

**HEARING ON “LEGISLATIVE PROPOSALS TO PROMOTE ACCOUNTABILITY
AND TRANSPARENCY AT THE CONSUMER FINANCIAL PROTECTION BUREAU”
ON FEBRUARY 8, 2012, BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES,
U.S. HOUSE OF REPRESENTATIVES**

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Thank you very much for inviting me to participate in this important hearing. My testimony¹ will address the following three bills that propose various changes to the operations and funding of the Bureau of Consumer Financial Protection (“CFPB”): H.R. 1355, H.R. 2081, and H.R. 3871. For the reasons set forth below, I strongly oppose enactment of H.R. 1355 and H.R. 2081. I do not oppose enactment of H.R. 3871.

H.R. 1355 would remove CFPB’s administrative autonomy and subject CFPB’s funding to congressional appropriations, thereby severely undermining CFPB’s independence and its ability to fulfill its statutory mandate. H.R. 2081 would remove CFPB’s Director as a member of the Board of Directors of the Federal Deposit Insurance Corporation (“FDIC”) and would thereby prevent CFPB’s Director from receiving the benefit of regular interactions and discussions with federal banking regulators. In addition, H.R. 2081 would increase the influence of the Federal Reserve Board (“FRB”) over FDIC and thereby enhance FRB’s ability to promote the use of the Deposit Insurance Fund (“DIF”) as a potential bailout fund for

¹ Portions of this testimony are derived from the following article: Arthur E. Wilmarth, Jr., “The Financial Services Industry’s Misguided Quest to Undermine the Consumer Financial Protection Bureau,” George Washington Univ. Law School Public Law & Legal Theory Paper No. 2012-4 (Dec. 22, 2011), available at <http://ssrn.com/abstract=1982149>. That article will be published in Vol. 31, Issue 2 of the *Review of Banking and Financial Law* (Boston Univ. Law School, Spring 2012).

uninsured creditors of “too big to fail” (“TBTF”) banks. Accordingly, in my view, H.R. 1355 and H.R. 2081 would seriously harm the public interest and should not be enacted.

1. Congress Established CFPB to Accomplish an Important Mission, and CFPB’s Structure and Powers Are Similar to Those of Other Financial Regulators

Congress created CFPB because the previous dispersion of consumer protection responsibilities among several federal bank regulators produced a systematic failure of the consumer protection function during the credit bubble leading up to the financial crisis. Congress determined that a single federal financial regulator with the sole mission of protecting consumers was essential in light of “the spectacular failure of the [federal] prudential regulators to protect average American homeowners from risky, unaffordable” mortgages during the housing boom.² A Senate committee report found that federal banking agencies “routinely sacrificed consumer protection” while adopting policies that promoted the “short-term profitability” of large banks, nonbank mortgage lenders and Wall Street securities firms.³ The Senate report concluded that “it was the failure by the [federal] prudential regulators to give sufficient consideration to consumer protection that helped bring the financial system down.”⁴

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) authorizes CFPB to issue regulations, perform investigations, create public education

² Senate Report No. 111-176, at 15 (2010); *see also* H.R. Rep. No. 111-517, at 874 (2010) (Conf. Rep.) (“The Bureau will have the authority and accountability to ensure that existing consumer protection laws and regulations are comprehensive, fair, and vigorously enforced”), *reprinted in* 2010 U.S.C.C.A.N. 722, 730.

³ Senate Report No. 111-176, at 15 (2010) (quoting congressional testimony of Patricia McCoy on Mar. 3, 2009). For additional analysis of failures by federal bank regulators to protect consumers during the housing boom that led to the financial crisis, *see, e.g.*, Kathleen Engel & Patricia A. McCoy, *The Subprime Virus* 157-205 (2011); Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 120-32, 141-44 (2010); Oren Bar-Gill & Elizabeth Warren, “Making Credit Safer,” 157 *University of Pennsylvania Law Review* 1, 81-95 (2008); Adam J. Levitin, “Hydraulic Regulation: Regulating Credit Markets Upstream,” 26 *Yale Journal on Regulation* 143, 151-69 (2009); Arthur E. Wilmarth, Jr., “The Dodd-Frank Act’s Expansion of State Authority to Protect Consumers of Financial Services,” 36 *Journal of Corporation Law* 893, 897-919 (2011), available at <http://ssrn.com/abstract=1891970>.

⁴ Senate Report No. 111-176, at 168 (2010).

programs, and prosecute enforcement proceedings in order to protect consumers against unfair, deceptive, abusive, and discriminatory financial practices. Title X promotes CFPB's independence from political influence by granting CFPB autonomy in its policymaking, rulemaking and enforcement functions and by giving CFPB an assured source of funding from the Fed.⁵

CFPB's governance, powers and funding are comparable to those of other federal financial regulators. CFPB's single-Director model of leadership is similar to the governance structure for the Office of the Comptroller of the Currency ("OCC") and the Federal Housing Finance Agency ("FHFA"). CFPB's regulatory and enforcement powers are comparable to those exercised by OCC, FHFA, FDIC and FRB. Indeed, CFPB's powers are more limited in some respects than those of other federal banking agencies. Unlike FDIC and FHFA, CFPB cannot put any institution into receivership or conservatorship. Unlike FDIC, FHFA, FRB and OCC, CFPB cannot remove or suspend officers, directors and employees of financial institutions or impose industry-wide prohibitions on such persons.⁶

CFPB's ability to fund its operations without relying on congressional appropriations is, again, comparable to the OCC, FHFA, FDIC and FRB.⁷ The financial services industry and its allies have strongly defended the governance structure, authority, independence, and assured funding of both OCC and FHFA.⁸ Accordingly, it appears that the opposition to CFPB is primarily motivated CFPB's consumer protection mandate, not its structure.

CFPB's opponents have alleged that the bureau will be an unaccountable agency with virtually unlimited powers. On the contrary, Title X of Dodd-Frank imposes significant

⁵ Wilmarth, *supra* note 1, at 18-21.

⁶ *Id.* at 21-25.

⁷ *Id.* at 23.

⁸ *Id.* at 29-34, 66-67.

limitations on CFPB's powers and also provides for extensive oversight of CFPB. CFPB must perform a detailed cost-benefit analysis before it adopts any rule. CFPB must also consult with a wide variety of parties, including other financial regulators, before it issues any rule. If any prudential regulator objects to a proposed CFPB rule, CFPB must explain in its final rulemaking how it has responded to that objection. Title X imposes additional restrictions on CFPB's ability to adopt any rule designed to prevent unfair, deceptive or abusive acts and practices. The most significant check on CFPB is the authority of the Financial Stability Oversight Council to suspend and overrule CFPB's regulations. CFPB is the only financial regulator whose rules are subject to override by an appellate body consisting of the heads of other agencies.⁹

Title X also subjects CFPB to extensive oversight by the executive and legislative branches. For example, CFPB must provide semiannual reports to the President and Congress and is audited each year by the Government Accountability Office.¹⁰ Thus, claims about CFPB's alleged lack of accountability are refuted by Dodd-Frank's unambiguous provisions that limit CFPB's authority and impose substantial oversight on CFPB.

2. H.R. 1355 Would Destroy CFPB's Independence and Would Leave CFPB Vulnerable to Political and Industry Influence.

H.R. 1355 would greatly weaken CFPB in several ways. Section 2(1) would repeal CFPB's status as an "independent" bureau and would move CFPB from the Federal Reserve System ("Fed") to the Treasury Department ("Treasury"). Thus, Section 2(1) would transfer CFPB from an independent agency that is relatively insulated from political influence to an executive branch agency that is highly susceptible to political intervention. Moreover, Section 2(2) would remove critical statutory protections that enable CFPB to function as an autonomous bureau in setting policy. Those protections currently (i) prohibit the Fed from intervening in

⁹ *Id.* at 25-28.

¹⁰ *Id.* at 28.

examinations, enforcement actions or other proceedings before CFPB, (ii) bar the Fed from appointing, directing or removing any of CFPB's officers or employees, (iii) preclude the Fed from merging CFPB with any of the Fed's other units, and (iv) prohibit FRB from reviewing or interfering with any of CFPB's rules, orders, legislative recommendations or legislative testimony.¹¹

Section 2(2) of H.R. 1355 would repeal all of the foregoing guarantees of CFPB's policy-making autonomy. However, H.R. 1355 would not make any similar changes to OCC, which is an autonomous bureau within Treasury. Federal statutes prohibit Treasury from preventing or delaying the issuance of any OCC regulation, and they also bar Treasury from intervening in any matter (including any enforcement matter) pending before the Comptroller of the Currency unless specifically authorized by law.¹² If H.R. 1355 deems it essential to remove CFPB's autonomy and to subject CFPB to Treasury's unlimited oversight, why doesn't H.R. 1355 contain similar provisions removing OCC's policy-making independence as well?

It is noteworthy that Representative Neugebauer, the chief sponsor of H.R. 1355, strongly criticized Treasury for seeking to exert "influence on OCC rulemaking" when Treasury's General Counsel submitted a public comment letter criticizing proposed regulations issued by OCC in June 2011 concerning the preemption provisions of Title X of Dodd-Frank.¹³ Why is one federal financial regulator (OCC) deserving of autonomy when another (CFPB) is not? Can this apparent anomaly be explained by the fact that "OCC is widely viewed as the most committed regulatory champion for the interests of major banks,"¹⁴ and those same banks have

¹¹ *Id.* at 20-21.

¹² *Id.* at 22 (discussing 12 U.S.C. §§ 1, 1462a(b)(3)).

¹³ *Id.* at 32 (quoting Rep. Neugebauer's statement in which he also requested "assurances that the Treasury has permitted the OCC to act independently in the rulemaking for this and all provisions of the Dodd-Frank Act").

¹⁴ *Id.* at 29-32 (quote at 29).

devoted enormous lobbying resources in opposing CFPB's creation and in seeking to undermine its effectiveness?¹⁵

Section 2(3) would seriously impair CFPB's ability to attract qualified employees by requiring CFPB to pay its employees in accordance with the General Schedule for civil service employees. If Section 2(3) were adopted, CFPB would become the *only* federal financial regulatory agency that is *not* exempted from civil service restrictions on pay, and CFPB would therefore find it extremely difficult, if not impossible, to attract employees with the training, skills and experience needed to carry out CFPB's consumer protection mission.

Section 3 of H.R. 1355 would remove CFPB's assured source of funding from the Fed and would make CFPB's entire budget subject to congressional appropriations. Any regulatory agency that depends on Congress for its budget is vulnerable to political influence exerted by the regulated industry through the appropriations process.¹⁶ For example, Congress controls the budget of the Consumer Product Safety Commission ("CPSC"), and since its creation in 1980 that agency has been "chronically underfunded and understaffed. . . . As a result, CPSC has been no match for the industry participants it is charged with regulating."¹⁷

Except for the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"), no federal financial regulator is subject to congressional appropriations.¹⁸ Congress has undermined the effectiveness of CFTC and SEC over the past

¹⁵ *Id.* at 5-11, 14-17.

¹⁶ Rachel E. Barkow, "Insulating Agencies: Avoiding Capture Through Institutional Design," 89 *Texas Law Review* 15, 42-44 (2010).

¹⁷ *Id.* at 67; *see also id.* at 42 n.103, 44, 67 (describing CPSC's lack of adequate resources to fulfill its statutory mandate, due to Congress' refusal to increase its budget); Andrew Zajac, "New leadership on U.S. product safety: Obama vows to revitalize ailing CPSC," *Chicago Tribune*, May 6, 2009, at C14 (reporting that CPSC had been "underfunded for years" and had only 430 employees in 2009, compared with 978 in 1980; as a result, the "gutted agency became a docile captive of the industry it regulates").

¹⁸ Sean Lengell, "Schumer: Boost SEC's budget to fight fraud," *Washington Times*, Sept. 4, 2009, at A09.

two decades by frequently failing to provide those agencies with adequate funds.¹⁹ After Republicans took control of the House in the 2010 midterm elections, Republican leaders announced plans to delay implementation of Dodd-Frank’s reforms of the derivatives and securities markets by squeezing the budgets of CFTC and SEC.²⁰

During 2011, Republicans blocked any significant increases in the CFTC’s and SEC’s operating budgets.²¹ At congressional oversight hearings in December 2011, CFTC chairman Gary Gensler and SEC chairman Mary Schapiro expressed grave doubts about their agencies’ ability to adopt and enforce the new regulations required by Dodd-Frank unless Congress approved major increases in their budgets.²² Republican leaders and the financial services

¹⁹ Speech by SEC Chairman Mary Schapiro: Brodsky Family Lecture at Northwestern University Law School (Nov. 9, 2010) (stating that, when Ms. Schapiro became SEC chairman in January 2009, the SEC was “underfunded and understaffed We were behind, and falling further behind”), available at <http://www.sec.gov/news/speech/2010/spch110910mls.htm>; Testimony by Lynn Turner, Former SEC Chief Accountant, at a hearing on “Enhanced Investor Protection After the Financial Crisis,” before the Senate Committee on Banking, Housing, and Urban Affairs (July 12, 2011), at 5, 13 (stating that one reason why CFTC and SEC were “ineffective” during the decade leading up to the financial crisis was that both agencies “lacked adequate funding and resources”; in particular, “SEC was essentially starved by Congress of necessary resources during much of the 1990s,” and SEC again lacked adequate funding between 2005 and 2007), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=c7085db2-ae43-471a-aa5c-357f2226a096&Witness_ID=df29c589-0882-4468-b4be-96f53902b567; “Memo to Congress: It’s time for SEC to be self-funded,” *Investment News*, May 16, 2011, at 0008 (stating that “SEC has been chronically underfunded for years”) (available on Lexis); Richard Sansom, “Republicans’ return to power threatens CFTC’s implementation of Dodd-Frank,” *SNL Daily Gas Report*, Jan. 12, 2011 (reporting that “CFTC has been underfunded for at least a decade”).

²⁰ Bruce Carton, “How Can Congress Kill Dodd-Frank? By Underfunding It,” *Compliance Week*, Jan. 2011; Kelsey Snell, “Industry Looks to Derail Dodd-Frank Enforcement,” *National Journal*, Feb. 15, 2011.

²¹ Carton, *supra* note 20; William D. Cohan, “Republicans Try to Starve Wall Street Watchdog,” *Bloomberg.com*, Nov. 27, 2011; Sansom, *supra* note 19; Robert Schmidt et al., “The Great Regulatory Hold-Up,” *Bloomberg BusinessWeek*, Feb. 14-20, 2011, at 24; James B. Stewart, “As a Watchdog Starves, Wall St. Is Tossed a Bone,” *New York Times*, July 16, 2011, at A1; *see also* Roger Nayak, “The sticky politics of MF Global’s demise,” *SNL Financial Services Daily*, Dec. 7, 2011 (reporting that “some observers feel that tightened budgets have hamstrung the CFTC and the SEC” in their efforts to implement Dodd-Frank, and noting that the agencies had already missed 71 of 95 deadlines for adopting rules to carry out Dodd-Frank’s reforms of derivatives regulation).

²² Joe Adler, “MF Global, Gensler Dominate Hearing on Derivatives Rules,” *American Banker*, Dec. 2, 2011; Lindsey White, “As regulators face Senate, Gensler grilled over MF Global,” *SNL Bank and Thrift Daily*, Dec. 7, 2011; *see also* Kevin Wack, “Reform Implementation and Budget Crunch Collide,”

industry did not disagree with these gloomy assessments of the likely impact of budget stringency on the two agencies.²³

Republican legislators and major banks took a very different position when they pushed for legislation to create FHFA as a new and more powerful regulator for Fannie Mae (“Fannie”) and Freddie Mac (“Freddie”).²⁴ Republicans and their banking allies insisted that FHFA must have an independent, secure funding source that was *not* subject to congressional appropriations. They pointed out that Fannie and Freddie had frequently used their political clout to persuade Congress to cut the budget of FHFA’s predecessor agency, the Office of Federal Housing Enterprise Oversight (“OFHEO”) and thereby undermine OFHEO’s enforcement efforts. Representative Richard Baker (R-LA), a leading proponent of legislation to establish FHFA, declared that OFHEO “historically has been impaired” because it “must come to the Congress for its funding.”²⁵ Mr. Baker emphasized the importance of creating “an independently funded regulator, with all the tools a modern regulator should have to oversee vastly complex financial

American Banker, July 22, 2011, at 4 (reporting on congressional testimony by CFTC chairman Gensler and SEC chairman Schapiro that their agencies could not fulfill their responsibilities under Dodd-Frank without significant budget increases).

²³ See Snell, *supra* note 20 (reporting that CFTC chairman Gensler’s “worries” about his agency’s ability to implement Dodd-Frank with a constrained budget “are music to the industry”).

²⁴ See Wilmarth, *supra* note 1, at 33-34 (describing support by Republicans and major banks for establishment of FHFA as a more powerful regulator for Fannie and Freddie).

²⁵ 151 Cong. Rec. H 9131 (daily ed. Oct. 26, 2005) (remarks of Rep. Baker). In the following passage, a prominent journalist described how Fannie’s supporters in Congress used the appropriations process to hamstring OFHEO’s supervisory effort:

Fannie’s allies in Congress . . . made sure that . . . OFHEO, unlike any other [financial] regulator, would be subject to the appropriations process, meaning its funding was at the mercy of politicians – politicians who often took their cues from Fannie. [¶] Not surprisingly, OFHEO was a notoriously weak regulator.

Bethany McLean, “Fannie Mae’s Last Stand,” *Vanity Fair*, Feb. 2009, at 51; *see also* Binyamin Appelbaum et al., “How Washington Failed to Rein In Fannie, Freddie: As Profits Grew, Firms Used Their Power to Mask Peril,” *Washington Post*, Sept. 14, 2008, at A01 (reporting that OFHEO “was required to get its budget approved by Congress, while agencies that regulated banks set their own budgets. That gave congressional allies [of Fannie and Freddie] an easy way to exert pressure” on OFHEO”).

enterprises to protect the American taxpayer from unwarranted losses.”²⁶ In 2008, Congress passed legislation to establish FHFA as a “strong, independent regulator” that would be funded by assessments collected from government sponsored enterprises (“GSEs”), and that legislation made clear that FHFA would *not* be subject to the appropriations process.²⁷

In creating CFPB, Congress drew directly on FHFA’s secure funding model. The Senate committee report on Dodd-Frank declared that “the assurance of adequate funding [from the Fed], independent of the Congressional appropriations process, is absolutely essential to the independent operations of any financial regulator.”²⁸ The Senate report pointed out that the need for independent funding of financial regulators

was a hard learned lesson from the difficulties faced by [OFHEO], which was subject to repeated Congressional pressure because it was forced to go through the annual appropriations process. It is widely acknowledged that this helped limit OFHEO’s effectiveness. For that reason, ensuring that OFHEO’s successor agency . . . would not be subject to appropriations was a high priority for the Committee and the Congress in [passing] the Housing and Economic Recovery Act of 2008.²⁹

Several Republican leaders who are now pushing for legislation to subject CFPB to the appropriations process were strong proponents of secure funding for FHFA.³⁰ Observers have noted that it is very difficult to identify a persuasive rationale for the attempt to remove CFPB’s budgetary independence beyond the desire “to undercut an agency [Republican leaders] never liked to begin with.”³¹

²⁶ *Id.*

²⁷ House of Representatives Report No. 110-142, at 87-88, 126-27 (2007).

²⁸ Senate Report No. 111-176, at 163 (2010).

²⁹ *Id.*

³⁰ Kate Davidson, “Question of Hypocrisy in GOP Assault on the CFPB,” *American Banker*, Mar. 21, 2011, at 1 (noting that Rep. Spencer Bachus (R-AL), Jeb Hensarling (R-TX), Ed Royce (R-CA) and other current Republican House members supported legislation to establish a regulator for GSEs whose funding would *not* be subject to congressional appropriations).

³¹ *Id.*

Subjecting CFPB to the appropriations process will make the bureau vulnerable to the enormous political clout wielded by large financial institutions and their allies. The financial sector (including finance, insurance and real estate firms) spent \$5.1 billion on lobbying and campaign contributions between 1998 and 2008.³² The financial sector was the “leading contributor to political campaigns” after 1990,³³ and it accounted for 15% of total lobbying expenditures by *all* industry sectors between 1999 and 2006.³⁴

The financial sector employed nearly 3,000 registered lobbyists in 2007.³⁵ In 2008 and 2009, the six largest banks (Bank of America, JP Morgan Chase, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley) employed more than 240 lobbyists who previously worked in the executive branch or Congress.³⁶ Financial firms that were heavily involved in political lobbying also engaged in more risky activities. An IMF staff study determined that financial firms that engaged in the most intensive lobbying between 1999 and 2006 also made higher-risk mortgage loans, securitized more of their loans, and suffered above-average losses in their stock market values during the financial crisis.³⁷

The financial sector received excellent legislative returns on its huge political investments between 1990 and 2007. A second IMF staff study found that lobbying expenditures by financial firms significantly increased the likelihood of passage for bills favored

³² Essential Information & Consumer Education Foundation, *Sold Out: How Wall Street and Washington Betrayed America* 6, 15-16, 99-101 (Mar. 2009) [hereinafter *Sold Out*], available at http://www.wallstreetwatch.org/reports/sold_out.pdf.

³³ Johnson & Kwak, *supra* note 3, at 90; *see also* Levitin, *supra* note 3, at 160-61 (“The financial-services industry has been the single largest contributor to congressional campaigns since 1990”).

³⁴ Deniz Igan, Prachi Mishra & Thierry Tressel, “A Fistful of Dollars: Lobbying and the Financial Crisis,” IMF Working Paper WP/09/87, Dec. 2009, at 18, 32 (tbl.1a), available at <http://ssrn.com/abstract=1531520>.

³⁵ *Sold Out*, *supra* note 32, at 15-16, 100-01.

³⁶ Kevin Connor, *Big Bank Takeover: How Too-Big-to-Fail’s Army of Lobbyists Has Captured Washington* (Institute for America’s Future, May 2010), available at <http://www.ourfuture.org/files/documents/big-bank-takeover-final.pdf>.

³⁷ Igan, Mishra & Tressel, *supra* note 34, at 4-6, 19-20, 22, 24-27.

by the financial services industry and also increased the probability of defeat for bills opposed by the industry.³⁸ Lobbying by the financial sector helped to produce a series of landmark political victories between 1994 and 2005, including enactment of (i) interstate banking legislation in 1994,³⁹ (ii) the Gramm-Leach-Bliley Act (“GLBA”) in 1999,⁴⁰ (iii) the Commodity Futures Modernization Act (“CFMA”) in 2000,⁴¹ and (iv) bankruptcy reform legislation in 2005.⁴² In addition to those affirmative victories, the financial services industry successfully blocked passage of more than a dozen bills introduced between 2000 and 2007 that would have imposed tighter restrictions on high-risk mortgage lending.⁴³

Federal financial regulators who recommended tougher restrictions on financial institutions during the credit boom experienced strong “pushback” from the financial services industry.⁴⁴ Regulators also had strong career-based incentives (including the possibility of being hired for lucrative positions with large financial institutions or their professional service providers) that discouraged them from challenging the formidable political influence wielded by

³⁸ Deniz Igan & Prachi Mishra, “Three’s Company: Wall Street, Capitol Hill, and K Street,” IMF Working Paper, June 2011, at 4, 15-18, available at <http://ssrn.com/abstract=1915164>.

³⁹ See Johnson & Kwak, *supra* note 3, at 89 (describing the significance of Congress’ passage of interstate banking legislation, which made possible the establishment of large nationwide banking organizations).

⁴⁰ For discussions of the importance of GLBA, which repealed key provisions of the Glass-Steagall Act and allowed commercial banks to affiliate with securities firms and insurance companies by forming financial holding companies, see *id.* at 89, 91-92, 133-34.

⁴¹ See *id.* at 8-9, 92, 134-37 (describing CFMA, which largely exempted over-the-counter derivatives from federal regulation).

⁴² The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) “radically altered the policies underlying consumer bankruptcy . . . , marking a significant shift in favor of creditors,” because BAPCA made it much more difficult for consumers to obtain a substantial or complete discharge of their debts in bankruptcy. Ronald J. Mann, “Bankruptcy Reform and the ‘Sweat Box’ of Credit Card Debt,” 2007 *University of Illinois Law Review* 375, 376-77; see also Eugene R. Wedoff, “Major Consumer Bankruptcy Effects of BAPCPA,” 2007 *University of Illinois Law Review* 31 (surveying the changes made by BAPCPA to consumer bankruptcy statutes).

⁴³ Igan, Mishra & Tressel, *supra* note 34, at 17-18, 55-59 (Appendix).

⁴⁴ Wilmarth, *supra* note 3, at 907-08; *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011) [hereinafter FCIC Report], at 20-22, 172-73, 307; see also Johnson & Kwak, *supra* note 3, at 7-9, 97, 103, 134-37; *Sold Out*, *supra* note 32, at 8, 42-49 (noting that “officials in government who dared to proposed stronger protections for investors and consumers consistently met with hostility and defeat”).

major banks and their allies.⁴⁵ Many regulators concluded that deregulation and forbearance were safer alternatives, especially during a period of unprecedented political strength for the financial sector.⁴⁶ One of the clear lessons from the financial crisis is that direct congressional control over regulatory agency budgets is likely to produce weak and ineffective regulatory control over the giant institutions that currently dominate our financial markets.

3. H.R. 2081 Would Prevent Beneficial Interactions between Consumer and Prudential Regulators and Would Allow FRB to Exert Undesirable Influence over FDIC

H.R. 2081 would remove CFPB's Director from FDIC's Board of Directors and would transfer that board seat to FRB's Chairman. That change would injure the public interest in two very significant respects. First, it would deprive CFPB's Director of the opportunity for regular interactions and discussions with senior federal bank regulators – including FDIC's chairman and vice chairman, the Comptroller of the Currency, and an FDIC director with state bank supervisory experience. The financial services industry and its Republican supporters opposed CFPB's creation because it placed the consumer protection function in a separate agency from safety and soundness supervision.⁴⁷ If that separation is truly a matter for concern, the industry and its supporters should welcome the fact that CFPB's Director sits on FDIC's Board of Directors and will therefore regularly participate in discussions of issues affecting bank safety and soundness. Those discussions should help CFPB's Director to understand the safety and soundness concerns of his bank regulatory counterparts. It would therefore be counterproductive to remove the opportunity for these beneficial deliberations and exchanges of views by enacting H.R. 2081.

⁴⁵ Johnson & Kwak, *supra* note 3, at 89-104, 118-19.

⁴⁶ *Id.* at 7-9, 97, 103-09, 134-43, 151-52; FCIC Report, *supra* note 44, at 173, 307.

⁴⁷ Wilmarth, *supra* note 1, at 5-6.

An equally serious flaw in H.R. 2081 is that it would give FRB greater influence over FDIC's determinations as to whether FDIC should invoke the "systemic risk exception" ("SRE") in the Federal Deposit Insurance Act, codified in 12 U.S.C. § 1823(c)(4)(G). Under the SRE, the Treasury Secretary may, upon the joint recommendation of two-thirds of FDIC's and FRB's boards, reimburse the uninsured creditors of a closed bank if the Secretary determines (in consultation with the President) that a failure to protect those creditors "would have serious adverse effects on economic conditions or financial stability." Funds for reimbursing the bank's uninsured creditors would be drawn from the DIF. As a practical matter, the SRE enables Treasury, FDIC and FRB to use the DIF as a bailout fund for uninsured creditors of a failed TBTF bank – including, potentially, the parent holding company of that bank.⁴⁸

H.R. 2081 would effectively give FRB "two bites at the apple" in determining whether the SRE should be invoked to protect uninsured creditors of a failed TBTF bank. First, FRB's Board of Governors would express its own recommendation on whether to invoke the SRE. Second, FRB's chairman would participate as a voting member of FDIC's Board of Directors in determining whether the FDIC should concur with FRB. FRB's chairman would likely be a highly influential voice during the deliberations of FDIC's Board.

During the period leading up to the financial crisis and during the crisis itself, FRB exhibited a strong propensity to grant forbearance to major financial institutions and to support bailouts of their uninsured creditors. In contrast, FDIC demonstrated a significantly higher degree of independence from industry influence and also expressed a strong aversion to TBTF bailouts. Like CFPB, FDIC has a clearly defined mission and an assured source of funding. FDIC has long viewed its fundamental purpose as protecting bank depositors and defending the

⁴⁸ See Arthur E. Wilmarth, Jr., "The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem," 89 *Oregon Law Review* 951, 1001, 1022-23, 1042-43 (2011), available at <http://ssrn.com/abstract=1719126>.

integrity of the DIF.⁴⁹ FDIC also has a guaranteed funding source that is not subject to congressional control or industry influence. FDIC collects risk-adjusted assessments from FDIC-insured institutions, and virtually all banks operate with FDIC insurance.⁵⁰

FDIC has frequently demonstrated its commitment to protecting the DIF as well as its willingness to resist banking industry influence. For example, during the late 1990s and early 2000s, FDIC fought hard to maintain stronger capital rules for U.S. banks (including leverage capital requirements) during international negotiations over the Basel II capital accord. FDIC also strongly questioned the reliability of Basel II's "advanced internal risk-based" ("A-IRB") method for determining capital requirements. In contrast, the Fed aligned itself with the largest banks in pushing for incorporation of the A-IRB methodology into the Basel II accord.⁵¹ FDIC's deep skepticism about the A-IRB approach proved to be well-founded when large financial conglomerates relied on internal risk-based models "to operate with capital levels that were 'very, very low, . . . unacceptably low' during the period leading up to the financial crisis."⁵²

During the financial crisis, FDIC chairman Sheila Bair disagreed with Fed and Treasury officials on several occasions about the desirability of establishing bailout programs for large troubled financial institutions. For example, FDIC refused to concur with the Fed and Treasury

⁴⁹ David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic* 219-20 (2009) (stating that FDIC Chairman Sheila Bair was "a fierce and relentless defender of the FDIC fund [during the financial crisis], putting protection of that kitty above all else"); Tom Fox, "How the FDIC got to the top of the heap: The No. 1-ranked agency's leader extols his workers' sense of purpose," *Washington Post*, Nov. 24, 2011, at B4 (quoting Acting FDIC Chairman Martin Gruenberg's view that "[t]he great strength of the [FDIC] is that it has a very clear and understandable mission, and that mission is to insure the deposits that people have in federally insured financial institutions").

⁵⁰ Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, *The Law of Banking and Financial Institutions* 62-63, 316-18 (4th ed. 2009); Michael P. Malloy, *Principles of Bank Regulation* § 1.11 at 36 (West Concise Hornbook, 3d ed. 2011).

⁵¹ Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* 99-130 (Aug. 2008); Arthur E. Wilmarth, Jr. "Reforming Financial Regulation to Address the Too-Big-To-Fail Problem," 35 *Brooklyn Journal of International Law* 707, 759 n.203 (2010), available at <http://ssrn.com/abstract=1645921>.

⁵² Wilmarth, *supra* note 48, at 1010 (quoting "Base Camp Basel," *Economist* (Jan 21, 2010), available at www.economist.com/node/15328883).

in using the SRE to protect the bondholders of Washington Mutual (“WaMu”) when WaMu failed on September 25, 2008. Chairman Bair insisted that WaMu’s bondholders, rather than the DIF and taxpayers, should bear the losses caused by WaMu’s reckless lending policies.⁵³

Similarly, Chairman Bair originally resisted proposals by Treasury and the Fed to use the SRE on two subsequent occasions: (i) on September 29, 2008, when federal officials invoked the SRE to protect uninsured creditors (including bondholders) when Wachovia failed, and (ii) in October 2008, when federal officials approved a program to guarantee debt securities issued by FDIC-insured banks. On both occasions, Fed and Treasury officials exerted great pressure to overcome Chairman Bair’s reluctance to expose the DIF to potential losses by invoking the SRE.⁵⁴

FDIC also demonstrated a much tougher attitude than FRB and OCC when the largest banks sought to exit the Troubled Asset Relief Program (“TARP”) by repurchasing the preferred stock they had sold to Treasury. From November 2009 to June 2011, FDIC tried unsuccessfully to force several major banks (including Bank of America, Wells Fargo and PNC) to issue to investors at least \$1 in new common stock for every \$2 of TARP preferred stock they repurchased from Treasury. FDIC insisted on the 1-for-2 ratio in order to “increase the quality” of the seven banks’ capital structures and limit the risk those banks posed to the DIF.⁵⁵

However, OCC pushed for much more lenient terms for the big banks, and FRB took an intermediate position. Over the FDIC’s objections, regulators ultimately allowed the banks to

⁵³ Wessel, *supra* note 49, at 218-21 (explaining that New York Fed President Timothy Geithner argued strongly that the SRE should have been invoked to authorize FDIC to protect bondholders when WaMu failed, but Fed chairman Ben Bernanke agreed with FDIC chairman Bair’s position that the SRE should not be used): FCIC Report, *supra* note 44, at 365-66 (stating that Treasury officials also disagreed with Chairman Bair’s position)

⁵⁴ Wessel, *supra* note 49, at 221-23, 232-33; FCIC Report, *supra* note 44, at 366-69.

⁵⁵ “Exiting TARP: Repayments by the Largest Financial Institutions,” SIGTARP Audit Report 11-005 (Sept. 29, 2011), at 17-63 (quotes at 19-30).

repurchase their TARP preferred stock while failing to meet the 1-for-2 ratio advocated by FDIC.⁵⁶

Thus, FDIC's clearly-defined mission and its secure source of funding have encouraged FDIC to act with significantly greater independence from the views of major banks, compared to OCC and the Fed. That independence has manifested itself in the FDIC's much stronger resistance to TBTF bailouts. Two lessons emerge from this story. First, the FDIC's greater willingness to resist industry influence indicates that CFPB's clearly-defined consumer protection mission and assured funding will encourage a similarly independent attitude within CFPB. Congress should not enact any legislation (like H.R. 1355) that would blur CFPB's mission or undermine its autonomy. Second, it would be bad public policy to enact H.R. 2081, because that legislation would give FRB an undesirable influence over FDIC and potentially undermine FDIC's determination to resist TBTF bailouts and protect the interests of both depositors and taxpayers.

Thank you again for the opportunity to present this testimony.

Arthur E. Wilmarth, Jr. (2/7/12)

⁵⁶ *Id.* at 20-63.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Arthur E. Wilmarth, Jr.	2. Organization or organizations you are representing: None
3. Business Address and telephone number: 	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets. 	
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