Testimony of

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U.S. House of Representatives
The Honorable Barney Frank, Chairman

Hearing on

Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

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SUMMARY
Thank you, Chairman Frank, Rep. Bachus and members of the committee. I am Edmund Mierzwinski, Consumer Program Director for the U.S. Public Interest Research Group, the federation of state PIRGs. I am pleased to be able to offer the views of U.S. PIRG at the hearing on Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals. U.S. PIRG is a founding member of Americans for Financial Reform, a coalition of nearly 200 national, state and local consumer, employee, investor, community and civil rights organizations spearheading a campaign for real reform in our banking and financial system.[1]

We are generally quite pleased with the Obama Administration's legislative proposals as presented last month to the nation,[2] although not all have yet been presented to date in legislative language. In particular, we strongly support the establishment of a Consumer Financial Protection Agency. Among its critical concepts are its independence, its recognition that federal law should always serve as a floor of protection not a ceiling, and its shared enforcement with states.

The remainder of the plan addresses all of the elements of reform we believe are necessary to reform our collapsed financial system and inoculate it against further catastrophic events. It closes the so-called shadow market gaps in regulation, it strengthens existing prudential regulation and it provides for systemic risk amelioration.

Its proposed new investor protections in the form of greater fiduciary responsibilities for broker-dealers were released last Friday in legislative language. If improved, these will be important reforms. The administration's proposed limits on and greater transparency for executive pay and bonuses are also important. Executive compensation policies should be fair to investors and should provide incentives to keep corporate leaders from making decisions that are detrimental to the safety and soundness of our financial system.

The Administration's proposal establishes a Financial Services Oversight Council and also vests the Federal Reserve with many new powers aimed at controlling system-wide risk. If the Congress and the public are to accept the Federal Reserve as a systemic regulator, strong measures must be added to ensure the Federal Reserve is truly independent, transparent and responsive to the public. We must open up and democratize the Federal Reserve so that it is publicly accountable.

There are some additional areas where the aforementioned Obama proposals could be perfected. We discuss these in the testimony. There are others where it is lacking. In particular, we find that the proposed regulation of Credit Rating Agencies is insufficient to police those firms and solve the problems they caused. We also find that the proposal is missing adequate provisions on mortgage foreclosure prevention and solving the home affordability crisis. Without more effective strategies to keep people in their homes, our nation will continue to face the catastrophe of millions of mortgage foreclosures.

[1] More information on Americans for Financial Reform is available at http://www.ourfinancialsecurity.org
[2] "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, June 17, 2009.

In summary, President Obama has taken a critical and in some ways a bold step toward restoring integrity and fairness to our financial system, but the battle for reform has only just begun. We look forward to working with the President and the Committee to move these proposals into law in the strongest form possible. We have no illusions about the difficulty of the fight to come. Our principles will only prevail if the voices of the public are heard over those of bankers, traders, mortgage brokers and their armies of lobbyists. We appreciate the opportunity to provide that voice today.

I. **Comments on the President's Consumer Financial Protection Agency proposal**

In our testimony in June before this committee,[3] we outlined the case for establishment of a robust, independent federal Consumer Financial Protection Agency to protect consumers from unfair credit, payment and debt management products, no matter what company or bank sells them and no matter what agency may serve as the prudential regulator for that company or bank. We described the many failures of the current federal financial regulators. We discussed the need for a return to a system where federal financial protection law serves as a floor not as a ceiling, and consumers are again protected by the three-legged stool of federal protection, state enforcement and private enforcement. We rebutted anticipated opposition to the proposal, and not a moment too soon. Since that hearing, the opposition from the vested interests who relied on that system to protect them from enforcement of the consumer laws has increased to a shrill level, despite its lack of substance. The companies and regulators that are part of the system that failed to protect us are both claiming that it wasn't their fault and that nothing needs to be done.

In that June testimony, we offered detailed suggestions to shape the development of the agency in the legislative process. We believe that, properly implemented, a Consumer Financial Protection Agency will encourage innovation by financial actors, increase competition in the marketplace and lead to better choices for consumers.

The idea of a federal consumer protection agency focused on credit and payment products has gained broad and high-profile support because it targets the most significant underlying causes of the massive regulatory failures that occurred. First, federal agencies did not make protecting consumers their top priority and, in fact, seemed to compete against each other to keep standards low, ignoring many festering problems that grew worse over time. If agencies did act to protect consumers (and they often did not), the process was cumbersome and time-consuming. As a result, agencies did not act to stop some abusive lending practices until it was too late. Finally, regulators were not truly independent of the influence of the financial institutions they regulated.

[3] Joint written testimony of Edmund Mierzwinski, U.S. PIRG and Travis Plunkett, Consumer Federation of America, on behalf of over a dozen groups, 24 June, 2009, Hearing of the U.S. House Financial Services Committee on "Regulatory Restructuring: Enhancing Consumer Financial Products Regulation," available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/mierzwinski_-_submitted_with_plunkett.pdf (last visited 14 July 2009).

In our earlier testimony, we provided extensive examples for the record of the failure of existing agencies to do their job, and in some cases, to focus instead on preventing state enforcers from doing theirs. We will not repeat all of that material here, but summarize much of it below.

In that previous testimony, we also outlined the reasons that the Obama Administration proposal has tremendous potential to solve the problems caused by the conflicts of interest, lack of will charter-shopping and other barriers to robust consumer protection that defeated our and Congressional efforts to force the existing regulators to fulfill their role of implementing Congressional intent in issuing rules to protect consumers, examining institutions for compliance with those rules and, finally, enforcing those rules when they did not.

Combining safety and soundness supervision – with its focus on bank profitability – in the same institution as consumer protection magnified an ideological predisposition or anti-regulatory bias by federal officials that led to unwillingness to rein in abusive lending before it triggered the housing and economic crises. Though we now know that consumer protection leads to effective safety and soundness, structural flaws in the federal regulatory system compromised the independence of banking regulators and encouraged them to overlook, ignore and minimize their mission to protect consumers. This created a dynamic in which regulatory agencies competed against each other to weaken standards and ultimately led to an oversight process that was cumbersome and ineffectual. These structural weaknesses threatened to undermine even the most diligent policies and intentions. They complicated enforcement and vitiated regulatory responsibility to the ultimate detriment of consumers.

Within agencies in which these functions are combined, regulators have often treated consumer protection as less important than their safety and soundness mission or even in conflict with that mission.[4] For example, after more than 6 years of effort by consumer organizations, federal regulators are just now contemplating incomplete rules to protect consumers from high-cost "overdraft" loans that financial institutions often extend without the knowledge of or permission from consumers. Given the longstanding inaction on this issue, it is reasonable to assume that regulators were either uninterested in consumer protection or viewed restrictions on overdraft loans as an unnecessary financial burden on banks that extend this form of credit, even if it is deceptively offered and financially harmful to consumers. In other words, because regulators apparently decided that their overriding mission was to ensure that the short-term balance sheets of the institutions they regulated were strong, they were less likely to perceive that questionable products or practices (like overdraft loans or mortgage pre-payment penalties) were harmful to consumers. Last week, USA Today explained the issue in powerful terms:

> Today, each of the nation's 10 largest banks allows consumers to overdraw with checks, debit cards or at ATMs, a 2009 USA TODAY survey reveals. Large banks also reserve the right to process large transactions first, triggering more overdraft fees by emptying the account more quickly. Some even charge consumers before they overdraw by

[4] Occasionally, safety and soundness concerns have led regulators to propose consumer protections, as in the eventually successful efforts by federal banking agencies to prohibit "rent-a-charter" payday lending, in which payday loan companies partnered with national or out-of-state banks in an effort to skirt restrictive state laws. However, from a consumer protection point-of-view, this multi-year process took far too long. Moreover, the outcome could have been different if the agencies had concluded that payday lending would be profitable for banks and thus contribute to their soundness.

> deducting a purchase when it's made, rather than when it clears, pushing the account into the red sooner.[…] Meanwhile, the Federal Reserve is examining the fairness of certain overdraft practices. It's unclear whether those efforts will be enough to rein in overdrafts, now the single-largest driver of consumer fee income for banks. In 2009, banks are expected to reap a record $38.5 billion from overdraft fees, nearly twice the $20.5 billion they stand to collect from credit card penalties such as late and over-limit fees.[5]

Two other examples of agency failures discussed in detail in the previous testimony are the Federal Reserve's failure to implement Home Ownership and Equity Protection Act (HOEPA) rules for fourteen years as the mortgage crisis grew and the Office of the Comptroller of the Currency's (OCC) focus on eviscerating state consumer protections while enforcing no consumer laws itself:

The Federal Reserve Board was granted sweeping anti-predatory mortgage regulatory authority by the 1994 HOEPA. Final regulations were issued on 30 July 2008 only after the world economy had collapsed due to the collapse of the U.S. housing market triggered by predatory lending.[6]

Meanwhile, in interpretation letters, amicus briefs and other filings, the OCC preempted state laws and local ordinances requiring lifeline banking (NJ 1992, NY, 1994), prohibiting fees to cash "on-us" checks (par value requirements) (TX, 1995), banning ATM surcharges (San Francisco, Santa Monica and Ohio and Connecticut, 1998-2000), requiring credit card disclosures (CA, 2003) and opposing predatory lending and ordinances (numerous states and cities).[7] Throughout, OCC ignored Congressional requirements accompanying the 1994 Riegle-Neal Act not to preempt without going through a detailed preemption notice and comment procedure, as the Congress had found many OCC actions "inappropriately aggressive."[8]

In 2000-2004, the OCC worked with increasing aggressiveness to prevent the states from enforcing state laws and stronger state consumer protection standards against national banks and their operating subsidiaries, from investigating or monitoring national banks and their operating subsidiaries, and from seeking relief for consumers from national banks and subsidiaries.

These efforts began with interpretative letters stopping state enforcement and state standards in the period up to 2004, followed by OCC's wide-ranging preemption regulations in 2004 purporting to interpret the National Bank Act, plus briefs in court cases supporting national banks' efforts to block state consumer protections.

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[5] Kathy Chu, "Banks' 'courtesy' loans at soaring rates irk consumers," USA Today, 8 July 2009, available at http://www.usatoday.com/money/perfi/credit/2009-07-08-banks-overdraft-fees_N.htm (last visited 14 July 2009).
[6] 73 FR 147, Page 44522, Final HOEPA Rule, 30 July 2008
[7] "Role of the Office of Thrift Supervision and Office of the Comptroller of the Currency in the Preemption of State Law," USGAO, prepared for Financial Services Committee Chairman James Leach, 7 February 2000, available at http://www.gao.gov/corresp/ggd-00-51r.pdf (last visited 21 June 2009).
[8] [Statement of managers filed with the conference report on H.R. 3841, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Congressional Record Page S10532, 3 August 1994

Meanwhile, OCC's only two meaningful consumer protection actions since 1995 followed earlier actions against the same wrongdoers by other, smaller agencies.[9] Essentially, the agency was shamed into a few pro-consumer activities.

While some might argue that the Federal Reserve Board does deserve some credit for leading regulators (after Rep. Carolyn Maloney of this committee showed them the way) in enacting credit card protections in 2008, [10] that action is the exception that proves the rule. Congress, led by Maloney, ultimately passed a stronger law, the 2009 Credit Card Accountability, Responsibility and Disclosure Act (CARD Act).[11]

The Fed's abject failure to heed years of warnings on the mortgage crisis, its actions (with other regulators) encouraging the above-explained overdraft fees and its disdain for the Federal Trade Commission's efforts since 2003 to complete a concurrent rulemaking to improve consumer rights in the Fair Credit Reporting Act are more typical of its point of view. In many ways, the inactions of the one agency that did not embrace the credit card rules, the OCC, likely led to the final action by Congress this year. The OCC's failure to act on rising credit card complaints at the largest national banks triggered Congress to investigate, resulting in passage of the law.

Although a Consumer Financial Protection Agency (CFPA) would not be a panacea for all current regulatory ills, it would correct many of the most significant structural flaws that exist, realigning the regulatory architecture to reflect the unfortunate lessons that have been learned in the current financial crisis and sharply increasing the chances that regulators will succeed in protecting consumers in the future. As proposed by the President, the CFPA is designed to achieve the regulatory goals of elevating the importance of consumer protection, prompting action to prevent harm, ending regulatory arbitrage, and guaranteeing regulatory independence.

The CFPA, as proposed by President Obama, is granted broad authority to assure a marketplace that promotes fair treatment, fair competition, and the marketing of asset-building financial products. In particular, it provides broad, generic authority to address unfair, deceptive and abusive practices beyond those identified in existing substantive statutes and beyond disclosures. It is given authority to address arbitration abuses. It places all consumer protection statutes together in one place for holistic protection. It is granted authority to set standards for products that are deserving of and that warrant public trust and reliance.

A. The structure of the CFPA as proposed by President Obama has several other critical components that must not be weakened.

1) The CFPA gets a full set of examination, supervision, and data collection tools.
2) The proposal recognizes the need for stable, diversified funding (although its funding sources need specificity).

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[9] [9] Testimony of Arthur E. Wilmarth, Jr., Professor Of Law, George Washington University Law School, Hearing On "Credit Card Practices: Current Consumer And Regulatory Issues" On April 26, 2007, Before The Subcommittee On Financial Institutions And Consumer Credit Of The Committee On Financial Services, available at http://financialservices.house.gov/hearing110/htwilmarth042607.pdf (last visited 14 July 2009).

[10] The final rule was published in the Federal Register a month later. 74 FR 18, page 5498 Thursday, January 29, 2009

[11] HR 627 became Public Law No. 111-24 on 22 May 2009.

3) The commissioners are independent (although the bill could be improved by requiring stronger consumer protection qualifications and a revolving door ban.)

In its work to protect consumers and the marketplace from abuses, the CFPA as envisioned by the Administration would have a full set of enforcement and analytical tools. The first tool would be that the CFPA could gather information about the marketplace so that the agency itself could understand the impact of emerging practices in the marketplace. The agency could use this information to improve the information that financial services companies must offer to customers about products, features or practices or to offer advice to consumers directly about the risk of a variety of products on the market.

For some of these products, features or practices, the agency might determine that no regulatory intervention is warranted. For others, this information about the market will inform what tools are used. A second tool would be to address and rein in deceptive marketing practices or require improved disclosure of terms. The third tool would be the identification and regulatory facilitation of "plain vanilla," low risk products that should be widely offered. The fourth tool would be to restrict or ban specific product features or terms that are harmful or not suitable in some circumstances, or that don't meet ordinary consumer expectations. Finally, the CFPA would also have the ability to prohibit dangerous financial products. We can only wonder how much less pain would have been caused for our economy if a regulatory agency had been actively exercising the latter two powers during the run up to the mortgage crisis.
Under the Administration proposal, the agency will have broad rule-making authority to effectuate its purposes, including the flexibility to set standards that are adequate to address rapid evolution and changes in the marketplace. Such authority is not a threat to innovation, but rather levels the playing field and protects honest competition, as well as consumers and the economy.

The Administration's plan also provides rule-making authority for the existing consumer protection laws related to the provision of credit would be transferred to this agency, including the Truth in Lending Act (TILA), Truth in Savings Act (TISA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Protection Act (RESPA), Fair Credit Reporting Act (FCRA), Electronic Fund Transfer Act (EFTA), and Fair Debt Collection Practices Act (FDCPA). Current rule-writing authority for nearly 20 existing laws is spread out among at least seven agencies. Some authority is exclusive, some joint, and some is concurrent. However, this hodge-podge of statutory authority has led to fractured and often ineffectual enforcement of these laws. It has also led to a situation where federal rule-writing agencies may be looking at just part of a credit transaction when writing a rule, without considering how the various rules for different parts of the transaction effect the marketplace and the whole transaction. The CFPA with expertise, jurisdiction and oversight that cuts across all segments of the financial products marketplace, will be better able to see inconsistencies, unnecessary redundancies, and ineffective regulations. As a market-wide regulator, it would also ensure that critical rules and regulations are not evaded or weakened as agencies compete for advantage for the entities they regulate.

Additionally the agency would have exclusive "organic" federal rule-writing authority within its general jurisdiction to deem products, features, or practices unfair, deceptive, abusive or unsustainable, and otherwise to fulfill its mission and mandate. The rules may range from placing prohibitions, restrictions or conditions on practices, products or features to creating

standards, and requiring special monitoring, reporting and impact review of certain products, features or practices.

A critical element of a new consumer protection framework is ensuring that consumer protection laws are consistently and effectively enforced. As mentioned above, the current crisis occurred not only because of gaps and weakness in the law, but primarily because the consumer protection laws that we do have were not always enforced. For regulatory reform to be successful, it must encourage compliance by ensuring that wrongdoers are held accountable.

B. A new CFPA will best achieve accountability by relying on a three-legged stool: enforcement by the agency, by states, and by consumers themselves.

First, the CFPA itself will have the tools, the mission and the focus necessary to enforce its mandate. The CFPA will have a range of enforcement tools under the Administration proposal. The Administration, for example, would give the agency examination and primary compliance authority over consumer protection matters. This will allow the CFPA to look out for problems and address them in its supervisory capacity. But unlike the banking agencies, whose mission of looking out for safety and soundness led to an exclusive reliance on supervision, the CFPA will have no conflict of interest that prevents it from using its enforcement authority when appropriate. Under the Administration proposal, the agency will have the full range of enforcement powers, including subpoena authority; independent authority to enforce violations of the statues it administers; and civil penalty authority.

Second, both proposals allow states to enforce federal consumer protection laws and the CFPA's rules. As stated in detail below, states are often closer to emerging threats to consumers and the marketplace. They routinely receive consumer complaints and monitor local practices which will permit state financial regulators to see violations first, spot local trends, and augment the CFPA's resources. The CFPA will have the authority to intervene in actions brought by states, but it can conserve its resources when appropriate. As we have seen in this crisis, states were often the first to act.

C. In particular, the bill proposes to reverse decades of rollbacks and restrictions on state innovation and enforcement. These provisions must not be weakened.

1) The CFPA rules establish federal law as a floor of protection, not a ceiling against further state action.
2) The CFPA rules are enforceable by state attorneys general.
3) The bill rolls back the OCC's and other banking agencies' wrongheaded preemption of state laws.

A key principle of federalism is the role of the states as laboratories for the development of law.[12] State and federal consumer protection laws can develop in tandem. After one or a few states legislate in an area, the record and the solutions developed in those states provide important information for Congress to use in deciding whether to adopt a national law, how to craft such a law, and whether or not any new national law should displace state law.

[12] *New State Ice Co. v. Leibman*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

Consumers need state laws to prevent and solve consumer problems. State legislators generally have smaller districts than members of Congress do. State legislators are closer to the needs of their constituents than members of Congress. States often act sooner than Congress on new consumer problems. Unlike Congress, a state legislature may act before a harmful practice becomes entrenched nationwide. In a September 22, 2003 speech to the American Bankers Association in Hawaii, Comptroller John D. Hawke admitted that consumer protection activities "are virtually always responsive to real abuses." He continued by pointing out that Congress moves slowly. Comptroller Hawke said, "It is generally quite unusual for Congress to move quickly on regulatory legislation – the Gramm-Leach-Bliley privacy provisions being a major exception. Most often they respond only when there is evidence of some persistent abuse in the marketplace over a long period of time." U.S. consumers should not have to wait for a persistent, nationwide abuse by banks before a remedy or a preventative law can be passed and enforced by a state to protect them.

States can and do act more quickly than Congress, and states can and do respond to emerging practices that can harm consumers while those practices are still regional, before they spread nationwide. These examples extend far beyond the financial services marketplace.

States and even local jurisdictions have long been the laboratories for innovative public policy, particularly in the realm of environmental and consumer protection. The federal Clean Air Act grew out of a growing state and municipal movement to enact air pollution control measures. The national organic labeling law, enacted in October 2002, was passed only after several states, including Oregon, Washington, Texas, Idaho, California, and Colorado, passed their own laws. In 1982, Arizona enacted the first "Motor Voter" law to allow citizens to register to vote when applying for or renewing drivers' licenses; Colorado placed the issue on the ballot, passing its Motor Voter law in 1984. National legislation followed suit in 1993. Cities and counties have long led the smoke-free indoor air movement, prompting states to begin acting, while Congress, until this month, proved itself virtually incapable of adequately regulating the tobacco industry. A recent and highly successful FTC program—the National Do Not Call Registry to which fifty-eight million consumers have added their names in one year—had already been enacted in forty states.

But in the area of financial services, where state preemption has arguably been the harshest and most sweeping, examples of innovative state activity are still numerous. In the past five years, since the OCC's preemption regulations have blocked most state consumer protections from application to national banks, one area illustrating the power of state innovation has been in identity theft, where the states have developed important new consumer protections that are not directed primarily at banking. In the area of identity theft, states are taking actions based on a non-preemptive section of the Fair Credit Reporting Act, where they still have the authority to act against other actors than national banks or their subsidiaries.

There are seven to ten million victims of identity theft in the U.S. every year, yet Congress did not enact modest protections such as a security alert and a consumer block on credit report information generated by a thief until passage of the Fair and Accurate Credit Transactions Act (FACT Act or FACTA) in 2003. That law adopted just some of the identity theft protections that

had already been enacted in states such as California, Connecticut, Louisiana, Texas, and Virginia.[13]

Additionally FACTA's centerpiece protection against both inaccuracies and identity theft, access to a free credit report annually on request, had already been adopted by seven states: Colorado, Georgia, Maine, Maryland, Massachusetts, New Jersey and Vermont. Further, California in 2000, following a joint campaign by consumer groups and realtors, became the first state to prohibit contractual restrictions on realtors showing consumers their credit scores, ending a decade of stalling by Congress and the FTC.[14] The FACT act extended this provision nationwide.

Yet, despite these provisions, advocates knew that the 2003 federal FACTA law would not solve all identity theft problems. Following strenuous opposition by consumer advocates to the blanket preemption routinely sought by industry as a condition of all remedial federal financial legislation, the final 2003 FACT Act continued to allow states to take additional actions to prevent identity theft. The results have been significant.

Since its passage, fully 47 states and the District of Columbia have granted consumers the right to prevent access to their credit reports by identity thieves through a security freeze. Indeed, even the credit bureaus, longtime opponents of the freeze, then adopted the freeze nationwide.[15]

Efficient federal public policy is one that is balanced at the point where even though the states have the authority to act, they feel no need to do so. Since we cannot guarantee that we are ever at that optimum, setting federal law as a floor of protection as the default—without also preempting the states—allows us to retain the safety net of state-federal competition to guarantee the best public policy.[16]

[13] See California Civil Code §§ 1785.11.1, 1785.11.2, 1785,16.1; Conn. SB 688 §9(d), (e), Conn. Gen. Stats. § 36a-699; IL Re. Stat. Ch. 505 § 2MM; LA Rev. Stat. §§ 9:3568B.1, 9:3568C, 9:3568D, 9:3571.1 (H)-(L); Tex. Bus. & Comm. Code §§ 20.01(7), 20.031, 20.034-039, 20.04; VA Code §§ 18.2-186.31:E.

[14] See 2000 Cal. Legis. Serv. 978 (West). This session law was authored by State Senator Liz Figueroa. "An act to amend Sections 1785.10, 1785.15, and 1785.16 of, and to add Sections 1785.15.1, 1785.15.2, and 1785.20.2 to the Civil Code, relating to consumer credit."

[15] Consumers Union, U.S. PIRG and AARP cooperated on a model state security freeze proposal that helped ensure that the state laws were not balkanized, but converged toward a common standard. More information on the state security freeze laws is available at http://www.consumersunion.org/campaigns/learn_more/003484indiv.html (last visited 21 June 2009).

[16] For further discussion, see Edmund Mierzwinski, "Preemption Of State Consumer Laws: Federal Interference Is A Market Failure," Government, Law and Policy Journal of the New York State Bar Association Spring 2004 (Vol. 6, No. 1, pgs. 6-12).

C. Additional Suggestions to Improve the President's proposal[17] on the Consumer Financial Protection Agency

1. Provide consumers with a private right of action to enforce its organic rules

The bill lacks any mechanism for holding wrongdoers accountable to individual consumers for violating rules or giving consumers remedies for harm when rules are violated. While it is important to have both strong federal and state enforcement, strong consumer enforcement also helps guarantee compliance.

Consumers themselves are an essential, in some ways the most essential, element of an enforcement regime. Recourse for individual consumers must, of course, be a key goal of a new consumer protection system. The Administration's plan appropriately states that the private enforcement provisions of existing statutes will not be disturbed. However, the Administration's plan does not address the enforceability of new CFPA rules, but it is equally critical that the consumers who are harmed by violations of these rules be allowed to protect themselves. Its predecessor, H.R. 1705, as introduced by Reps. Delahunt and Brad Miller, provided such a right of action for consumers to enforce these rules.

Consumers must have the ability to hold those who harm them accountable for numerous reasons:

- No matter how vigorous and how fully funded a new CFPA is, it will not be able to directly redress the vast majority of violations against individuals. The CFPA will likely have thousands of institutions within its jurisdiction. It cannot possibly examine, supervise or enforce compliance by all of them.

- Individuals have much more complete information about the affect of products and practices, and are in the best position to identify violations of laws, take action, and redress the harm they suffer. An agency on the outside looking in often will not have sufficient details to detect abusive behavior or to bring an enforcement action.

- Individuals are an early warning system that can alert states and the CFPA of problems when they first arise, before they become a national problem requiring the attention of a federal agency. The CFPA can monitor individual actions and determine when it is necessary to step in.

- Bolstering public enforcement with private enforcement conserves public resources. A federal agency cannot and should not go after every individual violation.

[17] Last week, Chairman Frank and over a dozen co-sponsors introduced HR 3126, to establish a Consumer Financial Protection Agency. Our comments generally apply to both the President's language[17] and the Chairman's language unless noted.

- Consumer enforcement is a safety net that ensures compliance and accountability after this crisis has passed, when good times return, and when it becomes more tempting for regulators to think that all is well and to take a lighter approach.

- The Administration's plan rightly identifies mandatory arbitration clauses as a barrier to fair adjudication and effective redress. We strongly agree -- but it is also critically important to access to justice that consumers have the right to enforce a rule.

Private enforcement is the norm and has worked well as a complement to public enforcement in the vast majority of the consumer protection statutes that will be consolidated under the CFPA, including TILA, HOEPA, FDCPA, FCRA, EFTA and others. While consumers, under the administration proposal, would retain their existing rights to enforce violations of these statutes, they also should gain the right to enforce CFPA rules.

2. Strengthen its authority over civil rights enforcement

We concur with the detailed testimony today of the Leadership Conference on Civil Rights that systemic discriminatory and abusive lending practices were major contributors to the current financial crisis. Any attempt to protect consumers from unscrupulous financial products must therefore also seek to prevent and remedy illegal discrimination. As proposed, the Consumer Financial Protection Agency will significantly enhance protections for American consumers.

Racial minorities have received a disproportionately high number of high-cost subprime mortgages, and African Americans and Latinos will lose at least $213 billion dollars in wealth as a result of the current economic downturn. A robust Consumer Financial Protection Agency will be aware of these disparities and proactively work to reduce them.

Among the changes that should be made are the following, as recommended by the Leadership Conference on Civil Rights. Civil rights must be part of the agency's stated mission; fair lending compliance and enforcement must be built into the agency's formal structure; enforcement authority under the Fair Housing Act currently held by HUD and the Department of Justice should not be diminished; and all agencies engaged in regulating financial institutions or enforcing civil rights and fair lending statutes must cooperate and openly share information. Further, we concur that CFPA rules should be enforceable by individuals and those who violate CFPA rules must be accountable to the individuals they harm. More specifically, the bill should include a private right of action by consumers; that CFPA must have clear authority to impose mandates/sanctions on institutions found to be out of compliance with fair lending statutes; and, that the CFPA Consumer Advisory Council should include persons with fair lending and civil rights expertise.

3. Add greater consumer representation and empowerment provisions

The CFPA should have the authority to grant intervener funding to consumer organizations to fund expert participation in its stakeholder activities. The model has been used successfully to fund consumer group participation in state utility ratemaking. Second, a government chartered consumer organization should be created by Congress to represent consumers' financial services interests before regulatory, legislative, and judicial bodies, including before the CFPA. This

organization could be financed through voluntary user fees such as a consumer check-off included in the monthly statements financial firms send to their customers. It would be charged with giving consumers, depositors, small investors and taxpayers their own financial reform organization to counter the power of the financial sector, and to participate fully in rulemakings, adjudications, and lobbying and other activities now dominated by the financial lobby.[18]

Rather than simply expanding or complicating regulation, government-chartered citizen groups can balance the power of regulated entities and keep their regulators from being captured. Government-chartered consumer organizations and intervener-funding and other citizenship strategies address the same broad problem: the imbalance between the concentrated power of affected industries and the diffuse power of ordinary people. By designing regulation so that it engages and informs citizens, facilitates organizing, and puts citizens into direct encounters with the industry as well as with regulators, these policies energize citizenship, and they begin to redress the structural power imbalance.[19]

4. The Proposal's Consumer Arbitration Provisions Are a Work In Progress

We strongly commend the administration for giving the CFPA the power to eliminate forced arbitration in consumer contracts. We have provided the committee staff with perfecting language to ensure that the provision achieves its goals.

This week, Minnesota Attorney General Lori Swanson filed an important lawsuit against one of the largest arbitration companies.[20] The lawsuit will shed important light on this system of private justice. Just the first few sentences of her complaint document the problem:

> 1. Just about every American has a credit card. The credit card companies often require—deep in the fine print of the consumer agreement—that the consumer forfeit his or her right to have any dispute resolved by a judge or jury. Instead, the agreements often require that any disputes be resolved exclusively through a private system of binding arbitration—and frequently through the National Arbitration Forum. The Forum represents to the public, the courts, and consumers that it is independent, operates like an impartial court system, and is not affiliated with any party. The consumer does not know that the Forum works alongside creditors behind the scenes—against the interests of consumers—to convince creditors to place mandatory pre-dispute arbitration clauses in their customer agreements and to appoint the Forum as the arbitrator of any disputes that

[18] As his last legislative activity, in October 2002, Senator Paul Wellstone proposed establishment of such an organization, the Consumer and Shareholder Protection Association, S 3143.

[19] For a more detailed treatment, see Edmund Mierzwinski, "Regulation as Civic Empowerment," pages A11-A14, the American Prospect, July-August 2009, Special Report On The Credit Crisis and Working America, available online at http://www.prospect.org/cs/articles?article=regulation_as_civic_empowerment (last visited 14 July 2009).

[20] News release, "Attorney General Swanson sues national arbitration company for deceptive practices," 14 July 2009 available at http://www.ag.state.mn.us/Consumer/PressRelease/090714NationalArbitration.asp (last visited 14 July 2009). The civil complaint is on file with the author. Also see Kathy Chu and Taylor McGraw, "Minnesota lawsuit claims credit card arbitration firm has ties to industry," USA Today, 15 July 2009, available at http://www.usatoday.com/money/perfi/credit/2009-07-14-credit-card-arbitration-firm-lawsuit_N.htm (last visited 15 July 2009).

may arise in the future. The Forum does this so that creditors will file arbitration claims against consumers in the Forum, thereby generating revenue for it.

2. The consumer also does not know—and the Forum hides from the public—that the Forum is financially affiliated with a New York hedge fund group that owns one of the country's major debt collection enterprises.

5. Clarify Its Independence and Limit Its Exposure To Cost-Benefit Requirements Under OMB

In recent Congressional testimony, Professor Rachel Barkow stated:

> Finally, my last major point is to raise the issue of the relationship between the CFPA and the President. It is unclear from the Act as it is currently written whether the CFPA will be subject to presidential directives and oversight, including review by the Office of Information and Regulatory Affairs (OIRA) in the President's Office of Management and Budget (OMB). I take no position on whether or not the agency should be subject to this type of review.[21]

Our position is that a truly independent agency should not be subject to this type of review and that the proposal's references to onerous cost-benefit rules, which are generally under purview of OIRA, should be deleted to better allow the agency to conduct its mission.

6. Additional Suggestions To Improve the CFPA

We have provided committee staff with a number of perfecting amendments to clarify various parts of the legislative language to meet its legislative intent. For example, its laudable provision on whistleblower protection must be upgraded from a modest grievance process to a full set of due process rights for workers, as Congress has established in several recent laws in other sectors. Its provisions on state enforcement and establishment of a federal floor of protection should be fine-tuned to avoid potential misinterpretation.[22] We also concur with the National Community Reinvestment Coalition that the Community Reinvestment Act (CRA) should be transferred to the new agency.[23]

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[21] Professor Rachel Barkow, 8 July 2009, Hearing of the Consumer Protection Subcommittee of the Energy and Commerce Committee, "The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC," available at http://energycommerce.house.gov/Press_111/20090708/testimony_barkow.pdf (last visited 15 July 2009).

[22] In addition to points we have made to staff, Professor Prentiss Cox makes a number of useful points on clarifying state preemption and attorney general enforcement terms of the bill, 8 July 2009, Hearing of the Consumer Protection Subcommittee of the Energy and Commerce Committee, "The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC," available at http://energycommerce.house.gov/Press_111/20090708/testimony_cox.pdf (last visited 15 July 2009).

[23] Legitimate questions have been raised about the continuing role of CRA protests in merger proposals, which will continue to be under prudential regulators as well as about non-consumer aspects of the CRA including community development lending. These provisions all need to be worked out, but we believe the issues are not insurmountable. (Note, HR 3126 does not include the transfer of the CRA.)

II. Comments on the President's Proposal To Reform Executive Pay and Bonuses and Additional Recommendations on Whistleblowers and Frontline Worker Incentives

We will seek to better align compensation practices with the interests of shareholders and the stability of firms and the financial system through the following five principles. First, compensation plans should properly measure and reward performance. Second, compensation should be structured to account for the time horizon of risks. Third, compensation practices should be aligned with sound risk management. Fourth, golden parachutes and supplemental retirement packages should be reexamined to determine whether they align the interests of executives and shareholders. Finally, transparency and accountability should be promoted in the process of setting compensation.

"Financial Regulatory Reform, A New Foundation," 17 June 2009, Treasury Department, at 29

A system that rewards failure and short-term gains with catastrophic risk undoubtedly contributed to the collapse of the big banks, AIG and the entire financial system. Failed leadership and the outright ignorance of facts by the executives and staff on the highest levels made their multi-billion dollar compensation packages and bonuses incredibly hard to comprehend for those of us stuck with the bill of bailing them out. Executive compensation policies should be fair to investors and should provide incentives to keep corporate leaders from making decisions that are detrimental to the safety and soundness of our financial system.

The Wall Street Journal reported that "from 2002 to 2008, the five biggest Wall Street securities firms paid an estimated $190 billion in bonuses. Those companies churned out $76 billion in combined profits during the same period. Last year, the companies had a combined net loss of $25.3 billion, yet paid bonuses of roughly $26 billion." Ninety percent of institutional investors think the current compensation system has overpaid executives, while 75% support giving shareholders "say on pay."[24]

To begin to address this issue, the Administration proposes a number of changes to the current system. Within these proposals are some common sense solutions that simply work to better align a corporation's decisions and investments with what's best for the real owners – the shareholders. And now that taxpayers are the reluctant shareholders in large banks, the insurance and auto industries – we're owners too.

There are two key elements to the proposed reforms:

- Shedding light on the process of determining executive compensation and including shareholders in the process

- Aligning performance and reward incentives with long-term performance and the recognition of risk, not short-term gains

[24] Statistical source: Americans For Financial Reform "Executive Compensation" white paper, available at http://ourfinancialsecurity.org/2009/07/executive-compensation/ (last visited 4 July 2009).

A. Shedding light on the process of determining executive compensation and including shareholders in the process

Compensation committees can easily consist of individuals in the same industries who want to keep their friends in the money, and often do. There is little to no independence or requirement to act in the interest of shareholders when it comes to compensation.

The Administration recommends that public companies "facilitate greater communication between shareholders and management over executive compensation" and should "include on their proxies a nonbinding shareholder vote on executive compensation." Studies have found that this practice, widely known as "say on pay," has been effective in several other countries in terms of producing shareholder value and compensation and retirement packages that are more in line with performance.[25]

Critics will say that the shareholders do not understand the complexities of compensation and therefore would not add value. The bank executives repeatedly – in many times and within many aspects of the financial crisis – used the complexity argument to scare people from asking tough questions. That needs to end. If they language is oblique and terms are from the inside, then these institutions need to make it a more clear and transparent communication. And there isn't one shareholder who does not understand that bringing a company and the financial system to a collapse calls for new leadership.

B. Aligning performance and reward incentives with long-term performance and the recognition of risk, not short-term gains

Executives and employees have the incentive to "bet the house" because in many cases they are not playing with their own money. They are paid based on what they bring in – not necessarily on what they risked to get there. And as long the money poured in, no one rocked the boat.

The common sense approach is to align to align compensation with long-term performance and not short-term or immediate financial gain.

A responsible executive compensation program should not pay out short term bonuses unless performance is maintained a period of time, to avoid the possibility of rewarding executives just prior to a collapse in performance. Short-term incentive plans, if not designed with effective safeguards, could inappropriately encourage senior executives to manage for the short term and take on excessive risk. Evidence indicates that the current financial crisis was exacerbated by executives being rewarded for short-term financial performance without regard to whether that level of performance was sustainable.

Short term bonus payments to top executives of failed financial institutions have renewed interest in finding more efficient methods of compensation. Tens of millions of dollars in bonus payments were made to firms such as Bear Sterns, AIG and Lehman Brothers.

[25] Sudhakar Balachandran, Fabrizio Ferri & David Maber, *Solving the Executive Compensation Problem through Stockholder Votes? Evidence from the U.K.*, 2007 Nov.; Jie Cai & Ralph Walking, *Stockholders Say on Pay: Does it Create Value?* 2008 Dec.

In 2007, the Committee for Economic Development, a distinguished panel of business and academic leaders, found that "[d]ecision making based primarily on short-term considerations damages the ability of public companies, and therefore, of the U.S. economy to sustain superior long-term performance."

Goldman Sachs Chairman and CEO Lloyd Blankfein agreed, stating that "an individual's performance should be evaluated over time so as to avoid excessive risk taking and allow for a 'clawback' effect. To ensure this, all equity awards should be subject to future delivery and/or deferred exercise over at least a three-year period." [26] This week, Goldman announced a return to profitability and a return to large bonuses.

> "I find this disconcerting," said Lucian A. Bebchuk, a Harvard law professor. "My main concern is that it seems to be a return to some of the flawed short-term compensation structures that played an important role in the run-up to the financial crisis."[27]

C. Improving incentives and protections for frontline workers

Executive pay reforms should also be accompanied by fixing frontline worker incentives so that they are not forced to sell wealth-depleting products to consumers to meet work goals and requirements and to maintain their pay levels above-minimum wage. In the bank pay pyramid, the fewer highly-compensated employees make greater bonuses when their work culture compels low-paid frontline workers to pile high-cost credit cards, overdraft accounts and other profitable but unfair products onto unsuspecting consumers.

Perversely, an incentive system similar to one at the top is at work at the street level of the biggest banks, although the street level workers can't actually win. In the tens of thousands of bank branches and call centers of our biggest banks, employees-including bank tellers earning an average of $11.32 an hour-are forced to meet sales goals to keep their jobs and earn bonuses. Many goals for employees selling high-fee and high-interest products like credit cards and checking accounts have actually gone up as the economy has gone down.

Risk-taking in the industry will quickly outpace regulatory coverage unless financial sector employees can challenge bad practices as they develop and direct regulators to problems. Whistleblowers are critical to combating fraud and other institutional misconduct. The federal government needs to hear from and protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare. If we previously had more protections for whistleblowers, we would have had more warning of the eventual collapse of Wall Street. We commend the administration for including employee protection in its reform, but urge that it be strengthened.

Since 2000, Congress has enacted or strengthened whistleblower protections in six laws. They include consumer product manufacturing and retail commerce, railroads, the trucking industry, metropolitan transit systems, defense contractors, and all entities receiving stimulus funds. All of these laws provide more incentives and protections for disclosure of wrongdoing than does the

[26] Both CED and Blankfein quoted in Americans For Financial Reform "Executive Compensation" white paper, available at http://ourfinancialsecurity.org/2009/07/executive-compensation/ (last visited 4 July 2009).
[27] Graham Bowley, "With Big Profit, Goldman Sees Big Payday Ahead," the New York Times, 15 July 2009.

current proposal from the administration. For example, it does not protect disclosures made to an employer, which is often the first action taken by loyal, concerned employees, and the impetus for retaliation. Also conspicuously absent are administrative procedures and remedies that include best practices for fair and adequate consideration of claims by employees.

We recommend the following improvements in any reform legislation before the committee.

Whistleblower protections. Innovation in the industry will quickly outpace regulatory coverage unless bank branch, call-center, and other financial sector employees can challenge bad practices as they develop and direct regulators to problems. The federal government needs to hear from and provide best practice whistleblower rights consistent with those in the stimulus and five laws passed or strengthened last Congress to protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare.

Fair compensation. New rules need to restructure pay and incentives for front-line finance sector employees away from the current 'sell-anything' culture. The hundreds of thousands of front-line workers who work under pressure of sales goals need to be able to negotiate sensible compensation policies that reward service and sound banking over short-term sales.

III. Comments on Administration plan to provide greater protection for investors

A. New Fiduciary Responsibilities a Critical Step

The critically-important section 913 of the proposed Investor Protection Act of 2009[28] empowers the SEC to impose a fiduciary duty on dealer-brokers in order to harmonize the regulation of these professionals with that of investment advisors. This heightened standard of care is a positive step towards ensuring that investors have the protection needed to engage in sound and beneficial investments. By folding broker-dealers in with investment advisors, this legislation deals with the reality of these professions: those who act as advisers should be regulated as advisers. While the thrust of this amendment is commendable, it is critical that Congress take steps to ensure that the legislative language used to empower the SEC is drawn as narrowly as possible to meet legislative intent.

We agree with the position of the Consumer Federation of America that any "watered down" language that provides less than the most robust protection for investors in adviser/investor relationships does not go far enough to right the wrongs of previous practices. In particular, the language of Sec. 913 subsections (k) and (f), the sections that may be used to impose a fiduciary duty on brokers, dealers, and investment advisers, is permissive, "…the Securities and Exchange Commission **may** promulgate rules…." Instead we join the North American Securities Administrators Association[29] and the CFA to urge that the legislative language mandate that the SEC adopt the highest standard of care in order to avoid overly broad standards and that broker-

[28] Legislative language is available at http://www.treas.gov/press/releases/docs/tg205071009.pdf (last visited 14 July 2009).

[29] Testimony of Fred J. Joseph, Colorado Securities Commissioner and President, North American Securities Administrators Association Before the United States Senate Committee on Banking, Housing, and Urban Affairs, "Enhancing Investor Protection and the Regulation of Securities Markets," March 26, 2009.

dealers not be able to escape that higher standard of protection. Roper goes further and argues that there should not be an artificial delineation allowing broker-dealers to escape their fiduciary duties between offering advice and selling.

As the Consumer Federation of America has noted on numerous occasions, over the past two decades, in response to competition from both financial planners and discount brokers, full service brokers have transformed their business model into one that is, or at least appears to be, largely advice-driven. They have taken to calling their sales representatives "financial advisers," offered investment planning services, and marketed their services based on the advice offered. The SEC permitted this transformation without requiring brokers to comply with the Investment Advisers Act provisions designed to govern such conduct. Instead, each time the SEC has had to make a choice between protecting investors and protecting the broker-dealer business model, it has chosen the latter. The President's plan attempts to reverse that trend, by ensuring that all those who offer advisory services are subject to the appropriate fiduciary standard of care and loyalty and by improving the quality of pre-engagement disclosure investors receive about these obligations.

The Administration also proposes a study of the use of mandatory arbitration clauses in investor contracts and, based on that study, very commendably recommends "legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers." We believe that the study will show that the SEC should and must use that authority to prohibit forced arbitration in investor contracts, just as we believe that the CFPA should ban them in credit and deposit accounts. It is a myth that forced arbitration lowers the costs of dispute settlements. This may be true among equivalent business players; it is rarely true between small investors and big securities firms and more rarely, if ever, true in any standard consumer contract, between, for example, a credit card company and a consumer, a hospital or cell phone company or car dealer and a consumer, or, worse, between a nursing home and a bed-ridden, aged consumer.[30]

B. Other Improvements Needed To Protect Small Investors

While Congress needs to hold the SEC accountable; it must also preserve its independence. Congress also needs to fully fund the SEC, including its consumer and investor protection and enforcement divisions. Given demonstrated weaknesses in the agency's oversight revealed by both the current crisis and the Bernie Madoff scandal, Congress should assess the funding needs of the SEC and then take steps to bring the agency as quickly as possible to the point that it can fully carry out its mission of oversight of the markets and financial professionals. In addition, the SEC should be authorized to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action. Too often, the Department of Justice passes on securities-related cases because of its own resource constraints and competing priorities.

Finally, although we commend the administration for its proposals in the Investor Protection Act of 2009 to improve and clarify its own aiding and abetting liability, it regrettably does not propose to reinstate investor rights to enforce aiding and abetting liability under Section 10(b) of

[30] For more information and studies on these matters, see the U.S. PIRG-supported coalition Fair Arbitration Now! website at http://www.fairarbitrationnow.org/ (last visited 14 July 2009).

the Securities Exchange Act of 1934 and SEC Rule 10b-5, as largely eliminated by the Supreme Court in *Central Bank*[31] in 1994 and even more harshly limited in *Stoneridge* in 2008.

Even when individuals' claims are small, the costs to society and the economy of a fraud may be in the hundreds of millions or billions of dollars. Yet, absent the ability to proceed collectively, individuals have no means of redress because – as the wrongdoers know – it is frequently economically impossible for victims to pursue claims on an individual basis. Private investors form a key front-line defense against financial fraud and abuse as they are in the unique position to identify and take action against unlawful conduct. The ability of investors to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Legislation should ensure that all individuals have the right to access federal courts individually or as a member of a class action.
As we told the Supreme Court in our 2008 friend of the court brief in *Stoneridge*:[32]

> Few, if any, of the major corporate frauds of the last decade have been perpetrated by corporate securities issuers (including their officers, directors, managers, and other insiders) acting alone. Outside actors have played significant roles in nearly every one – in some instances by making false statements calculated to deceive investors about the issuer's financial condition and in others by participating in deceptive financial transactions calculated to achieve the same result. […] The victims of several of the most notorious recent frauds have achieved a substantial measure of recovery (though in each case far from all of their losses) only because courts allowed them to proceed against culpable outside actors.

Further, the administration regrettably does not propose to reduce unduly high pleading requirements and other barriers to justice for small investors established by the so-called Private Securities Litigation Reform Act of 1995.[33]

IV. Comments on Administration plan to reform prudential regulation[34]

For the last three decades, financial regulators, Congress and the executive branch have steadily eliminated core pieces of the regulatory system that had restrained the financial sector from acting on its own worst tendencies. The post-Depression regulatory system aimed to force disclosure of publicly relevant financial information; established limits on the use of leverage; drew bright lines between different kinds of financial activity and protected regulated commercial banking from investment bank-style risk taking; enforced meaningful limits on economic concentration, especially in the banking sector; provided meaningful consumer protections (including restrictions on usurious interest rates); and contained the financial sector so that it remained subordinate to the real economy.

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[31] U.S. PIRG joined Trial Lawyers for Public Justice (now Public Justice) in an unsuccessful amicus in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).
[32] *Stoneridge Investment Partners, LLP v. Scientific-Atlanta, et al.* , Brief of AARP, Consumer Federation of America, and U.S. PIRG as *amici curiae* in support of petitioner, available at http://www.uspirg.org/html/consumer/archives/stoneridgeamicus-aarp.pdf (last visited 14 July 2009).
[33] Public Law 104-67.
[34] Parts of this section come from the Americans for Financial Reform white paper "Restoring Prudential Financial System Regulation" I co-authored, available at http://ourfinancialsecurity.org/afr/pdfs/restoring_prudential_regulation.pdf (last visited 14 July 2009).

This regulatory system was highly imperfect, of course, but it was not the imperfections that led to the system's erosion and collapse. Instead, it was a concerted effort by Wall Street, which gaining momentum steadily until it reached fever pitch in the late 1990s that continued through the first half of 2008.

One of the key flaws in that system was a lack of prudential supervision by the financial regulators themselves. They failed to use their broad powers. Bank regulators were supposed to hold banks to adequate capital standards, prevent unsafe and unsound lending and maintain an adequate deposit insurance base. With too little congressional oversight, regulators became too cozy with the banks. Worse, the Congress acceded to industry demands to reduce deposit insurance premiums and to even base them on weak "risk" standards. As a result, many banks avoided making adequate payments into the funds even as the level of risk they placed on the system grew. This worsened moral hazard.

Further, the bank regulatory system has remained largely outside of congressional purview because bank regulators are not paid out of congressional appropriations. Instead, regulators receive regulatory dues assessments from banks and largely control their own budgets.

We need a simpler and more transparent financial system that is far less vulnerable to speculative abuse and systemic risk, as well as a reliable policing mechanism in order to restore the financial markets to their proper role as facilitators of the real economy. A core principle of both efforts is that any institution that creates credit (and hence risk) must be subject to prudential regulation. It does not matter whether the institution calls itself a commercial bank, an investment bank, a mortgage broker, a hedge fund or a private equity firm. There must be no category of institution that escapes supervision. As candidate Barack Obama astutely stated in an important campaign speech on March 27, 2008, at Cooper Union in New York: "We need to regulate institutions for what they do, not for what they are."

As the Administration has correctly proposed, a variety of actions must be taken to improve capital standards, reduce leverage, require real "skin in the game" in securitizations, and bring off-balance sheet entities onto balance sheets.

The administration has also proposed a modest consolidation-- between the two most problematic regulators, the Office of the Comptroller of the Currency and the Office of Thrift Supervision. "Competition" between the OCC and OTS for "memberships" in the form of regulatory dues assessments created a regulatory race to the bottom, in which banks sought the least attentive regulator that would grant them the most powers. This and other proposed reforms will greatly reduce the charter-shopping that is a hallmark of the failed system.

We also believe that the deposit insurance system should be reviewed and reforms should be considered after its degradation over the years as banks requested more and more exceptions from paying adequate premiums. Further, imposition of significantly higher premiums on larger banks will both fairly price the cost of their risks and, as a bonus, temper their size organically, thereby reducing the number of institutions that may become too-big-to-fail.

Congress should also consider giving the FDIC more authority over holding companies, not only in winding down situations. The administration has instead proposed "a new authority" like the

FDIC. But as FDIC Chair Sheila Bair has testified,[35] "Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level." This means that the FDIC needs greater authority over the actions of an entire holding company, not just a failing bank, to limit risk caused by the holding company's actions.

Additional Suggestions: Each prudential regulator should issue an annual report on emerging risks so that the public will know what trends the regulators are observing. The data included in public Call Reports, or statements of condition, of institutions under federal regulation should be broadened and subject to more detailed public disclosure so that the public and the Congress can better evaluate where institutions obtain their income and where their risks are changing over time. Each regulator should also implement an effective complaint system that actually assists consumers and complements the efforts of the Consumer Financial Protection Agency.

V. Comments on Administration plan to improve systemic risk regulation and reform the Federal Reserve

We join others in the bedrock belief that requiring financial firms to sell safer, less risky products in the first place, by establishing a CFPA, will help reduce the potential for overall risk in the system. Second, a revitalization of the prudential regulators further limits risk. Third, greater accountability and quicker responses through information sharing, such as among the members of the proposed Financial Services Oversight Council, which would have the ability to gather information from any financial firm, ensures a broader scope of oversight. Nevertheless, the role of the interconnectedness of the system in the recent economic collapse demonstrates that greater attention to systemic risk response is needed.

The most important step in addressing systemic risk is to ensure the safety and soundness, fairness, transparency, and accountability of financial markets, participants, and products. If regulatory agencies perform those functions properly, then systemic risk will be far less of a problem. Congress must close loopholes in the regulatory structure to ensure that all financial products and activities are subject to appropriate oversight, provide agencies with sufficient resources to do their jobs, and hold them accountable to do so. Finally, regulators must regulate. Policy makers should not permit the question of a new systemic risk regulator to eclipse the tasks of strengthening other forms of oversight and accountability; nor should they over-assume the existence of systemic risk. Nevertheless they should also understand that systemic risk can derive from a variety of different practices, and not just from the very biggest players.

U.S. PIRG remains agnostic on whether the Federal Reserve Board or some other agency instead should become the systemic risk regulator. If it is to be the Federal Reserve, a series of democratization and transparency steps must be taken first. At a minimum, the Fed's governance must be reformed substantially before it could be considered as an appropriate systemic risk regulator, for example by removing bank representatives from the governance of the regional

[35] Statement of Sheila C. Bair Chairman, Federal Deposit Insurance Corporation on Regulating and Resolving Institutions Considered "Too Big To Fail"; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 6, 2009, available at http://www.fdic.gov/news/news/speeches/chairman/spmay0609.html (last visited 14 July 2009).

Reserve Banks. Further, as an example of the banking industry's untoward sway over monetary policy, under current rules, the Federal Open Market Committee is composed of the 7 Fed governors, plus the presidents of the Regional Federal Reserve Banks (whose voting rights rotate). Yet each of these presidents is chosen by a non-democratic system dominated by the banks. Past reforms designed to place public and labor representatives on these boards have not been adequately implemented and deserve greater scrutiny and improvements. Earlier and more public access to Fed deliberations is a critical transparency step.

The Administration has proposed a variety of important systemic risk actions and responses. One that is most problematic, however, is its proposal to identify "systemically significant" institutions up-front and subject them to higher standards and more regulatory scrutiny. Essentially, large parts of the administration's paper are devoted to creating a regulatory system under the Fed for institutions that we would call too-big-to-fail, and are designated in the paper as Tier 1 FHCs (Financial Holding Companies) or "any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed."[36]

We agree with the Consumer Federation of America that such riskier firms should be subject to heightened regulation, but that "heightened standards should ratchet up along a continuum rather than turn on or off according to a determination that a particular institution poses a systemic threat."

We are also concerned that the prominent identification of firms as "TBTF" by some automatic criterion vastly increases their own moral hazard. If you know you are too-big-to-fail, you'll take more risks, and increase your impact on systemic risk.

As the Nobelist Joe Stiglitz has testified, we don't necessarily want too many of these firms:

> Being too big to fail creates perverse incentives for excessive risk taking. The taxpayer bears the loss, while the bondholders, shareholders, and managers get the reward. […] The only justification for allowing these huge institutions to continue is that there are significant economies of scope or scale that otherwise would be lost. I have seen no evidence to that effect. […] In short, we have little to lose, and much to gain, by breaking up these behemoths, which are not just too big to fail but also too big to save and too big to manage.[37]

VI. Comments on Administration plan to cover the shadow markets

Financial oversight has failed to keep up with the realities of the marketplace, characterized by globalization, innovation, and the convergence of lending and investing activities.[38] This has allowed institutions to structure complex transactions and take on risky exposures without

[36] Page 22, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, June 17, 2009.

[37] See testimony of Professor Joseph Stiglitz at a hearing of the Joint Economic Committee entitled "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions," 21 April 2009, for further discussion.

[38] Parts of this section are based on the Americans for Financial Reform white paper "Regulating the Shadow Markets," prepared by Heather Slavkin of the AFL-CIO and a committee including the author of this testimony, available at http://ourfinancialsecurity.org/afr/pdfs/regulating_shadow_markets.pdf (last visited 14 July 2009).

fulfilling the regulatory requirements Congress deemed necessary to prevent a systemic financial crisis after the Great Depression. These unregulated and under-regulated activities and institutions, the "shadow financial system," were permitted to become so intertwined with the real economy that the government has chosen to use taxpayers' money to bail them out when they failed.

Again, as President Obama said during the campaign, "We need to regulate institutions for what they do, not what they are." This means that hedge funds, private equity funds, derivatives, off-balance sheet lending vehicles, structured credit products, industrial loan companies and other shadow markets actors and products must be subject to transparency, capital requirements, and fiduciary duties befitting their activities and risks.

Shadow market institutions and products must be subject to comprehensive oversight. We need to return to the broad, flexible jurisdiction originally provided in federal securities regulation, which allowed regulators to follow activities in the financial markets. This means ensuring that all institutions that are active in the shadow financial markets provide regular information to regulators and the public about their activities and their counterparty relationships, requiring derivatives to be traded on regulated exchanges that are transparent and impose meaningful margin requirements, and requiring money managers to provide comprehensive disclosures and to act as fiduciaries for their investors.

U.S. PIRG has long supported these reforms as well as supported closing existing loopholes that others have sought to expand or exploit. For example, the administration proposal takes important steps in closing Industrial Loan Company loopholes that not only allow commercial firms to intrude into the banking sphere but to do so in an under-regulated way, where their regulators do not have full ability to examine and regulate the ILC's parent holding company. As we testified in 2006 before the FDIC in opposition to Wal-Mart's application for deposit insurance coverage for an industrial bank chartered in Utah:[39]

> Oversight of the holding company is the key to protecting the safety and soundness of the banking system. It is immaterial whether the owner of the bank is a financial or a commercial entity. Holding company regulation is essential to ensuring that financial weaknesses, conflicts of interest, malfeasance or incompetent leadership at the parent company will not endanger the taxpayer-insured deposits at the bank.
>
> Years of experience and bank failures have shown this to be true. For example, recent accounting scandals at Sunbeam, Enron, Worldcom, Tyco, Adelphia and many others involved deliberate deception about the financial health of the companies involved. If these companies had owned banks, not only would employees, investors and the economy have suffered, but taxpayers as well.
>
> Moreover, allowing a Wal-Mart-owned industrial bank to enter the FDIC system would further widen the ILC loophole to the BHCA, which should instead be closed. It is time to shut down this parallel banking system, not allow its further expansion.

[39] See 28 March 2006 testimony of U.S. PIRG before the FDIC available at http://static.uspirg.org/consumer/archives/PIRGWalmarttestimony.pdf (last visited 14 July 2009).

Some have suggested that certain aspects of the shadow financial markets, particularly hedge funds and derivatives such as credit default swaps, should be overseen only by a systemic risk regulator instead of being subject to comprehensive regulation. This would be a terrible mistake. The shadow financial markets must be subject to comprehensive, routine oversight appropriate to the activities involved. Systemic risk regulation should function as an addition to this oversight, not a replacement for it, focusing on problems that arise from interactions among institutions regulated by different regulatory bodies or emerging risks not fully addressed by the other regulators.

We concur with the Consumer Federation of America[40] that the President's plan attempts to address both problems associated with unregulated shadow markets: the ability of risks to grow undetected and the potential for abuse. It addresses the former problem both through its approach to systemic risk regulation, and through its requirement that all financial firms be subject to functional regulation by the appropriate regulatory authority. Hedge fund advisers, for example, would not only be required to register with the SEC; they would also be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability, provide confidential reports to regulators on their holdings, and submit to SEC compliance inspections.

We concur with the Consumer Federation of America's detailed analysis that the proposed plan on derivatives represents significant improvement over the current situation. Whether investors and the markets reap the full benefits of this regulatory proposal will depend on several key factors, including how rigorous the capital and margin requirements for dealers turn out to be and how vigorously regulators enforce the business conduct rules and other rules to prevent market abuse. More fundamental factors that will determine success are: 1) how effective regulators are in preventing dealers from evading the central clearing and requirement through the use of customized contracts and 2) how forcefully they push to move as much as possible of the standardized markets onto regulated exchanges.

Among the most important of the plan's other provisions on derivatives include whether its emphasis on exchange, not clearinghouse, trading is maintained. Because of the potential benefits exchange trading offers not only for price transparency and competition, but also for effective risk reduction and fraud prevention, we join the CFA in urging Congress to ignore the self-interested arguments of derivatives dealers and ensure that, as legislation is drafted to implement the administration plan, it includes the strongest possible provisions to require exchange trading of standardized derivatives as soon as that is feasible, with a strong preference against unnecessary customization.

[40] For a more detailed treatment, see testimony of Travis Plunkett, Consumer Federation of America, 16 July 2009, at this same hearing before the Committee on Financial Services, U.S. House of Representatives on "Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals."

VII: Comments on the Administration Plan To Regulate Credit Rating Agencies[41]

One disappointing area of the administration's proposal is its failure to propose robust reforms of the Credit Rating Agencies – including Standard and Poor's, Moody's and Fitch's.

With Wall Street combining mortgage loans into pools of securitized assets and then slicing them up into tranches, the resultant financial instruments were attractive to many buyers because they promised high returns. But legal and internal rules prohibit many pension and government funds and other investors from investing in financial instruments unless they are highly rated by credit ratings agencies. The credit rating firms enabled these investors to join the speculative frenzy, by attaching top ratings to securities that actually were high risk—as subsequent events have revealed.

The credit ratings firms have a bias to offering favorable ratings to new instruments—and have a long record of failure including enthusiastic ratings for Enron debt—because of their complex relationships and conflicts of interest with securities issuers, and their desire to maintain and obtain other business dealings with issuers and investment banks.

This institutional failure and conflict of interest might and should have been forestalled by the SEC, but the Credit Rating Agencies Reform Act of 2006 gave the SEC insufficient oversight authority. In fact, the SEC must give an approval rating to credit ratings agencies if they are adhering to their own standards—even if the SEC knows those standards to be flawed.[42] The SEC itself has documented substantial credit ratings firm failures over the last decade, including conflicts of interest and an inability of the firms to manage the proliferation of complex instruments.[43]

Despite these manifold problems and their well-document massive impact on the economic collapse, the administration proposal merely proposes some minimal changes. We support these efforts, but they are not sufficient.

One option to address the failure of the credit ratings firms would be to increase the regulatory controls over their operations, such as authority to monitor credit rating firm performance and to oversee and regulate the process by which the firms derive their ratings. Due to structural conflicts of interest, this approach may also not be sufficient. Additionally, Congress should

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[41] Americans for Financial Reform will soon be issuing a detailed white paper on Credit Rating Agency issues, prepared by Robert Weissman of Essential Action and a committee including the author of this testimony.
[42] Available at http://www.sec.gov/news/testimony/2007/ts092607cc.htm.
[43] See "The Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," Securities Exchange Commission, July 2008, available at http://www.sec.gov/news/ press/2008/2008-135.htm.
[44] See for example, S. 1073, introduced May 19, 2009 by Senator Jack Reed (important features of S. 1073 include: SEC review of credit rating firm methodologies and transparency rules for methodologies; strong conflict of interest prohibitions or at least disclosures; and development of scorecards to reveal credit rating firm performance over time); Testimony of Robert F. Auwaerter, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, May 19, 2009, available at http://www.house.gov/apps/list/ hearing/financialsvcs_dem/hrcm051209.shtml.

consider establishing civil liability for credit ratings firms that are grossly negligent or worse, giving parties that relied on improper credit ratings the right to recover damages.[45]

A more transformative solution would be to establish a public credit ratings agency, as Essential Action has proposed.[46] This agency, which could be funded by a small financial transactions tax,[47] would provide ratings for all financial instruments, as a condition of the securities being legally trade-able. On some occasions, the public agency may conclude that an instrument is "not ratable," because it is too complex to provide an accurate risk appraisal. Private ratings firms could continue to operate, and they could offer their own judgments about the riskiness of financial instruments. However, financial regulations that rely on an independent assessment of risk would be required to use the ratings of the public agency. Establishing a public credit ratings agency would eliminate existing conflicts of interest and the corrupting complex relationship between private ratings firms and issuers. It would treat credit ratings as a public good, and align the government-mandated use of credit ratings with independent and publicly generated risk assessments.

Conclusion

We appreciate the opportunity to work with both the President and the Committee to seek enactment of the strongest possible reforms following the unfortunate collapse of our financial system that has had a severe effect on our members and other consumers. We believe that the President and the Committee are correct to prioritize the establishment of strong consumer protections while re-establishing federal law as a floor not a ceiling. We look forward to working with you to first establish a fully empowered Consumer Financial Protection Agency and then to ensure that comprehensive reforms covering the entire financial system are enacted. Mr. Chairman, please have any members of the committee contact us with any questions.

[45] According to Robert Weissman of Essential Action, some First Amendment issues could be avoided by attaching liability not to the voicing of an opinion but by requiring entities performing statutorily specified gatekeeper functions to agree to accept liability as a condition of certification to perform the gatekeeper role. See Testimony of Eugene Volokh, before the Financial Services Committee, U.S. House of Representatives, May 5, 2009, available at: http://www.house.gov/apps/list/hearing/ financialsvcs_dem/hrcm051209.shtml

[46] M. Ahmed Diomande, James Heintz and Robert Pollin, "Why U.S. Financial Markets Need a Public Credit Rating Agency," Washington, DC: Essential Action (forthcoming).

[47] "A financial transactions tax (FTT) can be an important force for constraining the financial sector.[…] An FTT could raise an enormous amount of money. It could easily raise an amount equal to 1 percent of GDP, currently $150 billion a year or more than $1.8 trillion over the course of a decade." See the Americans for Financial Reform white paper on "Financial Transactions Taxes" as prepared by Dean Baker, Center for Economic Policy Research, available at http://ourfinancialsecurity.org/2009/07/financial-transactions-taxes/ (last visited 14 July 2009).