

WRITTEN STATEMENT

OF

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ON

COMMUNITY AND CONSUMER ADVOCATES' PERSPECTIVES

ON

THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

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

The current recession, while probably reflecting the confluence of a number of different trends in the world economy, both within the United States and abroad, was sparked by problems in residential mortgages; these problems themselves reflected a confluence of economic and regulatory events. A rapid rise in housing prices across the country, fueled at least in part by low interest rates, combined with lax mortgage underwriting practices, resulted in high levels of defaults on mortgage loans when interest rates started to rise and housing prices started to decline. Falling housing prices and low loan to value ratios on mortgages, some of which contained repricing features that abruptly increased monthly payments to levels that borrowers could not meet, coupled with borrowers' inability to refinance or sell their homes as prices declined, led to defaults. The effects of these defaults were absorbed by investors in mortgage backed securities, particularly securities backed by subprime and Alt-A mortgages, rather than be absorbed on the balance sheets of lending financial institutions, as had been the case in past housing bubbles that eventually burst. As investors lost confidence in these mortgage backed securities, the flow of funds to make new housing loans, particularly to subprime borrowers, also

dried up. Constraints on the availability of credit further reduced housing demand, leading to further declines in housing prices and further defaults. The loss of confidence in subprime and Alt-A mortgage backed securities spread to other mortgage and asset backed securities turning a housing bubble into what in the past would have been referred to as a “panic” in the market for mortgages, and other asset backed securities and collateralized debt obligations. This “panic” in turn further disrupted the flow of funds available for mortgage credit for all classes of borrowers leading to further declines in housing prices, creating a downward spiral that is only now being arrested through a panoply of new government programs and extraordinary actions by financial services regulators.

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

A primary reason for regulating consumer financial products and services is that we believe that these products can be beneficial to consumers. If we did not believe that these

services can be beneficial, we would simply make them illegal as some states have done for gambling transactions. For example, consumer mortgages finance home ownership thereby contributing to stable communities and to quality of life. The availability of home mortgages on reasonable terms requires that each step in the process for supplying home mortgages, from the raising of funds in the money markets or through deposits to the payment to the seller, must operate efficiently and in coordination with other steps.

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

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

Finally, in order for financial intermediaries to originate or arrange home mortgages that have a high likelihood of being repaid, the terms of these mortgage loans to consumers have to be fair and reasonable. While almost any underwriting standards and credit terms may seem adequate in a market where home prices are appreciating rapidly and a troubled loan can be refinanced or paid off by selling the home at a profit, in a more stable or a falling housing market, the terms of the loan and the underwriting standards must ensure that the vast majority of loans can be repaid according to their terms. This is necessary in order to minimize the personal

tragedies caused by foreclosures, to maintain access to home mortgage credit for those who are willing and able to repay, and ultimately to avoid the downward spiral in home values brought on by foreclosures and ever tightening credit.

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

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

These considerations weigh strongly against the creation of a separate agency to assume sole responsibility for consumer protection in financial services. The countervailing argument is, of course, that the current system did not work to prevent the mortgage crisis and that changes are needed. It cannot be denied that the mortgage crisis has been a product of multiple failures, both on the part of private sector participants in their failure to recognize their own long term interests and on regulators in their failure to identify and respond to problems in a timely manner. Investors in mortgage backed securities failed to carefully evaluate their investments and placed undue reliance on rating agencies and the system that produced those securities. In some cases, the regulators of these investors, both in the United States and abroad, failed to

recognize this failure in regulated entities. Rating agencies failed to recognize the significance of changes in the composition of mortgage pools that they were rating. Lenders failed to use careful underwriting standards and to limit specialized loans, such as “no doc” loans, to the few cases where they were appropriate. In some cases, regulators of these lenders failed to recognize the failures of these lenders. Finally, home buyers failed to make sure that they understood and could afford the mortgages that they were entering into and regulators failed to take steps to make sure that consumers were reasonably able to understand the mortgage transactions that they were entering into. In addition, the Federal Reserve’s interest rate policy has been criticized by some as having contributed to the crisis by keeping rates too low for too long and then by raising them too rapidly. These types of, and other similar, failures are not unique to the current crisis or events and have contributed to past bubbles and panics.

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

In the current regulatory structure in which financial institution regulators are responsible for both prudential supervision and consumer rules, the economic and transactional analysis of consumer transactions that is part of the consumer oversight process both benefits from an

understanding of prudential concerns and informs prudential supervisors. This two-way flow of information creates synergies that will be difficult, if not impossible, to replicate in an independent consumer regulatory agency. Nevertheless, in my view, historically the prudential supervisors have, in some cases, paid insufficient attention, and devoted insufficient resources to, consumer regulatory issues. Although regulatory actions in the area of home mortgages and credit cards in the recent past strongly suggest that the Federal Reserve Board has increased its attention to these areas, more could be done and steps could be taken to ensure that it is.

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

Finally, the proposed legislation to create a new consumer financial protection agency includes broad new regulatory and examination authorities. These Proposals should be evaluated on their own merits. Clearly, there have been problems in the area of mortgage origination outside of the insured depository institution regulatory structure that may benefit from centralized federal oversight. Other areas of consumer financial services may also benefit from

additional federal oversight. These responsibilities can be housed within the existing regulatory structure or, in a new agency, consistent with recognition of the close relationship between prudential and consumer interests. However these issues are resolved, it should be done in a way that the resolution recognizes the vertical integration of our financial markets and the common goals of regulatory policies rather than fostering conflicts between them.

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