill delegates this responsibility to the Agency, partly due to evidence that the Federal Reserve Board was slow to crack down on deceptive marketing practices during the housing bubble. A related provision, Section 1037, would allow the Agency to set forth the duties of front-line personnel such as loan officers or brokers who deal directly with consumers when providing a consumer financial product and to make sure that their compensation methods do not undermine those duties.

- *Transparency and Disclosure:* Third, Section 1032 would empower the Agency to adopt rules mandating better consumer disclosures. This and other sections of the bill direct the Agency to re-design disclosures based not on speculation, but on empirical tests using real consumers and pilot disclosure forms. The bill would transfer this responsibility to the Agency due to the Federal Reserve Board's protracted hesitation and delay in revamping disclosures. The Agency would also be responsible for producing a badly needed, combined TILA-RESPA mortgage disclosure form.

- *Safer Loans:* Fourth, in the provision on standard consumer financial products found in Section 1035, the bill would allow the Agency to gently "nudge" consumers toward safer financial products, such as fixed-rate mortgages, with easy-to-understand terms. Consumers would be offered a relatively safe, plain-vanilla product first. This would make it easier for consumers to comparison shop and help them avoid "snow jobs" by standardizing the terms of safer products and bringing those products front and center to consumers' attention. At the same time, consumers would remain free to choose different products with other features subject to warnings or other safeguards.

- *Existing Consumer Financial Protection Laws:* Finally, the bill would transfer the authority to administer other existing federal consumer financial protection laws to the Agency. These laws would include the Truth in Lending Act, HOEPA, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Fair Credit Billing Act, and the Home Mortgage Disclosure Act.[37]

[37] The Agency would also receive responsibility for administering the Consumer Leasing Act, the Electronic Fund Transfer Act, the Truth in Savings Act, the Alternative Mortgage Transaction Parity Act, the S.A.F.E. Mortgage Licensing Act, the Community Reinvestment Act, the privacy provisions in title V of the Gramm-Leach-Bliley Act, and provisions of the Federal Deposit Insurance Act dealing with deposit insurance disclosures.

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

1. Federal Regulators Cannot Serve Two Masters

The housing bubble and hazardous mortgages by federally regulated depository institutions show that we cannot expect consumer protection to be paramount to federal banking regulators when times are good. At the top of the economic cycle, federal banking regulators are prone to interpret their safety and soundness mandate in favor of the short-term profitability of the banks they regulate, to the detriment of the long-term welfare of consumers. For this reason, the consumer protection function should be removed from federal banking regulators and housed in its own agency whose sole mission is consumer protection.

The bank regulatory agencies' own mission statements make it clear that consumer protection is a low priority. For example, the Federal Reserve Board divides its duties into four general areas:[38]

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

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

Similarly, safety and soundness regulation is the paramount mission of the OCC and OTS. The OCC describes its mission as having four objectives, with consumer protection coming last:[39]

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

Like the OCC, OTS describes safety and soundness as its principal job:[40]

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38 THE FEDERAL RESERVE SYSTEM, PURPOSES & FUNCTIONS 1 (9th ed. 2005).

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

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

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

In theory, safety and soundness and consumer protection should normally overlap. In practice, they have not, as recent experience has shown. During the housing boom, federal banking regulators too often equated short-term profitability, including profits from excessive fees on consumers,[41] with safety and soundness. In their effort to protect the short-term profitability of banks and thrifts, federal regulators often dismissed consumer protection as conflicting with that mission. When agencies derive most of their operating budgets from assessments on the entities they regulate – as do the OCC and OTS – the pressure to sacrifice consumer protection for profit maximization by those entities can be overwhelming.[42]

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

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

The Act contains three main safeguards to help ensure that the Agency's actions comport with bank safety and soundness. First, the National Bank Supervisor would be the only permanent member of the Agency's Board. Second, at numerous points throughout the bill, the Act mandates consultation or coordination by the Agency with its fellow federal regulators, including federal banking regulators and the Securities and Exchange Commission and Commodity

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41 Examples include regulators' slow response to curtailing large prepayment penalties and their continued indecision on costly overdraft protection on checking accounts.

42 For instance, the OCC derives 95% of its budget from assessments on national banks. The twenty largest national banks contribute almost 60% of those assessments. See, e.g., Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PENN. L. REV. 1, 93-94 (2008); Testimony of Arthur E. Wilmarth, Jr., Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (Apr. 26, 2007).

Futures Trading Commission.[43] Finally, the Agency must file regular reports with Congress to enable Congress to exercise its oversight power.

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

A wide range of experts across the political spectrum, from the Treasury Department under former Secretary Paulson to former Federal Reserve governors and the Congressional Oversight Panel, have recommended housing consumer financial protection in its own agency.[44] A separate federal agency dedicated to consumer protection for all consumer credit would offer several distinct advantages. First, it would rescue consumer financial protection from its current orphan state and make consumers the Agency's top priority. Second, it would consolidate industry-wide enforcement in the Agency, meaning that all financial services providers would be subject to the same level of enforcement.

This latter point is necessary to thwart shopping for the easiest regulator. Under the current regime, consumer compliance examinations and enforcement are divided among federal banking regulators and sometimes other agencies, even though the Federal Reserve Board writes the rules for most federal consumer credit laws. Other federal consumer financial protection laws – such as Section 5 of the Federal Trade Commission Act and the Community Reinvestment Act – are individually implemented by the four federal banking regulators with respect to their regulated entities. Each agency can make its own choice about the extent to which it enforces or does not enforce the law. Ending this fragmentation of enforcement would discourage lenders from switching charters in search of the easiest regulator.

Finally, transferring consumer credit laws to one agency whose sole mission is consumer protection would provide regulators with a complete overview of the entire consumer credit market, its structure, and emerging issues. Right now, consumer financial protection suffers from a silo mentality because it is parceled out among so many agencies. Consolidating it in one agency would overcome this silo mentality. In addition, consolidation would concentrate expertise for consumer financial products in one agency. The provisions of the Act authorizing a research division and periodic reporting requirements are essential to developing and deploying this expertise.

3. How to Avoid Future Agency Inaction

Consolidating oversight in one federal agency poses a final concern about agency capture and inaction. The FTC, for example, had a vigorous enforcement record on mortgage abuses during the Clinton Administration but a lackluster record during the George W. Bush Administration, at least until 2008. During that same period, OCC and OTS preemption raised industry capture concerns. These problems are not unique to those agencies, moreover. Administrations and

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[43] See, e.g., §§ 1016, 1022, 1031 of the Act.

[44] THE DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 170-74 (March 2008) (proposing a Conduct of Business Regulatory Agency), available at www.treasury.gov; CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM 30-37 (Jan. 2009), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf. Just last week, former Federal Reserve governors Laurence H. Meyer and Frederic S. Mishkin testified before this Subcommittee advocating transferring the Federal Reserve's consumer protection functions to the new Agency.

agency chairs come and go, which means that over its lifetime, every agency will have periods of drift and inaction. Not every agency head can be a Ben Bernanke or a Sheila Bair.

The drafters of the Act thought long and hard about this issue and carefully designed the bill to counteract possible agency inaction. The Act takes a two-pronged approach. First, it makes federal consumer financial protection standards a floor, not a ceiling. Second, it vests back-up enforcement authority in fellow federal regulators and in the states.

i. A Minimum Federal Floor

To address the concern that at some point in the future, the Agency, with respect to its rule-making authority, might drag its feet on needed reforms, the Act specifies that federal consumer financial protection standards will operate as a floor. As such, the federal standards will preempt state laws that are weaker. However, states would remain free to enact stricter consumer protections so long as those protections are consistent with the federal statute. The Agency would retain the power to determine whether a state law was consistence. § 1041.

A minimum federal floor, rather than a ceiling, is critical for three reasons. First, that approach provides an important safeguard against the possibility that the Agency might adopt unduly weak rules or fail to update the rules. Second, states are closer to local conditions and often more responsive to emerging problems at home. A federal floor would preserve the states' ability to protect their citizens. Finally, giving latitude to the states to adopt stricter standards would preserve the states' important role as laboratories of experimentation. Enabling individual states to test other approaches would help prevent federal rules from becoming ossified. This dual federal-state approach, in fact, may have resulted in lower default rates on mortgages at state banks and thrifts (Figure 1).

Bankers have voiced fears that a patchwork of state laws will make compliance too costly and complex. Those fears are vastly overstated. In fact, in the past, when Congress has enacted federal consumer legislation as a floor, only a handful of states have passed stronger statutes of their own.[45] Bankers have managed to adjust to those few variations. In all other states, the federal standard prevails standing alone.

[45] For example, in the Depository Institutions Deregulation and Monetary Control Act of 1980, Congress allowed states to opt out of federal deregulation of usury caps on first-lien residential mortgages. Fourteen states originally opted out, although some of those later repealed their usury caps. Similarly, only six states exercised their right to opt out of federal preemption under the Alternative Mortgage Transaction Parity Act. Elizabeth Renuart and Kathleen E. Keest, *The Cost of Credit: Regulation, Preemption, and Industry Abuses* §§ 3.9.4.1, 3.10.1, 3.10.2 (Boston: National Consumer Law Center, 3d ed. 2005 and annual supplement).

ii. Back-up Enforcement Power

In financial services regulation, we have experienced starkly different models of enforcement, depending on the regulatory scheme. For national banks and federal savings associations, especially after 2004, the OCC and OTS invoked their visitorial powers to argue that they had sole enforcement power for any consumer protection abuses by their regulated entities. Then those agencies resisted vigorous enforcement action against abusive mortgages, while continuing to assert that no other agency had authority to act in their stead.

In contrast, when the Securities and Exchange Commission succumbed to lax enforcement in the late 1990s and 2000s, state attorneys general retained the power to prosecute securities fraud on their own. That power resulted in landmark actions by the attorneys general of New York, Massachusetts, and Connecticut, among other states, and lit a fire under the S.E.C. to initiate actions of its own. Similarly, in insurance regulation, the decentralization of enforcement among the fifty states meant that when there were serious market conduct problems, some states were likely to take enforcement even if others were not. The Act incorporates these lessons by giving back-up enforcement authority to other federal regulators and the states to provide a strong antidote to any inaction by the Agency.

Vis-à-vis other federal regulators, to avoid traffic jams, the Act gives primary enforcement to the Agency. Other federal regulators, however, can recommend enforcement to the Agency. Furthermore, if the Agency fails to initiate enforcement within 120 days of a recommendation, then the federal regulator that made the recommendation may take enforcement action of its own.[46]

Vis-à-vis the states, the Act gives state attorneys general the power to enforce the Act upon notice to the Agency. The Agency can intervene as of right if it chooses.

In sum, the Act would put an end to the regulatory arbitrage that fueled the credit crisis and give consumers a needed voice. I would welcome any questions.

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[46] Nothing in the Act affects the enforcement authority of the Department of Justice, the S.E.C., or the Commodity Futures Trading Commission.