

**NOMINATIONS OF: RANDALL S. KROSZNER,
ELIZABETH A. DUKE, AND LARRY A. KLANE**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

NOMINATIONS OF:

RANDALL S. KROSZNER, OF NEW JERSEY, TO BE A MEMBER OF THE BOARD
OF GOVERNORS, FEDERAL RESERVE SYSTEM

ELIZABETH A. DUKE, OF VIRGINIA, TO BE A MEMBER OF THE BOARD OF
GOVERNORS, FEDERAL RESERVE SYSTEM

LARRY A. KLANE, OF THE DISTRICT OF COLUMBIA, TO BE A MEMBER OF
THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

THURSDAY, AUGUST 2, 2007

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THURSDAY, AUGUST 2, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:45 a.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. My apologies to all of you this morning for—they are doing an experiment, I guess, or test on constitutionality this morning. Not a good excuse but, nonetheless, that is reason I am a few minutes late, and I apologize to my colleagues and to the witnesses and to your families.

Let me make an opening statement, if I can, and then I will be turning to my colleague from Alabama, the Ranking Member, and any other Members who wish to make some opening statements here. We will then swear in the witnesses and hear your testimony, and then we will raise some questions with you.

First of all, I am pleased to welcome all of you here this morning. Today the Committee will meet in open session to hear from Dr. Randall Kroszner, Ms. Elizabeth Duke, and Mr. Larry Klane, who have been nominated to the Federal Reserve Board of Governors.

One of the most important and influential nominations that we consider in this Committee is that of a Governor of the Federal Reserve Board. The seven Federal Governors are the only individuals appointed by the President of the United States and confirmed by the U.S. Senate who have a voice in our Nation's monetary policy. The Governors are responsible for upholding the Fed's dual man-

date: to promote employment and achieve price stability. Fulfilling this mandate creates the conditions necessary for our economy to grow and for every American to have an opportunity to participate in the shared prosperity of our Nation.

The role of the Fed is critical not just in setting monetary policy; it also serves as a regulator of the safety and soundness of our largest lending institutions and, very significantly, as a regulator and enforcer of the laws passed by the U.S. Congress and signed by the President to protect consumers and ensure that they have an opportunity to participate and succeed in the American economy.

The duties of the Fed are no less important than the Fed's monetary policy responsibilities. In fact, given the depth of experience that the Fed's current Governors have in monetary policy, issues of consumer protection and bank supervision are of particular importance with respect to the nominees that we have before us today.

It is for all of these reasons that the Fed Governors should be of the highest caliber and quality to serve our Nation. The position of Governor also requires substantial political independence. In establishing the Federal Reserve, the Congress created a system in which each Fed Governor's seat has a fixed 14-year term. I know some of my colleagues wish that the Founders had thought of us in that way. Governors at the Fed enjoy the third longest term given to any appointee in the Federal Government, beyond only the lifetime appointment awarded to Federal judges and the 15-year term given to the Comptroller General.

Of the nominees, Dr. Kroszner has been nominated to fill a full 14-year term. The others have been nominated to partial terms of years. All of the nominees have indicated in their questionnaires that, if confirmed, they intend to serve their full terms. Given the length of these terms, a nominee to the Federal Reserve Board of Governors requires careful deliberation and very thoughtful consideration.

In closing, I want to return to the importance of the Fed's role as an agency charged by the Congress with many important consumer protection functions, particularly with respect to subprime lending and credit cards. I have not been shy about expressing my view that the Fed's actions have been unsatisfactory in my view over the past several years in that regard, and I look forward to exploring this area, among others, with our witnesses today.

Before I turn to my colleague, the Ranking Member, I will briefly introduce the nominees.

Dr. Randall Kroszner assumed the role of Governor of the Federal Reserve Board on March 1, 2006. His current term expires on January 31, 2008, and he has been nominated to serve a new 14-year term expiring February 1, 2022.

I got to tell you, Doctor, when I was thinking about that number, I have a 5-year-old daughter, and she will be a junior in college when that is over with. It gives a dimension to this that I cannot imagine her being in that position, but that is how long a time we are talking about here with your nomination and the consideration of the Senate.

Dr. Kroszner previously served on President Bush's Council of Economic Advisers from 2001 to 2003 and has a distinguished background. I would note he was educated at Brown University, where my brother-in-law—in fact, a good part of my sister's family are there. They have strong connections to Brown University as well.

Elizabeth Duke has been nominated to fill a term—let me ask you, first of all, Doctor, your family members are here. I know you have some, I think, with you here today. Would you care to introduce them? We would like to welcome them to the Committee.

Mr. KROSZNER. Yes, please. I have my mother, Helen Kroszner, and my niece, Kimberly Kroszner, with us here.

Chairman DODD. Well, thank you for joining us here this morning. Nice to have you with us.

Elizabeth Duke has been nominated to fill a term which expires January 31, 2012. Ms. Duke is Senior Executive Vice President and Chief Operating Officer for Towne Bank in Virginia. Ms. Duke also served as the Chair of the American Bankers Association—I believe the first woman to do so, if I am correct—from September 2004 through September 2005 and in doing so was the first woman to chair the ABA. And I wonder if you have any family members here, Ms. Duke, you would like to introduce.

Ms. DUKE. Yes, I do. My two sisters and my two nieces.

Chairman DODD. Where are they here? Right there. Thank you. You got the front row seats here. Good. Nice to have you with us this morning.

Mr. Larry Klane has been nominated to fill a term ending January 31, 2010. Mr. Klane is currently the President of Capital One Global Financial Services. Again, do you have any family here, Mr. Klane?

Mr. KLANE. I do. Behind me is my wife, Polly, who is carrying a child that we expect in roughly 2 months.

Chairman DODD. Congratulations.

Mr. KLANE. Thank you. With her are her folks, Alecne and Jack. Chairman DODD. Great.

Mr. KLANE. I also have my father, and if you do not mind, I would just like to mention someone who is not here, and that is my mother, who passed away 3 weeks ago and for whom we are having a memorial service tomorrow. She is with us in spirit.

Chairman DODD. You bet she is. She may have some questions for you, in fact.

Mr. KLANE. She asked many during her life.

Chairman DODD. I am sure she did.

[Laughter.]

In fact, I think you can hear her right now. Anyway, let me recognize my colleague from Alabama, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman, for scheduling this hearing.

This panel of nominees will have very important responsibilities, as Chairman Dodd has mentioned. The Federal Reserve must implement sound monetary policy, ensure the vitality and viability of

our Nation's financial institutions and payment system, and maintain financial stability.

During Chairman Bernanke's appearance before this Committee in July, we had a full discussion of the Nation's economic performance and risk factors on the horizon. Although we have seen the stock market waver in the past few days, the economy is performing well with strong GDP growth.

We also continue to enjoy a low unemployment rate, both historically and relative to other industrialized nations. The risk of inflation, not slow growth, remains the predominant concern as we continue to see a rise in energy and food prices.

During Chairman Bernanke's appearance last month, we also had an extended discussion of the Federal Reserve's recent activities that Senator Dodd brought up relating to subprime mortgage lending because you are not only the central bank, you are a bank regulator, as you well know. I remain concerned that the weaknesses in the subprime market may have broader systemic consequences. We have been told that the problem is largely isolated and contained, but I am concerned that it may not be. I will be particularly interested in hearing your views on the scope of the problem today and how the Federal Reserve will monitor and manage the situation going forward.

The Federal Reserve Board also faces the challenge of implementing significant new capital requirements for our banking system. Chairman Dodd and I are pleased that the banking regulators, all of them, were able to reach a consensus on final regulations to implement Basel II. On this Committee we will continue to monitor this process as the new standards go into effect.

The three nominees, Mr. Chairman, before this Committee this morning all bring specific expertise and insights to the Board, a lot of balance. Governor Kroszner has already done so for the past year and a half. Elizabeth Duke and Larry Klane will bring valuable insights to the Board given their broad experience in the banking and financial services industry. These talents will be particularly helpful as the Federal Reserve works to address the issues that I cited earlier.

I am pleased that the President has sent forward this panel of nominees, and I look forward, Mr. Chairman, to working with you and other Members of this Committee to get these nominations to the floor and get them confirmed so they can go to work.

I do want to say one thing about Governor Kroszner. This is your third appearance, third nomination hearing before this Committee. In February of 2006, the Committee confirmed you to the position that you currently hold, member of the Board of Governors of the Federal Reserve. In November of 2001, the Committee here, the Banking Committee, considered your nomination as a member of the Council of Economic Advisers favorably. The Senate confirmed you for this position, and you served the Council through July of 2003, when you went back to the Fed. So the 14-year term is a long time, but that is why we set it up for you to be independent. I wish we had 14-year terms.

Thank you, Mr. Chairman.

Chairman DODD. Before I turn to Senator Bunning, I just want to underscore the point that Senator Shelby has raised. I could not

help but notice this morning, Richard, two headlines: “U.S. Crisis Sends World Markets Tumbling,” and then in the *Financial Times*, “German Subprime Lender Is Bailed Out Here.” So for those who think this problem has been contained, again, just watching what is happening—all of us would hope it had been contained, but clearly it is not at this point here.

And so this is a matter the Fed has got to take very, very seriously, and let me turn to Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I am glad we are holding this hearing, and I hope that we can soon hold a markup on these nominees.

When the current vacancies came up last year, I made it clear to the Fed that I thought those seats should be filled with people with real-world experience in banking. In fact, I wish more seats were filled with folks with real-world experience and less from academia. Naturally, I am pleased that the President sent us two nominees with extensive experience in the marketplace. I have been critical of the Fed in the past for going too far in interest rates actions. Part of the reason the Fed went too far was because the room was filled with academics, not considering the impact their actions would have on industry and individuals. I am confident that the perspective these nominees will bring to the Fed will only improve Fed policy and decisionmaking.

Mr. Chairman, you and I have been critical of the Fed’s handling of the housing boom and bust. Many Members of this Committee agree that the Fed was asleep at the switch as lenders got more and more irresponsible. Only after we pressured the Fed to act did they rein in the worst of the nontraditional and subprime lending practices.

The Fed has started taking action, and it was clear from our hearing with Chairman Bernanke 2 weeks ago that the Fed would take further steps. It is especially important for people with industry experience to be on the Board while new regulations are under consideration.

As I tell all nominees to the Fed, I told these three when they visited me that it was important for them to speak up and speak their minds in the meetings. Too often in the past, the Fed has been dominated by a single voice. Chairman Bernanke has been much better than his predecessor, and I expect that will continue. I believe these nominees will make sure that they are heard when they need to be.

Again, Mr. Chairman, I hope that we can quickly move these nominees through the Committee and through to the floor. I look forward to hearing from our nominees and their testimony.

Chairman DODD. Thank you, Senator.
Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you for holding today’s hearing. As always, I appreciate the opportunity to hear from nominees, and I welcome them to the Banking Committee, along with you.

Today we will be considering the nominations of three highly qualified individuals to be Members of the Board of Governors of the Federal Reserve System. I have had the opportunity to sit down and meet with all three and believe that they will bring a great deal of real-world experience to the Board of Governors.

First, I would like to welcome and comment on the nomination of Larry Klane. Besides from being born in my State of Colorado, Mr. Klane will bring an expertise of consumer and small business credit to the Fed. As an executive of Capital One, Mr. Klane will be a valuable asset to the Fed as it considers how to better ensure that consumers understand their credit card bills and the terms of their credit card agreements and mortgage loans.

Next, I would like to turn to the nomination of Elizabeth Duke. Ms. Duke is a former Chairman of the American Bankers Association and now the chief operating officer of Towne Bank in Hampton Roads, Virginia. Along with Mr. Klane, Ms. Duke will bring her 20-plus years of banking experience to the Federal Reserve Board of Governors, which is dominated by academia.

Finally, I would like to welcome Dr. Randall Kroszner back before the Committee. As we are all aware, Dr. Kroszner is already a Governor who was appointed to fill an unexpired term. I look forward to continuing to work with him and the Fed in the future.

In closing, I would encourage all the nominees to become familiar with the Government Performance and Results Act, which has been named PART Assessment by the administration. The Results Act is a key tool in giving agencies the focus and vision to carry out effective and efficient programs. I would exhort the nominees to become familiar with the appropriate strategic plans, annual performance plans, annual accountability reports, and financial statements. If properly utilized, they can help you achieve success in meeting your mission. I would also point out to you that you can look at how your agencies are performing if you look under *Expectmore.gov*. Or it might be *.com*, but it will get you there.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

I am going to ask the witnesses to stand and raise their right hands and be sworn. Do you swear or affirm that the testimony you are about to give is the truth, the whole truth, and nothing but the truth, so help you God?

Mr. KROSZNER. I do.

Ms. DUKE. I do.

Mr. KLANE. I do.

Chairman DODD. And do you agree to appear and testify before any duly constituted Committee of the U.S. Senate?

Mr. KROSZNER. I do.

Ms. DUKE. I do.

Mr. KLANE. I do.

Chairman DODD. I thank you very much.

Dr. Kroszner, we will begin with you and your opening statement, and I would just say to you and to all of the witnesses and our colleagues here, any corroborating or supporting evidence you want to add will all be included in the record.

**STATEMENT OF RANDALL S. KROSZNER, MEMBER-DESIGNATE,
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. KROSZNER. Thank you very much. Chairman Dodd, Senator Shelby, and Members of the Committee, I am very pleased to have the opportunity to appear before you today as a nominee to serve a new term on the Board of Governors of the Federal Reserve System. I am honored that President Bush has nominated me to serve another term on the Board. If confirmed by the Senate, I will work to the best of my abilities to fulfill the significant responsibilities of this office.

During the last quarter century, the Federal Reserve has achieved much success in reducing and stabilizing inflation and inflation expectations. This success has helped to contribute to a tendency for the fluctuations in employment and output to be lower than in the past and a reduction in the frequency and severity of recessions. If confirmed, I would continue to work with Chairman Bernanke and the other members of the Federal Open Market Committee—the FOMC—to continue to underscore the role of long-term price stability in achieving prosperity and maximum employment.

The Federal Reserve also has a fundamental responsibility to consumers and users of the banking and financial system. Discriminatory or abusive lending practices should not be tolerated, and the privacy of individuals and their financial data must be protected. Since I joined the Federal Reserve, we have undertaken a number of initiatives to better protect and to better inform consumers. These include: issuing guidance on nontraditional mortgage products and on subprime mortgages and improving our collaboration with the State banking supervisors; launching a pilot project in collaboration with other Federal agencies and State regulators to examine non-depository lenders for compliance with consumer regulations; improving disclosures for privacy notices and credit cards; improving the handbook on adjustable rate mortgages that creditors are required to give to all adjustable rate mortgage applicants, and committing to propose new rules before the end of the year to require that lenders provide other mortgage disclosures more quickly and to improve mortgage loan advertisements; undertaking a series of hearings, including one that I chaired in June, to assess the impact of specific practices in the mortgage market; and committing to propose new rules exercising our authority to ban unfair or deceptive practices under the Home Ownership and Equity Protection Act. If confirmed, I will continue to place the highest priority on protecting consumers while ensuring that creditors continue to provide credit responsibly.

An important part of my research as an economics professor at the University of Chicago, and my practical policy work as a member of the Council of Economic Advisers, was devoted to banking and financial regulation as well as banking and financial crises. The safety and soundness of the U.S. banking system and U.S. payments system is critical to achieving economic growth, maximum employment, and general economic stability, and the Federal Reserve works closely with other Federal regulators and international regulators to achieve this goal. The Federal Reserve also has an important role to play in responding to and mitigating the

impact of financial crises and shocks. If confirmed, I would continue to work vigorously to protect and promote the safety and soundness of the system.

Thank you once again for holding this hearing, and I look forward to your questions.

Chairman DODD. Thank you very much.

Ms. Duke.

**STATEMENT OF ELIZABETH A. DUKE, MEMBER-DESIGNATE,
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Ms. DUKE. Thank you, Chairman Dodd, Senator Shelby, Members of the Committee. It is an honor to come before you today as a nominee for the Federal Reserve Board of Governors. I am grateful to President Bush for nominating me and to you for holding this hearing to consider my nomination.

For most of my 32 years in banking, I worked for State member community banks. Our primary Federal regulator was the Federal Reserve. We cleared our checks, initiated our wires, and safe-kept our securities with the Federal Reserve Bank of Richmond. And I served as a director of the Richmond Fed. So I come to you with a full appreciation of the responsibility entrusted to a Federal Reserve Governor. If I am confirmed, I promise to bring everything that is in me, every day, to fulfill the trust you will be putting in me.

My experience with monetary policy comes from being impacted by it. I learned my first painful lesson about inflation and monetary policy when the national prime rate went from 8 percent to 21 percent. Our small business customers couldn't have survived, so we actually created our own lower prime and learned to live with it. Later, I worked through recessions and expansions with those same customers. With these experiences in mind, I strongly support the dual mandate Congress has given the Federal Reserve of pursuing both stable prices and maximum employment.

In addition to monetary policy, the Federal Reserve is charged with the safety and soundness of the financial system. I weathered the banking and thrift crisis and wrote my checks to the FDIC to restore the fund. In more than 25 years of teaching, I have taught probably more than 3,000 bankers and bank examiners the basics of sound banking practices. The importance of safety and soundness in our banking system is a part of my DNA, and I think it is the most important experience that I could bring to the Federal Reserve.

The Fed has sole responsibility for consumer protection regulations governing regulated and non-regulated financial service providers. I look forward to reviewing the comments, research, and work already underway with respect to subprime lending regulations and guidance.

And I believe I can bring some relevant experience to the process. I worked with the Virginia banking commission when they were first given responsibility for supervision of nonbank mortgage lenders after the collapse of one of the most predatory lenders I have ever seen.

As Chairman of the American Bankers Association, I worked with bankers and regulators in all States on numerous regulatory

matters. I don't believe we can solve the subprime issue without cooperation and coordination across the full spectrum of regulation, supervision, and enforcement of all mortgage loan participants. I would welcome the opportunity to lead such an effort.

The role of the Federal Reserve in our Nation's payment system doesn't have the headline cachet of monetary policy or consumer regulation, yet I believe it has every bit as much of an impact on the everyday lives of the American consumer. We are in the midst of a payment revolution with evolving technology and the passage of Check 21. I would hope to be actively involved with the payment infrastructure as well as modernization of the rules and regulations governing payments.

Finally, service on the Federal Reserve Board would feed my passion for financial education. I have been in the classroom, raised money to teach the teachers, conducted awareness media tours, and lobbied for curriculum changes. All of our work on consumer disclosure will be in vain if we don't raise a generation of consumers who can use those disclosures to make good financial choices.

Thank you for allowing me this time. I look forward to your questions.

Chairman DODD. Thank you, Ms. Duke.

Mr. Klane.

**STATEMENT OF LARRY A. KLANE, MEMBER-DESIGNATE,
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. KLANE. Chairman Dodd, Senator Shelby, and Members of the Committee, I am honored to appear before you today as a nominee to serve as a member of the Board of Governors of the Federal Reserve and would like to thank you for scheduling this hearing. I also want to thank the President for his confidence in nominating me for the position. If confirmed by the Senate, I look forward to working with the other Board members to fulfill the full range of objectives that Congress has established for the Federal Reserve. It has been a lifelong personal goal for me to enter public service, and I can think of no better place to contribute than the Board of Governors.

I have spent 25 years working in business, finance, and banking. For the past 14 years, I have devoted my career to financial services, including 7 years in wholesale financial services and the capital markets at The Bankers Trust Company and its acquirer, Deutsche Bank. I have spent the past 7 years in consumer and small business lending, principally in the United States, but also in Canada and Europe.

As President of Capital One's Global Financial Services Division, I currently serve roughly 10 million consumers and small businesses, and I have been the President of our Federal Savings Bank and am currently the Chairman of our bank in the United Kingdom.

Let me turn briefly to a couple of specific areas of responsibility at the Federal Reserve Board. In Chairman Bernanke's recent testimony on monetary policy, he devoted substantial attention to consumer protection matters, and I would like to underscore the importance of this element of the Board's responsibilities by begin-

ning there. As a banking practitioner, I have gained firsthand knowledge of consumers and their financial needs and, if confirmed, I would bring my energy, focus, and experience to vigorously fulfilling the Fed's consumer protection responsibilities.

In addition to protecting consumers through guidance, rule-making, and supervisory focus, I would also strongly support the Federal Reserve's longstanding commitment to financial literacy. In connection with my service on the Board of America's Promise—a nonprofit organization dedicated to improving the lives of America's children—I have seen the power of education, including financial education. The Federal Reserve also has responsibility for the stability of America's financial system as well as for the direct supervision of many financial institutions and all bank holding companies. My experience with a broad array of banking regulators in the United States and abroad has shown me firsthand the importance of good supervision—not only for maintaining sound financial institutions, but also for protecting consumers.

The Federal Reserve also oversees the smooth functioning of the payments system. In recently reading the testimony of Fed nominees who came before this Committee following the tragedy of 9/11, one particularly appreciates this aspect of the Federal Reserve's duties. With technology, business, and other developments impacting the U.S. payments system, this is an area of continued importance.

Of course, a central—if not the central—responsibility of the Federal Reserve is the pursuit of sound monetary policy. Congress has given the Fed a “dual mandate” of maximum employment and price stability and, if confirmed, I would approach monetary policy firmly within this framework.

In conclusion, Mr. Chairman and Members of the Committee, if confirmed to the Board of Governors, my objective would be to use my experience in banking and business to help the Federal Reserve execute the broad responsibilities that Congress has set before it. I thank you for your consideration and look forward to your questions.

Chairman DODD. Well, thank you, the three of you. I appreciate your statements, and what I am going to do is have a clock on for—there are four of us here, so I will put 10 minutes up. I will not hold anybody to it rigidly, but that way we each get an idea, and it should be an adequate time to at least start the questioning. And if more Members show up, we may reduce that in the second round to a little less than that to make sure we get some opportunity to respond.

Let me begin. I was taken with all of your opening statements. They are, very smartly, brief, which is always good advice, I suppose, at moments like this. But I noted in all three testimonies, all three statements, the reference to the importance of the responsibility to consumers and the users of the banking and financial systems, and how, Doctor, you talked about discriminatory and abusive lending practices should not be tolerated, the privacy of the individual and their financial data must be protected. Ms. Duke, I think you—or, Mr. Klane, rather, you talked about Chairman Bernanke's statement to underscore the importance of the element of the Board's responsibilities in consumer protection matters, and,

Ms. Duke, you talked about the Fed has the sole responsibility for consumer protection regulations governing regulated and non-regulated financial service providers.

I thank all three of you for highlighting that particular importance, and I would like to at least begin my questioning with you regarding these matters, because it has been a matter of concern. As you have heard from Senator Bunning and others, with the passage of the HOEPA bill back in 1994, a long time went on before the Fed assumed its responsibility under that legislation, which was not a voluntary request on the part of the U.S. Congress for the Fed to assume a major responsibility in protecting consumers from the very practices that you have identified in your opening statements here. In fact, it was not until, of course, this problem began to emerge in a public way that the Fed has begun to respond with guidance and more recently with the hearings on the rule-making function and authority. And let me just say I am pleased that, in fact, Chairman Bernanke's testimony here just a few days ago talked about the speed with which they hope to promulgate these rules, a comment period so that we can have some response. That is little solace to those who are going through this today in a sense, who have lost their homes or find themselves in financial ruin here because there was not a better cop on the beat to make a difference in their lives. And certainly I accept the notion that there is a certain amount of speculation involved in this matter here. I do not know exactly to what extent, but certainly I recognize that is part of it, but I think also all of us recognize that an awful lot of it here was rather underhanded activity, in a way, on the part of some people here that it caused this situation to emerge.

So I am going to begin asking you about these questions here because they are extremely important to me. I know they are important to Senator Shelby and Senator Bunning. All of us on this Committee care very much about what is happening.

I would, first of all, ask you whether or not—just as a general proposition here, I showed you the headline in the Financial Times and the story here. What is your view on this? Do you believe this problem has been contained? I mean, there has been some suggestion in informal conversation out of the Fed that the problem has been contained. And yet all the evidence we are seeing is to the contrary. Where do you stand on that question, Doctor? Has this problem been contained or not contained, in your view?

Mr. KROSZNER. Well, certainly you are exactly right that there are a lot of challenges in this market. There are a lot of families and households that are feeling pain—who face the prospect of losing their homes—and that is something that can be a real tragedy. The Fed needs to respond to that, and I think we have been responding to that.

Chairman DODD. I have a suggestion. Three and a half years ago, the Fed staff had information that this was a problem that was emerging. Three and a half years ago. And yet, you know, here is the bill sitting there and not much happening here at all.

Mr. KROSZNER. The Fed actually did, with the other regulators, issue guidance in 1999 and an expanded guidance in 2001 concerning subprime mortgages, and then we also went ahead in 2005

and 2006 with the nontraditional mortgage guidance, as well as more recently the subprime guidance. And so we are trying to reduce the pain, to keep people in their homes, because it makes sense both from the point of view of the individuals, from the point of view of the community, as well as from the point of view of the lenders and servicers in almost all circumstances.

With respect to the broader implications, we are monitoring this very closely ourselves and in conjunction with our colleagues at the Securities and Exchange Commission, the other banking regulators, as well as banking regulators around the world, to look for signs of where the market is going.

I think that at this stage the economic fundamentals are really unchanged from where Chairman Bernanke talked about them in this Committee about 2 weeks ago, and so we have not seen an effect on the broader real economy. But we are looking very, very carefully at that.

With respect to individuals, they are going to continue to face challenges. I think this is going to be with us for some time, and that is why Chairman Bernanke announced that we really are going to be doing some important regulatory changes or at least proposing those by the end of the year.

Chairman DODD. Should I conclude from your answer that it is not contained, in your view?

Mr. KROZNER. Well, with respect to the macro economy, the real economy does not yet seem to be affected by this. With respect to individuals and their families, I think we are going to be seeing more delinquencies and we are going to be seeing more foreclosures.

Chairman DODD. So it is not contained.

Mr. KROZNER. With respect to the individuals, yes.

Chairman DODD. Ms. Duke.

Ms. DUKE. I think the problems in the credit market, unfortunately I do have some experience with trouble debt, and that specific issue will probably get a lot worse before it gets better. What worries me now, having been through a trouble debt situation before, is that with these loans now having been sliced and diced and ending up in various different places, they are being serviced by various entities who may themselves be experiencing some stress. And so I am not sure really what is going to happen to the collection processes of these loans.

A lot has been made of the foreclosure rates. As a lender, foreclosure is the last step, and at that point, from the standpoint of the lender, you have actually lost the battle there. Where we really need to step in is earlier than that.

So while I agree, I do not think that the subprime issues have impacted the overall economy, the day-to-day functioning of the economy, what worries me is the very specific situation of a borrower who, for whatever reason, is in a loan that they cannot pay and not sure what to do, where to do it. I think some of the things that we will need to take a look at are finding a trusted third-party intermediary. It has been my experience that a borrower in trouble, the last person they want to talk to is the lender. They need someone to bring information to bear as to what the options might be

to get through this, and also in some cases some liquidity to provide as a bridge to get from one piece of financing to another.

Chairman DODD. Well, I appreciate your answer on that, and I will turn to you in a second, Mr. Klane, on this. You know, looking here at nominees to this very important Board here, in a sense a dose of good reality here, I mean, the slowdown in growth of real GDP has clearly been affected by this matter. The idea somehow these are segregated issues here that do not affect the larger economic picture of the country is troubling. And I want you to be very straightforward. I know you have all been coached to be careful about what you say here, but we are looking for some important guidance from the people who are going to be sitting here making very important decisions. And the suggestion that somehow what is happening in the housing market is not affecting real growth in GDP I find rather breathtaking.

Mr. Klane, let me ask you if you have an opinion on this.

Mr. KLANE. Frankly, Senator Dodd, I share your—

Chairman DODD. You have got to bring your mike closer to you. Is it on? There you go.

Mr. KLANE. Is that good?

Chairman DODD. Yes.

Mr. KLANE. Chairman Dodd, I share your concern across the subprime mortgage issues that you have outlined in a number of dimensions: first is the question of how we got to where we are; second is the difficulty for human beings and their families who are caught in the situation as well as their communities, which suffer during these times; and then, third, what it means for the economy as a whole—whether it is Bear Stearns' hedge funds that can no longer support themselves because of investments in CDOs that find their roots in subprime mortgages, or the headlines which you shared with us.

Going forward, if confirmed, I would put my full energy against the commitments that the Federal Reserve has made in order to take all of the arrows in the regulatory quiver to protect consumers with respect to, for example, rulemaking under the Home Equity Protection Act. I would jump into these issues vigorously, with all of my energy.

I applaud, by the way, this Committee and you for bringing together significant home mortgage originators and servicers to create a series of principles in order to help families, as best they can, work through the foreclosure process. I undoubtedly think that we will see some more worsening before it gets better. I also applaud the compassion that underlies that effort and the compassion that underlies the work of the Federal Reserve and the Reserve banks as they engage communities around the country, as Ms. Duke commented, to encourage people in trouble to feel more free to reach out to the lenders before it is too late, and hopefully to work things out. I know the Federal Reserve and the SEC have clarified some accounting rules that would otherwise get in the way of servicers helping people work out of troubled loans that were part of securitizations. I applaud these efforts and, if confirmed, would continue to work to help households with troubled loans and their communities.

I would also join the Board with a concern around whether the subprime mortgage issues have broader impact on the economy and financial markets. I would be as vigilant as possible and take, together with the rest of the Board, whatever actions would be deemed necessary, depending on how things unfold.

Chairman DODD. Let me ask you, Senator Menendez in a March 22nd hearing we had on this subject matter here—Roger Cole, who is the Director of the Division of Banking Supervision and Regulation, was testifying. Senator Menendez asked him the following question—he said as to why the Federal Reserve Board seems to have done so little as the subprime crisis was building, Mr. Cole said, “I will say”—and I am quoting him here. “I will say that given what we know now, yes, we could have done more.”

What I want to know from all of you very quickly, if you can here, is: One, do you agree with Mr. Cole that the Fed and other regulators could have done more, in your view today as you stand before us here, sit before us? And, second, to point out that for years the Fed had begun to act, there were people drawing attention to the problem, and do you believe the Fed acted in a timely fashion? On both those questions, Doctor, do you want to—

Mr. KROSZNER. Well, I think it is very difficult to make policy with 20/20 hindsight. As I mentioned before, the banking agencies together issued subprime mortgage guidance in 1999, expanded in 2001, in 2005, and 2006 the non-traditional mortgage guidance; and this year the new subprime guidance has come out.

I think we have undertaken a lot of actions with respect to the individual banks and institutions that we do regulate. Something that I think is very important to recall is that our regulatory ambit is relatively contained. The enforcement powers and supervisory powers we have are only over depository institutions. Many of the problems that have come up have been outside our direct enforcement and supervisory ambit. So it is very difficult to have gotten information from, or supervised or taken any actions against those who are outside what we regulate and supervise.

Chairman DODD. So your answer would be that you could not have done more and the Fed acted in a timely fashion? Is that how I read your answer?

Mr. KROSZNER. Well, as I had said, it is very difficult to make policy with 20/20 hindsight, but I think we were taking actions on these issues back in 1999, 2001—

Chairman DODD. I am not asking you to make policy. I am just asking you the question of whether or not you think the Fed acted in a timely fashion and could have done more, looking back.

Mr. KROSZNER. Looking back, I think we did undertake a lot of actions, and unfortunately a lot of the greatest challenges occurred outside what we could have done, outside where we could have had enforcement or supervision.

Chairman DODD. Ms. Duke, the same question.

Ms. DUKE. I think if you look at it in hindsight, clearly something different could have been done and had a different outcome. And I think this may be a good opportunity to look at the whole mortgage origination and delivery process across all originators.

Chairman DODD. Well, I agree with that. That is why we are here.

Mr. Klane.

Mr. KLANE. I just want to start by noting the sources of the subprime problems are complex and go well beyond regulatory action or inaction. I would look forward to working with the Committee on all elements, including the complexity of so many different types of mortgage originators, the multiplicity of supervisory agencies, and the role of the securitization market. The model of mortgage origination is more complex than in the past.

All that being said, sitting here with hindsight, I think we can say very clearly that if the Fed had acted somewhat earlier, we might have had to some extent a better outcome.

Chairman DODD. Thank you very much.

Senator Shelby.

Senator SHELBY. I want to pick up on the same subject, subprime, because it is my understanding that a lot of the subprime loans, a lot of them in the future will be reset at a higher rate of interest. Now, if you have thousands and thousands—and we do—or billions and billions of dollars' worth of subprime loans where they pay nothing down to speak of and pay basically interest only for the first 2 years, and then they are going to reset those upward in 2 years; I see problems down the road, and most people that I have been in contact with have.

Ms. Duke, you have been a president of a bank. You have been an executive of a bank. You went through the—you referred to it earlier, a lot of us did—21-percent prime. You remember that, obviously. A lot of us are concerned about the rating agencies here. I hope Senator Dodd will hold a hearing on this. We asked the SEC Chairman right here in this Committee the other day—because I introduced legislation to bring—and it had broad support—to bring competition to our rating agencies. We are concerned about conflicts of interest and things like that.

How can you take—you know, the basic question: How can you take a bunch of questionable loans, bundle them together, and then sell them as securities and rate them investment grade, AAA at times, because you put a few things with them? Some of those, as we have seen some of our most reputable investment banks saying that some of those funds are basically worthless now.

Does that trouble you as a former banker, having to work out problems on businesses and mortgage loans? You have had the experience.

Ms. DUKE. I have had the experience of working out troubled debt. I have had the experience of having that debt mount up a lot faster than anybody ever expected. But all of that experience was in the case of a lender face to face with the borrower. We still held those loans and—

Senator SHELBY. And these were sold, most of them were securitized.

Ms. DUKE [continuing]. That is the part that really concerns me, is identifying where those loans are right—

Senator SHELBY. Well, somebody is holding the risk there, are they not?

Ms. DUKE. Somebody is.

Senator SHELBY. I mean, you spread the risk. You pass it on. But somebody is holding that risk, and, gosh, I would hate to be the

one holding some of that risk knowing that a lot of that stuff is going to be reset.

Mr. Klane, you come out of the banking industry. You understand that well, and you understand risk. Somebody is going to eat those loans, aren't they?

Mr. KLANE. Well, I think we can see some of the implications of that in some of the hedge funds holding CDOs and CLOs already. You point out one of the areas of complexity that has caused some of these problems—and it is really not directly related to, by the way, consumer protection issues. You certainly raise a number of important points, and I think it also underscores the importance going forward of having underwriting criteria that take into account rate reset.

Senator SHELBY. I want to get into Basel II with you, and I will start with Dr. Kroszner. We are all concerned about capital standards here. We raised that many times, Senator Dodd, his predecessor Senator Sarbanes, everybody on this Banking Committee, Democrat and Republican. We had a good banking system.

Several of us—Senator Dodd and I—have served on this Committee a long time, and we went through the thrift crisis right here. We do not want to go through that again in any way. Capital brings a cushion, and some of us are concerned where we are going with Basel II. Some of those models might work, and some of them might not work. I know that some of the big banks have told me personally that what is driving that is freeing up capital, you know, lowering capital.

You will be a bank regulator. You will not be the only one, and we brought this up with the FDIC and Sheila Bair, the Chairman, and others. There is widespread concern. I hope it works. I know where you are today. We were glad to see what you did, you know, with the other banking regulators. But some of us have—we hope Basel II works. But we would hate to see problems come before this Committee for the taxpayer like we went through with the thrifts because we lowered capital standards.

Do you want to comment on that?

Mr. KROSZNER. Certainly. First, I would like to thank Senator Dodd, Senator Shelby, and other Members of the Committee who were very helpful in making sure that we got to a good outcome, at least in principle, among the regulators to move ahead with modernization of the capital standards, the so-called Basel II. I think it is very important from a safety and soundness point of view that we do move ahead with them because we must encourage modern risk management techniques.

The traditional Basel I system was fine 25 years ago, but it is not appropriate today for our large institutions. And if regulation does not keep up, we will not be maintaining our duty to maintain the safety and soundness of the system.

Basel II has very large numbers of belts and suspenders in it to ensure that capital will not fall inappropriately. The key—

Senator SHELBY. What do you mean by inappropriately?

Mr. KROSZNER. Relative to risk.

Senator SHELBY. Okay.

Mr. KROSZNER. And so Basel II was very helpful in giving incentives for banks and other financial institutions to reduce risk. Un-

fortunately, in the current system, Basel I, there are some perverse incentives that could lead banks to take on excess risk because the capital charges are not sensitive to risk. But moving to a more modern framework, we are giving the institutions the right incentive to try to reduce risk. I believe that there would be sufficient capital in the system to adjust for any of those risks.

I would never, ever want to subject the financial system, the U.S. economy, or the taxpayer to the problems that happened in the savings and loan crisis. This is something that I have done a lot of research on and have, I think, a very strong paper trail on—that we need strong capital in order to have a safe and sound banking system. And I believe Basel II will be consistent with that, but it will also help us reduce risks in that system.

Senator SHELBY. How will this affect the small and medium-size banks?

Mr. KROSZNER. Well, this is a very important consideration that has led us to agree to propose a so-called standardized approach for the smaller and medium-size banks, which is something that they had requested, and I think will improve the risk sensitivity, but also maintain sound capital for those institutions and maintain a level, competitive playing field.

Senator SHELBY. Ms. Duke, you come out of the small banks, but you also have come out of one of the big holding companies, too. If you were a CEO of a small bank in Portsmouth, Virginia, now, would you be concerned from Basel II or would you be concerned about capital standards? Would you be concerned that some of the big banks might have a competitive advantage over, say, a community bank?

Ms. DUKE. I think there are a lot of banks of all sizes who are wrestling with exactly those issues. Frankly, I think we wrestled with them when Basel I was being proposed, and I think we are going to have to get some experience with them. The concern of the smaller banks is that larger banks will be able to hold less capital and that that would make them more competitive.

I suspect that the benefit of the risk management and risk measurement practices that are pioneered by the large banks with larger resources; will actually ultimately accrue also to the smaller banks.

Senator SHELBY. Mr. Klane.

Mr. KLANE. Well, I would like to say I am not expert on the technical aspects of the evolving Basel II Accord.

Senator SHELBY. But you have had a lot of experience in the banking industry.

Mr. KLANE. Yes, indeed, and I think that having a well-capitalized banking system lies at the very core of the creation of the Federal Reserve system. As a banker, I have seen the power of being well-capitalized, as opposed to the opposite.

Senator SHELBY. And there are days you are glad you had that capital.

Mr. KLANE. Capital is a very handy tool, and I appreciate your focus on it.

Senator SHELBY. Put it up there.

[Laughter.]

Mr. KLANE. I would say that, per our earlier conversation, Senator Shelby, the financial system has taken on increasingly complex risks, such as the CDOs which have caused such concern. We need to ensure that banks and financial institutions understand the assets on their balance sheets and that they hold capital that is consistent with the risks of those assets—

Senator SHELBY. Let me stop you a minute. Who understands those complex rules—I mean, this bundling and what they mean and all this, the derivatives that come through it today? It is very important, Doctor, for the Fed to understand as a bank regulator, it is very important for the FDIC to do it, the Comptroller of the Currency, the other bank regulators. Am I right?

Mr. KLANE. It is absolutely important for them to understand it. It is certainly important for financial institutions who hold them to understand it. And it is important for the regulators to ensure that those financial institutions have appropriate risk management frameworks so that they can manage the risk that they are taking on daily.

Senator SHELBY. One thing that you and Ms. Duke you bring to the Federal Reserve Board of Governors is experience in the financial markets. Dr. Kroszner and others are academics. It is very important to have them, too, and a little balance. I commend the President for nominating you two.

Thank you, Mr. Chairman.

Chairman DODD. Thank you.

Before turning to Senator Bunning, all of our guests here this morning in the Committee, of course, are distinguished, but I wanted to recognize Wade Henderson, who is CEO and President of the National Leadership Conference on Civil Rights, and we thank him for being here this morning and submitting some questions.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Each of you were in my office, and we had meetings, and I stressed the importance of you being an independent voice and speaking up when you had something to say in one of the Fed meetings. It is especially important for you if you dissent to speak up. I mean if you have a reason to dissent. Obviously, dissent for the sake of dissenting is not what I am talking about. I am talking about if you disagree with the policy that is being discussed.

Can I count on you? You know, it is easy to say before you are confirmed, but can I count on you? When I read the minutes of the Fed and I see no dissent and I see no disagreement, I am saying they have got a bunch of people over there that think the same all the time. And that is impossible because I know you have disagreements on policy. If you do not, there is something the matter.

Can I count on you before I cast my vote on you to leave this Committee and go to the floor and then when I get to the floor, before I vote on your nomination? I want to be able to count on you to speak out, all of you.

Mr. KROSZNER. Definitely. I think if you were to poll the other members of the FOMC, they would certainly say that I have not been a shrinking violet either at the formal meetings or in informal discussions. That is a part of my background, is to speak up, to

speak my mind, and if I disagree, to put those ideas forward. So you can count on me.

Senator BUNNING. Ms. Duke.

Ms. DUKE. Yes, sir. I think I have a history of speaking my mind, and—

Senator BUNNING. Yes, I would imagine you did.

[Laughter.]

Mr. KLANE. Likewise, Senator, I would absolutely commit to bringing all of my points of view forward, and if I dissented, not of course just for the sake of dissenting, I would do so clearly and would move forward with what I thought was right.

Senator BUNNING. I am going to follow up on the Chairman and the Ranking Member on the subprime thing, because this is under my skin and under my craw, because this was on a prior Chairman's watch. The prior Chairman was kind of looked at as God Himself, and no one is God Himself. We all make mistakes. Believe me, I know from being here for 21 years how many mistakes I have made.

The Fed has got to see in regulating banks what kind of securities and what kind of loans they are making to their customers, because by the time the Fed gets to look at the banking sheets and when they are regulating them, almost all of those loans have been bundled and sold off, and Standard & Poor's and Moody's and all the rating systems are rating that paper as AAA. And that is what has caused what we have in the subprime lending institutions right now. We have paper that is useless or worthless because the Fed did not look beyond the sheet.

Now, I asked this question of Chairman Bernanke, and he said, "We did not have any power to do that." And I said, "Well, you better have power to do it. You better look beyond," because all of a sudden now we have a crisis, or darn close to a crisis. I think it is a crisis. And I lived up here through the thrift mess, and we had numerous opportunities prior to the mess to clean it up. In fact, President Reagan offered a bill prior to the bailout of the thrifts, the year before, that was killed by certain Members of the House of Representatives because it was going to affect their States more dramatically.

I am going to hold you responsible if you do not look beyond the balance sheets and look at what is going on in the banking system as far as loans. You, Ms. Duke, as a banker know exactly what kind of loans you have made to your customers on mortgages. And to accommodate someone for a \$400,000 home with a mortgage that is not responsible—and that is all I can say, it is not responsible. You know, if you loan somebody money or if a mortgage company loans somebody money, that they know 5 years from now that the interest rates may not be the same and it has been an interest-only mortgage and now they have got to adjust it, we are looking for trouble. So I am asking you to look beyond.

Now, you are going to have to convince Chairman Bernanke because he does not think he has the power to look beyond. But you as three new members, or one being reappointed and two new members, you are going to have to look beyond the balance sheets of the banks you regulate to find out what kind of mortgages they

are dealing with on a daily basis. And we have got to stop it because to get it better, we have to stop what is happening.

I know that you have given guidelines and made rules and regulations, and hindsight is 20/20 always. But looking into the future, we have got to correct the problem.

Can I count on you to do that? That is another thing, all three.

Mr. KROSZNER. Certainly, Senator. As I mentioned before, our supervisory and enforcement powers are limited to certain depository institutions, but we are now working much more closely with the States and with the Federal Trade Commission to deal with these problems, to share information, to share expertise.

One of the initiatives that Chairman Bernanke mentioned in his testimony before you just a couple of weeks ago was an initiative we have spearheaded to work with the State supervisors, the Federal Trade Commission, and the other Federal banking regulators to do consumer compliance exams in non-depository institutions, to be able to reach mortgage brokers and finance companies, and to reach others that traditionally we had not been able to reach. I think that is one very important step. We are trying to get at exactly what you are talking about.

More broadly, we have been working very closely with the States—and since I have been at the Fed, I think our relationship with the States is as close as it has ever been—to get them to adopt guidance that we put out. We have had a lot of success in working with them to get that. So we are trying to expand the scope to be able to make sure that wherever the problems are in the system, we can reach out to them. And also, as the Chairman had mentioned in his testimony 2 weeks ago, we expect to be proposing rules that, although not enforced by the Fed—

Senator BUNNING. Thank you. I have got a couple more questions I want to get in before my time runs out. Thank you very much.

Ms. Duke, when you were Chairman of the American Bankers Association, you advocated for many policy positions that could come before you at the Fed. Will you be able to view those issues in an unbiased manner? And are there any policy decisions at the Fed that you think that you should not participate in?

Ms. DUKE. Yes, Senator, as Chairman of the American Bankers Association for at least 1 year, and for a couple years prior to that I was the primary spokesperson and the key listener for the association, and you will find that there are a number of statements that I have made on the record regarding various banking issues.

The positions taken by the association were the result of a lot of discussion and a lot of investigation into various regulatory matters, and I think that experience would serve me well. But in making any decision as a Governor of the Federal Reserve, my only viewpoint would be that of public policy and the public interest.

Senator BUNNING. Thank you.

Mr. Klane, I have got to ask you this one because it is very important to the foreign policy of this country. On Tuesday, Deutsche Bank announced that it had ended all contracts with clients in Iran. Given your experience in the management of the Deutsche Bank's Global Division, do you think the timing was appropriate? Should the bank have terminated their ties with Iran at an earlier date?

Mr. KLANE. Senator Bunning, let me say that when I was at Deutsche Bank and in the business that I ran, we had nothing to do with Iran. I am not really in a position to comment on the rules and regulations and the timing of Deutsche Bank's decisions. But I would say that with respect to my being on the Board of Governors, if confirmed, I would certainly do whatever was necessary to ensure that the institutions which the Federal Reserve supervises fully comply with U.S. laws and regulations.

Senator BUNNING. Do you think the Fed has a direct involvement in seeing what banks are dealing and not dealing in that manner?

Mr. KLANE. Most certainly for the institutions which it regulates.

Senator BUNNING. OK. Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I am going to change the subject. I have got a few things that other Members have not asked, and I will give you a chance to respond to those.

Both former Chairman Greenspan and the current Chairman of the Fed Bernanke have expressed concerns about industrial loan corporations because they are exempt from the bank holding company and, therefore, not subject to the consolidated supervisory requirements that other banks and both bank holding companies are.

Do you think corporate owners of ILCs should be brought under consolidated supervisory requirements to ensure safety and soundness? I will let each one of you respond to that, if you would like, please.

Mr. KROSZNER. I do think it is important to maintain the safety and soundness of the system that we have consolidated supervision of organizations that would be very heavily involved in the banking and payment system.

Senator ALLARD. Do you want to answer my question more directly, as it applies to ILCs, industrial loan companies?

Mr. KROSZNER. I would say it would be the same for an ILC.

Senator ALLARD. OK. Ms. Duke.

Ms. DUKE. I think the owners of any banking institution, including ILCs, whether it be a corporation or whatever, should have Federal supervision on a consolidated basis.

Senator ALLARD. Mr. Klane.

Mr. KLANE. I completely agree.

Senator ALLARD. OK. Now, the U.S. continues to have a low national savings rate, which contributes to our growing current account deficit. Again, Chairman Bernanke testified, "To reduce its dependence on foreign capital, the U.S. should take action to increase its national savings rate."

What suggestions do you have for promoting savings and investment among Americans? Does anybody want to comment on that? Let me start with Mr. Klane, and then we will go back. Governor Kroszner, you always had to start things out, so we will give you the last word.

Mr. KLANE. Well, to underscore the importance of your point, I think long-term excessive deficits are not a good thing, and that increasing the U.S. savings rate over time would be good for us now and for future generations. Essentially we are borrowing today and

will need to re-pay later. There is a private component to that, and there is a Government component to that. I would hope that we could make progress against both aspects of that.

There are many public policy ideas that come before you and your colleagues in the House in order to orient Americans toward savings, and I am not here to advocate a particular one, but I think the general proposition is important. And I would also add that this is an area where general education and financial literacy can have a positive impact, not only for an individual's ability to look at disclosures, but also for broadly understanding their own level of savings and what it means for their retirement. This could have a very beneficial macroeconomic implication.

Senator ALLARD. Ms. Duke.

Ms. DUKE. I am not sure I have an answer for how to improve the savings rate. I do think it is important. I do worry particularly on an individual basis with the level of savings, particularly for those of my generation, the baby boomers, the level of savings that will be available to fund retirement and that sort of thing.

As a banker, I have on occasion promoted ideas that would encourage savings in banks, but I do not have an answer for that right at the moment.

Senator ALLARD. Mr. Kroszner.

Mr. KROSZNER. It is certainly a very complicated issue to try to understand exactly how to get people to save more. I do not have any particular proposal to put forward today, but I do think it is important to think about the incentives in the tax system, because many analyses that have been done comparing the U.S. tax system with other countries suggests that there is more of a bias against savings with respect to the tax system in the U.S. than there is elsewhere. So I think looking at that and whether there are lessons to be learned from other countries for tax reform here could potentially be valuable.

Senator ALLARD. I want to follow up with some questions on the subprime area. Most of the questions, as I have understood them, have focused on securitization and how those securities get rated and whatnot. But I am wondering if maybe the problem is more fundamental about that and that is our exotic loans that we kick out there.

Do we need to do something to prevent exotic loans from happening? At one time in our banking system we did not have those, at least that I am aware of. And so do we need to do something about those exotic loans, or do we—maybe on a security we need to have some analysis made as to what percentage of the security is exotic loans. I would like to have you comment. Ms. Duke, you can go first this time.

Ms. DUKE. The securitization process has really given us a lot of benefits, and I worry that sometimes it sounds like we are opposed to securitization.

Senator ALLARD. I agree, and I support that.

Ms. DUKE. It has given us a ton of benefits, and I think now we are seeing probably some of the difficulties in working through that.

Senator ALLARD. So the question is—

Ms. DUKE. The exotic mortgages?

Senator ALLARD. Yes, do we need to—somehow or other, on the analysis that maybe that information is already available, what percentage of the security is exotic.

Ms. DUKE. I don't know whether that—what percentage is available. I don't know whether they are actually packaged separately. Some of what are today considered to be exotic mortgages in the old world, the nontraditional mortgages, those were mortgages that were not made at all, with the exception in—directly in the banks, where there was the ability to look at the full set of circumstances surrounding the borrowing. And so I think there are occasions there are uses for particularly the low documentation loans, that sort of thing.

Senator ALLARD. But, you know, you have to evaluate the use of it versus the benefits, and right now the benefits seem to be less than what anybody anticipated. And so I guess it serves us—

Ms. DUKE. Well, I think you are right. Any lender is going to have to evaluate what the likely losses are on the loan before they make the loan or invest in the mortgage.

Senator ALLARD. But if we look at today's problem, lenders have not done a very good job in doing that.

Ms. DUKE. No, they have not.

Senator ALLARD. So what do we do? If they do not do a very good job and really perform overall—when you look at it, maybe we do not allow for some of these exotic loans.

Ms. DUKE. I think the process is new enough that we have a lot to learn about that, and I suspect that there are very few of those loans being made right today.

Senator ALLARD. Mr. Klane?

Mr. KLANE. Senator Allard, I think you raise related and important issues. The first issue concerns innovations. I think innovation in lending is a good thing for consumers. It is important, though, that these products not become so complex that a human being cannot understand them. This is a consumer protection and disclosure-related challenge. In addition, leading products should be underwritten appropriately and delivered to individuals that can afford them.

These are very important issues, but in dealing with them, I would not want to squash innovation. Innovation has greatly benefited many Americans in pursuing their dreams of, in this case, homeownership.

The second part of your question concerns securities which commingle loans, some of which may be poorly underwritten and others well underwritten; they may contain "exotic" products, or they may be plain vanilla. I am not an SEC attorney, but I believe that in publically traded securitizations, there are certainly important disclosure obligations so that investors who buy them know what they are getting. These objections should be fully and vigorously enforced.

I think it would be on the whole a bad outcome if all innovation in lending were somehow ceased. I think that would be a detriment to consumers.

Senator ALLARD. Mr. Kroszner.

Mr. KROSZNER. I very much would underscore both what my colleagues have said about the importance and value of the

securitization market for homeownership and having good, solid underwriting standards. As you know, we put out guidance last year on nontraditional mortgages—I think that is the same as you are talking about for some of the more exotic products—because we wanted to make sure that if they were being used, the underwriting standards were appropriate for the person that was using them.

So I think taking an approach of guidance this way and also, exactly as Ms. Duke had mentioned, the markets have also responded, are ways to deal with some of the challenges in this area.

Senator ALLARD. A final question. My time is running out here. You are all familiar with the strategic plans, annual performance plans, annual accountability report, and financial statements of the Federal Reserve. Have you had a chance to look at those? Are you familiar with those?

Ms. DUKE. I have not.

Senator ALLARD. OK. Let's put that aside. What do you consider to be the most important priorities and challenges facing the Fed as it strives to meet the needs of the American people? Mr. Klane.

Mr. KLANE. I think, as in my opening statement, there are at least four areas that I highlighted. It is hard to trade them all off, but obviously the sound pursuit of monetary policy, particularly in the current environment, is critical.

I began my remarks with consumer protection, I think illustrating the importance and the urgency, really, at this point in time, of that element. The safety and stability of the payment system and continued sound supervision is important. And I would not at all dismiss the importance of maintaining a safe payment system in the context of changing technology and whether it is terrorism or money-laundering activities that affect it. We need to get all of these right, and I think these are all legitimately critical for the Federal Reserve Board.

Senator ALLARD. Ms. Duke.

Ms. DUKE. I think I would agree on those and add to that the understanding and perhaps changes in the way we view this whole securitization process where there are entities that are now facing banking risks that are not indeed bankers.

Senator ALLARD. Mr. Kroszner.

Mr. KROSZNER. Certainly maintaining the appropriate balance in the dual mandate, to make sure that we have maximum employment growth consistent with low and stable inflation, and ensuring that inflation expectations remain contained; second, as I had said in my opening statement, a fundamental responsibility to prevent discriminatory and abusive practices in lending; and, third, to ensure the broader stability of the banking and financial system.

Senator ALLARD. I am one that pushes hard for a lot of accountability in our agencies. I do that by reviewing the PART program, which has been put out by the President, where they set goals and objectives that are measurable. And when you show up before any Committee that I might be on, you can usually count on the question relating to your agency because I want to know how it is performing. I am an appropriator and I serve on the Budget Committee. And I think it is important as Members of the Congress to focus on accountability and ways of measuring it. It helps us better

justify to the taxpayer the need for the program or the need to eliminate the program because it is—although I do not think they ever eliminate anything around here. But I do think that that is part of our responsibility, and you are liable to get some questions from me on that.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

We have been joined by Senator Casey. Senator, thank you for being here.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Mr. Chairman, thank you very much, and I appreciate the work that has gone into this hearing and for the witnesses who are here and for your service. We appreciate that.

I am one of the sponsors, along with Senator Schumer and Senator Brown, of the Borrowers Protection Act, a lot of provisions in that legislation. One of them that I wanted to ask you about is lender liability. What we are trying to do with that act is to respond aggressively and in a timely way to the subprime crisis in America for a lot of families who were in many cases devastated by policies and practices which, frankly, should have been cracked down on a long time ago and by the failure of our system to allow people to have the kind of information that they need in a very clear and understandable way before they sign on the dotted line, so to speak.

So one of the issues that we have focused on is lender liability, and I am very concerned about and disturbed by not only what has happened in the past up until now in terms of the inability of our regulatory apparatus to deal with this, but I am also concerned about the kind of dismissive or casual reference to the crisis right now, people saying it is contained, it is getting better, we are moving in the right direction. I do not have that sense at all, and for the families devastated, they cannot—you know, alleged containment or alleged better policy is not going to help them. And I am concerned about the families who are caught already in those mortgages that will be reset, but I am also concerned about families down the road who will be adversely impacted if we do not get this right.

One of the issues, of course, is what happens with regard to lender liability, and I wanted to throw it out to any one of the three of you or all of you to comment on strategies to protect borrowers and, in particular, the aspect of lender liability. Maybe, Mr. Klane, if you could start, and we will go right to left.

Mr. KLANE. Well, Senator, I share your concern about the subprime mortgages situation from a number of the dimensions that you highlight, including just the sheer human cost for people who have, unfortunately, found themselves in a bad place.

I think the question of protecting borrowers is important. I look forward to reviewing the bill, which I have not yet had a chance to. There are many ideas that have been put forth, including ideas by the Federal Reserve. I know the Federal Reserve is considering these ideas as they think about rule writing under HOEPA. I would look forward, if confirmed, to throwing my energy behind moving expeditiously in this area.

With specific respect to lender liability, there are important—I am not a lawyer—but there are important liabilities that lenders currently have. I think part of what you are grappling with is how to extend that liability perhaps deeper into the securitization chain.

It is an extremely complicated question. I have not devoted my career to focusing in on that particular one. Extending liability could well play a role in solving the situation. But, if so, it would have to be done in a way that did not eliminate the offering of credit or the vibrancy of the securitization markets. And I would look forward to helping find that right balance when learning more about the issue.

Senator CASEY. Thank you.

Ms. Duke.

Ms. DUKE. Senator, I would share your concern, and there are a number of factors involved here. One is for the originators of mortgages, the original lenders of mortgages, and the questions would be, you know: What are the requirements for entry into that business? What sort of penalties can we enforce against that particular originator? And then the second piece is: If that loan is sold into the secondary market, what liability would attach to the assignee?

The difficulty in assignee liability is that, first of all, it has to be absolutely evident from the file, anything that was a matter of judgment, subject to a matter of judgment after the fact would create additional risk and uncertainty and probably reduce the availability of credit in that marketplace.

I think it might be helpful to look to the experience of some of the States because I know a number of States have grappled with this. Some States I think are very happy with their law. I know in Georgia they had strict assignee liability, and it actually reduced the availability of credit. I do not have the details of what the law was, but I think that would be a good place to look to see what issues caused that.

Senator CASEY. Thank you.

Mr. KROSZNER. I would very much agree that it is extremely valuable to use the States as a laboratory to see what can be effective and what is not, because we want to protect consumers, but we also want to make sure that responsible borrowers can still get credit to people who can use it responsibly.

I think it is very clear that the challenges that many of America's families and households are facing now with respect to keeping their homes is one that is going to be with us and is probably going to continue to grow for some time. And so I sympathize with the view that it is very important to try to keep people in their homes, to deal with this issue, which is a very important issue.

One of the things that we have done at the Federal Reserve is, with the other agencies, put out a very clear statement that lenders and servicers should work with borrowers to try to keep people in their homes, to try to restructure the loans to keep people there. It is for the benefit of the family, for the community, and in almost all cases for the benefit of the servicer.

Senator CASEY. Thank you, and even at the risk of redundancy, I know that Chairman Dodd and Ranking Member Shelby have been very concerned about this issue and have brought this issue

to the fore in this Committee. And I appreciate the work they have done on this issue already.

But just so we fully amplify this issue, I would ask each of you to submit for the record I guess two sets of testimony, really: one on the act, the Borrowers Protection Act, your own view on that and your analysis of it; and, second, maybe a more broader ranging written testimony regarding the subprime crisis and how to deal with it. I think that would help us in our deliberations.

RESPONSE FROM GOVERNOR RANDALL KROSZNER

Let me begin by updating you on several recent actions by the Federal Reserve in response to financial market developments. As Chairman Bernanke recently noted, the Federal Reserve, in cooperation with other federal agencies, is closely monitoring these developments and has taken steps to increase liquidity in the markets. In particular, changes to our discount window program are designed to assure depository institutions of the availability of a backstop source of liquidity so that concerns about funding do not constrain them from extending credit and making markets. Also, the Federal Open Market Committee has stated that it is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.

It is crucial to protect consumers from abusive practices while continuing the flow of credit by responsible lenders into the subprime mortgage market, and the Federal Reserve has been active in addressing issues in the mortgage markets. Starting in 1999, the Federal Reserve along with the other federal supervisory agencies issued guidance related to subprime mortgage lending practices and expanded guidance in 2001. In December 2005, we and the other federal supervisory agencies issued proposed Inter-agency Guidance on Nontraditional Mortgage Product Risks, which was finalized in September 2006. The guidance addresses the need for an institution to have appropriate risk management practices and underwriting standards, including an assessment of a borrower's ability to repay the loan at the fully indexed rate, assuming a fully amortizing repayment schedule, including any balances added through negative amortization. The guidance details recommended practices for lenders' consumer disclosures so that a borrower receives clear, balanced and timely information. In May of this year, the Federal Reserve and the other federal supervisory agencies have also issued similar guidance for subprime mortgages, stressing the same fundamental principles of prudent underwriting and consumer protection. Various outreach and research efforts have deepened our understanding of the issues and revealed that many of the most-worrisome practices are found in credit extensions by nondepository lenders and brokers, many of which are outside the supervisory scope of the federal banking agencies. To that end, the Board and the other agencies coordinated with the Conference of State Bank Supervisors (CSBS) on the two most recent guidance documents to promote and encourage their rapid adoption beyond federally supervised institutions. The CSBS published nearly identical guidances and has urged the States to implement them in order to ensure a more level playing field in the mortgage market and provide consistent protection of consumers.

In addition, the Federal Reserve has launched a cooperative pilot project with the CSBS, the Office of Thrift Supervision, the Federal Trade Commission, and the American Association of Residential Mortgage Regulators aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operations. As part of this effort, the Board will examine nonbank subsidiaries of bank holding companies for compliance with federal consumer protection laws, including the Home Ownership and Equity Protection Act (HOEPA). The other partners in the project will conduct similar reviews of nondepository subsidiaries of thrift holding companies, independent mortgage lending companies, and mortgage brokers doing business with these entities. The partner agencies intend to share information about the examinations, review the lessons learned, and seek additional ways to cooperate to ensure effective and consistent supervision of these entities. At the conclusion of the reviews, the agencies will analyze the results and determine whether

the project is to be continued and, if so, what the focus of future reviews will be.

In April of this year, the Board and other federal financial institutions regulatory agencies issued a statement to encourage supervised institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. Last week, the Board, the other federal financial regulatory agencies, and the CSBS issued a statement encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review the governing documents for securitization trusts to determine the full extent of their authority to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.

I share your concerns about the subprime mortgage market and the need to consider actions to stop abuses while preserving access to credit for all borrowers. Your proposed legislation (the Borrower's Protection Act, S. 1299) addresses some of the issues the Board has focused on that may require regulation under the Home Ownership and Equity Protection Act (HOEPA). Those issues include:

- Prepayment penalties,
- Failure to require escrows for taxes and insurance,
- Stated income and low-documentation lending, and
- Failure to give adequate consideration to a borrower's ability to repay a loan.

In June of this year, I chaired a public hearing at the Board to gather information about how we might use our HOEPA rulemaking authority to address concerns about these loan terms and features. In addition to testimony, the Board received approximately 100 comment letters from the public in response to the topics discussed at the hearing. Board staff are analyzing these letters and the testimony to formulate recommendations for action to the Board. In addition, the Board continues to seek input from consumer and industry groups, the Federal Reserve's Consumer Advisory Council, our fellow regulators, and others who may have useful insights about mortgage lending practices. The Board plans to issue proposed rules under its HOEPA authority before the end of the year.

I am also pleased to serve as the Federal Reserve's representative on the board of directors of NeighborWorks America, which has a program to encourage borrowers facing mortgage payment difficulties to seek help by making early contact with their lenders, servicers, or trusted counselors. NeighborWorks' Center for Foreclosure Prevention recently launched a national advertising campaign to raise awareness about its 24-hour national hotline that connects struggling borrowers with homeownership counselors. Since the launch of the campaign this past June, the daily call volume has increased almost two-fold from 1,000 to almost 2,000 calls a day.

RESPONSE FROM LARRY A. KLANE

Reflections on S. 1299

The proposed Borrower's Protection Act of 2007 addresses many elements of the mortgage market that may have contributed to the current problems, particularly in the subprime mortgage area. In particular, by addressing the duties of brokers and the standards of care and underwriting of originators, the bill centers on two critical issues. Without undertaking an exhaustive analysis of the bill—which is outside my area of expertise—I would, however, make the following points:

Clarifying the role and responsibility of brokers—in this bill as “fiduciaries”—is something that could help consumers understand their relationship with these entities. Clarifying and increasing the level of loyalty and duty that the broker provides to the borrower should put borrowers in a better position to obtain appropriate mortgages.

As the root of the subprime problem is that too many loans were made to borrowers who could not ultimately afford them, improved underwriting standards are clearly necessary. The combination of legislation, good regulation, and market forces needs to come together to ensure that loans are made on the reasonable basis that a borrower can repay the loan. I would

also note that strengthening the duties of the broker, as the bill does, may preserve a broader array of consumer choice than by pre-defining “affordability.”

While clear disclosures enable a fiduciary to fulfill its duty, the bill does not explicitly raise the issue of disclosures to borrowers. I want to emphasize the importance of disclosures and clear documentation so that borrowers can understand and evaluate the products being considered.

“How to deal with the Subprime Crisis”

The problems in the subprime mortgage market have many far-reaching implications for individual households and communities. The central problem is that too many subprime loans were made to borrowers who could not ultimately afford them. Any solution to this problem will need to address at least two issues: first, helping existing subprime borrowers and communities cope as well as possible with today’s situation, and second, creating structural elements to help avoid this problem in the future.

With regard to the first issue, existing lenders and servicers need, and should be encouraged, to help troubled borrowers to the fullest extent they can. This requires adequate human resources to assist troubled borrowers, and it requires troubled borrowers to communicate with their lenders long before foreclosure is imminent. I support all of the efforts to encourage both of these actions. In this regard, the Federal Reserve Banks, community groups, and financial institutions each have an important role to play in assisting troubled borrowers. I also support the SEC’s recent efforts to clarify that where these mortgages are part of a securitization, servicers can make best efforts to modify loans without jeopardizing the treatment of the securitization.

Creating a more permanent structural solution to avoid a recurrence of problems going forward is a multifaceted challenge. While there are many components, here are a number of issues that I believe are important to address in the subprime mortgage market:

- The fragmented nature of the mortgage broker industry creates challenges both in regulatory oversight and in enforcing standards. Many consumers do not understand that the broker has no fiduciary duty toward them.
- Loans must be reasonably affordable to the borrower. Unaffordable loans should not be made.
- Financially educated consumers are essential to a well-functioning market. Too many current borrowers were not adequately prepared to understand the complexity and appropriateness of their loans’ terms.
- Consumer disclosures on mortgage loans should be strengthened and clarified so mortgage brokers can make wise and informed choices.

While subprime borrowers must be adequately protected, overall success includes reputable lenders willing to extend credit and who have the required expertise in the full credit spectrum. Any solution must be careful to create an environment where reputable institutions are willing to participate in the market and to innovate in order to create products that offer choice to consumers.

RESPONSE FROM ELIZABETH DUKE

I share your concern about sub-prime loans and about current conditions in the mortgage market. The discussions held in this nomination hearing have only intensified my desire to delve more deeply into the issues and use my experience as a small business lender to help formulate changes that will have long term benefit for homeownership and the mortgage market in this country.

I would like to start with some observations about sub-prime lending generally and then comment on your bill.

First, I would like to emphasize that the growth of the secondary market—with non-traditional lenders making non-traditional loans—has resulted in higher levels of home ownership and an opportunity for building wealth in segments of the population that were closed out of traditional mortgage lending. So our challenge here is to reduce the cost in terms of financial difficulty and foreclosure while preserving flexibility and opportunity with mortgage products in the future.

Chairman Bernanke has discussed with this committee the Federal Reserve's intention to propose rulemaking under HOEPA later this year. New regulations are a good first step, but we must also look to the enforcement of those regulations. We should encourage the joint state and federal regulatory discussions and pilot programs already underway to achieve this end. Although banks are participants in the mortgage market, the market has expanded well beyond insured financial institutions. I think it is time to review the entire mortgage marketplace including prime, jumbo, alt-A as well as non-traditional mortgages. It is important that we consider all the players and all the regulators in the marketplace to ensure uniformity across the full spectrum of originators, loan servicers, rating agencies and investors.

As the mortgage market expanded rapidly in recent years, competition led to breakdowns in risk assessment and risk pricing. Now, concerns about credit risk have caused liquidity to dry up. Consequently, very few loans with high risk features are being made today. Innovation in mortgage lending over the last few years has created loan structures and terms with which there was little experience when the loans were made. In designing the mortgage products of the future, statistical studies of the contribution of various risk features to actual credit loss will be quite helpful to all in assessing and pricing risk. Use of the Federal Reserve research capability to dissect the decisions and conditions that led us to this state could identify changes that can prevent a recurrence.

Stemming the tide of foreclosures may be the most pressing and the most difficult problem of the day. Foreclosure is the highest cost loan resolution option for the borrower, the lender, and the community. Successful loan work-outs require good communication between the borrower and the lender, and we should do everything possible to facilitate this, including support of trusted third party intermediaries. Workouts also require flexibility to match modifications to individual borrower circumstances. To this end, we should continue to investigate any legal, accounting or structural impediments to loan modifications. And we should be supportive of flexibility and creativity in providing responsible lending to fund restructured loans. We should recognize, however, some foreclosures will need to take place. In cases where there is no possibility of workout, the lender should be able to take responsibility for the property, including taxes and maintenance. The lender will also have the greatest incentive to re-sell the property so it can be reoccupied and the recovered funds can be invested in new loans.

Your legislation recognizes the immediacy of the current foreclosure problems and indicates the willingness of Congress to provide assistance to state, local and community based groups. Just as all real estate markets are local, so are real estate problems. It will take the commitment of many on the front lines supported by state and federal governments to resolve each loan individually. One way to make more private funds available might be to designate the circumstances under which refinance assistance could qualify for CRA credit.

Legislation governing mortgage standards and practices must be evaluated in light of the balance between consumer protection and credit availability. As lenders are increasingly separated from originators and borrowers, they will be unwilling to assume risks they can neither assess nor control. In evaluating the balance, I would look to the experience of the states that have already enacted similar legislation. And I would hope we would undertake the study of the full mortgage market that I proposed above and use the information from such a study to guide our regulatory changes impacting this important part of our economy.

I wanted to move to another issue, the question of referral of cases to the Department of Justice under the Equal Credit Opportunity Act Amendments of 1976. Here is the record just since 2001 in this administration. Since 2001, the Fed has made the following referrals: in 2001, the Fed made one referral; in 2002, six referrals; in 2003, zero referrals; in 2004, three referrals; in 2005, two referrals; in 2006, five. So literally in those years, in those 6 years, just a handful of referrals. And I would ask you to comment on that because one of the problems that we often encounter in Government—and I saw this in State government, and I have seen a little

bit of it in my short time in Washington—is it is great to have a law, it is great to have a statute or a law and regulations in an agency and a budget and all the trappings of what Government can do to regulate and to enforce the law. But sometimes when you look back at enforcement statistics or, in this case, referral data, it tells you a lot about—sometimes it does not really matter if the agency or the administration or the public official who is running that agency, if that person or that administration, so to speak, is not fully committed to the detail in the statute to make such referrals, it does not matter whether or not you have the power to refer.

I would ask you to comment on that because you are asking for confirmation and you are asking for power, and that is the privilege that we all have to exercise that power. I want to know how you are going to exercise the power to refer matters to the Department of Justice and how you make that determination.

Mr. KLANE. Senator Casey, I first of all want to say that supporting and enforcing our country's fair lending laws is an absolute, critical centerpiece of both the Fed's responsibilities and good supervision. I would take this responsibility, if confirmed, with the utmost of seriousness.

I cannot comment on, of course, the Fed's historic record or their judgment on individual cases. I can say as a practicing banker two things: one is that in the business areas that I am responsible for, I take fair lending laws very seriously. Second, I would also say as one supervised by the Federal Reserve, I have felt a rather vigorous energy against this area. And while I cannot comment on the overall pattern of referrals, I can give you at least some assurance that I have seen them very actively involved. And I would not hesitate as a board member for one moment if, based on fact and good analysis, an institution showed a pattern of discrimination, to do whatever the law required us to do, including referring it to the Department of Justice.

Senator CASEY. Thank you.

Ms. Duke.

Ms. DUKE. I am not sure I have much to add to that. I have been supervised by both the Federal Reserve and the FDIC, and I can also attest to their energy in pursuing fair lending and examining specific files looking for evidence, patterns of any sort of discrimination. And I think that is entirely appropriate, and I think that is something that would be our responsibility to oversee the supervisory process, to review the reporting, and to review the reports of the exams.

Senator CASEY. Do those numbers seem low? I know I am out of time. I mean, these are national numbers. This is not one community or one State. These are—what is your sense of that?

Chairman DODD. You are not out of time. You can continue.

Ms. DUKE. I am not sure that I can comment as far as whether or not they seem low. I would say, you know, perhaps they might in terms of a big statistical number, but, frankly, all of the banks that I am familiar with are putting a lot of time and energy into themselves policing what is going on on the front lines of the banks. And so I would be surprised if there is widespread violation among those banks, because I know the amount of resources that

are going on inside the banks in order to prevent any problems from occurring.

Senator CASEY. Thank you.

Doctor.

Mr. KROSZNER. I think following on what Ms. Duke has said, we have tried in our regulatory, supervisory, and compliance processes to be proactive, to ask whether something may not be appropriate, and to take remedial action before something becomes a systematic pattern or practice. That is why I would not overemphasize the particular number of actual referrals because a lot of compliance activity does not actually get to the referral level.

But with respect to referrals, as Sandy Braunstein, the head of our Consumer and Community Affairs Division, had testified before Congress recently just in the first 6 months of 2007, we have already made five referrals. So we are active in this area, but I would not want to put too much emphasis just on the particular numbers because there is a lot of remediation that goes on in advance, not only by the Federal Reserve, but by the other regulators also.

Senator CASEY. Thank you. It may be lead to more questions later, but being a first-year Senator, when you get 2 minutes and 47 seconds extra, that is pretty good stuff. Thank you, Mr. Chairman.

[Laughter.]

Senator SHELBY. That is what you call a "kind Chairman."

Chairman DODD. It will cost you at some point.

[Laughter.]

No. In fact, I wanted you to know, Senator, we set that time, but before you arrived, I had said this is a loose number here. There are not that many of us here.

And I should point out, by the way, that I want the witnesses to know that the fact that there are not as many members here is not an indication of their lack of interest. But with so many other commitments, wrapping up here in the last few days here before the August break, there are Committees meeting trying to get legislation out, as well as matters on the floor. And I am going to leave the record open for several days because I am sure they will have questions from both the minority and the majority here. And I would urge you to respond to those in an appropriate fashion and time so we can have the benefit of your answers to those questions.

Let me turn to Senator Shelby. I have an additional line of questioning I want to follow. We do not really need the clock on at this point. Why don't we just conduct this a little more informally.

Senator SHELBY. Thank you, Mr. Chairman. I just have an observation.

Dr. Kroszner, you are a member of the Board of Governors. You have written extensively. We were very impressed with your published articles dealing with finance and monetary policy and the economy and so forth.

It would be my understanding that as Members of the Fed—and since you are on the Fed—that your top responsibility should be price stability, you know, a goal of trying to keep our currency strong, trying to make sure that inflation does not erode the foundation of our monetary system and destroy our economy.

So I know that Chairman Greenspan and Chairman Bernanke have indicated that here, and before that, Senator Dodd and I go back a while to Dr. Volcker. You know, so important.

How important to you as a member of the Fed now and a future member of the Fed is price stability, as far as your responsibility at the Fed?

Mr. KROSZNER. I think it is crucial to fulfilling our dual mandate, because I think the best way to achieve maximum employment growth is through low and stable inflation.

Senator SHELBY. That is right.

Mr. KROSZNER. So if we can keep inflation expectations contained, if we can keep actual inflation contained, that is a very good environment for business people and individuals to be making decisions that will maximize prosperity and their welfare.

Senator SHELBY. And at times, as a member of the Board of Governors of the Federal Reserve, all three of you will have to make some tough decisions. I referred to Dr. Volcker, and Ms. Duke alluded to that earlier. We were here when interest rates—prime went to 21 percent. Is that correct?

Ms. DUKE. Yes, sir.

Senator SHELBY. And there was a crisis in this country, but the inflation was rampant. The Fed had to choke it off the best they can, and it is not easily done. The best thing is to not let inflation get away from you. Is that correct, Dr. Kroszner?

Mr. KROSZNER. Definitely, and this is why we take a very, very serious look at inflation, where it is now and also where it is going. Because we want to make sure that the path of inflation is one that is well contained, the path of inflation expectations of what people think is going to happen to inflation is contained, because it affects individual's business behavior. And we know from research and data from around the world that a low and stable environment is the best way to maximize prosperity.

Senator SHELBY. You know, you have been nominated to a 14-year term, the maximum term on the Fed. I think that is one reason when we created the Federal Reserve, to make the Fed independent so you, all three of you, can make the tough decision without regard to the political whims of the moment. And I believe you will make them. I think you have to make them.

I wish you well, and I look forward to supporting your nominations. I hope Senator Dodd will schedule a markup as soon as possible, and we will get you to the Fed and get you to work there.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, as well.

Let me, if I can, we received some—and we will continue to receive correspondence regarding the nominations. I mentioned the presence of Wade Henderson, who is here in the room. We received a letter from the Leadership Conference on Civil Rights, which says that even though it has been aware of the prevalence of unfair and deceptive loans for several years, the Fed has inexcusably failed to invoke its HOEPA authority in a way that would have protected homeowners. And just that point that I raised in the first line of questioning is a matter of deep concern to me regarding the fact this legislation was passed in 1994, and almost nothing happened with it. And so I appreciate it.

There is a line of questioning I want to follow up here that relates again to the subprime, and then I have some questions as well. This is not the only subject matter, but this is a looming economic issue. And, Doctor, you are on the Fed today, and obviously with the two nominees before us and given the length of service and the importance of this question and how the Fed is going to respond to this is a matter of deep concern to people all across this country. I cannot go anywhere without this issue being raised, as you might expect, anywhere in the country, the concerns about it and what has happened.

I spoke yesterday with a number of mortgage bankers around the country just to solicit their opinions as to what they thought was happening and what solutions might lay out there for us to try and deal with what has—the seizing up of credit that is really getting rather dramatic here and could have very, very serious implications. That was their opinion, by the way, and many of them almost virtually universally in talking to people in various parts around the country, from the Far West to the Midwest and East that I spoke with.

We held hearings in this Committee on the problems of the subprime market, and they raised some serious concerns about the incentive structures. I want to talk about the incentive structures in here because they worry me and trouble me because they seem to be having a dual set of standards regarding parts of our population. I am very worried about that being the case.

For example, mortgage brokers originate about 75 percent of subprime mortgages. They make their money on fees called “yield spread premiums,” which I am sure all three of you are very familiar with here. The higher the interest rate they get a borrower to take, the higher their fees—a direct correlation between the two. Moreover, the more loan volume they generate, the more fees they generate as well here.

The problem is that these yield spreads lead to higher interest rates for borrowers, higher interest rates lead to prepayment penalties, which are included in the subprime area, and as lenders are forced to lock in their higher yield. This is a widespread problem. While almost no prime loans have prepayment penalties, nearly all subprime loans include them as part of their packages.

I wanted to ask all three of you here, beginning with you, Dr. Kroszner, I want to hear how you would address this. I think there ought to be a standard here that applies with some universality here because it seems to have built into it almost designed burdens here that make it clearly the subprime market—which, by the way, maybe I should have said this earlier, and I am pretty confident I am speaking for almost everybody here—I think that is true. Certainly I feel very strongly that this is a very, very important element, the subprime market in our country. The idea of homeownership and the value of the wealth creation associated with that, the improvements of neighborhoods and communities, I directly correlate to the ability of people to have an equity interest in their own home. Nothing does a better job, in my view, to stabilize communities and neighborhoods than homeownership. And it has been a goal going back to the Truman administration and talking about

the importance of this. It has been embraced, by and large, on a bipartisan basis over the years.

We also know that if you have one foreclosure in a fragile neighborhood, one foreclosure out of an entire one-eighth of a mile, which is roughly what a city block is here, the value of every other home—every other home in that neighborhood—declines by \$3,000 to \$5,000, with one foreclosure. So the ripple effects of this are profound and serious, in my view.

I want to know why we should not here, if we are going to have a subprime market, recognize we are going to be extending credit to people who are fragile—at least that is the idea in terms of their ability economically to address all of these. Why are we making it more burdensome for them? And why are we allowing brokers out there, in effect, to charge fees in a sense or collect fees based on the interest rates they are able to sell to people who are less well informed in terms of these matters and then have prepayment penalties, of course, which even increase the burden financially, thus increasing the likelihood of foreclosure, thus increasing the likelihood of the very problems we are trying to address? And why shouldn't the Fed, I ask the question, take the position here of banning prepayment penalties here and have a different system by which brokers earn their fees?

Mr. KROSZNER. Well, Senator, I couldn't agree with you more about the importance of this problem. There are hundreds of thousands of families and households who are facing the potential loss of their home, and as I mentioned in my response to Senator Casey, that number is probably going to be increasing over time. So this is a very, very important problem that I know the Chairman and every member of the Federal Reserve Board takes extremely seriously.

I am also very glad that you focused on the issue of incentives because, as an economist, I really think of things in terms of incentives. I think that is exactly the right way to think about things. What were the incentives in the market? How can we improve incentives to make sure that responsible lenders can continue to provide credit to responsible borrowers in this market without having a seizing of credit, without choking that credit off?

As you know, in the subprime mortgage guidance that we just put out, we have proposed a 60-day grace period so that there would be a minimum of 60 days, a minimum of 2 months, before a reset in an adjustable rate mortgage comes. That person would not have to pay prepayment penalties and would be able to arrange for alternative financing.

One of the things that we looked at in great detail in the HOEPA hearing that I held on June 14th was exactly this issue of prepayment penalties. Different States have different regulation of them. As I had mentioned before, I think looking at the data that have come from the States to understand the implications of various restrictions on prepayment penalties are important, and this is one of the areas that we are looking very seriously at under our HOEPA authority.

And so I agree that what we can do with the HOEPA authority, that we do expect to propose rules by the end of the year, to be able to set standards that will apply to all brokers to make sure that

there are appropriate underwriting standards, to think about practices such as prepayment penalties, whether they are appropriate or not, and in what cases they are not appropriate.

Chairman DODD. Let me just share some data with you here, and this is from the Home Mortgage Disclosure Act data. The Home Mortgage Disclosure Act and the data collection under that act found some very serious disparities—alarming disparities, in my view—in the incidence of higher-priced subprime lending for African Americans and Hispanics in this country. The 2005 data shows that 54.7 percent of African American borrowers and 46.1 percent of Hispanic borrowers got high-priced loans when buying a home compared to 17.2 percent of non-Hispanic and non-African American.

In the Fed's analysis of the data, significant racial and ethnic differences remained unexplained even after accounting for other information. Reported in the Home Mortgage Disclosure Act's data, the Fed found that borrower-related factors accounted for only about one-fifth of the disparity.

Now, in my view, this reveals some very significant problems in our mortgage system, a problem that is almost certainly reflected in other parts of the financial services sector.

I wonder if you are as alarmed as I am about this data, which shows here the disparity in higher-priced mortgages here within that community. And I want to know specifically as a member of the Board, would you support the elimination of prepayment penalties for people in that area? And what ideas specifically do you have to change the relationship on how brokers collect fees? If they are going to get them based on getting higher rates from people, it seems to me that ought not to be the consideration in determining whether or not or what fee a borrower pays here. Too many of them hold themselves out as mentors, as you and I know. You have seen their website, which I talked about at earlier hearings, where one of the first questions you are asked is tell that borrower you are his mentor or her mentor, in a sense. The idea they are mentors, of course, is ridiculous. They are not the mentor. They are not the advisor. They are out there trying to get those loans here.

So I want to know with some specificity here, this is very, very important to me, to have some assurance and some sense of security that if a person is going to be on that Board for 14 years, how are we going to deal with this issue and whether or not you embrace the same view I do here that these ideas are just wrong, and they are dangerous, in my view, what it means for our country.

Mr. KROSZNER. I very much agree that it is extremely important to protect people in these markets, and we have to protect them against abusive practices. And exactly as you said before, there are incentives in the market that I do not think many borrowers are aware of because I do not think that we have sufficient disclosure to the borrowers about some of these practices.

I think many borrowers think exactly as you describe, that the particular broker may be acting in their interest, but that is not in many cases the case. They are acting in the interest of maximizing their profits, which, as you said, may be related to charging the borrower more, not getting the best deal for the borrower.

So I think one important thing that we need to do is make the consumers more aware of who is the broker working for and the incentives that the broker—

Chairman DODD. Doesn't it need to go beyond disclosure, though, in your view? I know you advocate disclosure. I do not disagree. Disclosure is very important. I do not minimize your point on that. I agree with you totally. But it seems to me that more than disclosure is required. Shouldn't the broker have to declare either I am the agent for the lender or I am the agent for the borrower here, it seems me.

Mr. KROSZNER. Well, I do not want to get into the details of exactly what to—

Chairman DODD. Well, I do. I do.

Mr. KROSZNER [continuing]. Disclose.

Chairman DODD. I am interested in details on this.

Mr. KROSZNER. Certainly, these are exactly the kinds of things that we are looking at in developing our HOEPA rules, and we are still reviewing those. That is why I do not want to commit to particular details. But obviously thinking about exactly these kinds of issues, about disclosing who is the person working for and what those incentives are. And I completely agree with you about thinking about the role of prepayment penalties. This is exactly what we were discussing at the HOEPA hearing. What kind of incentives do they create? Are they something, as some people have argued, that can help to reduce costs to borrowers, or are they something that really are abusive or abusively used against borrowers?

So that is why we are looking at the data from the individual States which have different regulations, talking with consumer groups, talking with a number of others to try to understand how best to respond to this problem. Because as you said, we do not want credit to seize up. We want to make sure that the American dream can still be reached by many, many people who may not have the same length of credit histories or may have more fragile credit histories. So we want to make sure that responsible lending continues there, but we want to prevent abusive practices.

Chairman DODD. Let me come back to that.

Ms. DUKE, I will not repeat the questions. You have got a flavor of where I come out on this thing here. It is very important to me here. These are long terms here on the Federal Reserve. This is going to be a major issue, and I want to get some sense of where you are on these issues.

Ms. DUKE. Senator, I agree with you about the concern, and it is something that I am a little frustrated about, in that right now I only can answer this question in the light of my own experience.

Chairman DODD. I agree.

Ms. DUKE. I am anxious to get to the point—would be anxious to have available to me the research capability of the Federal Reserve. I think also the reserve bank structure, which goes into all parts of our country, is another great asset of the Fed in order to really examine the entire process.

Chairman DODD. Do these numbers I cited to you here regarding people who are getting high-priced loans, the disparity, does that concern you?

Ms. DUKE. It concerns me, and it concerned me when those numbers first came out. And, again, I would very much like to delve into the research and information on all of the various reasons why those numbers would be different, whether they are in the origination structure, whether they are in the incentive structure, whether they are in the way that companies market mortgage loans. I would really like to have the chance to take a look at all of those—

Chairman DODD. How about prepayment penalties? How do you feel about that?

Ms. DUKE. On prepayment penalties, I agree with the guidance that a borrower should have a period of time before a rate changes in order to make a decision to do something different. My familiarity with prepayment penalties in the past has historically been when the lender had made a rate commitment to the borrower and wanted to make sure that that money stayed invested for a given period of time.

Chairman DODD. Why is there a distinction—

Ms. DUKE. But in a situation where the price is changing—

Chairman DODD. For a prime loan, you do not have prepayment penalties.

Ms. DUKE. Right.

Chairman DODD. A subprime you do. Why the distinction?

Ms. DUKE. I do not know.

Chairman DODD. Well, you have been in this—you chaired the ABA. You must have some idea.

Ms. DUKE. I do not know why the prepayment penalties have—

Chairman DODD. Dr. Kroszner, why would you have a distinction between a prime and a subprime loan and requiring a prepayment penalty for the subprime and not for the prime?

Mr. KROSZNER. My understanding is—and I certainly do not speak with certainty on this—is because of concerns about rapid prepayment of some of these types of instruments, to be able to get what some people have argued, to get lower interest rates, to be able to securitize them, the prepayment penalties were helpful to be able to get them into the securities, to be able to get them out to the market. But I have not evaluated that.

Chairman DODD. Doesn't it seem inherently contradictory? A subprime borrower is a borrower who does not qualify for a prime loan, so obviously their financial situation is more fragile. So we are going to have a prepayment penalty on them here, thus increasing the more difficult problem of meeting their obligations. It seems to me just to be counterintuitive unless you have some other purpose in mind here that you would have that distinction between a prime loan and a subprime loan.

Mr. KROSZNER. What some people have argued—and, again, I have not evaluated this—is that there may be more frequency of prepayments, more frequency of moving from one home to another, and so this provides some form of protection for the people who are buying the securitized mortgages, and so that allows a lower initial interest rate to be provided.

I have not evaluated that argument, so I do not know how important or extensive that is.

Chairman DODD. Let me ask Mr. Klane. I have been focusing here, but you have heard my line of questioning here. Why don't you respond to what I have been raising?

Mr. KLANE. Chairman Dodd, let me build on two important things that you said, if I may. The first has to do with the importance of the issue. I want to provide some perspective on the issue, from where I sit, that is not often introduced, but underscores this Committee's concern.

Sometimes we think of the subprime population as a marginal element of the United States, and I did a little research on the topic. There is no bright-line definition of a "subprime borrower." And a subprime borrower is different from a subprime loan. Within financial institutions and regulators, a good starting point is to define a subprime borrower as someone who has a FICO score, Fair Isaac—it is a credit score—of 660 and below. That is just a starting point, and there is lots of grayness. And I asked the question: What percent of people in America have 660 FICO scores and below? The answer to that question is 30 percent.

In the housing market, sometimes loans with FICO scores of 620 and below are considered subprime. Again, these are gray areas. There is 20 percent of Americans with FICO scores of 620 and below.

But if you think of either number, 20 or 30 percent of our population that is affected and captured in the scope of, the spirit of the conversation, I think it underscores why it affects so many of the constituencies and communities that all of you serve and that we as bankers serve. And I just want to say, as part of my record, how significant I think that is, just as a sheer piece of the American public.

The second topic concerns the fragmentation of the mortgage banking system, which makes actually fixing it very difficult. There is no one regulator, no one bullet, I believe, that will fix it. But it is fragmentation—75 percent of volume generated by brokers, virtually none of whom would be supervised directly by an institution like the Fed—that gives particularly important weight to the rule-writing capabilities under HOEPA, which do have an advantage of affecting all participants in the mortgage market, whether or not the Federal Reserve directly supervises them.

So I think the focus that you have encouraged and that the Fed is now showing by its commitment to rule writing under HOEPA is important to create a national standard. Of course, because it affects everyone, it needs to be done with care. You do not want to create more harm than good. But I think a national standard against a very fragmented, problematic area is a good start.

I have looked at the letter from the Leadership Conference on Civil Rights, and I think there are very many important elements of concern that are raised there. I think there are legitimate concerns with the use of prepayment penalties, for that matter. That being said, I would also want to throw myself, if confirmed, into this debate. I would want to benefit from a much broader conversation that I could have as an individual consumer or from my own personal banking experience, to work with the Committee and the other Governors to come up with a good, strong, appropriate set of

rules which would cover and include prepayment penalties as appropriate.

Chairman DODD. There are two areas here—and Senator Shelby has talked about one of them in particular, and I agree with him on it, and that is the credit rating agency and the broker side. If I had to pick two areas, it seems to me, that the Committee ought to be looking at potentially and legislatively, as well as really examining what more—and we just, of course, dealt with the credit rating agencies about a year ago here—thanks to Senator Shelby, by the way, who pursued that aggressively. Looking back at it, maybe now that we know more, maybe we should have done more in a sense, and I don't know whether he agrees with that at all or not, but it is something I want to look at.

Senator SHELBY. Competition.

Chairman DODD. Well, something out there. The fees driven again, anecdotally, I am told—and I would not want to suggest this is based on any empirical data, but anecdotally, when you get—someone suggested to me the other day that as much as 60 percent of the fees collected by the credit rating agencies have come specifically from the secondary mortgage market. And if that is true lately here, then you wonder how these AAA ratings occurred here. The obvious question arises, whether or not the fees were driving the conclusions on rates.

Now, again, it is anecdotal. I am not suggesting that is some data we collected here on the Committee that I would require, but there is enough people out there talking about it that it raises some very legitimate concerns.

Before I turn to Senator Shelby, and then I have some additional questions here, let me ask you, because in my conversations with a lot of these mortgage bankers around the country, soliciting their sort of opinions on various things, several have suggested—and I probably ought to address this to you, Doctor, although the rest of you can comment on it as well. Several have suggested that the seizing up here warrants allowing the—that Fannie and Freddie should play a helpful role at this particular juncture in restoring the flow of credit to the sector. Obviously, there are consumer issues that need to be addressed, and we are dealing with GSEs, and we have got to deal with that legislation. But the idea that Fannie and Freddie would be able to have some credit flow into this market might do something right now to deal with what you have described and I have described as seizing up, and they described yesterday.

Now, again, this was their conclusions here. I just want to share with you in my conversations yesterday what several of them said to me they thought might be a valuable move to be made at this particular point. What is your reaction to that?

Mr. KROSZNER. Well, obviously that is a very important issue that is part of the GSE debate as to what is the particular role of the GSEs and how can they be focused on providing affordable housing. So I think that is certainly something to seriously consider, what sort of role they could play.

Chairman DODD. I know that. I am talking about right now whether or not, you know, encouraging, having the administration encouraging—I realize we have got some legislation to deal overall

with GSEs, but right now, given the role that Freddie and Fannie can play here about having them have extend some additional credit here to lighten up or to at least release some of the seizure.

Mr. KROSZNER. Well, there may be some issues with respect to the particular rules and regulations that they are operating under, and so I want to say only with respect to that that they have to be consistent with the regulations that are there. But if they could be helpful in this area, I think it would be very valuable—

Chairman DODD. Do you think they could be?

Mr. KROSZNER [continuing]. To focus them on this mission. There has been some debate about what the legal requirements and restrictions are on their portfolio.

Chairman DODD. I just want to know what do you think.

Mr. KROSZNER. I think it could be helpful to have them focus on affordable housing more than they have been.

Chairman DODD. Do any of you have any opinion on this? Ms. Duke or Mr. Klane? No? OK.

Senator Shelby.

Senator SHELBY. I want to get back to subprime because I think subprime loans in the markets are very important. Very important. It has always been my understanding—I used to do some of this—that you price risk. You price risk. You have prime loans. You have investment grade this and bonds. You are pricing risk, are you not, in a sense?

Mr. KROSZNER. Definitely.

Senator SHELBY. And you cannot take risk out of a market. There is always going to be risk.

I think that you, as the Fed, as a regulator, ought to do everything you can, and the other agencies, to make sure that fraud and sharp dealings and all this kind of stuff, taking advantage of people, is eliminated as much as we can. Senator Dodd and I are very much interested in that. But I do not think you can take risk out of the marketplace, and when people borrow money, that is a risk for all of us, whether we have a high credit rating and a lot of income or marginal. We have promoted homeownership, and we think that is very important in this country. In some areas, maybe we have overpromoted it. I do not know that. It is a question that some of your academic friends will be studying because that is important, too, and where we come down on that or not.

As far as prepayment penalties, Senator Dodd, I know myself personally and I knew professionally that in a lot of commercial loans where they sell these—they securitize, that they have prepayment penalties because they are selling those bonds based on that this will be a certain payout.

Am I correct on that, Ms. Duke?

Ms. DUKE. Yes.

Senator SHELBY. So the subprime market is not the only area where you have prepayment penalties. I have seen a lot of very high-priced loans—I mean, not risky loans with a good interest rate that have prepayment penalties. Haven't you?

Ms. DUKE. Yes.

Senator SHELBY. OK. But I think there ought to be fairness out there in the market. I agree with Senator Dodd on that, and you as a regulator too ought to look at that because we need to cut that

out. We do not need a marketplace where people are taken advantage of or the risks are not fully explained and the people that are doing that maybe have incentives the wrong way.

Incentives make the market work, and without incentives, the market will never work. But I guess there are incentives and then there are incentives. And how do we get there?

Senator DODD, that is all I have.

Chairman DODD. Well, thank you, Senator Shelby, and I appreciate that point on the prepayment penalties. My point was we do not have them in prime and we do in subprime, and that is my concern here. I understand the—

Senator SHELBY. Excuse me a minute. We do have prepayment penalties in prime loans—I mean, in very quality blue-chip loans. I know we do.

Ms. DUKE. On the commercial side.

Chairman DODD. Commercial side.

Senator SHELBY. That is right.

Chairman DODD. But not in the mortgage area. That is my point here.

Senator SHELBY. OK.

Chairman DODD. It is the very constituency that is, arguably, more fragile, or they would not be in the subprime. Yes, that is my point here. Again, we are dealing with a constituency here that the fact they are subprime lender, we automatically—that is a recognition that they are in a more delicate position financially than others. And so my concern is here that we are adding—well, I have made the point. It is adding to their financial burden at a time we are trying to keep them in—it is one thing to get a person in a house. If you cannot keep them in there, then, of course, the ripple effects are what concern me here, which becomes very, very valuable.

Let me, if I can, raise just a few other questions, if I can. Ms. Duke, as Chairwoman of the American Bankers Association, you wrote a regular column for the ABA journal, and you wrote a column entitled “Singing the Regulatory Blues,” in which you discuss Sarbanes-Oxley, the FACT Act, the PATRIOT Act, the Gramm-Leach-Bliley Act, and you stated, and I quote, “The goal, as Jane Byrne, the Center’s Director, put it, is to roll back regulation.” But what specific regulations do you think ought to be rolled back?

Ms. DUKE. Senator, there is not any one particular regulation that causes the burden in banking. It is the combination of all of the regulation. I would really talk about two examples. One would be the BSA regulations, which there the issue with the banks is as much the uncertainty of some of the requirements as it is the specifics of the requirements.

The other area I would highlight would be in the payments area. The payment system has changed over the years, and as each new form of payment came through, whether it was ATMs or debit cards, now Check 21, each one carries with it its own set of regulations and its own process for collection, its own process for return. And when you put all of those together, it is very difficult from the banking side to really predict what the impact of that regulation is going to be on any given payment, much less from the consumer

side, and in some cases they do not even know where the payment—what path that payment has taken.

And so when we talk about regulatory burden, it is the sum total of that burden more than it is any specific regulation.

Chairman DODD. I appreciate that. I am not going to argue with you, obviously, but this is something we ought to look at all the time here to determine whether or not things we have done are doing the job we want them to do. I just get concerned when you—we sweep with the broad brush in here without some specificity.

So it might be helpful to the Committee that you give us maybe some additional ideas in response to the written questions in this area. I would be interested in knowing. I am not trying to pin you down here, in this kind of a setting here, to those specifics. But in the next few weeks if you would let us know specifically what you have in mind, I would be appreciative.

Ms. DUKE. Senator, if I could, none of that would preclude me, as a regulator, from proposing and enforcing a new regulation whenever it was warranted.

I would first like to recognize the ongoing efforts of many to reduce and streamline our existing regulatory framework. The regulatory agencies have been engaged individually and collaboratively in reviewing existing regulations. This committee put much thought and effort into the regulatory relief bill that passed last year. The SEC and PCAOB have been engaged in an ongoing effort to reduce the burden of Sarbanes-Oxley Section 404 while retaining investor protection. I doubt that a year passes without at least one hearing in this committee related to regulatory burden.

And I would like to reiterate my earlier pledge that if I am confirmed, nothing would preclude me from proposing, enforcing or voting in favor of any regulation.

The cost of regulatory compliance has concerned bankers for as long as I have been in banking. It would be an easy fix if we could all point to one especially burdensome regulation as the source of the problem. Unfortunately, it is the sum of many different regulations that create the overall burden. When I was a community banker, I thought small banks had the true burden because we had such limited resources. When FDICA passed, the number of implementing regulations exceeded the number of employees in my bank by 2. When I was with larger banks, I realized that the compliance task was equally difficult, primarily due to operational complexity and long lines of communication.

Numerous studies have attempted to quantify regulatory compliance costs. However, in recent years, the discussion has turned from purely cost to regulatory risk and uncertainty. I'll offer a few examples.

Smaller banks, in particular, struggled with Sarbanes-Oxley Section 404 compliance. And many who were not required to comply under the law felt examiner pressure to comply anyway.

The expanded anti-money laundering responsibilities created by the Patriot Act have elevated regulatory risk. All banks are committed to detecting and reporting suspicious activity, but few banks are certain they know how to do so adequately. One area where banks are particularly uncertain is in the servicing of money service businesses. As business types are identified as high risk, banks that feel unable to monitor the risk at a reasonable cost are stopping service to those businesses.

Finally, I mentioned payment system regulation in my testimony. Electronic payments are coming of age, surpassing paper payments in the last few years as the payment of choice. Check 21 and ACH conversion promise to accelerate this change. As each payment method has evolved, so has its body of regulation. The result is a complicated tangle of forward collection and return rules and timetables. If they are confusing to bankers, they must be even more confusing to consumers. The Federal Reserve System is at the heart of the payment system in this country. If confirmed, I would like to devote time to studying the regulations and procedures surrounding payments with the goal of proposing changes that would make the payment system more efficient, understandable and predictable.

Chairman DODD. I appreciate you saying that, as well. That is not a bad comment to make at this point.

Mr. Klane, you were just talking here about the FICO standards here in terms of people's creditworthiness. I note here, and let me ask you the question and have you respond to it.

Capital One has come under some scrutiny and received some criticism for refusing to report consumers' credit limits on their credit cards, which can artificially depress, some argue, customer's FICO scores. This issue rose during the Committee's consideration of the Fair Credit Reporting Act reauthorization. Critics allege that Capital One was gaming the system by deliberately depressing the consumers' credit scores to gain competitive advantage by making its own customers appear to be greater credit risks and therefore less likely to receive marketing offers with more favorable terms from competitors.

In June of this year the U.S. District Court for South Carolina allowed a lawsuit which alleged that the credit bureau's violation of the Fair Credit Reporting Act for failing to obtain that information to proceed.

As I understand it last month the company announced that it would be reversing its policies in this regard. Critics raise concern about this practice in light of the cross-marketing practices, arguing that the company benefited from marketing products such as its home equity lines of credit to its customers who scores the company had depressed.

I wonder if you might share with us any involvement you had in establishing? Why did Capital One decide to change its credit limit reporting? Do you believe that critics who suggest that a failure to report credit limits do depress consumers' credit scoring? Are they wrong in doing so? And what do you believe its effect on consumers for failing to report their credit limits? And should the Board consider prohibiting this practice?

There is a lot of questions there and we will repeat them if you want.

Mr. KLANE. No thank you.

First of all, let me say that I do not run Capital One's domestic credit card business. So in that regard, it is very difficult for me to comment on practices in a very particular area, let alone a singular practice.

And of course, I am not here to represent Capital One. I am, of course, here as a private citizen looking to perform public service in the context of the responsibilities that Congress has laid out to the Federal Reserve Board. I would be very honored to do so.

As you rightly note, Capital One as an institution, I also learned, has changed its policy with respect to this. The rationale for having done this practice, as I understand it—again I am not responsible for the policy—had less to do with the items listed in the accusation than a belief that the credit line is a sensitive piece of information and the interplay between credit risk and credit line assignment is a legitimate competitive issue to be kept proprietary. The value of that I am not here to establish.

In any case, taking all of these points into account, the institution decided, as you note, to change its policy. And therefore, it is

no longer a current issue. But I do not have responsibility for that unit, Senator.

Chairman DODD. Should the Board, in your view, would you recommend as a member of the Board supporting prohibiting this kind of a practice from occurring?

Mr. KLANE. I would approach all of the questions that come to the Board with absolute integrity and objectivity and in order to fulfill the mandate set before it, always keeping in mind the point of view of the public interest.

There are many practices, we have discussed many today, in mortgage which are not good practices. I would look forward to the opportunity, if confirmed to the Board, to take stock of the particular practice that you have highlighted, which I am not an expert on, as well as others and determine what regulatory perspective—whether rule writing, guidance, or supervisory influence—would be appropriate. I would take that as a very important element of being on the Board.

Frankly, I think that my experience in banking, knowledge of consumers in a practical way, complements the existing Board expertise. I can assure you the consciousness with which I bring consumer interest with the roughly 10 million small businesses and consumers that I serve is very, very important. And I think it would be helpful to the Board's overall deliberation. In any case, my energy would very much be against these type of issues.

Chairman DODD. I am informed by my staff here that—and they raise the issue here and I will raise it with you—that as I understood it, you did run the home-equity loan shop at Capital One.

Mr. KLANE. I run Capital One Home Loans but that is not—

Chairman DODD. Their point is that—which did the cross-marketing and therefore benefitted from the withholding of the information. How do you respond to that?

Mr. KLANE. Capital One Home Loans markets to Capital One customers. Capital One Home Loans also markets to the general public through advertising and other ways. All consumers who wish to apply for a loan have access to it.

Chairman DODD. But if, in fact, their credit rating under FICO were such that competitors would be less interested in them as customers is that not—aren't you advantaged to some degree as a result?

Mr. KLANE. I do not see why that would be the case, Senator.

Chairman DODD. Let me raise the issue quickly with you, as well, about Regulation Z, and again to you, Doctor, as well. I have been impressed that over the last number of months, as a result of the work of Senator Shelby and myself and others here, and having hearings on the credit card industry and some of their practices that some have changed, clearly. The universal default, double cycle billing, a number of other matters here have—major companies have changed, anyway.

Obviously, I have a concern that these things can move back and forth, depending on where people are and a position to have some influence on these practices. My concern is that once those who care about these elements are no longer in a position to do much about it, the practices can return unless there are some clear rules.

I am told that there are some \$20 billion in fees that have increased in the last 20 years in the credit card industry as a result of additional provisions that have been added to this. Again, I am a great advocate of credit cards. Do not misunderstand me. I think they are a wonderful and very helpful to a lot of people.

But I have been very concerned about again capturing and holding people. There was a story the other day, I do not know if you saw this thing, Dick, where some guy had 2,000 credit cards shipped to him. Obviously a rare case but nonetheless some indication of the consumer frustration with this issue and what happens.

So I would be interested if you have any comments or ideas on the credit card, the Regulation Z area, and the decision by the Board to take up this matter? And specifically what suggestions you would make to the Board to prohibit certain activities, which again I point out are being stopped by major companies, the ones who allow for minimum monthly payments, obviously.

Mr. KLANE. If I may, while I do not run Capitol One's U.S. credit card division, I am very aware of the broader set of issues.

I would also like to start out by saying that I share, as a consumer and as a broad industry participant, the very legitimate concerns that this Committee and others have had with respect to practices throughout lending but including credit cards. I see a number of practices there that I would regard as bad practices.

I would say there is some important progress being made and I point to two things, both of which you have referred to, Senator. One is this Committee itself, just by bringing focus on the issue, has given some incentive—we have spoken about incentive structures—to a number of issuers to change practices I think for the better of the consumer. I would applaud the work of you and the Committee in that regard.

With respect to Reg Z and truth in lending, this is the first revision since, I believe, 1981. The world has changed tremendously since that point in time. I have been rather impressed with the ambition, and to some extent of the length, of the change in the disclosure regime. Of course, it is in a comment period now. I am very encouraged by the Federal Reserve's work there.

I also want to emphasize one element that I think is quite right-minded. And that is they have adopted a consumer perspective. I have worked in consumer finance for many years. And it is quite extraordinary, on the altar of doing something clearer for the consumer, how much gets done that is unclear or burdensome in its structure or length. Of course, Senator Schumer, came forward years ago with the concept of a "Schumer box."

The Federal Reserve has done consumer research to actually see how consumers absorb information and what is the most important information. That spirit is reflected in Reg Z. I think that is a great direction.

If confirmed to the Board, I would be very eager to apply my experience to absorbing the comments that are being received and putting out final guidance, final rules. Also, I would note this is just one of three parts of the Truth-in-Lending revision. This is the revolving open-ended credit part. We still have fixed term loans that is installment loans to see. I believe they will also be approaching mortgage lending.

I agree that disclosure is an enormously important element. Well disclosed practices can help lead to a free and vibrant market, which can yield great outcomes for consumers. But it may not be enough and certain practices in and of themselves might be just bad and legitimately banned. That goes far beyond disclosure, something that has to be taken with great care because you can, to my earlier comment, potentially do more harm than good.

But I would like to say to you and Senator Shelby and the rest of the Committee that if confirmed to the Board I do not walk in with some religious belief that disclosure is the end of what needs to be done in all lending, let alone credit cards. If certain practices should or ought to be banned, upon reflection, receiving comments, that would yield good and better outcomes, I would certainly, as a Board member, be open to that Senator.

Chairman DODD. Let me, because we have only about 10 minutes left on a vote here and I have had you sitting here for a long time already this morning. You said something that provokes a question that I will ask you and then have you submit an answer to us here.

I mentioned two practices. You suggested, at least I heard you suggest, there may be additional practices than the ones I have mentioned, the universal default and double cycle billing, that run that, in your mind, as ones that are offensive or wrong and should probably be banned or treated differently than they presently are.

I would be very interested in having you expand on that answer, if you think there are additional areas that would certainly warrant our attention, whether it is disclosure or some further action necessary. I would be interested in that.

Mr. KLANE. I would be delighted to.

I would like to highlight two specific practices and two more general areas in credit card lending where I have concerns.

On the specific practices, as we discussed in the hearing, I share the Committee's concern with "universal default" and double-cycle billing. It is encouraging that a number of issuers who engaged in these practices have recently changed their approach, but to the extent some industry participants continue these practices, I remain concerned.

In addition, I believe that current credit card disclosures are not adequate. This is the first of the two more general areas I want to address. The complexity of current disclosures, along with the difficulty in using them to focus on the most consumer-relevant terms and conditions, leave consumers inadequately equipped to make informed choices among products and issuers. Disclosures must be made clearer and more consumer-relevant. In this regard, I am highly encouraged by the on-going work of the Federal Reserve in its efforts to revise Regulation Z. The use of consumer focus groups and the explicit effort to create simpler and more comprehensible disclosures is a strong step in the right direction. These proposed regulations are out for public comment, and I look forward to the Federal Reserve's finalizing them. Once they are final, we will be able to judge, after some experience, whether further adjustments, amendments, or expansions need to be made.

My second general area of my concern is penalty repricing of accounts, which occurs when a customer breaks one or more of the rules embodied in the credit card contract's terms and conditions. While it is legitimate in general for an issuer to be able to change the price of credit on open-ended lines to customers who demonstrate higher levels of riskiness through such rule breaks, I am concerned about:

- insufficient disclosures and/or notices to consumers on repricing actions (e.g., initially when receiving the card, at the moment of rule break, and at the moment of repricing);

- the inclusion of multiple repricing rules that can be triggered by a single infraction; and
- the options available to consumers who have experienced repricing (e.g., the ability to return to the prior rate based on good performance over time or the ability to pay off the existing balance at the prior rate over some time frame).

The Federal Reserve's proposed revisions to Regulation Z, including the 45-day notice provision, address some aspects of the concerns I have outlined. However, the general area of repricing deserves continued attention to ensure that consumers are adequately protected and able to make good decisions on their use of credit cards.

The weight of what is on my mind is the disclosures that—

Chairman DODD. One of the things that concerns me here is the amount of consumer debt in the country. We are talking about, I think if my members are right here, someone mentioned the other day, I think I saw this, something \$9,300 is the average revolving debt of a household in the United States. And that is mostly credit card debt, I presume here.

And of course, a savings rate that is negative in the country, at a time when we ought to be incentivizing savings, it seems to me, and trying to do what we can to reduce the level of consumer debt.

Much of it is, of course—and today, with the bankruptcy laws having been changed, the ability for people to find some relief and move on here is obviously making life much more difficult for people.

Quickly, Dr. Kroszner, do you have any—I want to know what your reaction to this is?

Mr. KROSZNER. I think very much along the lines of what my colleague, Mr. Klane, has said—one of the things that we have really tried to do is make disclosure effective. This is a basic principle I have been teaching in business school for 16 years to do some basic consumer testing.

We have a great responsibility that you have given us to regulate disclosure. I do not think we had used that as effectively as we could have in the past because we had not asked consumers what is useful to them, what do they need to know, what is helpful to them.

So we have really tried to get at that. And I think the new proposal that we have out there which much more clearly explains penalty rates, much more clearly explains what potential things could happen as they have different credit events.

And in addition and importantly, give them 45 days to be able to search for an alternative credit card or alternative source of credit, if they are going to be facing some sort of penalty rate, is something that will be very helpful in making it much less likely for some of these practices to come back.

Chairman DODD. Very good. Any further questions?

Senator SHELBY. No.

Chairman DODD. I have kept you a long time here. Again, I appreciate your willingness to serve. Let me say I think that is very, very important and I congratulate you on being nominated. It is a high honor, obviously.

As I pointed out earlier, these are terms of office that are only exceeded by Federal judges and the Comptroller General—not that the both of you are necessarily having the length of term that Dr.

Kroszner is being offered here with a 14-year term. But obviously, tremendously important.

The Federal Reserve Board's influence on the ability of our economy to grow and to expand and to create opportunity for people is just so very important. Obviously these issues we have talked about here, there are many other issues to talk about when discussing the role of the Fed. But the ones that are so important to many Americans today, the issue of subprime lending and what happens with credit cards and the like has obviously provoked a lot of questions here today because of the importance of those issues.

And so I thank you for your willingness to serve. I commend you for that. That is admirable in my view and we do not celebrate public service enough, in my view, in this country. And so I thank you for doing that.

Senator SHELBY. Senator Dodd, since they are all here, we know that tomorrow we will be getting out of here and we will be back the day after Labor Day, I guess. But do you have any idea when you might hold a markup on these nominations?

Chairman DODD. No, not yet.

Committee adjourned. Thank you.

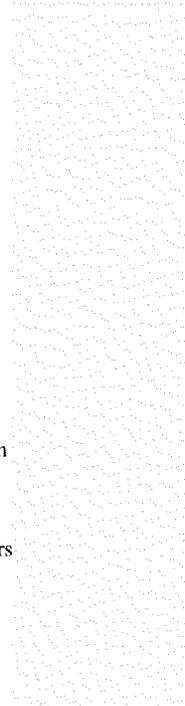
[Whereupon, at 12:02 p.m., the hearing was adjourned.]

[Prepared statements, biographical sketches of the nominees, and responses to written questions supplied for the record follows:]

For release on delivery
9:30 a.m. EDT
August 2, 2007

Statement of
Randall S. Kroszner
Member
Board of Governors of the Federal Reserve System
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

August 2, 2007



Chairman Dodd, Senator Shelby, and Members of the Committee, I am pleased to have the opportunity to appear before you today as a nominee to serve a new term on the Board of the Governors of the Federal Reserve System. I am honored that President Bush has nominated me to serve another term on the Board. If I am confirmed by the Senate, I will work to the best of my abilities to fulfill the significant responsibilities of this office.

During the last quarter century, the Federal Reserve has achieved much success in reducing and stabilizing inflation and inflation expectations. This success has helped to contribute to a tendency for the fluctuations in employment and output to be lower than in the past and a reduction in the frequency and severity of recessions. If confirmed, I would continue to work with Chairman Bernanke and the other members of the Federal Open Market Committee to continue to underscore the role of long-term price stability in achieving prosperity and maximum employment.

The Federal Reserve also has a fundamental responsibility to consumers and users of the banking and financial system. Discriminatory or abusive lending practices should not be tolerated, and the privacy of individuals and their financial data must be protected. Since I joined the Federal Reserve, we have undertaken a number of initiatives to better protect and to better inform consumers. These include: issuing guidance on non-traditional mortgage products and on subprime mortgages and improving our collaboration with the state banking supervisors; launching a pilot project in collaboration with other federal agencies and state regulators to examine non-depository lenders for compliance with consumer regulations; improving disclosures for privacy notices and credit cards; improving the handbook on adjustable-rate mortgages (ARM) that creditors are required to give to all ARM applicants, and committing to propose new rules before the end of the year to require that lenders provide other mortgage

disclosures more quickly and to improve mortgage loan advertisements; undertaking a series of hearings, including one I chaired in June, to assess the impact of specific practices in the mortgage market, and committing to propose new rules exercising our authority to ban unfair or deceptive practices under the Home Ownership and Equity Protection Act. If I am confirmed, I will continue to place the highest priority on protecting consumers while ensuring that creditors continue to provide credit responsibly.

An important part of my research as an economics professor at the University of Chicago, and my practical policy work as a member of the Council of Economic Advisers, was devoted to banking and financial regulation as well as banking and financial crises. The safety and soundness of the U.S. banking and payments systems is critical to achieving economic growth, maximum employment, and general economic stability, and the Federal Reserve works closely with other regulators to achieve this goal. The Federal Reserve also has an important role to play in responding to and mitigating the impact of financial crises and shocks. If confirmed, I would continue to work vigorously to protect and promote the safety and soundness of the system.

Thank you once again for holding this hearing, and I look forward to your questions.

Center for the Study of the Economy and the State Grant, Graduate School of Business, University of Chicago, 1994 – 2001, 2003 – 2006.
 Center for International Business Education and Research Grant, Graduate School of Business, University of Chicago, 1993 - 1999.
 National Science Foundation Grant SES-9211231, 1992 - 1994.
 William S. Fishman Scholar, Graduate School of Business, University of Chicago, 1992 - 1993.
 R. C. Hoiles Postdoctoral Fellowship, 1989 - 1990.
 Claude R. Lambe Fellowship, 1988 - 1989.
 Richard M. Weaver Fellowship, 1988 - 1989.
 National Science Foundation Graduate Fellowship, 1984 - 1987.
 Phi Beta Kappa, 1983.
 Sigma Xi, Scientific Research Society of North America, 1983.

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

<u>Organization</u>	<u>Office held (if any)</u>	<u>Dates</u>
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None

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and inclusive dates of employment.

Board of Governors of the Federal Reserve System, Washington, DC
 Member, 2006 - present.
 Graduate School of Business, University of Chicago, Chicago, IL
 Professor of Economics, 1999 – present (on leave 2001 – 2003 and on leave 2006 to present).
 Associate Professor of Economics, 1994 - 1999.
 Assistant Professor of Economics, 1990 - 1994.
 Council of Economic Advisers, Executive Office of the President, Washington, DC
 Member, confirmed by the U.S. Senate November 28, 2001 and served until July 3, 2003.
 Junior Staff Economist, 1987 - 1988.
 Visiting Scholar, American Enterprise Institute, 2003 – 2006.
 Research Consultant, Research Department, Federal Reserve Bank of Chicago, 1994 – 2006.
 Visiting Scholar, Research Department, Federal Reserve Bank of New York, 1996, 1998 – 2001.
 John M. Olin Visiting Fellow in Law and Economics, University of Chicago Law School, 1999 - 2000.

Visiting Scholar, Research Department, International Monetary Fund, 1993, 1994, 1995 and 2000.

Visiting Scholar, Board of Governors of the Federal Reserve, Division of International Finance, 1999, and Division of Research and Statistics, 1995.

Visiting Scholar, Federal Reserve Bank of Minneapolis, 1999.

Visiting Scholar, Financial Markets Group, London School of Economics, 1999.

Bertil Danielson Visiting Professor of Banking and Finance, Stockholm School of Economics, Sweden, 1998 - 1999.

Visiting Scholar, Research Department, Federal Reserve Bank of Kansas City, 1997.

Visiting Professor, Institute for International Economic Studies, Stockholm University, 1996.

Visiting Scholar, Research Department, Federal Reserve Bank of St. Louis, 1996.

Visiting Professor, Kennedy Institute of North American Studies, Free University of Berlin, Germany, 1995.

Visiting Professor, Finance Department, Stockholm School of Economics, Sweden, 1994.

Visiting Scholar on International Financial Markets, U.S. Securities and Exchange Commission, 1992.

Research Fellow, G.T. Management (Asia) Ltd., Hong Kong, 1990.

Economist, The Economics Resource Group, Cambridge, MA, 1989 - 1990.

Government Experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part time service or positions.

Board of Governors of the Federal Reserve System, Washington, DC.
Member, confirmed by the U.S. Senate February 14, 2006, and serving since March 1, 2006.

Council of Economic Advisers, Executive Office of the President, Washington, DC
Member, confirmed by the U.S. Senate November 28, 2001 and served until July 3, 2003.

Junior Staff Economist, 1987 - 1988.

Federal Economic Statistics Advisory Committee, Department of Labor, Washington, DC
Member, 2005 - 2006.

Federal Deposit Insurance Corporation, Center for Financial Research, Washington, DC
Senior Fellow, from 2004 to 2006

Published Writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

Academic Articles:

“Financial Crises, Financial Dependence, and Industry Growth,” forthcoming in Journal of Financial Economics, with Luc Laeven and Daniela Klingebiel.

“Corporate Campaign Contributions, Repeat Giving, and the Rewards to Legislator Reputation,” Journal of Law and Economics, April 2005, 48(1), 41-72, with Thomas Stratmann.

“The Economics of Corporate Governance Reform,” Journal of Applied Corporate Finance, Spring/Summer 2004, 16(2-3), 42-50.

“Sovereign Debt Restructuring,” American Economic Review, May 2003, 93(2), 75-79.

“Economic Organization and Competition Policy,” Yale Journal on Regulation, Summer 2002, 19(2), 541-97, with Wallace Mullin, Judson Jaffe, and Cindy Alexander.

“Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability,” Journal of Financial Economics, December 2001, 62(3), 415-52, with Philip Strahan.

“The Rise in Managerial Stock Ownership,” Journal of Applied Corporate Finance, Fall 2000, 8-18, with Clifford Holderness and Dennis Sheehan.

“Congressional Committees as Reputation-Building Mechanisms: Repeat PAC Giving and Seniority on the House Banking Committee,” Business and Politics, April 2000, 35-52, with Thomas Stratmann.

“What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions in the United States,” Quarterly Journal of Economics, November 1999, 1437-67, with Philip Strahan.

“Interests, Institutions, and Ideology in Securing Policy Change: The Republican Conversion to Trade Liberalization after Smoot-Hawley,” Journal of Law and Economics, October 1999, 643-73, with Douglas Irwin.

“Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearing Houses and Recent Over-the-Counter Innovations,” Journal of Money, Credit, and Banking, August 1999, 569-618.

"Were the Good Old Days that Good? Changes in Managerial Stock Ownership since the Great Depression," Journal of Finance, April 1999, 435-69, with Clifford Holderness and Dennis Sheehan (winner of the Brattle Prize for Best Corporate Finance Paper in the Journal of Finance).

"Interest Group Competition and the Organization of Congress: Theory and Evidence from Financial Services Political Action Committees," American Economic Review, December 1998, 1163-87, with Thomas Stratmann.

"The Political Economy of Banking and Financial Regulatory Reform in Emerging Markets," Research in Financial Services, vol. 10, 1998, 33-51.

"Rethinking Banking Regulation: A Review of the Historical Evidence," Journal of Applied Corporate Finance, Summer 1998, 48-58.

"Organization Structure and Credibility: Evidence from Commercial Bank Securities Activities before the Glass-Steagall Act," Journal of Monetary Economics, August 1997, 475-516, with Raghuram G. Rajan.

"Log-Rolling and Economic Interests in the Passage of the Smoot-Hawley Tariff," Carnegie-Rochester Conference Series on Public Policy, December 1996, 173-200, with Douglas A. Irwin.

"Regulatory Incentives and the Thrift Crisis: Dividends, Mutual-to-Stock Conversions, and Financial Distress in the Thrift Industry," Journal of Finance, September 1996, 1285-1320, with Philip E. Strahan (nominated for the Smith Breeden Prize for best paper of the year in the Journal of Finance).

"Is the Glass-Steagall Act Justified? A Study of the U. S. Experience with Universal Banking before 1933," American Economic Review, September 1994, 810-32, with Raghuram G. Rajan.

"Money's Marketability Premium and the Microfoundations of Keynes' Theory of Money and Interest," Cambridge Journal of Economics, August 1994, 379-90, with Tyler Cowen.

"German-Language Precursors of the New Monetary Economics," Journal of Institutional and Theoretical Economics (Zeitschrift fuer die gesamte Staatswissenschaft), September 1992, 387-410, with Tyler Cowen.

"Empirical Predictions of the New Monetary Economics: Perspectives on Velocity," Journal of Policy Modeling, Summer 1990, 265-79, with Tyler Cowen.

"Scottish Banking Before 1845: A Model for Laissez-Faire?" Journal of Money, Credit, and Banking, May 1989, 221-31, with Tyler Cowen (reprinted

in Lawrence H. White, ed., International Library of Macroeconomic and Financial History, no. 11, Aldershot, UK: Elgar 1993).

"The Development of the New Monetary Economics," Journal of Political Economy, June 1987, 567-90, with Tyler Cowen (reprinted in Lawrence H. White, ed., International Library of Macroeconomic and Financial History, no. 11, Aldershot, UK: Elgar, 1993).

Books:

The Economic Nature of the Firm: A Reader, second edition, New York: Cambridge University Press, 1996, co-edited with Louis Putterman. (First edition 1986. Spanish language edition, 1994.)

Explorations in the New Monetary Economics, Cambridge: Basil Blackwell, 1994, with Tyler Cowen.

Book Chapters:

"An Agenda for Global Growth: European Challenges," pp. 47-59 in Gertrude Tumpel-Guggerell and Peter Mooselchum, eds., Structural Challenges for Europe, Northampton, MA: Edward Elgar, 2003.

"Currency Competition in the Digital Age," pp. 275-96 in David Altig and Bruce Smith, eds., Evolution and Procedures in Central Banking, New York: Cambridge University Press, 2003.

"Asset Price Bubbles, Information, and Public Policy," pp. 3-14, in William Hunter, George Kaufman, and Michael Polmerleano, eds., Asset Price Bubbles: Implications for Monetary, Regulatory, and International Policies, Cambridge, MA: MIT Press, 2003.

"Obstacles to Optimal Policy: The Interplay of Politics and Economics in Shaping Bank Supervision and Regulation Reforms," pp. 233-66 in Frederic S. Mishkin, ed., Prudential Supervision: What Works and What Doesn't, Chicago: University of Chicago Press and National Bureau of Economic Research, 2001, with Philip Strahan.

"Is the Financial System Politically Independent? Perspectives on the Political Economy of Banking and Financial Regulation," pp. 127-62 in Finanssektorn Framtid [Government Inquiry on the International Competitiveness of the Swedish Financial Sector], Volume D, Stockholm: Swedish Ministry of Finance, 2000.

"Global Government Securities Markets: Economics and Politics of Recent Market Microstructure Reforms," pp. 86-110 in Guillermo Calvo and Mervyn King, eds., The Debt Burden and its Consequences for Monetary Policy, London: Macmillan, 1997.

"How Should Financial Institutions and Markets Be Structured? Analysis and Options for Financial System Design," pp. 97-122 in Liliana Rojas-Suarez, eds., Safe and Sound Financial Systems: What Works for Latin America, Washington: Inter-American Development Bank and Johns Hopkins University Press, 1997, with George Kaufman (reprinted in translation in Ilter Turan, ed., Finansal Piyasaların Derinleşmesi, Istanbul: Koc Üniversitesi, 1997).

"Free Banking: The Scottish Experience as a Model for Emerging Market Economies," pp. 41-64 in Gerard Caprio and Dimitri Vittas, eds., Reforming Financial Systems: Historical Implications for Policy, New York: Cambridge University Press, 1997.

"The Political Economy of Banking and Financial Regulation in the U.S." pp. 200-13 in George M. von Furstenberg, ed., The Banking and Financial Structure in the NAFTA Countries and Chile, Boston: Kluwer Academic Publishers, 1997.

"The Evolution of Universal Banking and Its Regulation in Twentieth Century America," pp. 70-99 in Anthony Saunders and Ingo Walter, eds., Universal Banking: Financial System Design Reconsidered, Chicago: Irwin, 1996.

"Scottish Free Banking," pp. 398-400 in John Eatwell, Murray Milgate, and Peter Newman, eds., New Palgrave Dictionary of Money and Finance, London: Macmillan, 1992, with Tyler Cowen.

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"Corporate Governance," forthcoming in David Henderson, ed., The Concise Encyclopedia of Economics.

"Errors of Banking Crisis Response," forthcoming in George J. Kaufman, ed., Systemic Financial Crises: Resolving Large Bank Insolvencies.

"The Rodney Dangerfield Recovery," Rising Tide, Summer 2005, pp. 24-25.

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"The Possible Extension of the Terrorism Risk Insurance Act," Shadow Financial Regulatory Statement 207, May 2004, with Scott Harrington and reprinted in the American Banker.

"Enabling Institutional Investors to Play a More Effective Role in Corporate Governance," Shadow Financial Regulatory Statement 204, February 2004, with Charles Calomiris.

"Taxpayer Exposure to Liabilities of the Pension Benefit Guarantee Corporation," Shadow Financial Regulatory Statement 198, September 2003.

"Legislation on Fannie Mae and Freddie Mac," Shadow Financial Regulatory Statement 196, with Peter Wallison.

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"Fostering Prosperity," Journal of Indexes, Third Quarter 2003.

"Federal Terrorism Risk Insurance," National Tax Journal, September 2002, 55(3), 647-57, with Jeffrey Brown and Brian Jenn.

"Private and Public Interests in Bank Regulatory Reform: Understanding Branching Deregulation in the United States," Jahrbuch fuer Wirtschaftsgeschichte, 2002/1, pp. 217-226.

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"The Legacy of the Separation of Banking and Commerce Continues in Gramm-Leach-Bliley," Federal Reserve Bank of Minneapolis, The Region, June 2000, 18-21.

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"Less is More in the New International Financial Architecture," pp. 447-52 in William C. Hunter, George G. Kaufman, and Thomas H. Krueger, eds., The Asian Financial Crisis: Origins, Implications, Solutions, Boston: Kluwer Academic Publishers, 1999.

"A Comment on 'The Impact of Consolidation and Safety-Net Support on Canadian, U.S., and UK Banks, 1893-1992'," Journal of Banking and Finance, February 1999, pp. 572-77.

"The Role of Private Regulation in Maintaining Global Financial Stability," Cato Journal, Winter 1999, pp. 355-61 and reprinted in John Blundell and Colin Robinson, eds., Regulation without the State: The Debate Continues, London: Institute for Economic Affairs, 2000, pp. 69-76.

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"Commentary: Institutions and Policies for Maintaining Financial Stability," Maintaining Financial Stability in a Global Economy, Jackson Hole Symposium, Federal Reserve Bank of Kansas City, 1997, pp. 299-306.

"The Market as International Regulator," Financial Times, July 21, 1997, pp. 13-14 and reprinted in The Complete Finance Companion, London: Pittman Publishers, 1998, pp. 398-404.

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"New Monetary Economics," pp. 487-89 in David Glasner, ed., Business Cycles and Depressions: An Encyclopedia. New York: Garland Press, 1996, with Tyler Cowen.

"Comment on Richard Sylla's 'The 1930s Financial Reform in Historical Perspective,'" pp. 30-33 in Dimitri Papadimitriou, ed., Stability in the Financial System, New York: St. Martins, 1996.

"Reforming U.S. International Telecommunications Regulation," Via Satellite, February 1991, 57-64, with Robert W. Hahn.

"Lost in Space: U.S. International Satellite Communications Policy," Regulation, Summer 1990, 57-66, with Robert W. Hahn.

"Banking in Hong Kong: Regulation, Stability, and the Role of Money Market Mutual Funds," Asian Monetary Monitor, July/August 1990, 16-36.

"Mutual Fund Banking," Cato Journal, Spring/Summer 1990, 223-37, with Tyler Cowen.

"Futures Markets, Loans, and Asset Marketability: A Review Essay on Jeffrey Williams's The Economic Function of Futures Markets," Market Process, Spring 1990, 77-81, with Tyler Cowen.

"An Assessment of Deregulation and Privatization in the United States," Business in the Contemporary World, Spring 1989, 55-63, with Thomas Gale Moore.

"The Mismanagement of Air Transport," The Public Interest, Spring 1989, 100-11, with Robert W. Hahn.

"Review of M. Baranzini and R. Scazzieri, eds., The Foundations of Economics," Journal of Comparative Economics, June 1988, 260-3.

"Technology and the Control of Labor: A Review of David Noble's Forces of Production," Critical Review, Spring 1987, 6-16.

"Recent Developments in the New Monetary Economics," Zeitschrift fuer Wirtschaftspolitik, vol. 36, 1987, 207-20, with Tyler Cowen.

Working Papers:

"Is It Better to Forgive (Partially) than to Receive? An Empirical Analysis of the Impact of Debt Repudiation," revised, December 2004.

"Throwing Good Money After Bad? The Role of Board Linkages and Bank Lending During Distress," Working Paper 8694, revised July 2004, with Philip Strahan.

"Promoting Global Economic Growth: The Productivity Challenge," revised July 2003.

"Stock Market Responses to Bank Restructuring Policies during the East Asia Crisis," World Bank Working Paper 2571, March 2001, with Daniela Klingebiel, Luc Laeven, and Pieter van Oijen.

Political**Affiliations
and activities:**

List memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Registered as a Republican in District of Columbia.

No offices held or services rendered.

Political**Contributions:**

Itemize all political contributions of \$500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify specific amounts, dates, and names of recipients.

None.

Qualifications:

State fully your qualifications to serve in the position to which you have been named.

- 1) I have been a Governor of the Federal Reserve System and serve as the Chairman of the Committee on Consumer and Community Affairs and Chairman of the Committee on Supervisory and Regulatory Affairs. I am also a member of the Committee on Economic Affairs, Committee on Employee Benefits, and the Payments System Policy Advisory Committee. I am the Board's Principal for the following: Governors of Central Banks of the American Continent, Center for Latin American Studies, Working Party Three of the Organization for Economic Co-operation and Development, the Financial Stability Forum, Consumer Advisory Council, Federal Financial Institutions Examination Council, Thrift Institutions Advisory Council, and represent the Fed on the board of NeighborWorks America.
- 2) I am on leave as professor of economics in the Macroeconomics and International group at the Graduate School of Business of the University of Chicago, where I had been teaching Money & Banking for 16 years. I have written widely on domestic and international banking and financial regulation, corporate governance at both financial and non-financial firms, international banking and financial crises, debt defaults, monetary economics, and economic history. I was Editor of the Journal of Law and Economics and have been Associate Editor of a number of scholarly journals, including the Journal of Financial Services Research, Journal of Economics and Business, and Economics of Governance. I was a Research Associate of the National Bureau of Economic Research where I was involved in

a variety of programs ranging from corporate finance to industrial organization and regulation.

- 3) I have had regular contact with the Federal Reserve System (including the Board in Washington and regional Federal Reserve Banks such as New York, Kansas City, Minneapolis, and St. Louis) as a visiting scholar and consultant. I have visited and consulted for many central banks and finance ministries around the world, including Central Bank of Argentina, Bank of Sweden, Swedish Finance Ministry, Bundesbank (Germany), and the European Central Bank. I have also visited and consulted for international financial institutions, including the Bank for International Settlements, the International Monetary Fund, World Bank, Inter-American Development Bank, and Asian Development Bank.
- 4) As a Member of the President's Council of Economic Advisers (2001-2003), I have extensive administrative and policy experience in areas such as banking and financial policy, international financial crises, and macroeconomic forecasting (as chair of the so-called Troika 2 process). I regularly attended international meetings of deputy finance ministers and deputy central bank governors. In addition, I was Director of the Stigler Center for the Study of the Economy and the State where I had administrative responsibilities for both fund raising and disbursement of funds to academics and for outreach activities.
- 5) As a member of the board of directors of the National Association of Business Economists (2005-2006), I have had regular contact with economists in the private sector, thereby providing me with additional insights into real world economic conditions.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

I currently serve as a Governor of the Federal Reserve System. I am on an unpaid public service leave of absence from my professorship at the University of Chicago's Graduate School of Business until March 2008.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

As long as the University of Chicago Graduate School of Business will grant me a leave of absence, I will have the option of returning to the University.

3. Has anybody made you a commitment to a job after you leave government?

No.

4. Do you expect to serve the full term for which you have been appointed?

Yes.

**Potential conflicts
of interest:**

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None.

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

None.

3. Describe any business relationship, dealing or financial transaction (other than tax paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None.

4. List any lobbying activity during the past ten years in which you have engaged in for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None.

5. Explain how you will resolve any conflict of interest that may be disclosed by your responses to the items above.

None.

**Civil, criminal and
investigatory
actions:**

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None.

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None.

**Statement of Elizabeth A. Duke
Nominee to the Board of Governors of the Federal Reserve System
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
August 2, 2007**

Chairman Dodd, Senator Shelby, Members of the Committee, it is an honor to come before you today as a nominee for the Federal Reserve Board of Governors. I am grateful to President Bush for nominating me and to you for holding this hearing to consider my nomination.

For most of my 32 years in banking, I worked in state member community banks. Our primary federal regulator was the Federal Reserve. We cleared our checks, initiated our wires and held our securities with the Richmond Federal Reserve Bank. And I served as a director of the Richmond Fed. So I come to you with a full appreciation of the responsibility entrusted to a Federal Reserve Governor. If I am confirmed, I promise to bring everything that is in me, every day, to fulfill the trust you will be putting in me.

My experience with monetary policy comes from being impacted by it. I learned my first painful lesson about inflation and monetary policy when the national prime rate went from 8% to 21%. Our small business customers couldn't have survived, so we created our own lower prime and learned to live with it. Later, I worked through recessions and expansions with those same customers. With these experiences in mind, I strongly support the dual mandate Congress has given the Federal Reserve of pursuing both stable prices and maximum employment.

In addition to monetary policy, the Federal Reserve is charged with the safety and soundness of the financial system. I weathered the banking and thrift crisis and wrote my checks to restore the FDIC fund. In more than 25 years of teaching, I have probably taught over 3,000 bankers and bank examiners the basics of sound banking practices. The importance of safety and soundness in our banking system is a part of my DNA. It is the most important experience I could bring to the Federal Reserve.

The Fed has sole responsibility for consumer protection regulations governing regulated and non-regulated financial service providers. I look forward to reviewing the comments, research, and work already underway with respect to sub-prime lending regulations and guidance.

And I believe I can bring some relevant experience to the process. I worked with the Virginia banking commission when they were first given responsibility for supervision of non-bank mortgage lenders after the collapse of one of the most predatory lenders I have ever seen.

As Chairman of the American Bankers Association, I worked with bankers and regulators in all states on numerous regulatory matters. I don't believe we can solve the sub-prime issue without cooperation and coordination across the full spectrum of regulation, supervision, and enforcement of all mortgage loan participants. I would welcome the opportunity to lead such an effort.

The role of the Federal Reserve in our nation's payment system doesn't have the headline cache of monetary policy or consumer regulation, yet I believe it has every bit as much of an impact on the everyday lives of the American consumer. We are in the midst of a payment revolution with evolving technology and the passage of Check 21. I would hope to be actively involved with the payment infrastructure as well as modernization of the rules and regulations governing payments.

Finally, service on the Federal Reserve Board would feed my passion for financial education. I have been in the classroom, raised money to teach the teachers, conducted awareness media tours, and lobbied for curriculum changes. All of our work on consumer disclosure will be in vain if we don't raise a generation of consumers who can use those disclosures to make good financial choices.

Thank you for allowing me this time. I look forward to your questions.

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

I have been involved with the following. Except as noted I do not remember the dates of involvement.

Organization	Office held (if any)	Dates
American Bankers Association	Chairman	2004-2005
	Board of Directors	1999-2006
	Government Relations Council (Chairman and Administrative Committee)	
	Communications Council	
	Grassroots Task Force	
	Community Bankers Council (Administrative Committee)	
	BankSim Committee (Chairman)	
Virginia Bankers Association	President	1999-2000
	BankPAC Committee	2006-2007
	State Government Relations Council (Chairman)	
	Federal Government Relations Committee	
	Community Bankers Council	
	Board of Directors	
	VBA School Board of Trustees (Chairman) Operations Committee (Chairman)	
Federal Reserve of Richmond	Director	1998-2000
FNMA Advisory Council	Member	2004-2006
Virginia Council on Economic Education	Board of Directors	ended 2006
Hampton Roads Partnership	Board of Directors	
Old Dominion University Foundation	Director	
	Executive Committee	
	Chairman, Investment Committee	
Economics Club of Hampton Roads	Director	
Virginia Beach Chamber of Commerce	Director	
Executive Advisory Council Old Dominion School of Business	Member	2007

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and inclusive dates of employment.

2005 – Present	TowneBank Senior Executive Vice President Chief Operating Officer Director	Suffolk, VA
2004 -2005	Wachovia Bank Executive Vice President – Merger Project Office	Birmingham, AL
2001 – 2004	SouthTrust Bank Executive Vice President/Community Bank Development	Birmingham, AL
2002	President/Virginia Beach and Chesapeake	Virginia Beach, VA
2001	SouthTrust Corporation Senior Vice President/Government Relations	
1985 – 2001	Bank of Tidewater	Virginia Beach, VA
1991	CEO	
1987	President	
1985	Vice President/CFO	
1976 – 1984	Bank of Virginia Beach	Virginia Beach, VA
1978	Vice President/CFO	
1976	New Accounts/Accounting	
1975 – 1976	First & Merchants National Bank Teller	Virginia Beach, VA
1975 – 1976	Cavalier Dinner Theatre Actress	Norfolk, VA
1975	Summer Theatre (Name not remembered) Actress	Whitefield, NH
1974 – 1975	Hahn’s Shoes Sales	Chapel Hill, NC
1974	Unto These Hills Actress, Costumer	Cherokee, NC
1984 – 1985	Stonier Graduate School of Banking	New Brunswick, NJ
1986 – 1991	Stonier Graduate School of Banking Instructor	Newark, DE

Employment Record continued

1980 – 1981	National School of Bank Investments	Urbana, IL
1982 – 1988	National School of Bank Investments	Norman, OK
1988 – 1990	National School of Bank Investments Instructor	Boulder, CO
1981 – 2006	Graduate School of Retail Bank Management Instructor	Charlottesville, VA
1995 – 2003	Virginia Bankers School of Bank Management Instructor	Charlottesville, VA

**Government
experience:**

List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part time service or positions.

Virginia Joint Legislative Subcommittee to Study Capital Access and Business
Financing - Member

Virginia Beach Development Authority - Commissioner

Norfolk Airport Authority - Commissioner, Treasurer

Virginia Beach Resort Area Advisory Commission - Member

Published**Writings:**

List the titles, publishers and dates of books, articles, reports or other published materials you have written.

I authored a monthly column in the ABA Banking Journal while I was Chairman. Articles were as follows:

11/04 – “Call Me First, But Not First Lady” – being the first woman chairman
 12/04 – “Singing the Regulatory Blues” – regulatory burden
 01/05 – “15 Minutes a Week” – grassroots involvement
 02/05 – “Social Security’s Easy Fix” – the need to fix social security
 03/05 – “Financial Literacy Leadership” – banker’s involvement in financial literacy
 04/05 – “Change at the Top” – retirement of Don Ogilvie, CEO
 05/05 – “Quiet, Competent Leadership” – appointment of Ed Yingling as new CEO
 06/05 – “Take Two Aspirin, Call Me in the Morning” – ABA training and education resources
 07/05 – “Getting the Word Out” – giving speeches, ABA’s various public communications resources
 08/05 – “Data Security: Behind the Headlines” – breaches, phishing and related ABA resources
 09/05 – “Can you Afford Not to be Part of ABA?” – five key ABA functions and contributions

Political**Affiliations**

and activities: List memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

None

Political**Contributions:**

Itemize all political contributions of \$500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify specific amounts, dates, and names of recipients.

03/20/07	Will Sessoms for Mayor	\$1,000
03/18/02	J Randy Forbes for Congress	\$500
04/14/01	J Randy Forbes for Congress	\$500
03/07/07	American Bankers Association PAC (BANKPAC)	\$1,000
03/17/06	American Bankers Association PAC (BANKPAC)	\$1,000
02/04/05	American Bankers Association PAC (BANKPAC)	\$1,000
02/17/04	American Bankers Association PAC (BANKPAC)	\$1,000
02/07/03	American Bankers Association PAC (BANKPAC)	\$1,000
03/26/02	American Bankers Association PAC (BANKPAC)	\$500
2005	Wachovia PAC	\$1,678.27
2004	SouthTrust PAC	\$2,119.92
2003	SouthTrust PAC	\$2,119.92
2002	SouthTrust PAC	\$1,148.29
2006	Virginia Bankers Association PAC	\$500
07/11/1999	Frank Drew for Virginia Delegate	\$500
10/26/1999	Glenn R Croshaw for Virginia Delegate	\$500

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

I have been a banker for more than 30 years. During my career I have had the following specifically relevant experiences:

10 years as Chief Executive Officer of a Community Bank. I stepped into the position upon the sudden death of my predecessor. In addition to the normal duties of a chief executive officer, I had to retain the confidence of the directors, the stockholders, the employees, the regulators, the customers and the community. During this time the bank grew from \$100 million to \$280 million in assets.

13 years as Chief Financial Officer of a Community Bank. This role included supervision of all accounting functions, preparation and filing of all regulatory and financial reporting, management of the bank's investment portfolio and development of a management information system. I came into this position without formal training in accounting but I did complete an MBA while working in this role.

16 years as a Commercial Lender. I worked primarily with small businesses and their owners. Lending to small business requires an understanding of the success drivers and impact of economic conditions on many different types of businesses. It requires an assessment of management character and ability. I successfully loaned money and handled the workout of some loans during the high interest rate years of the late 1970s and early 1980s and during the real estate crisis of the late 1980s and early 1990s. I have seen the impact of extreme economic conditions on individual businesses and consumers, and I have worked with troubled borrowers.

1.5 years as Chief Operating Officer of a large, diversified Community Bank. My current employer is a \$2.3 billion bank with subsidiaries in investments, insurance, employee benefits, commercial mortgage brokerage, residential mortgages, title insurance, real estate, property management and real estate brokerage. I have focused on the financial, regulatory and risk impacts of managing diverse financial services. In addition I have been directly involved with implementing check imaging and developing a strategy to manage the explosion of technology changes in bank payment systems and delivery systems.

29 years being supervised by the Federal Reserve as my primary federal regulator. For most of my career I have been supervised by the Federal Reserve. I have probably been directly involved in more than 20 examinations. I also have been responsible for determining how to comply with new and existing regulations.

2 de novo bank start-ups. I joined the first bank one week before it opened. On the second bank I was one of the organizers who recruited a board of directors, sold stock and obtained regulatory approval to open.

3 bank mergers. I negotiated two of the mergers. I worked on the integration of a community bank into a \$50 billion regional bank and then on the integration of that \$50 billion bank into a \$450 billion bank.

In addition to my work experience I have been actively involved with the banking industry trade associations.

Chairman of the American Bankers Association. Being elected Chairman was the culmination of a career-long association with the ABA. During my time as an officer of the association I spoke to and listened to bankers from all sizes and types of banks. I attended meetings of bankers from the largest banks in the world, of agricultural bankers, of community bankers, of state bankers associations and of women's banking associations. My objective was to communicate current legislative and regulatory issues and to hear the bankers' business concerns. I worked with the ABA staff to meld the various banker opinions into consensus positions which we then advocated to legislative and regulatory bodies. In addition, I participated in media tours and presentations for the ABA Education Foundation "Teach the Children to Save" and "Get Smart About Money" days to promote financial education in schools.

President of the Virginia Bankers Association. My experience with the VBA was very similar to my experience with the ABA. It was just more focused on Virginia Bankers and the Virginia state legislature.

Director of the Federal Reserve Bank of Richmond. The board received monthly economic briefings, gave economic reports covering local or industry conditions and voted on discount rate recommendations to the Board of Governors. In addition I served on the Audit Committee, the Human Resources Committee and the FRIT Committee. FRIT is the Federal Reserve Information Technology responsible for system-wide information technology.

Fannie Mae Advisory Committee. This committee was composed of participants from all aspects of the housing community. It met three times a year to discuss housing related issues.

Bank Management Instructor. Throughout my career I have served as instructor for numerous trade association educational programs. I have taught bank management to more than 3,000 bankers across the country.

Virginia Council on Economic Education. This organization has as its sole purpose economic education in our schools. Through this organization I learned a great deal about the challenges of providing meaningful economic coursework within an already crowded school day.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

Yes.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

I have no plans or agreements to resume employment with my previous employer.

3. Has anybody made you a commitment to a job after you leave government?

No.

4. Do you expect to serve the full term for which you have been appointed?

Yes.

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

I have an employment contract and change of control agreement with TowneBank. Under the terms of those agreements I have received vested and unvested stock options and vested and unvested restricted stock. I also participate in the bank's 401k plan and supplemental executive retirement plan. The contract includes a non-compete and a non-solicitation provision that will be the only part of the agreement to survive my resignation from the bank.

I am covered under a Wachovia retirement plan. I am eligible to draw reduced benefits now and unreduced benefits beginning in 2017.

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

I own TowneBank stock, a note convertible to TowneBank stock, restricted shares of TowneBank stock, vested options to purchase TowneBank stock and unvested options to purchase TowneBank stock.

I own Wachovia Bank stock and options to purchase Wachovia Bank stock.

I own stock in Bank of Hawaii, BB&T, KeyCorp and Wells Fargo bank.

My husband owns stock in Wachovia Bank and Fulton Financial Corporation.

3. Describe any business relationship, dealing or financial transaction (other than tax paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None.

4. List any lobbying activity during the past ten years in which you have engaged in for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

In various capacities I acted as spokesperson for the American Bankers Association on matters affecting banking. The American Bankers Association is an active lobbying organization and maintains the ABA BankPac.

In 1999 and 2000 I was President of the Virginia Bankers Association. The Virginia Bankers Association is an active lobbying organization and maintains the VBA BankPac.

I have testified on the following occasions:

6/15/2005 House Committee on Financial Services – Hearing entitled “Protecting Consumers and Promoting Competition in Real Estate Services”

4/20/2005 House Subcommittee on Financial Institutions and Consumer Credit – Hearing entitled “Implementation of the Check Clearing for the 21st Century Act”

4/25/2003 House Subcommittee on Financial Institutions and Consumer Credit – Hearing on H.R. 3951, The Financial Services Regulatory Relief Act

5. Explain how you will resolve any conflict of interest that may be disclosed by your responses to the items above.

Working with the Designated Agency Ethics Officer at the Federal Reserve Board, I will maintain compliance with applicable laws and regulations.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None.

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None.

Statement of Larry A. Klane
Nominee to the Board of Governors of the Federal Reserve System
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
August 2, 2007

Chairman Dodd, Senator Shelby, and Members of the Committee, I am honored to appear before you today as a nominee to serve as a Member of the Board of Governors of the Federal Reserve and would like to thank you for scheduling this hearing. I also want to thank the President for his confidence in nominating me for this position. If confirmed by the Senate, I look forward to working with the other Board members to fulfill the full range of objectives that Congress has established for the Federal Reserve. It has been a life-long personal goal for me to enter public service, and I can think of no better place for my contribution than the Board of Governors.

I have spent twenty-five years working in business, finance and banking. For the past fourteen years, I have devoted my career to financial services, including seven years in wholesale financial services and the capital markets at The Bankers Trust Company and its acquirer, Deutsche Bank. I have spent the past seven years in consumer and small business banking, principally in the United States, but also in Canada and Europe.

As President of Capital One's Global Financial Services division, I currently serve roughly ten million consumers and small businesses. I have been the President of our Federal Savings Bank and am currently the Chairman of our bank in the United Kingdom.

Let me turn briefly to a couple of specific areas of responsibility at the Federal Reserve Board. In Chairman Bernanke's recent testimony on monetary policy, he devoted substantial attention to consumer protection matters, and I would like to underscore the importance of this element of the Board's responsibilities. As a banking practitioner, I have gained first hand knowledge of consumers and their financial needs. If confirmed, I would bring my energy, focus, and experience to vigorously fulfilling the Fed's consumer protection responsibilities.

In addition to protecting consumers through guidance, rule-making and supervisory focus, I would also strongly support the Federal Reserve's long standing commitment to financial literacy. In connection with my service on the Board of America's Promise--

a non-profit organization dedicated to improving the lives of America's children--I have seen the power of education, including financial education.

The Federal Reserve also has responsibility for the stability of America's financial system as well as for the direct supervision of many financial institutions and all bank holding companies. My experience with a broad array of banking regulators in the United States and abroad has shown me first-hand the importance of good supervision--not only for maintaining sound financial institutions, but also for protecting consumers.

The Federal Reserve also oversees the smooth functioning of the payments system. In recently reading the testimony of Fed-nominees who came before this committee following the tragedy of 9/11, one particularly appreciates this aspect of the Federal Reserve's duties. With technology, business, and other developments impacting the U.S. payments system, this is an area of continued importance.

Of course, a central--if not the central--responsibility of the Federal Reserve is the pursuit of sound monetary policy. Congress has given the Fed a "dual mandate" of maximum employment and price stability, and, if confirmed, I would approach monetary policy within this mandated framework.

In conclusion Mr. Chairman and Members of the Committee, if confirmed to the Board of Governors, my objective would be to use my experience in banking and business to help the Federal Reserve execute the broad responsibilities that Congress has set before it. I thank you for your consideration and look forward to your questions.

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name:

KLANE,

LARRY

ALLAN

Position to which nominated: Board of Governors of the Federal Reserve System**Date of nomination:** May 16, 2007**Date of birth:** June 6, 1960**Place of birth:** Denver, Colorado**Marital Status:** Married**Full name of spouse:** Polly Ann Nyquist**Name and ages of children:** Rachael Klane (11) and Rebecca Klane (8)

Education:	Institution	Dates attended	Degrees received	Dates of degrees
	Harvard College Cambridge, MA	1978-1982	A.B., Philosophy	1982
	Stanford University Stanford, California	1985-1987	M.B.A	1987

Honors and awards:

List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships and any other special recognitions for outstanding service or achievement.

Decatur Prize, 1981 (for outstanding Scholarship; Harvard College)

Phi Beta Kappa, 1982 (Harvard College)

Magna Cum Laude, 1982 (Graduated with High Honors; Harvard College)

Arjay Miller Scholar, 1987 (top 10% of graduating class; Stanford Graduate School of Business)

Henry Ford Scholar, 1987 (top student in graduating class; Stanford Graduate School of Business)

Memberships:

List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
America's Promise Alliance	Board of Directors	2006 to present
Temple B'Nai Or	Board of Trustees	2002-2003
Harvard Club of Washington, D.C.	Member	approx. 2000 to present
Stanford Alumni Association	Member	1987 to present

Employment record:

List below all positions held since college, including the title or description of job, name of employment, location of work, and inclusive dates of employment.

Capital One Financial Corporation, McLean, VA – 2000-present
 President, Global Financial Services
 President and Director, Capital One Federal Savings Bank
 Chairman, Capital One Bank Europe PLC
 Responsible for an externally reported division, including Small Business, Home Loans, Installment Lending, Point of Sale Lending, Europe and Canada;
 Also oversee Corporate Development (mergers & acquisitions)

Deutsche Bank/Bankers Trust, New York, NY – 1994-2000
 Managing Director, Corporate Trust and Agency Services
 Managing Director, Strategy and Business Development, Global Institutional Services

The Walt Disney Company, Burbank, CA – 1993-1994
 Vice President, Corporate Strategic Planning

William Kent International, Arlington, VA – 1987-1993
 Vice President, Consulting Director

Booz Allen & Hamilton, San Francisco, CA – 1986
 Associate Consultant

Strategic Planning Associates, London, England – 1982-1985
 Analyst

Government experience:

List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part time service or positions.

Not applicable.

Published writings:

List the titles, publishers and dates of books, articles, reports or other published materials you have written.

Not applicable.

Political affiliations and activities:

List memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

I am a registered Democrat in the District of Columbia. I have not held an office in any political party, nor have I provided services to any political parties or election committee.

Political contributions:

Itemize all political contributions of \$500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify specific amounts, dates, and names of recipients.

5/9/2001	Friends of Phil Gramm	\$2000
2001	Capital One PAC	\$1420 (via bi-monthly contributions)
2002	Capital One PAC	\$5000 (via bi-monthly contributions)
2003	Capital One PAC	\$5000 (via bi-monthly contributions)
2004	Capital One PAC	\$5000 (via bi-monthly contributions)
5/24/2004	Shelby for Senate	\$2000
2005	Capital One PAC	\$5000 (via bi-monthly contributions)
2/16/2005	Friends of George Allen	\$1000
4/18/2005	Tim Johnson	\$1000
2006	Capital One PAC	\$5000 (via bi-monthly contributions)
2/26/2006	Rep. Crowley for Congress	\$1000
7/11/2006	McConnell Senate Committee '08	\$1000

Qualifications: State fully your qualifications to serve in the position to which you have been named.

I believe the knowledge, experience and judgment I have gained in over twenty-five years of working in business, finance, and banking would be highly valuable and qualify me to serve as a Governor for the Federal Reserve System.

For the past fourteen years, I have worked in financial services. I spent the first seven years in wholesale financial services at Bankers Trust Company/Deutsche Bank where I was initially responsible for strategy and business development for Global Institutional Services—a division housing a range of wholesale banking and financial transaction processing businesses. After roughly three years, I assumed responsibility for Corporate Trust and Agency Services, one of the major business lines within the division, which I ran for approximately four years. Throughout this entire period, I developed a deep understanding of and appreciation for the capital markets (in particular the dynamics of securitizations) and how they relate to the overall financing needs served by banks. In addition, I worked closely with regulators in the United States as well as abroad.

Rounding out my financial services experience, I have spent the past seven years in consumer and small business banking, principally in the United States, but also in Canada and Europe. As President of Capital One's Global Financial Services division, I serve approximately ten million U.S. and international consumers and small businesses, and have had the opportunity to learn first hand about their financial services needs. As President of Capital One's Federal Savings Bank as well as Chairman of Capital One Bank Europe, PLC, I have also worked with a variety of banking regulators on a broad array of issues. I believe my hands-on experience with supervisory and regulatory issues, including the application and implementation of regulations by financial institutions, will help the Board perform its significant duties in these areas. As I have learned in my years in financial services, good regulations and good regulators are critically important to protect consumers and to ensure sound financial institutions.

Prior to working in financial services, I spent roughly a decade at The Walt Disney Company and at a number of business consulting firms where I helped create business strategies cutting across a wide array of industries (e.g., consumer products, basic industrials, energy, etc.). Working with businesses within the United States and in both developed and developing international economies, I have gained broad exposure to multiple business sectors throughout the global economy and a deep understanding of America's economic relationship with the rest of the world.

Overall, my broad business, financial services, and consumer and small business banking experience have provided me with a unique perspective on economic and monetary policy. It is my hope and expectation that this perspective, grounded in experience over my career, would add a helpful dimension to the Board and the FOMC in its deliberations in this area as well. All of my experience sits, of course, on the backbone of the financial and economic education I garnered during my undergraduate and graduate work.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

I will sever all connections with my present employer if confirmed by the Senate. (My spouse, however, will continue her employment at my present employer.)

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

I currently have no plans after completing government service to resume employment with any employer or organization with which I have been associated in the past.

3. Has anybody made you a commitment to a job after you leave government?

No person, firm, or organization has made a commitment to me for a job after I leave government.

4. Do you expect to serve the full term for which you have been appointed?

I expect to complete my full term.

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

I will have no on-going financial arrangements with entities who might be directly affected by policies which I will influence in the position to which I have been nominated. I have participated in two deferred compensation plans at my present employer. Consistent with the existing terms of these plans and applicable law, the plans will distribute these funds to me automatically six months after I resign from my position. (My employer does not manage the underlying mutual funds in which these plans are invested, my current employer does not guarantee any returns, and returns on these plans are not tied in any way to my employer's performance.)

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

I (and my spouse) own numerous publicly traded securities of banks and other financial services companies which could give rise to potential conflicts of interest. These matters are addressed through my ethics agreement with the Board, which has been approved by the Office of Government Ethics.

3. Describe any business relationship, dealing or financial transaction (other than tax paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

I have had no business relationship, dealing or financial transactions with the Federal Government that might in any way constitute or result in a possible conflict of interest with the position to which I have been nominated.

4. List any lobbying activity during the past ten years in which you have engaged in for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

I have not engaged in any lobbying activity.

5. Explain how you will resolve any conflict of interest that may be disclosed by your responses to the items above.

As I stated in my ethics agreement with the Board, which has been approved by the Office of Government Ethics, I will recuse myself from any particular matter involving specific parties in which my current employer is a party (unless I first obtain a waiver) for the duration of my term. I will adhere to this recusal commitment whether or not my spouse continues her employment with my current employer. I will also divest all security interests in my current employer. In addition, my spouse will divest all security interests in my current employer and will receive no compensation in the form of stock, stock options, or other equity interests. Moreover, her salary, her bonus and any other compensation will not be based on my current employer's earnings or stock value.

I and my spouse will also divest all securities or interest in any bank, securities firms, or other entity that either by statute or ethics rules affecting the Board of Governors of the Federal Reserve have been determined to potentially give rise to a conflict of interest.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

**RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM RANDALL S. KROSZNER**

Q.1. Dr. Kroszner, at your confirmation hearing on August 2nd I asked you about the possibility of a spillover from the problems in the subprime market into the market in general and the broader economy. You responded: "I think that at this stage the economic fundamentals are really unchanged from where Chairman Bernanke talked about them here in this Committee about 2 weeks ago, and so we have not seen an effect on the broader real economy." Five days later you voted at the FOMC meeting to keep interest rates constant and voted for a statement that did not directly mention the house market and reiterated that the Fed's primary concern was inflation, not slow economic growth.

Two days later the market began a serious decline which caused the Fed's Federal Open Market Committee, on which you serve, to issue the following statement: "Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. . . . To promote the restoration of orderly conditions in financial markets, the Federal Reserve Board approved temporary changes to its primary credit discount window facility." The FOMC also acted to reduce interest rates at the discount window by 50 basis points. You voted in favor of the action and statements. Dr. Kroszner can you explain your testimony on August 2nd with your votes on August 17th? What changed between your testimony and the Federal Reserve's statements?

A.1. Financial market conditions have been volatile since early summer and at times markets have been under significant strain. Those strains eventually became sufficiently intense that the Federal Reserve concluded that they posed a significant risk to economic growth.

Let me provide additional background. The statement released after the August 7, 2007, FOMC meeting noted that "Financial markets have been volatile in recent weeks, credit conditions have become tighter for some households and businesses, and the housing correction is ongoing." The statement went on to note that, partly as a result of these developments, ". . . the downside risks to growth have increased somewhat." However, the minutes of that meeting indicated that, while the downside risks to growth had increased, ". . . Committee members again agreed that maintaining the existing stance of policy at this meeting was likely to be consistent with the overall economy expanding at a moderate pace over coming quarters and inflation pressures moderating over time." In the days following the August 7 meeting, conditions in financial markets deteriorated swiftly and sharply. Conditions in various money markets both in the United States and abroad became impaired, with overnight and term interest rates moving up sharply. Conditions in secondary mortgage markets also worsened, with adverse implications for mortgage credit availability, and various other financial markets also deteriorated. In light of these developments, the FOMC issued the statement referenced in the question. In addition, the Federal Reserve took a number of additional actions in mid-August to increase the availability of liquidity. More recently, the Federal Reserve reduced the target federal

funds rate and the primary credit discount rate by $\frac{1}{2}$ percentage point each on September 18, 2007. As noted in the associated statement, those actions were “intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time.” Most recently, the FOMC reduced both the funds rate and the primary credit rate a further $\frac{1}{4}$ percentage point to “help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets. . . .”

Q.2. Do you still believe that we have not seen an effect on the broader economy from the problems in subprime mortgages? If so, how do you explain the market problems that led to the Fed’s action? If not, how could your statement before this Committee at your nomination hearing be proven incorrect so quickly?

A.2. Since the time of my appearance before the Committee in early August, we have received a great deal of additional economic data about macroeconomic activity, and the impact of the problems in subprime mortgages is still uncertain; for example, real economic growth in the third quarter was estimated to be 3.9 percent and the economy added 166,000 jobs in October. Stresses continue in parts of the mortgage and financial markets, however, and we will continue to assess the potential effects on broader economic prospects.

Still, around the second week in August—about a week following my testimony before your Committee—conditions in financial markets deteriorated sharply further. That deterioration caused the Federal Reserve to reappraise the macroeconomic situation and led the Federal Open Market Committee to issue a statement on August 17 with the assessment that the downside risks to growth had increased appreciably. At its meeting on September 18, the Committee judged that macroeconomic developments warranted a half-percentage-point reduction in the federal funds rate, consistent with the pursuit of the price stability and maximum sustainable employment. In his remarks at the Federal Reserve Bank of Kansas City’s Economic Symposium on August 31, Chairman Bernanke described the developments that had taken place in financial markets in the immediately preceding weeks. A notable aspect of those developments has been the speed with which they have occurred. In response, the Federal Reserve has acted promptly and forcefully.

Q.3. Dr. Kroszner, can you share with the Committee your views on the separation between banking and commerce? Specifically, what are your views on Industrial Loan Companies?

A.3. Congress has, for a variety of reasons, sought to maintain a separation between banking and commerce in the United States. And there is no doubt that our financial system remains the envy of the world—competitive, innovative, and resilient. Nevertheless, the question of whether continuing the nation’s policy on the mixing of banking and commerce might help or hinder the U.S. financial system and economy as we move further into the 21st century seems worthy of consideration.

A large body of economic research discusses and attempts to quantify the costs and benefits associated with mixing banking and

commerce. Most of this research deals with bank ownership of commercial firms rather than commercial ownership of banks. In addition, much of the existing empirical research is based upon the experiences of other countries, whose financial markets, legal institutions and corporate cultures, which have developed over the course of centuries, are often quite different from those in the United States. As a result, this research has limited value in terms of predicting the likely effects of permitting greater mixing of banking and commerce in the United States. Furthermore, the existing literature does not provide a clear consensus as to whether the overall benefits associated with greater mixing of banking and commerce outweigh the costs.

While the literature on this issue is mixed, it is clear that permitting broad mixing of banking and commerce would be a significant shift in policy and one that could have significant structural implications for the financial markets and the economy. That is why I believe it is important for Congress to fully consider both the benefits and costs of mixing of banking and commerce before making any major changes in this area. It is also one of the reasons why I and my fellow Board members have urged Congress to review the exemption in current law that permits any type of firm, including a commercial firm, to acquire an FDIC-insured industrial loan company (ILC). The continued growth in both the number and size of ILCs controlled by commercial firms under this special exception threatens to remove from Congress the important decision on whether broad mixing of banking and commerce should, or should not, be permitted. The special exception for ILCs in current law also has the potential to undermine other important policy objectives established by Congress, such as the proper supervisory and regulatory framework for organizations that control an insured bank in the United States and for foreign banks that seek to enter the banking business in the United States.

Q.4. Dr. Kroszner, in response to a question at your confirmation hearing on your conduct at FOMC meetings you said: “I think if you were to poll the other members of the FOMC, I think they would certainly say that I have not been a shrinking violet either at the formal meetings or in informal discussions.” However, you have never cast a vote in dissent of an FOMC action during your time on as a Fed Governor. Can you give the Committee several examples of times that you were not a ‘shrinking violet’? Specifically, on what occasions do you think your opinion moved the consensus of the Board to a different outcome?

A.4. At the University of Chicago, where I have been a professor for many years, it becomes second-nature to state one’s views clearly, forcefully, and to the extent possible supported with empirical evidence. I have fully brought this approach to my activity at the Board and the FOMC. I am active in the discussions with the Chairman and with other members of the Board and FOMC both prior to the meetings and during the FOMC meetings themselves. Although it would not be appropriate to describe the specifics from such discussions, since they are intended to be confidential, I believe that such interactions have helped to shape policy decisions and the manner in which those decisions have been communicated.

In particular, given my role as chair of the oversight committee on banking supervision and regulation, I provide assessments of the banking and financial services industries that I believe other members of the FOMC find valuable in reaching their decisions. While it's not possible to know whether any member's comments have changed a consensus opinion, I have no doubt that my comments have been helpful to my fellow committee members and helped inform the consensus eventually reached.

Q.5. Dr. Kroszner, in response to a question at your confirmation hearing on tax policy you stated, "I do think it is important to think about the incentives in the tax system, because many analyses that have been done comparing the U.S. tax system with other countries suggests that there is more of a bias against savings with respect to the tax system in the U.S. than there is elsewhere. So I think looking at that and looking at if there are lessons from other countries that can be learned for tax reform here could potentially be valuable." Can you please elaborate on this point and inform the Committee which tax policies you think the U.S. should consider adopting from other nations? In your analysis can you please include a rough estimate of the net fiscal impact of these tax changes on gross federal revenue?

A.5. Recent reports by the Department of the Treasury (Business Taxation and Global Competitiveness, 2007) and by the Congressional Budget Office (Corporate Income Tax Rates: International Comparisons, 2005) have shown that the United States has the second highest statutory corporate tax rate among both the G7 and the OECD countries. If the international comparison is performed using "effective" corporate tax rates (for equity-financed investment) the United States ranks as the fourth highest among both the G7 and the OECD countries. ("Effective" corporate tax rates take account of additional features of corporate tax structures—particularly depreciation allowances—along with statutory corporate tax rates.) Even though the ranking of the United States is less unfavorable on an "effective" tax basis, many economists have suggested that the U.S. corporate tax structure be improved to encourage investment and raise the after-tax return to saving.

Overall (that is, taking account of both corporate and individual taxes), the United States relies more heavily on income taxes and less on consumption-based taxes than do most OECD countries (OECD, *Fundamental Tax Reform: An International Perspective*, 2005). Some studies suggest that shifting the mix of taxes toward consumption-based taxes could increase national saving (see, for example, JCT, Tax Modeling Project and 1997 Tax Symposium Papers). Other studies point to ways in which even an income-based (as opposed to a consumption-based) system could be made to be more encouraging of saving (see, for example, Treasury, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform*, 2006).

Ultimately, the effect of changes in the structure of the tax system on revenue collections would depend on the details of the policy change. Generally speaking, any framework could be designed to raise revenues relative to the status quo, to be revenue-neutral,

or to reduce revenues, depending on the setting of key parameters such as tax rates and what is included in the tax base.

Q.6. Dr. Kroszner you served on the President’s Council of Economic Advisors from 2001 through 2003. During your service you were involved in advising the President on many economic policies, including those that lead to the basis for many of the Bush tax cuts. Do you favor making the Bush tax cuts permanent? Do you believe that the estate tax should be permanently repealed? Do you think that the Bush tax cuts of 2003 increased or decreased total federal revenue?

A.6. As a member of the Federal Reserve Board, I have avoided taking a position on specific questions of fiscal policy and have instead attempted to articulate the principles that I think most economists would agree are important for the long-term health of the economy and for helping fiscal policy to contribute as much as possible to that health. With regard to taxes, I subscribe entirely to the following principles laid out by Chairman Bernanke earlier this year in testimony before the House Budget Committee (February 28, 2007):

In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation’s economic resources to devote to federal government programs, including transfer programs such as Social Security, Medicare, and Medicaid. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. Thus, members of the Congress who put special emphasis on keeping tax rates low must accept that low tax rates can be sustained only if outlays, including those on entitlements, are kept low as well. Likewise, members who favor a more expansive role of the government, including relatively more-generous benefits payments, must recognize the burden imposed by the additional taxes needed to pay for the higher spending, a burden that includes not only the resources transferred from the private sector but also any adverse economic incentives associated with higher tax rates.

The consensus view among economists is that tax cuts reduce revenue, on net. These effects are smaller than simple, “static” calculations would indicate because tax reductions stimulate additional economic activity. However, even though some of the revenue that would be shown as lost under a static calculation is recouped, not all of it is.

Q.7. Dr. Kroszner, in your appearance before the Committee, you stated that you are a strong believer in the Fed’s dual mandate for maximum employment and price stability. Are there approximate figures for the nation’s unemployment rate and inflation rate that match what you believe to be maximum employment and price stability? If so, can you share what those are?

A.7. I have avoided giving an estimate of the sustainable level of the unemployment rate. There are two main reasons for my reluctance to take that step. First, economic theory strongly suggests—and empirical evidence corroborates—that the sustainable level of the unemployment rate is not constant over time, but is influenced by a variety of forces at work in the economy. For example, during the late 1990s, when the underlying or structural rate of productivity growth was picking up, the evidence suggests that a lower level of unemployment could be sustained, for a time, consistent

with stable inflation. Because the sustainable unemployment rate is influenced by other factors, the Federal Reserve must always be alert to changes in such factors and must communicate to the public that it does not regard the sustainable rate of unemployment as a constant but as something that must be inferred, that likely changes over time, and that can be estimated at any given moment only with considerable imprecision. Articulating a specific estimate would risk suggesting that the sustainable rate of unemployment is a constant and is precisely knowable, neither of which is true. The second reason not to give an estimate of this variable is that such an estimate might be misconstrued as a commitment to achieving that specific rate of unemployment. In fact, one of the most important lessons of the past thirty years or so is that while central banks can and should work hard to smooth the fluctuations in real activity and to achieve high levels of employment, they should not pre-commit to delivering on specified levels of the unemployment rate. Central banks must accept whatever sustainable unemployment rate the economy generates, and must optimize the conduct of their policy given that circumstance; no matter how much they might like to do so, they cannot deliver a lower unemployment rate over the intermediate-to-long run without causing the economy to overheat and, thus, inflation pressures to build. An inflation objective is, in principle, quite different, because it can be chosen and deliberately pursued, and the central bank can be held accountable for failure to achieve it on average, over time. There are serious arguments on both sides of whether the Federal Reserve should articulate a specific numerical inflation objective. Because, as you know, those arguments are currently under discussion by the Federal Open Market Committee, I think it best for me not to express a view on the issue.

Q.8. Dr. Kroszner can you inform the Committee of any periods in American history where you believe that maximum employment was not being reached or that price stability was not achieved? During those periods, what actions do you believe the Fed should have undertaken to achieve its mandate?

A.8. For a long period of time beginning around the mid-1960s and ending earlier this decade, price stability was not achieved. The consensus view of macroeconomists is that prior to 1979, the Federal Reserve ran a monetary policy that was too expansionary and that allowed the inflation rate to rise to very damaging levels. Beginning under Chairman Volcker, the Fed then had to engage in a long-term effort to bring inflation down to levels consistent with a functional definition of price stability. Similarly, during periods of recession and the immediate aftermath thereof, maximum employment has not been achieved. At all times, under the dual mandate given to the Federal Reserve by the Congress, the Fed must strike a balance between the two legs of its dual mandate. Empirical evidence consistently shows that since the early-to-mid-1980s, the Fed has systematically reacted to economic weakness by running a more expansionary policy than would otherwise be appropriate, and has reacted to high inflation by running a more restrictive policy than would otherwise be appropriate. This systematic behavior has been an important underlying component of the much

more successful conduct of policy since 1979 than during the period before then.

Q.9. Dr. Kroszner at your confirmation hearing, you discussed the State's role in consumer protection, stating: "I would very much agree that it is extremely valuable to use the States as a laboratory to see what can be effective and what is not effective, because we want to protect consumers, but we also want to make sure that responsible borrowers can still get credit to people who can use it responsibly." Given this position, do you agree or disagree with the policy of preemption that the OCC has undertaken?

A.9. The principle of preemption is a judicial doctrine that is grounded in the Supremacy Clause of the U.S. Constitution. Ultimately, whether a state law is preempted by a federal law turns on whether Congress, in enacting the federal law, intended the federal law to supersede and preempt the state law. The Supreme Court has developed several standards for assisting the courts in determining whether Congress expressly or implicitly intended a federal law to preempt a state law. Recently, the Supreme Court reviewed certain aspects of the preemption rules issued by the Office of the Comptroller of the Currency and found that these rules were consistent with Congress' intent in enacting the National Bank Act. Because preemption ultimately involves questions of Congressional intent and application of the legal principles established by the Supreme Court under the Supremacy Clause, I believe the issue of whether a federal law or a federal agency's rules preempt state law is one that is best addressed by the Congress and the courts.

Q.10. Dr. Kroszner, when asked about the low number of referral of cases by the Fed to the Department of Justice under the Equal Credit Opportunity Act Amendments of 1976, during the height of the subprime mortgage market problems over the past few years, you stated: "Just in 2007, just in the first 6 months, we have already had five referrals. So we are active in this area." Do you believe that in the first half of 2007 there were only 5 cases in America that merited referral to the Justice Department? Do you believe the same to be true in 2006 when the Fed only referred five cases for the entire year? If not, can you please explain to the Committee why the Fed has referred such few cases?

During your time as Governor, you have taken a lead role in the areas of consumer protection and the mortgage market. What has been the resource allocation within the Fed to consumer protection and specifically to referring cases under the Equal Credit Opportunity Act Amendments of 1976? What has been the change in the resources allocated to this issue over the last five years (please provide this information on an annual basis).

A.10. The Federal Reserve has a long-standing commitment to ensuring that every bank it supervises complies fully with the federal fair lending laws, namely the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. Fair lending is an integral part of every consumer compliance examination we conduct. When conducting fair lending examinations, our consumer compliance examiners perform two distinct functions. First, examiners evaluate the bank's overall fair lending compliance program. In essence, exam-

iners make sure that management is committed to fair lending and has put in place the appropriate systems, policies, and staff to prevent violations. If an institution's staff or systems fall short, examiners direct the institution to take corrective action. Second, examiners determine if the bank has violated the fair lending laws. To that end, they review lending policies and practices to make sure they are not discriminatory. Examiners also test the institution's actual lending record for specific types of discrimination, such as underwriting discrimination in consumer loans, or pricing discrimination in mortgage or automobile lending.

Because the Federal Reserve requires the state-member banks it supervises to devote significant resources to fair lending and because we examine them routinely for fair lending compliance, we expect fair lending violations—especially those involving a pattern or practice of discrimination—to be rare among the banks we supervise. Our experience has been that such violations are indeed rare, but when they occur, we do not hesitate to take strong action. If we have reason to believe that there is a pattern or practice of discrimination under ECOA, the Board has a statutory responsibility under that Act to refer the matter to Department of Justice (DOJ), which reviews the referral and decides if further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. As I mentioned in my testimony, in the first six months of this year alone, we referred five institutions after concluding that we had reason to believe that they had engaged in a pattern or practice of discrimination. Last year, we referred four institutions. If a fair lending violation does not constitute a pattern or practice, the Federal Reserve makes sure that the bank remedies it. From 2004 through 2006, we cited approximately sixty banks for such violations involving discrimination on a prohibited basis under ECOA. Our fair lending findings and referrals only pertain to the banks that we supervise, which are a subset of the overall market. Thus, our findings of fair lending violations are not a measure of the number of fair lending violations in the entire market.

You also ask about the resources dedicated to consumer protection over the past five years. As of June 30, 2007, the Federal Reserve Banks employed 287 professional personnel dedicated to consumer compliance supervision. The number of staff dedicated to consumer compliance supervision varies over time in response to changes in the number and complexity of state member banks that we supervise. Note that since 2002, the number of state member banks, including large complex banks, has generally declined. In 2002, there were 950 state member banks and of those 18 had over \$1 billion in assets. In June 2006, there were 888 state member banks and of those 8 had over \$1 billion in assets.

The following is a table showing the number of professional personnel, including examiners, dedicated to consumer compliance supervision at the Reserve Banks since 2002. Consumer compliance examiners assess compliance with fair lending, as well as other consumer protection statutes. Thus, it is not possible to separately measure staffing dedicated to the referral of matters under the Equal Credit Opportunity Act.

RESERVE BANK STAFFING DEDICATED TO CONSUMER COMPLIANCE

	December 2002	December 2003	December 2004	December 2005	December 2006	June 2007
Staff	300	292	279	269	274	287

In addition to Reserve Bank staffing, the Board has a Fair Lending Enforcement Section, which brings additional expertise to the examination process and ensures that fair lending laws are enforced consistently and rigorously throughout the Federal Reserve System. Many other Board staff members, such as oversight analysts and attorneys, also regularly work on fair lending matters.

Q.11. Dr. Kroszner, at your confirmation hearing you stated: “I think the best way to achieve maximum employment growth is through low and stable inflation.” Do you believe that the Fed should implement an explicit target (or target range) for inflation to best achieve this goal?

A.11. As I noted earlier, there are serious arguments on both sides of this question. Because, as you know, those arguments are currently under discussion by the Federal Open Market Committee, I think it best for me not to express a view on the issue.

Q.12. Dr. Kroszner, at your confirmation hearing you discussed the value of low inflation, concluding: “we know from research and data from around the world that a low and stable environment is the best way to maximize prosperity.” Over the last five years the American economy has enjoyed a period of remarkably low and stable inflation. Do you believe that the economy has maximized prosperity over the last five years?

A.12. I believe that, by pursuing the dual mandate of price stability and maximum sustainable employment, the Federal Reserve did indeed maximize its contribution to general prosperity during the past five years. Indeed, over the last five years, the growth of real GDP in the United States averaged 2.9 percent at an annual rate. More generally, the U.S. economy demonstrated remarkable resilience in the past several years in the face of very substantial shocks including the tragic attacks on 9/11, corporate governance scandals, financial crises in Latin America, and huge swings in the price of imported crude oil. I have no doubt that the Fed’s policy of maintaining low and stable inflation helped support this resilience.

Q.13. Dr. Kroszner, at your confirmation hearing I was very pleased that you agreed with me in a question about practices in the subprime mortgage market when you stated: “it is extremely important to protect people in these markets, and we have to protect them against abusive practices.” What specific abusive practices do you think the Fed has failed to protect individuals against?

A.13. When the Board saw problems in the parts of the market we supervise and examine, we took strong action by issuing guidance with other regulators. We first issued guidance on subprime lending in 1999 and again in 2001. When problems surfaced concerning nontraditional mortgages, we issued guidance on those. The guidance addressed both underwriting and consumer protection principles, including marketing practices. Then we immediately turned

our attention to the subprime markets, especially the hybrid arms, developing substantially similar guidance for those markets. The guidance addressed several issues, including underwriting standards used to qualify borrowers for subprime hybrid ARMs.

We share the concerns of Congress that certain lending practices may have led to the problems we are seeing in the subprime market today. We plan to propose rules under our HOEPA authority by the end of this year that would apply to subprime loans offered by all mortgage lenders. We are looking closely at practices such as prepayment penalties, failure to offer escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the failure to give adequate consideration to a borrower's ability to repay. I chaired a full day hearing in June on these practices that yielded valuable insight from both industry and consumer groups. The Board also solicited written comments from the public on the practices discussed at the hearing. The Board received nearly 100 comment letters, and staff is closely examining the issues raised and discussing possible remedies.

Q.14. Dr. Kroszner, at your confirmation hearing, we discussed the question of why there are pre-payment penalties for subprime residential mortgages but not for prime residential mortgages. At the hearing, you stated: "What some people have argued—and, again, I have not evaluated this—is that there may be more frequency of prepayments, more frequency of moving from one home to another, and so this provides some form of protection for the people who are buying the securitized mortgages, and so that allows a lower initial interest rate to be provided. I have not evaluated that argument, so I do not know how important or extensive that is." Why have you not evaluated the prepayment issue given your service as the HOEPA point person for the Fed over the past 18 months?

Can you please provide the Committee with your evaluation of this argument? Do you believe that pre-payment penalties are appropriate for subprime mortgages and not for prime mortgages? Do they constitute one of the abusive practices that you mentioned at the hearing or do they not?

A.14. We are still evaluating the hearing testimony and comment letters on prepayment penalties in order to determine the appropriate regulatory response. In addition, we have had meetings with a number of participants involved in mortgage lending to assess the potential utility of prepayment penalties and the costs they impose on consumers. These are very difficult issues to resolve; however, I anticipate that we will propose rules to address abuses in the subprime market by the end of this year.

Q.15. Dr. Kroszner, how do you explain the Federal Reserve's findings from the HMDA data that in 2005, 54.7% of African-American borrowers and 46.1% of Hispanic borrowers got high-priced loans when buying a home compared to 17.2% of non-Hispanic whites?

A.15. The 2005 HMDA data show substantial differences across racial and ethnic groups in the incidence of higher-priced lending. Accounting for a variety of individual characteristics, however, can substantially reduce the differences. Nonetheless, these disparities raise important questions, and I share the concern they may result in part from illegal discrimination. It is not possible to determine

whether a lender has violated fair lending laws from HMDA data alone, however, because the data do not include many factors that lenders routinely use to set loan prices, such as credit scores and loan-to-value ratios. Thus, when the Federal Reserve conducts an examination of a lender's pricing, examiners obtain additional information to determine whether any pricing disparity by race or ethnicity is fully attributable to legitimate factors, or whether any portion of the pricing disparity may be the result of illegal discrimination.

Q.16. In the Fed's analysis of the data, significant racial and ethnic differences remained unexplained even after accounting for other information reported in the HMDA data. The Fed found that borrower-related factors accounted for only about one-fifth of the disparity. Do you believe that there is racial discrimination in the mortgage market? If so, how do we root it out of the system? What specific additional steps should the Fed undertake to do so? If you do not believe that there is racial discrimination, how do you explain these racial disparities?

A.16. I believe aggressive enforcement of fair lending laws can help root out illegal discrimination. To that end, the Federal Reserve is committed to rigorously enforcing the fair lending laws, and we recently referred two nationwide mortgage lenders to the DOJ because we found evidence that Hispanic and African-American borrowers paid more for their loans than did comparable white borrowers.

These referrals resulted from a process of targeted reviews of institutions for pricing discrimination that the Federal Reserve initiated when the HMDA pricing data first became available in 2005. We developed, and continue to refine, a HMDA data analysis program that identifies institutions with statistically significant pricing disparities by race or ethnicity. Because HMDA data lack many factors that lenders routinely use to make credit decisions and set loan prices, such as information about the borrower's creditworthiness and loan-to-value ratios, HMDA disparities alone cannot be used to determine whether a lender discriminates. Thus, we analyze HMDA data in conjunction with other supervisory information to evaluate a lender's risk for discrimination.

For the 2005 HMDA pricing data, Federal Reserve examiners performed a pricing discrimination risk assessment for each institution that we identified through our HMDA data analysis. These risk assessments incorporated not just the institution's HMDA data, but also the strength of the institution's fair lending compliance program, our past supervisory experience with the institution, consumer complaints against the institution, and the presence of fair lending risk factors such as discretionary pricing. Based on these comprehensive assessments, we determined which institutions would receive a targeted pricing review. Depending on the examination schedule, the targeted pricing review could occur as part of the institution's next examination, or outside the usual supervisory cycle. We have already initiated this same review process based on our analysis for the 2006 HMDA data.

Q.17. Dr. Kroszner, we discussed the role that the GSE's play in the housing market at your confirmation hearing. I specifically

asked about the role that Freddie and Fannie “can play here about having them have extend some additional credit here to lighten up or to at least release some of the seizure.” You responded that: “I think it could be helpful to have them focus on affordable housing more than they have been.” Does that response mean that you believe that OFHEO should allow the GSEs to, consistent with safety and soundness and proper consumer protection practices expand their portfolio holdings in subprime mortgages during this period of market turmoil?

A.17. We encourage the GSEs (Fannie Mae and Freddie Mac) to help refinance subprime mortgages and securitize these mortgages to the fullest extent allowed by their charters. However, the GSEs do not need to expand their portfolios to do so. Fannie Mae and Freddie Mac currently hold hundreds of billions of dollars of their own mortgage securities in their portfolios; these could be readily sold to provide the financial wherewithal to fund new mortgages directly if they wish to do so. Moreover, the substantial repayment of mortgages currently held in their portfolios also gives them considerable room for holding additional subprime mortgage assets without expanding the size of their portfolios. Finally, the GSEs’ ability to securitize mortgages is not constrained by the size of their portfolios, and they should be encouraged to actively securitize subprime mortgages to the extent allowed by their charters. In the longer run, I believe that we should focus the GSEs’ portfolios on affordable housing in the manner suggested by Chairman Bernanke in his speech in March 2007. In this way, the GSEs’ portfolios would have a clear and focused public purpose, and the systemic risks associated with these portfolios would be more limited.

Q.18. Dr. Kroszner, during your time as a member of the Board of Governors you have dealt extensively with the negotiations regarding the updating of the BASEL bank capital standards. It was my understanding that the agencies had a commitment to act on the Basel II and Basel IA approaches in tandem. Now that the standardized option will take the place of Basel IA, can you assure us that that the proposed rule for the standardized approach will be issued at the same time that the final rule on the advanced approach is issued to preserve the commitment to keep the new capital rules for large banks and all the other banks moving forward in tandem?

A.18. As indicated in the interagency press release on July 20, 2007, the agencies have agreed to proceed promptly to issue a proposed rule that would provide all non-core banks with the option to adopt a standardized approach. As you noted, this new proposal will replace the earlier issued Basel IA proposal. The press release stated the agencies’ intention that the proposed standardized option would be finalized before core banks begin the first transition period year—the first opportunity for which is early 2009. It is important that banks intending to adopt the Basel II advanced approaches at the first opportunity have sufficient lead time to develop appropriate internal systems and carry out an effective parallel run. It also is important for agency examination staffs to have time to assess bank systems before early 2009. The agencies have

just issued the final rule related to the advanced approach and substantial progress has been made on drafting the standardized proposal. The agencies have a firm commitment to move expeditiously to issue the standardized proposal, and I very much support that commitment. Thus, I anticipate that the two rules—Basel II advanced and standardized—would go into effect at the same time in early 2009.

Q.19. During the current credit crunch in the mortgage markets, there have been a number of reports of problems in the market for MBS issued by Freddie Mac and Fannie Mae, in addition to the subprime and jumbo markets. For example, Dow Jones Newswires reported on August 16, 2007, that prices on “some of the highest-quality mortgage bonds are plummeting . . . largely because they’re available to trade.” It appears that investors may be selling these GSE MBS in large numbers in order to raise funds to cover collateral calls for subprime securities. Ironically, it is the fact that the GSE MBS have retained their credit quality that makes it possible to sell them in these difficult times when liquidity for other mortgage assets has largely evaporated. Nonetheless, the fact that so much of this paper is reportedly being sold may be resulting in some problems in this market, including increased spreads that may result in higher costs for homeowners. Are these reports accurate? Has the Federal Reserve seen increased selling of GSE-issued MBS? If so, what has been the impact in the marketplace?

A.19. Relative to other forms of mortgage securities, the market for GSE-issued MBS has generally remained stable throughout the recent mortgage market difficulties. While spreads have widened somewhat, they have remained well below their recent historical highs. Moreover, this market has generally functioned smoothly. Mortgages that have been securitized by GSEs are well-accepted in the secondary market because they come with GSE-provided guarantees of financial performance, which in turn are unquestioned largely because market participants appear convinced that GSE commitments are backed by the full faith and credit of the U.S. government—the letter of the law and the protestations of government officials notwithstanding. Presumably, market participants believe that, in the event of a GSE failure, the government would have no practical alternative but to come to the rescue.

Q.20. If Fannie Mae and Freddie Mac were allowed to purchase their MBS, would that help maintain prices for those securities? if so, would that, in turn, make it easier for other entities to raise money by selling their GSE MBS?

A.20. Generally, Fannie Mae and Freddie Mac’s securities trade in a world-wide market of highly rated securities, and the prices of these securities are unaffected by the GSEs’ portfolio actions. Moreover, entities holding GSE MBS have had little problem selling their holdings if they wish. During the recent mortgage market difficulties, the prices of the GSE securities have been largely unaffected when compared to the price movements of other securities, even though the GSEs were constrained in their purchases of their own MBS by the portfolio caps. Thus, allowing Fannie Mae and Freddie Mac to purchase their own MBS has the effect of enhancing their profitability, but does not seem to have substantial effect

on the market prices for MBS issued by the GSEs. GSE securitization efforts provide ample liquidity for the GSE-guaranteed MBS market and there is little need to expand the GSEs' portfolio purchases of their own MBS.

Q.21. The Federal Reserve has never exercised its authority under the FTC Act to promulgate a regulation on unfair or deceptive acts and practices. You have said that you think it is more appropriate to address these problems on a case-by-case basis. Please explain your views in this area?

A.21. Because the Board and the other banking agencies can enforce the FTC Act in particular cases and issue supervisory guidance, the need for rules was not clear. A determination of unfairness or deception depends heavily on the facts of an individual case. Therefore, we believe that using our enforcement authority and issuing guidance are effective tools in dealing with unfair or deceptive practices. The Federal Reserve and the other banking agencies have used their broad authority to enforce the FTC Act against the institutions they supervise to prevent unfair or deceptive acts or practices. Also, the Board and the FDIC have jointly issued guidance and "best practices" for the institutions they supervise. The OCC has also issued guidance concerning potentially unfair or deceptive practices. Nonetheless, the Board will continue to assess whether there are unfair or deceptive practices that are appropriately addressed by adopting rules of general applicability under the FTC Act or other consumer protection laws.

Q.22. A recent *American Banker* article ("The Fed's Record on Abusive Loans," August, 29, 2007), points out that the "Fed has never taken an enforcement action related to unfair and deceptive practices," whereas other banking regulators have taken action 29 times in the past seven years. Please explain the lack of action in this area on the part of the Federal Reserve?

A.22. In conducting examinations and addressing consumer complaints, the Federal Reserve considers whether the practices of the institutions we supervise are potentially unfair or deceptive. Examiners generally are able to address any potential violations they find through the supervisory process, which is not public. We have generally found this approach to be effective in preventing unfair or deceptive practices.

Q.23. As you know, only the Federal Reserve, the Office of Thrift Supervision, and the National Credit Union Administration currently have the authority to promulgate a rule dealing with unfair or deceptive acts or practices. In your view, should the other agencies be given the same authority? Please explain your reasoning.

A.23. As we have noted, the practical difficulty in writing rules of broad applicability is that a practice may be unfair in some circumstances but not in others. Finding that a practice is unfair or deceptive is heavily dependent on the facts and circumstances. That is why the FTC has also preferred the same case-by-case enforcement approach that the Board, the OTS and the NCUA have followed. If other agencies have rulewriting authority under the FTC Act, they will face the same challenge.

In addition, the FTC Act authorizes the Board to write rules for all banks, which ensures consistency. If Congress were to authorize the OCC and FDIC to write rules, we would recommend that there be a mechanism for ensuring that all banks, as well as thrifts and credit unions, are subject to the same standards. We would also encourage the FTC and NCUA to adopt similar rules for nonbank lenders and federal credit unions, respectively.

Q.24. The Committee recently passed legislation to improve the regulation and transparency of the private educational loan market—the fastest growing segment in the \$85 billion student loan market. Among the growing trends in the private student loan market is the practice of some lenders using non-individual data—like a school’s default and graduation rate—in the underwriting used to establish the rate a student borrower is offered. It’s a practice that is eerily reminiscent of mortgage “redlining”, when mortgage rates and products were denied to people based on where they lived rather than their individual credit-worthiness. One of the ways Congress addressed mortgage redlining was through enactment of tough anti-discrimination laws and improving transparency of market practices in the form of HMDA (the Home Mortgage Disclosure Act), which the Federal Reserve oversees.

Do you think HMDA has been an important tool to promote transparency? Do you think a disclosure, transparency regime for private student loans similar to HMDA is a more useful approach to addressing concerns about potential “redlining” in the private student loan market or do you believe we should prohibit the practice of underwriting based on factors such as the school one chooses to attend?

A.24. I believe that HMDA data have been an effective tool to increase transparency in the mortgage market. Determining whether a similar approach—or other legislation that would prohibit certain underwriting factors—would be appropriate in the student loan market would require a careful analysis of that market and a balancing of the potential benefits, risks, and costs of each approach.

Q.25. Dr. Kroszner in one of your academic articles you discuss in great details the pros and cons of the Investment Company Act of 1940. Barbara Roper of Consumer Federation of America has said “The 1940 Act may be the most pro-investment piece of legislation ever enacted. It has made it possible for average Americans to participate in and profit from our markets. And that has supplied our equity markets with tremendous amounts of capital.” I observe that investors hold more than \$11 trillion of assets in the nation’s mutual funds, indicating broad support.

In your article, you conclude, and I quote—“the Act thus imposes costs on investors—and on modern corporate governance—without countervailing benefits to investors or to the functioning of the market generally” Can you share with the Committee your thoughts on why the Investment Company Act of 1940 is bad policy?

A.25. The development of mutual funds for individual investors fostered by the Investment Company Act of 1940 has been of tremendous value to individuals. I definitely concur with Barbara Roper that mutual funds have helped to make “it possible for aver-

age Americans to participate in and profit from our markets. And that has supplied our equity markets with tremendous amounts of capital.” In my article, I was commenting on only one specific aspect of the 1940 Act, namely, whether the restrictions on ownership embodied in the Act can constrain “the ability of institutions to discipline corporate management on behalf of households and other investors” (quoting p. 48 of my article). The other aspects of the 1940 Act that have helped to establish a vibrant and competitive mutual fund industry are to be applauded.

Q.26. Dr. Kroszner, you were a member of the Shadow Financial Regulatory Committee in 2005 when they made the following statement: “The Committee believes that the PCAOB’s basic functions ultimately should be transferred to the SEC.” Why do you believe that the PCAOB’s accounting oversight duties should be transferred back to the SEC, in light of the problems raised through the accounting crises that caused Congress to create the PCAOB only 5 years ago?

A.26. The credibility and accuracy of financial reports are crucial to the proper functioning of capital markets. It is thus important for Congress to have focused attention on these issues in light of the corporate governance scandals in 2001 and 2002. I believe it is valuable to continue to emphasize the necessity of high standards in auditing. The PCAOB is designed for, and making, constructive contributions towards that important purpose. With Mark Olson, my former colleague from the Federal Reserve Board, as the chair of the PCAOB, I know that it is in good hands. Over the long run, Congress can consider whether ultimately the PCAOB functions are most effectively and efficiently undertaken through a separate entity or within the SEC.

Q.27. Dr. Kroszner, you testified on behalf of the United States as an expert witness in a case before the United States Court of Federal Claims involving Citizens Federal Bank. The D.C. Circuit issued an opinion captioned *Citizens Federal Bank v. United States* which included comments critical of your expert testimony and indicated in multiple instances that you lacked some basic information regarding matters on which you rendered opinions. For example, the Court wrote: “Professor Kroszner’s opinion on the regulators’ attitude toward parent company debt is, in the Court’s view, entitled to very little weight in light of limited understanding of the regulatory structure and atmosphere to which Citizens [a thrift] was subject.”

What was your reaction to the Court’s opinion? Do you think your testimony in this case, and the judge’s finding that your viewpoint carried ‘little weight in light of [your] limited understanding of the regulatory structure’ has any bearing to your ability to be a Fed Governor, particularly given your portfolio at the Fed of bank supervision and regulation?

A.27. I have been undertaking research, teaching, and consulting related to banking and financial supervision and regulation for more than fifteen years and have published numerous articles on these topics in both academic and practitioner journals. In this opinion, I believe the Court is referring to specific facts and circumstances of a particular institution involved in the case. In an-

other case also before the United States Court of Federal Claims, *American Capital Corporation v. United States*, I also testified as an expert witness on behalf of the United States, and the Court's two opinions in that case suggest that the Court did put much weight on the testimony I provided. I believe my breadth of both practical and academic experience related to banking supervision and regulation has been very valuable to my portfolio at the Fed, which includes chairing the Board committee that oversees our division of banking supervision and regulation.

Q.28. Dr. Kroszner in your academic work you focused on issues of bank regulation in developing countries, you made the following conclusion: "An explicit central bank may not be needed, but rather mechanisms to provide added liquidity, perhaps through the clearing system, in times of trouble." Can you explain this finding and what implications it has for developing countries that are considering establishing a central bank? Under what circumstances would you recommend against a nation establishing a central bank?

A.28. As you noted, I made that statement in the context of academic research on monetary and financial structure and regulation, and consequently I was focusing only on particular aspects of the relevant issues. The questions of whether a nation should establish a central bank, and if so what form the central bank should take, are quite complicated. The answers depend on a wide variety of factors, such as the size of the economy and the financial system; the openness of the economy; the degree of integration it has achieved with a larger economy—perhaps a neighbor or close trading partner; and whether it has adequate political, legal, and social institutions to support the establishment and ongoing operation of an independent national central bank. Appropriate bank supervision, with strong tools, is needed for economies even where the decision has been made not to have a national currency and, hence, a national central bank.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CASEY
FROM RANDALL S. KROSZNER**

Q.1. Earlier this year Chairman Dodd sent a letter to the Federal Reserve Chairman, Mr. Bernanke, asking him to act on the Fed's authority and duty under HOEPA (The Home Ownership and Equity Protection Act) of 1994 to address predatory loans. We asked him to do three things:

- Require all mortgage originators to evaluate a borrower's ability to repay prior to making a mortgage loan and that the Fed create a presumption that a loan that requires a borrower to pay more than 50 percent of his or her income to cover the cost of principal, interest, taxes, and insurance is not a sustainable loan and fails to meet this test;
- Designate the failure to escrow taxes and insurance as an unfair and deceptive practice;
- Restrict the use of low- and no-documentation loans.

Do you support the Fed taking each of these three actions?

A.1. I chaired a Federal Reserve hearing in June 2007 to gather information on these and other practices and concerns in the subprime mortgage market from both industry and consumer groups. Specifically, in that hearing, we examined the failure to give adequate consideration to a borrower's ability to repay, the failure to offer escrow accounts for taxes and insurance, stated-income and low-documentation lending, as well as prepayment penalties. The Board also solicited written comments from the public on the practices discussed at the hearing. The Board received nearly 100 comment letters, and staff is closely examining the issues raised and discussing possible remedies. For example, failure to escrow for taxes and insurance can lead to a situation akin to payment shock for borrowers if the borrower did not understand or fully anticipate the cost of taxes and insurance that the borrower must pay. It is a common practice for these payments to be escrowed in the prime markets, and I see no reason that escrows should not be standard practice in the subprime markets too.

We are reviewing the testimony from the hearing and the public comment letters received in connection with the hearing. Chairman Bernanke has said that he expects we will issue proposed rules by the end of the year. It would be premature for me to comment on the precise content of the proposed rules or to express a view in support of any particular action at this juncture

Q.2. A central goal of HOEPA is equity protection. Given the decline in homeownership rates among African-Americans over the past few years, and given the equity stripping that we have seen in the subprime mortgage market: Has the Federal Reserve done everything in its power to protect the home ownership and equity of these consumers? What, if anything, can be done differently?

A.2. We have taken action on several fronts to address concerns about abusive subprime lending. Regarding equity loss among African-American communities, the Federal Reserve has a long-standing commitment to ensuring that every bank it supervises complies fully with the federal fair lending laws, namely the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. Fair lending is an integral part of every consumer compliance examination we conduct. We recently referred two nationwide mortgage lenders to the Department of Justice because we found evidence that Hispanic and African-American borrowers paid more for their loans than comparable white borrowers. And for these and all consumers, we are planning to propose rules under HOEPA later this year, to address concerns about abuses in the subprime mortgage market.

Q.3. Congress is considering a number of measures to address some of the abuses in mortgage lending, including the Borrower's Protection Act. That bill would establish lender liability for the actions of associate appraisers and brokers. Do you support establishing that liability?

A.3. Whether it is appropriate to hold a lender liable for the acts of brokers and appraisers—who are essentially independent contractors—raises many issues, including whether lenders are in a position to perform due diligence to guard against undue risk of liability.

Other actions can be taken to address broker abuses. Many states are strengthening their licensing requirements and oversight of brokers in response to the problems in the subprime market. The Conference of State Bank Supervisors (CSBS) will be looking at the activities of brokers as part of a pilot program with the Federal Reserve and other agencies to look at the actions of non-bank subsidiaries of bank holding companies with significant subprime mortgage lending operations. The CSBS also has developed a nationwide registration and licensing system for all mortgage brokers and loan originators not affiliated with depository institutions, to help limit the ability of bad actors to move to a new state, and to continue engaging in irresponsible practices there, after having run afoul of regulators in their old states.

Independence in the appraisal process is essential to ensuring that pressure is not placed on an appraiser to render a particular collateral value to enable a loan to be made. With respect to appraisers, the reform measures adopted pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 led to an improvement in the quality of appraisals. The states all have in place programs for the licensing and certification of appraisers, based on national standards. The Federal Reserve and the other federal banking agencies have appraisal regulations and guidelines that cover the real estate lending activity of federally regulated institutions. Through recent guidance, the Federal Reserve and the other agencies have stressed the importance of quality appraisals and, in particular, independence in the appraisal process from the individual who originates the mortgage.

Q.4. There is a great deal of data on mortgage lending from the Home Mortgage Disclosure Act. That data show unexplained racial disparities in mortgage lending, including interest rates and costs. Would you support using these data to identify banks and lenders with unexplained disparities, racial or otherwise, as a reason at the very least to open an investigation of those lenders?

A.4. Because HMDA data lack many factors that lenders routinely use to make credit decisions and set loan prices, such as information about the borrower's creditworthiness and loan-to-value ratio, we analyze HMDA data in conjunction with other supervisory information to evaluate a lender's risk for discrimination. The Federal Reserve developed, and continues to refine, a HMDA data analysis program that identifies institutions with statistically significant pricing disparities by race or ethnicity. Each institution identified by our HMDA analysis program is carefully assessed for pricing discrimination risk, based on its HMDA data, as well as the strength of its fair lending compliance program, our past supervisory experience with the institution, consumer complaints against the institution, and the presence of fair lending risk factors such as discretionary pricing. Based on these comprehensive assessments, we determined which institutions should receive a targeted pricing review. During a targeted pricing review, the Federal Reserve collects additional information, including potential pricing factors that are not available in the HMDA data, to determine whether any pricing disparity by race or ethnicity is fully attrib-

utable to legitimate factors, or whether any portion of the pricing disparity may be attributable to illegal discrimination.

Q.5. Two of you have worked for banks and governor Kroszner has been on the Federal Reserve Board for the past year. In your opinion, is it possible for banks or lenders to provide people with too much credit, so much that their financial situation is actually harmed?

A.5. While this is a possibility, a lender that continuously provides credit at levels that result in financial harm to borrowers, such as the loss of a borrower's home, will not remain a viable entity in the long term. The recent closure of numerous subprime lenders illustrate the fact that imprudent underwriting and unwarranted layering of risk can lead to excessive delinquencies, losses, erosion of capital and, ultimately, business failure. Therefore, the lender's assessment of a borrower's ability to repay, as the recent inter-agency mortgage guidance emphasizes, is a fundamental ingredient in prudent underwriting standards.

Q.6. Have banks in the recent past been extending too much credit to consumers and if so, what should regulators do about that?

A.6. Perspective gained from the passage of time will be beneficial in making the final determination of recent market events. Regulators have to strike the right balance between exercising their supervisory authority and encouraging banks to extend credit. Ultimately, regulators are responsible for promoting a healthy banking system in which banks have appropriate risk-management practices and consumers have access to credit.

Supervisors have been very active in responding to recent changes in the lending environment. Due to concerns about the quality of underwriting, the agencies issued guidance with respect to nontraditional mortgage loans more than a year ago, and there has been guidance regarding subprime lending programs since 1999. These statements all discuss the importance of the assessment of the borrower's ability to repay.

In addition, the CSBS has urged the states to adopt both the nontraditional mortgage guidance and the recent subprime mortgage lending guidance. To date, thirty-eight states have adopted the nontraditional mortgage guidance and thirty-one states have adopted the subprime guidance. Finally, the Board and the other agencies issued statements in April and September that encourage lenders and servicers to work constructively with borrowers who are in default or whose default is reasonably foreseeable.

Q.7. And should regulators look for ways to ensure that too much credit is not provided?

A.7. As discussed above, lenders have strong incentives to ensure that their underwriting remains prudent and does not result in unwarranted risk-taking. Additionally, excessive regulation can result in the unintended consequence of curtailing credit to otherwise creditworthy borrowers. Nevertheless, good banking supervision is vital to the health of banks. The Federal Reserve and the other agencies have a number of tools to address unsafe and unsound lending practices. Among them are the ability to issue guidance and regulation, when appropriate, and the bank examination proc-

ess, which provides direct and timely feedback to supervised institutions regarding their credit policies and underwriting practices.

Q.8. Do you believe that yield spread premiums, which financially reward mortgage brokers for steering borrowers to higher rate loans than they might otherwise qualify for and prepayment penalties which trap borrowers in unfair loans, can distort competition?

A.8. Compensation for mortgage brokers that depend on yield spread premiums can give mortgage brokers incentives to guide borrowers to higher rate loans than would compensation not based on the loan rate. More effective disclosure of costs would allow borrowers to better evaluate competing mortgage products and improve their awareness of whether the broker has the incentives to act in the best interest of the borrower. In some circumstances, a borrower might benefit from a yield spread premium if, in return for a higher rate, the broker pays some or all of the closing costs. A yield spread premium raises the rate a consumer pays on his loan, although it may, as noted, be used in whole or part to help cover closing costs. When market interest rates decline, individuals with relatively high loan rates have a greater incentive to refinance. Prepayment penalties can reduce the benefit of refinancing if the length of time set for the expiration of the prepayment penalty is relatively long.

Q.9. Last Thursday the Leadership Council on Civil Rights called upon the FRB to intervene in the subprime crisis, specifically noting that it is “glad that the nominees showed strong interest in getting rid of prepayment penalties and other abusive terms in subprime loans.” What are you planning to do to combat the abusive practice of steering of borrowers (and specifically minorities) into loans that are more expensive than loans for which the borrowers could qualify?

A.9. Federal Reserve consumer compliance examiners use the Interagency Fair Lending Examination Procedures to detect disparate treatment, such as steering minority borrowers into more expensive loans. If an institution makes both prime and subprime loans for the same purpose, such as for home purchases, differences in the percentages of minority and non-minority borrowers in various loan product categories are evaluated to determine whether they are significant and merit further review. If an institution has subprime mortgage subsidiaries or affiliates, examiners evaluate the various loan products offered, grouped by minority and non-minority borrowers, to determine if there are differences in the percentage of applications received by applicants in different groups at the institution compared to any of its subsidiaries or affiliates. Examiners also consider whether the institution has clear, objective standards for referring applicants to subsidiaries or affiliates, classifying applicants as “prime” or “subprime,” or deciding what kinds of alternative loan products should be offered or recommended to applicants. When conducting fair lending examinations, examiners may rely upon statistical analysis, report and loan file reviews, information learned from interviews conducted with bank staff and, when appropriate, third parties, as well as additional information obtained from the institution.

I also note that the Federal Reserve, the Office of Thrift Supervision, the Federal Trade Commission, and state agencies represented by the CSBS and the American Association of Residential Mortgage Regulators, are cooperating in an innovative pilot project to conduct targeted consumer-protection compliance reviews of selected non-depository lenders with significant subprime mortgage operations. The agencies plan to evaluate the risk-management practices used for ensuring compliance with state and federal consumer protection regulations and laws, including the Equal Credit Opportunity Act and the Federal Trade Commission Act. The collaborative state/federal pilot is scheduled to begin in the fourth quarter of this year and will focus on non-depository subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities. Additionally, the states will conduct coordinated examinations of independent state-licensed subprime lenders and their associated mortgage brokers. The agencies will select a sample of entities under their respective supervisory or other authorities for review or investigation. Any violations identified, such as illegal steering, would be addressed by appropriate corrective or enforcement action.

Q.10. What are you planning to do, as LCCR requests, to ensure that the FRB “uses [the keys to resolving the ongoing foreclosure crisis] as quickly as possible?”

A.10. We and the other federal financial regulators have issued guidance to financial institutions in April 2007 and to loan servicers in September 2007, urging them to work with borrowers to avoid foreclosure when possible. We have worked with other regulators to clarify accounting and tax issues that had the potential to hinder the workout process. We also are working closely with the CSBS to make similar efforts with respect to state-regulated institutions and servicers.

Q.11. What will you do to get rid of abusive terms and practices in the subprime market so that borrowers can remain in their homes and good, responsible lenders are not placed at a competitive disadvantage?

A.11. We plan to propose rules under HOEPA addressing unfair or deceptive practices in mortgage lending before the end of the year. The four practices discussed at our recent hearing—prepayment penalties, failure to require escrows for taxes and insurance, stated income lending, and failure to consider repayment ability—are currently under review, and we have received about 100 public comments on those practices which are also under review. In addition, we expect to propose rules aimed at abuses in mortgage advertising. The proposed rules will also be aimed at ensuring the consumers get their mortgage disclosures at a time when the information is likely to be most useful to them.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER
FROM RANDALL S. KROZNER**

Q.1. The subprime mortgage market is collapsing, and I am concerned about what is happening to the real people that are at the human end of this crisis, many of whom were deceived by unscru-

pulous mortgage brokers into taking out a mortgage that they could never afford. In his testimony before this committee, Chairman Bernanke agreed with me that additional regulation of the mortgage broker industry is warranted in light of this crisis. The positions you have taken in the past on the regulatory role of the Federal Reserve suggest that you may not agree with Chairman Bernanke's views on the regulation of brokers.

I have been fighting, along with Senators Brown and Casey, to pass federal legislation that would strengthen federal regulation of all mortgage brokers. We believe that inaction is too costly, for both consumers and the markets. Our bill would establish a fiduciary duty and good faith standards for mortgage brokers and other non-bank mortgage originators, require originators to underwrite loans at the fully indexed rate, and prohibit steering, among other things.

While I recognize that you cannot take a position on a specific piece of legislation, do you agree with the principle that increased federal regulation and oversight of the mortgage broker industry is appropriate? What types of regulations would you support to advance the goals of the Federal Reserve?

A.1. Greater oversight and regulation of mortgage originators, including mortgage brokers, is an approach that has merit. A nationwide registration and licensing system for all mortgage loan originators would help limit the ability of bad actors to move to a new state after having run afoul of regulators in other states. The Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators have a promising initiative to establish a national registry. It would be appropriate for any new legislation to ensure that all individual originators are included in the same nationwide registry.

Promoting access to credit and to homeownership are important objectives, and the Board believes that responsible subprime mortgage lending can help advance both goals. Therefore, the Board believes it is extremely important to strike the right balance by seeking to protect consumers from predatory lending practices without restricting credit from responsible lenders to borrowers with shorter or lower-rated credit histories. For example, the Board is looking at whether it should issue a rule under HOEPA requiring a lender to evaluate the borrower's ability to repay a loan. It seems self-evident that adequate consideration of repayment ability is necessary. However, our experience in crafting the recent interagency guidance on mortgage lending taught us that this principle is far easier to articulate in general terms than in detailed and objective rules stating which underwriting practices constitute "adequate" consideration. This is especially true for mortgage credit underwriting, which can depend on several pertinent consumer-specific factors. We are continuing to work on this and other issues, keeping in mind that any new rules must be specific enough so that creditors can determine whether their practices are in compliance because legal uncertainty could have the unintended effect of reducing credit options for creditworthy subprime borrowers. At the same time, rules must be flexible enough to allow creditors to consider the pertinent factors and individual circumstances of particular consumers and to innovate prudently and fairly.

Q.2.a. You recently chaired a hearing at the Federal Reserve examining the Board's authority to regulate the subprime lending industry under HOEPA. As you know, the Fed was heavily criticized for its failures to exercise its authority under HOEPA to regulate the industry. And I understand that you were responsible for HOEPA during your time at the Fed.

What is your current view of the Fed's authority under HOEPA? Given the recent problems in the subprime mortgage industry, what steps do you personally plan to take in your role as Governor, should you be confirmed for the full term, to prevent these abuses from happening again in the future?

A.2.a. The Federal Reserve has responsibility under HOEPA to prohibit acts or practices in connection with mortgage loans that it finds unfair or deceptive, or designed to evade HOEPA. In June 2007, I chaired a hearing on how we should use this authority to address abuses in the mortgage market, including the subprime sector. The hearing yielded valuable insight from both industry and consumer groups. The Board also solicited written comments from the public on the practices discussed at the hearing. The Board received nearly 100 comment letters, and staff is closely examining the issues raised and discussing possible remedies. In addition, we expect to propose rules aimed at abuses in mortgage advertising. The proposed rules will also be aimed at ensuring the consumers get their mortgage disclosures at a time when the information is more likely to be most useful to them.

Q.2.b. Do you agree that the current problems in the subprime mortgage market are a result of a market failure? Do you believe that this market will be able to correct itself without additional regulation from the Fed and other regulators?

A.2.b. As you know, the market for subprime mortgages has adjusted sharply in recent months. Originators are employing tighter standards and some large lenders are pulling back from using independent brokers. Still, we must consider what we can learn from this episode to help prevent problems from recurring. Loan delinquencies have been boosted by loose underwriting standards in late 2005 and 2006 together with broader economic factors such as the deceleration in house prices. We are evaluating how improved disclosures, more effective enforcement of underwriting standards at lenders, and new rules could help prevent this situation from arising in the future. In deciding which actions to take, we will do what we can to prevent abuses without curtailing responsible subprime lending.

Q.3. You have written that you believe that TRIA, the Terrorism Risk Insurance Act of 2002, should not be extended. In a 2004 editorial in the American Banker arguing against the original extension of TRIA, you wrote, "Any federal intervention into terrorism insurance markets after 2005 should be limited to workers' compensation insurance and possible preemption of state mandates that property insurance policies include coverage for fire losses caused by terrorist attacks." Please explain why you believe that private insurance and reinsurance markets are sufficient to bear the risks of large-scale terrorist attacks. What do you propose as

a solution if the private market cannot provide sufficient insurance to ensure continued construction and economic growth?

A.3. It is important to clearly define what constitutes “large-scale terrorist attacks.” Unfortunately, the possibility exists of a catastrophic event so large that private markets and the private insurance industry would not be able to bear the associated losses. For events of that scale and beyond, government has a role to play. However, I believe that the private sector is capable of handling losses associated with smaller-scale events, and that for those risks, private markets and private institutions should be allowed maximal scope to operate and innovate. Indeed, it should be noted that under current law, the Terrorism Risk Insurance Extension Act, private insurers actually now bear a large amount of risk for terrorism attacks via their deductibles under the program, copayments beyond those deductibles, as well as the aggregate industry retention level, which is now close to \$30 billion. Moreover, the study conducted last year by the President’s Working Group on Financial Markets found that conditions in the terrorism insurance market have improved since 9/11, with take-up rates rising and premium rates declining, even as the industry’s exposure to terrorism risk has increased over time under TRIA.

In designing a strategy to manage terrorism risk, I believe that policymakers should explore options that facilitate the transfer of risk to private insurance markets and capital markets. For example, as I suggested in my 2004 editorial, modifications to the corporate tax code that reduce insurers’ costs of holding the capital required to underwrite terrorism risk could be considered.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ
FROM RANDALL S. KROSZNER**

Subprime Market

As I have stated before, and expressed recently when Chairman Bernanke was before this Committee, I do not think the Fed’s response to the subprime market has matched the severity of crisis at hand. I remain unconvinced that the Fed took every action possible when it could have. Had it used its authority, earlier, with more veracity, perhaps the subprime market would not be in the same place it is today.

Q.1. Do you think the response the Federal Reserve has taken has been an appropriate and sufficient response thus far to mitigate the decline of the subprime market?

A.1. The Federal Reserve is responding to the decline in the subprime market. We are working to help those borrowers who are in distress and reviewing all of our options to help prevent problems from recurring. To help the borrowers who may be facing foreclosure, the Federal Reserve, along with other federal supervisory agencies, has issued two statements in 2007 to encourage lenders and loan servicers to identify and contact borrowers who, with counseling and possible loan modifications, may be able to avoid delinquency or foreclosure. The community affairs offices of the twelve Reserve Banks have also provided significant leadership and assistance to foreclosure-prevention efforts.

Prospectively, we are reviewing all of our options under the law to prevent these problems from recurring, while still preserving responsible subprime lending. In doing so, we recognize that some market adjustments are already underway as originators and investors have tightened lending standards. We issued principles-based guidance on underwriting and consumer protection standards for nontraditional mortgages in 2006 and for subprime mortgages in 2007. The guidances had a positive effect on the market, particularly with respect to nontraditional mortgage loans. Many institutions took steps to conform their policies and practices to the guidances even before they were finalized.

We currently are reviewing Truth in Lending rules to improve disclosures. Improving disclosures, however, requires extensive consumer testing and trials, and it may take some time to do it right. In addition, we are committed to using our rulemaking authority under the Home Ownership and Equity Protection Act to propose additional consumer protections later this year. We held a public hearing in June and solicited comments from the industry and consumer groups. We are taking great care to address the abuses without unduly constraining responsible credit.

Q.2. You have had an integral role in overseeing the Federal Reserve's authority under HOEPA. Can you describe the extent of your involvement in developing the Federal Reserve's response to the subprime crisis?

A.2. I have been a member of the committee of the Board that oversees the Division of Consumer and Community Affairs (DCCA) since the summer of 2006 and have chaired the committee since March 2007. I also have been a member of the committee of the Board that oversees the Division of Banking Supervision & Regulation since I arrived at the Board in March 2006 and have chaired this committee since March 2007. When I arrived at the Board, the inter-agency proposal on guidance for non-traditional mortgages had already been published (late December 2005) and, as a committee member, I was engaged in responding to comments and shaping the final guidance. I then assumed the primary responsibility in early 2007 to work with the other federal banking agencies, in coordination with the CSBS, to develop the subprime guidance that the agencies put out for comment in early March 2007 and finalized in late June 2007. I participate in our triennial meetings of the Consumer Advisory Counsel where we have valuable dialogue and debates among industry participants and consumer representatives on a variety of consumer issues, including subprime mortgages. In June, I chaired a day-long HOEPA hearing involving a wide spectrum of participants to gather information about potentially unfair and deceptive practices in the subprime mortgages. In particular, we focused on four areas: prepayment penalties, low- and no-documentation mortgages, failure to escrow for taxes and insurance, and the ability to repay. The information we obtained at that hearing and from the approximately 100 written comments that we subsequently received have been very helpful as the Board formulates additional rulemaking. I have been working very closely with the staff to develop these proposals, which we expect to issue in December.

Q.3. Do you think that, given the benefit of hindsight, the Federal Reserve could have done more to stem the fallout of the subprime market? Didn't we have a sense of how bad the subprime turmoil could be?

A.3. The Federal Reserve and other federal supervisory agencies have been providing principles-based guidance and supervisory oversight to the lenders that we supervise for many years. We first issued guidance on subprime lending in 1999 and again in 2001. When problems surfaced concerning non-traditional mortgages in 2004, we issued guidance on those. We then developed guidance for subprime mortgages, especially for adjustable-rate products. We also created disclosures that lenders were required to provide to borrowers to help them better understand mortgage products. Still, many subprime adjustable-rate mortgages made in late 2005 and 2006 were originated with very high cumulative loan-to-value ratios and less documentation of borrower income, as loan performance stayed strong amid continued house price appreciation. The sharp deceleration of house prices since 2005 has left many of the more-recent borrowers with little or no home equity and has led to higher delinquencies. In this situation, some borrowers found that refinancing—the typical way for many subprime borrowers to avoid large scheduled interest rate resets—has been difficult or impossible and some borrowers (particularly owner-investors) may have found that walking away from their properties was the best option.

Q.4. You chaired a hearing on June 14th of this year that was the last of five hearings examining possible actions under HOEPA. What has the impact of those hearings been thus far? What results from those hearings can we expect?

As we heard from Chairman Bernanke recently, he expects the Fed to propose additional rules under HOEPA later this year. Are you involved in developing additional action under HOEPA that the Fed may take or recommend? Can you describe what you expect those efforts to result in?

A.4. As oversight Governor for the Division of Consumer and Community Affairs at the Federal Reserve, I am very involved in the HOEPA rulemaking. As you noted, I chaired the hearing on June 14, 2007, on issues related to subprime mortgages. The hearing gathered information on how the Board might use its rulemaking authority under HOEPA. We heard from representatives of consumer and community groups, state officials, lenders and mortgage brokers, as well as secondary market participants. These witnesses provided valuable information about certain practices prevalent in subprime lending, including stated income lending, prepayment penalties, failure to escrow for taxes and insurance, and making loans without assessing the borrower's ability to repay. I anticipate that the proposed rules we will issue in December are likely to address these issues.

Earlier hearings held in 2006 have also provided valuable information which we have used in a number of ways. For example, the 2006 hearings indicated that consumers need better information about the risks of nontraditional mortgages such as interest only and payment option ARMs. The Board is committed to reviewing mortgage disclosures using consumer testing to make disclosures

more useful to consumers; however, because testing takes time, in the short run the Board and OTS have updated the Consumer Handbook on Adjustable Rate Mortgages to include information about nontraditional mortgage products.

Q.5. Are other areas of the subprime crisis that the Fed has not yet addressed?

A.5. In addition to our HOEPA rulemaking, we are engaged in a rigorous review of the mortgage-related rules under Regulation Z, which implements the Truth in Lending Act (TILA). We intend to issue proposals before the end of the year to ban several deceptive advertising practices and require important consumer disclosures earlier in the mortgage process to better enable consumers to compare and shop among loan products.

Q.6. The majority of subprime loans are originated by mortgage brokers, yet the Federal Reserve has not yet cracked down on these abuses. Do you think this is an area the Federal Reserve should look at? Should the Federal Reserve do more to hold lenders responsible for abuses by the brokers who originate their loans?

A.6. The states are the primary regulators of the mortgage brokers they license, and they have promising initiatives underway to address concerns about mortgage brokers' activities. Many states are strengthening their licensing requirements and oversight of brokers in response to the problems in the subprime market. The Federal Reserve is working with the states where appropriate. For example, the Conference of State Bank Supervisors (CSBS) will be looking at the activities of brokers in our pilot program to look at the actions of non-bank subsidiaries of bank holding companies. The CSBS also has developed a nationwide registration and licensing system for mortgage brokers and mortgage originators not affiliated with depository institutions. Such a system should limit the ability of bad actors to move to a new state and to continue engaging in irresponsible practices there, after having run afoul of regulators in their old states.

We and the other federal supervisory agencies do expect our institutions to have systems and controls in place for establishing and maintaining relationships with brokers and other third parties, including procedures for due diligence. Institutions are expected to have adequate oversight over third parties to monitor quality of originations and compliance with the institution's underwriting standards and applicable laws and regulations.

Whether it is appropriate as a general matter to hold a lender liable for the acts of brokers—who are essentially independent contractors—raises many issues, including whether lenders are in a position to perform due diligence to guard against undue risk of liability.

TRIA

In 2004, you wrote an article in which you said, "If Congress does decide to extend the Terrorism Risk Insurance Act, the program's scope should not be expanded, and the amount of losses that the private sector must bear before federal assistance kicks in should increase annually over the duration of any extension." Obvi-

ously, Congress did decide to extend TRIA, and as you know, we are currently grappling with the next steps for this legislation.

Q.7. Can you explain your current views on TRIA? Do you support further extensions of TRIA?

A.7. On the whole, my views on TRIA have not changed markedly since I wrote that article in 2004. In particular, I continue to oppose expansion of the role of the federal government in the terrorism insurance market, particularly for attacks using conventional materials. Indeed, last fall, the study conducted by the President's Working Group on Financial Markets reported that market conditions have improved since the terrorist attacks of 9/11, with take-up rates rising as premium rates have fallen. These improvements have occurred against the backdrop of the TRIA (and TRIEA), which has raised the private sector's level of exposure to terrorism losses over time; however, the continued federal involvement may have hindered the development of private market solutions during this time as well. In short, I would be more inclined to support temporary extensions of TRIA that reduce, rather than expand, the role of the federal government in the terrorism risk insurance market.

Q.8. How much of the burden do you think the private sector should bear for providing terrorism insurance? Do you think terrorism risk insurance is possible without government involvement?

A.8. Unfortunately, the possibility exists of a catastrophic event so large that private markets and the private insurance industry would not be able to bear the associated losses. For events of that scale and beyond, government has a role to play. However, I believe that the private sector is capable of handling losses associated with smaller-scale events, and that for those risks, private markets and private institutions should be allowed maximal scope to operate and innovate.

Q.9. Wouldn't you agree that short term authorizations lead to uncertainty and instability within the insurance market? What about the ripple effects, for example on real estate, housing, construction, mortgage-backed securities, etc?

A.9. Although short-term authorizations may lead to some uncertainty for commercial insurers and policyholders, I am not aware of evidence that they have significantly affected economic activity or the stability of financial markets.

Access to Capital

Over the last few years, the Federal Reserve, the Small Business Administration and others have conducted studies that reveal minorities have unequal access to credit for small business development, even when factors such as credit history and net worth are comparable to non-minorities.

Q.10. In your opinion, in addition to promoting financial education, how can we improve "access to capital" for minority-owned businesses?

A.10. Minority-owned businesses play an important role in the growth and expansion of our economy. Many of the Federal Re-

serve Banks have targeted programs in support of minority and small business development. As one example, the Federal Reserve Bank of Boston in 2007 developed a program to address the need for small loans by small businesses. The Massachusetts Banking Partners Small Business Loan Program is a state-wide initiative in partnership with local banks to bring loans and technical assistance to small businesses that generally have twenty or fewer employees, are located in low- or moderate-income census tracts, or require small loans. To promote participation in the program by banks and businesses, the Community Affairs program at the Federal Reserve Bank of Boston hosted a series of forums across the state, published an article featuring the loan program and provided technical assistance to lenders.

The Federal Reserve Bank of St. Louis also sponsored an initiative to foster entrepreneurship. Beginning with a survey of the local climate for entrepreneurial development, which was conducted in a number of cities including Arkadelphia, Tupelo and Memphis, the Bank has held forums and workshops to help entrepreneurs move their businesses to the next stage of development. The Bank also developed a resource guide and highlighted opportunities for entrepreneurs to access technical assistance and expertise.

The Federal Reserve is also committed to supporting the growth and expansion of minority-owned depository institutions. Of the approximately 200 such institutions nationwide, 20 are supervised by the Federal Reserve. In August, I spoke at the Interagency Minority Depository Institutions National Conference which was hosted in Miami. At that time, I announced a new training and technical assistance program the Federal Reserve is launching to address the needs of minority institutions. The program will include workshops, self-directed educational programs, and a web-based resource and information center. The Board is partnering with the Federal Reserve Bank of Philadelphia in the development of this program, which will be launched on a pilot basis this fall. The full program will be launched in early 2008.

Q.11. What role can the Federal Reserve play to encourage institutions to engage in expanding access to capital, both for individuals and businesses?

A.11. The Federal Reserve Board and the twelve Federal Reserve Banks each have established Community Affairs Offices. The function of these offices is to promote community development and access to credit. Each of the Reserve Banks develops an understanding of the needs of the communities within their District, by conducting research and outreach. The data developed and information gathered are then published in various media and academic journals and magazine articles, as well as presented in workshops and forums which can help meet the informational needs of the financial institutions in the respective Districts. The data which is developed provides a framework for developing programs and services. Those informational products are designed to foster depository institutions' provision of credit and banking services to traditionally underserved markets, increase consumers' awareness of the benefits and risks of financial products and encourage development

of new products, and promote among policy makers, community leaders and the private sector a better understanding of the practices, processes and resources that result in successful community development programs.

For issues which cut across several Districts, the Reserve Banks may offer programs collaboratively. For example, in 2006 the Reserve Banks developed a series of programs on the challenges of asset-building in low- and moderate-income communities. The Reserve Bank System also co-sponsored a research forum to feature academic research on issues related to asset building such as financial literacy, manufactured housing, public policy and savings products. This year, all twelve Reserve Banks are undertaking a project with the Brookings Institution, in which each Bank is conducting a case study of a targeted neighborhood with a high concentration of poverty. Those case studies will provide comparative data to help the Federal Reserve System understand better the provision of financial services in extremely low-income communities.

Q.12. What actions would you recommend the Federal Reserve take in this area?

A.12. See answer to 11 above.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR AKAKA
FROM RANDALL S. KROSZNER**

Q.1. Our modern, complex economy depends on the ability of consumers to make informed financial decisions. Without a sufficient understanding of economics and personal finance, individuals will not be able to appropriately manage their finances, evaluate credit opportunities, and successfully invest for long-term financial goals in an increasingly complex marketplace. What must be done to ensure that Americans have the knowledge and skills necessary to make informed financial decisions?

A.1. Consumers need to be well-informed in order to make decisions about the products and services that best suit their needs, particularly given the highly sophisticated and competitive financial services marketplace in the U.S. Informed consumers are essential to efficient market operations. Accordingly, the Federal Reserve has a long-standing commitment to promoting consumers' understanding of financial products and services. In addition to writing consumer protection rules and disclosure requirements to ensure consistency in the information that consumers receive when they obtain a loan or other banking service, we also publish numerous consumer information brochures that provide information about specific products that are available at no charge to the public by request or through our website at www.federalreserve.gov/consumerinfo/default.htm.

The Federal Reserve System also actively participates in various national, regional, and local initiatives to support financial education efforts. For example, Board staff advise the federal Financial Literacy and Education Commission, NeighborWorks America®, and the JumpStart Coalition, while staff in the Community Affairs and Public Affairs Offices of the Federal Reserve Banks work with coalitions that include community organizations, youth education

coalitions, and financial institutions to help further financial education. A listing of many of the Federal Reserve's offerings and recent activities in financial education can be found at www.federalreserveeducation.org, as well as in Chairman Bernanke's testimony on the topic in May 2006 at www.federalreserve.gov/newsevents/testimony/bernanke20060523a.htm.

Additionally, the Federal Reserve recognizes the value of expanding the body of research to increase the understanding of the effectiveness of financial education in general, as well as the efficacy of the various approaches to program design and delivery. Federal Reserve Board researchers have published studies on various aspects of financial education, several of which can be found at www.federalreserve.gov/research/staff/hogarthjeannem.htm. In addition, the biennial Federal Reserve System Community Affairs Research Conference has highlighted research on the effectiveness and role financial literacy programs play. Further, the Federal Reserve has sought to create a clearinghouse of such research to ensure easy access to literature on the topic. These studies can be found under the Financial Education Center section of the Federal Reserve Bank of Chicago's Consumer and Economic Development Research & Information Center website at www.chicagofed.org/cedric/cedric_index.cfm.

Q.2. Approximately 10 million households in the United States do not have accounts at mainstream financial institutions. Unfortunately, too many of these households depend on high-cost fringe financial services. They miss out on opportunities for saving, borrowing, and lower cost remittances found at credit unions and banks. What must be done to bring these households into mainstream financial institutions?

A.2. Many benefits can accrue to consumers by establishing a relationship with a depository institution, including potential cost savings and access to savings vehicles that non-bank financial service providers cannot provide. In addition, unbanked or underbanked populations may represent new market opportunities to depository institutions. The Federal Reserve has dedicated resources to engage in outreach, education, and technical assistance to help increase awareness of the challenges and opportunities in reaching the unbanked.

The Federal Reserve System has undertaken initiatives to gain a better understanding of the unbanked and to highlight opportunities for depository institutions to reach out to this market through the financial education activities and programs offered by the Federal Reserve's Community Affairs Offices throughout the country. For example, the Federal Reserve Banks of Philadelphia and St. Louis are convening conferences in the coming months to discuss innovative strategies for reaching the unbanked and developing products that are responsive to their needs. Several Federal Reserve Banks have examined the challenges immigrant communities confront in accessing financial services through their publications, conferences, and research, including the Federal Reserve Banks of Boston, Chicago, and San Francisco. The Federal Reserve System engages in partnerships to help increase awareness of the issues

and how they may differ in various markets. For example, the Board and several of the Federal Reserve Banks have recently worked with the Financial Literacy and Education Commission to develop a series of four regional workshops in Chicago; Edinburg, Texas; Seattle, and New York to address the challenges and opportunities in reaching the unbanked, as well as a forum on reaching and serving Asian communities. Given the importance of this issue, the Federal Reserve will continue to engage in efforts to bring unbanked consumers into mainstream financial institutions.

Q.3. I am deeply concerned that too many working families are taken advantage of by unscrupulous lenders through payday loans. What must be done to restrict payday loans and expand access to affordable, small loans?

A.3. As a member of the Federal Reserve Board, I support efforts to ensure that consumers, including working families, are not taken advantage of by unscrupulous lenders. None of the state member banks supervised by the Federal Reserve System engage in payday lending. Nonetheless, we have participated with the other federal supervisory agencies in issuing interagency guidelines that address matters related to payday lending. In addition, Board staff consulted extensively with the Department of Defense (DoD) when it developed a rule implementing the consumer protection provisions of section 670 of the John Warner National Defense Authorization Act for Fiscal Year 2007, also known as the Talent Amendment, which was effective October 1, 2007. The final DoD rule contains limitations and requirements for payday loans, motor vehicle title loans, and tax refund anticipation loans extended to active duty service members or their dependents by any creditor engaged in the business of extending such credit and their assignees.

The Federal Reserve works to expand access to affordable small loans in many ways. We encourage banks to expand access to affordable small loans through our supervision of banks pursuant to the Community Reinvestment Act (CRA). Guidance issued by the Federal Reserve Board and other supervisory agencies provides that making affordable small unsecured loans with reasonable terms will receive favorable consideration under the CRA. Further, the Federal Reserve System's Community Affairs staff continues to be involved in programs to help low- and moderate-income consumers make better financial choices. Several of the Reserve Bank community affairs programs host roundtables, help convene or provide advisory services to groups educating consumers about the problems inherent in payday lending, and in some cases, promote alternatives.

Q.4. Too many working families have their Earned Income Tax Credit benefits needlessly reduced by high cost-refund anticipation loans (RALs). What must be done to restrict these predatory loans and encourage alternatives to RALs?

A.4. The Federal Reserve is actively involved in efforts to provide financial education and programs to help low- and moderate-income consumers make better choices, as explained in the previous answer. The Federal Reserve also engages in research that explores issues relating to consumers' use of financial services, in-

cluding subprime loans and consumer literacy. Research providing information about the impact of credit products, policies and programs can be used in formulating future policies.

With respect to the cost of credit, the Federal Reserve does not have the authority to set loan fees or interest rates, but we do develop and enforce the disclosure requirements relating to terms and cost associated with loans subject to Regulation Z, which implements the Truth in Lending Act. As noted, the Talent Amendment does include restrictions on tax refund anticipation loans, payday loans and motor vehicle title loans, as defined by DoD, extended to active duty service members or their dependents. The rule, which was issued by DoD after consultation with Federal Reserve Board and other agencies' staff, limits the amount that the creditor can charge in interest and fees, including charges imposed for single premium credit insurance and other ancillary products sold in connection with covered transactions.

Q.5. I am concerned that consumers are not provided with enough information about the long-term consequences of making only the minimum credit card payments. What must be done to ensure that consumers are adequately informed of the true cost of making only the minimum payment?

A.5. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Bankruptcy Act") requires that creditors put on the periodic statement a toll-free telephone number to obtain an estimate of the time to repay if the consumer makes only minimum payments. The Act permits, but does not require, creditors to provide a more precise estimate based on the customer's actual account terms. In May 2007, the Board issued a proposed rule implementing the Bankruptcy Act. In the proposal, the Board recognized that the Act does not require an estimate based on actual account terms or placing the estimate on the periodic statement. Nonetheless, the Board strongly encouraged creditors to provide the actual repayment disclosure on periodic statements by creating incentives in the form of relief from other requirements. The Board also solicited comment on whether the Board should take other steps to provide incentives to creditors to use this approach. A recent study conducted by the GAO on minimum payments suggests that certain cardholders would find the actual repayment disclosure more helpful than the generic disclosures required by the Bankruptcy Act.

**RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM ELIZABETH A. DUKE**

Q.1. Ms. Duke, in your appearance before the Committee, you stated that you are a strong believer in the Fed's dual mandate for maximum employment and price stability. Are there approximate figures for the nation's unemployment rate and inflation rate that match what you believe to be maximum employment and price stability? If so, can you share what those are?

A.1. I do not have any specific unemployment rate in mind. I am not sure there is one specific number that would hold true under all conditions. When I was in school, I was taught that 6% constituted full employment. Yet, we have seen employment rates sub-

stantially below 6% that did not seem to contribute to higher inflation. Many economists now believe the productivity growth rate impacts the rate of employment that can be sustained without leading to higher inflation. So the unemployment rate would need to be evaluated in the context of productivity growth and the overall strength of the economy.

With respect to inflation, I would think the Fed's currently stated comfort range of 1–2% would be a proxy for price stability. I don't believe that zero inflation makes a reasonable objective as overshooting it could lead to deflation. And this range appears to have been successful in lowering long term inflation expectations in the marketplace. In my personal and business financial planning, I have used an expected long term inflation rate of 2–3% to make decisions. I believe my expectations are consistent with the market expectations that can be inferred from the pricing of TIPS securities.

Q.2. Ms. Duke, can you inform the Committee of any periods in American history where you believe that maximum employment was not being reached or that price stability was not achieved? During those periods, what actions do you believe the Fed should have undertaken to achieve its mandate?

A.2. Clearly, price stability was not achieved in the 1970s and early 1980s. Ultimately, the Fed did act to reduce the money supply, drive up interest rates and finally bring inflation down to the levels we enjoy today. However, it was an extremely painful process for consumers, businesses and the financial system. And, I suspect, it was a difficult time for the Fed as well.

Q.3. Ms. Duke, how do you explain the Federal Reserve's findings from the HMDA data that in 2005, 54.7% of African-American borrowers and 46.1% of Hispanic borrowers got high-priced loans when buying a home compared to 17.2% of non-Hispanic whites?

A.3. I do not have a full explanation, but some of the differences may relate to information not included in the HMDA data. That said, I would fully support use of the Fed's analytical resources to try to uncover and quantify the reasons for the disparity. It is important to understand the causes in order to be able to change the outcome.

Q.4. In the Fed's analysis of the data, significant racial and ethnic differences remained unexplained even after accounting for other information reported in the HMDA data. The Fed found that borrower-related factors accounted for only about one-fifth of the disparity. Do you believe that there is racial discrimination in the mortgage market? If so, how do we root it out of the system? What specific additional steps should the Fed undertake to do so? If you do not believe that there is racial discrimination, how do you explain these racial disparities?

A.4. Within the banks with which I have been associated, I have observed a high level of management attention, time, effort, money and resources invested in identifying and avoiding or eliminating potential racial discrimination. Underwriting and pricing decisions are increasingly based on statistical models that should be racially neutral. Regulators regularly conduct reviews and recommend im-

provements to bank processes and scoring systems. Most banks conduct internal reviews of their own HMDA data with particular emphasis on variations from norms. And regulators have been able to use the data to schedule targeted reviews of lending practices.

It is deeply troubling that despite all this effort and attention, disparities in lending still exist. We need to continue to be vigilant in our efforts to eliminate all bias in lending. But I think we also need to investigate all other possible explanations for disparity. Because we cannot solve a problem unless we can accurately identify its cause.

Some other factors that I have seen suggested as contributors would be:

- Differences in financial literacy and sophistication;
- Differences in creditworthiness not reflected in HMDA data;
- Differences in marketing methods and receptiveness to certain marketing practices; and
- Distrust of traditional banks.

I am sure there are other possible factors. And I realize that some of these may prove ultimately to have no impact. But I think the issue is important enough that we should pursue all possible explanations in an all out effort to finally change the results.

The Fed's role should be first as a vigilant regulator. The Fed should continue to actively monitor activities of banks under its supervision. It should continue to work with banks to further improve their own efforts. And, when the Fed finds evidence of illegal activity, it should promptly refer such cases to the Justice Department. Additionally, the Fed should use its research and data analysis capability to continue to work on diagnosing the possible contributing factors and potential solutions to this serious problem.

Q.5. Ms. Duke, do you think that the 2001 Bush tax cuts have resulted in an increase or decrease in real federal revenue?

A.5. I have neither the expertise nor the information to be able to answer this question.

Q.6 As you know, only the Federal Reserve, the Office of Thrift Supervision, and the National Credit Union Administration currently have the authority to promulgate a rule dealing with unfair or deceptive acts or practices. In your view, should the other agencies be given the same authority? Please explain your reasoning.

A.6. Your question appears to refer to rule-writing authorities under the Federal Trade Commission Act. I do not believe giving additional agencies rule-writing authority under this act will necessarily speed up the process of issuing sensible regulations or improve the effectiveness of the ultimate regulations.

Under the FTC Act, four agencies—the Fed, OTS, NCUA, and the FTC—currently have authority to write rules that apply to a portion of the financial industry. Ideally, all lenders should be subject to the same regulations. The more entities there are writing rules separately, the greater the opportunity for entities engaged in a specific practice to “charter shop” those practices and undermine the regulation. If, on the other hand, other rule-writers were introduced, and all were required to issue the same rules, it could be

harder, not easier, to achieve sensible rules of general applicability and these rules could be slower in coming.

I believe it is preferable for the Federal Reserve to use other authorities it has, under the Home Ownership and Equity Protection Act, to write rules related to unfair or deceptive mortgage lending activities. Rules written under these authorities would apply to all mortgage lenders. As you know, Chairman Bernanke has pledged to issue proposed rules under these authorities for public comment later this year. I support that process.

With respect to mortgage lending, I believe there is a much larger need to address the regulatory environment outside insured depository institutions than there is to redistribute the regulatory responsibilities within the regulatory structure governing insured depository institutions. More sub-prime loans have been originated outside the federal supervisory structure than inside it. Any regulation governing sub-prime lending will need to be accompanied by an effective supervision and enforcement regime.

Q.7. Ms. Duke, as you know the FOMC voted unanimously in its August meeting to keep Interest rates constant and in the accompanying statement that their “predominant policy concern remains the risk that inflation will fail to moderate as expected.” Over the next ten days, there were significant disruption in the equity and bond markets that caused the Fed to reverse course, cut the rate at the discount window by 50 basis points and issue the following statement ten days after their August meeting: “Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. In these circumstances, although recent data suggest that the economy has continued to expand at a moderate pace, the Federal Open Market Committee judges that the downside risks to growth have increased appreciably. The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.”

Do you believe that the FOMC made a mistake at their original August meeting? Do you believe that the predominant policy concern remains the inflation in light of the events since the August meeting of the FOMC? If you had been a Fed Governor, what actions, if any, would you have taken that were different from those taken by the Fed Governors?

A.7. I don’t believe anyone could have predicted the speed or the pervasiveness with which the credit markets dried up. I certainly don’t believe anyone could have predicted the timing. And I don’t believe anyone knows yet what the ultimate impact will be on the overall economy.

The discount window is the most appropriate tool available for use in a credit/liquidity crunch. It was, in fact, designed to be used in the case of a run on a bank. In this case, the “run” took place much more outside than inside the banking system. I don’t think we know yet how effective the Fed tools will be outside the banking system. The lowering of the discount rate combined with relaxation of the terms, expansion of collateral eligibility, and generally wel-

coming banks to use the discount window all combined to bring some confidence back into the market.

My primary concern, if I had been a Fed Governor during the last month, would be the gathering of as much information as possible on what impact turmoil in the financial markets was having on real economic activity.

Based on my observations and understanding of the situation, I do think the Fed has acted appropriately in recent weeks:

Q.8. Ms. Duke, at your confirmation hearing you expressed concern over the state of some subprime borrowers, saying: "what worries me is the very specific situation of a borrower who, for whatever reason, is in a loan that they cannot pay and not sure what to do, where to do it. I think some of the things that we will need to take a look at are finding a trusted third-party intermediary." Can you please explain in more detail what policies about to be enacted address your concerns? Please include what role you think the Fed can and should play in those policies.

A.8. The keys to successful work-outs are early identification of the problem, accurate information and communication. Many borrowers, especially those in trouble, do not want to talk to the lender. They might not trust the lender or they might not understand the options available for work-out. And in today's web of investors and servicers, they might not even be able to find the right person. There are a number of state, local and community-based organizations devoted to financial counseling and, specifically, to the housing markets. They would be in a position to help these borrowers, but I am sure they find themselves even more under-funded and under-staffed than usual in today's environment. So any resources provided to these groups would be helpful.

Any policies that would help borrowers identify these groups and encourage them to seek assistance would also be helpful. I have been horrified, however, to read of the scams perpetrated by criminals posing as debt assistance groups. Justice should be swift and penalties severe for that crime. We would need policies in place to ensure that the places we send borrowers for help have both expertise and the intent to actually help.

Servicers, as the intermediaries between borrowers and investors, are going to play a key role in the resolution of current loan problems. Servicers will need the legal, financial and human resource capacity to resolve troubled debt restructures. The banking regulators have recently issued guidance encouraging bank servicers to anticipate and work toward successful loan restructures. But not all servicers are financial institutions or subject to the recent guidance. Some servicers may actually be in a better position to accept reduced principal payouts in satisfaction of loans than they are to modify the terms of the loans. Lenders willing to finance reduced payouts would speed the resolution of such cases. CRA and FHA programs could be used to entice lenders to make loans available. Care must be taken, however, to limit such assistance to cases where there is documented income sufficient to make the payments on a fixed rate loan, the borrower has a past history of responsible payments, and the property is a primary residence.

I would also favor relief from taxes on debt forgiven on a primary residence.

We have seen recently the warning signs that financially troubled servicers could actually increase the number of loans that result in adverse action against borrowers. We must ensure that payments made to servicers are recorded and forwarded promptly to lenders, insurers and taxing authorities. It will be time-consuming and, in some cases, impossible to reverse consequences to borrowers whose payments were not properly credited. It will be especially difficult to defend the requirement for escrow of taxes and insurance if those payments are not forwarded in a timely manner.

The role of the Fed in this process would probably be limited to identification of barriers to loan work-outs such as servicer agreements and encouragement of banks to participate in workout lending, as in recent guidances issued by the Fed and others. Also, the Reserve Banks already maintain close ties to the local markets within their districts. Their knowledge of local market conditions, understanding of the loan workout process and existing community development activities could be very helpful across the country.

Q.9. Ms. Duke, you have been a very strong supporter of allowing banks to engage in real estate. You were quoted in a newspaper story that “Buying a house is probably the largest financial transaction most people engage in. It makes sense that financial institutions be able to own the agencies that produce that transaction.” Can you share some more detail as to why you hold this opinion?

A.9. The purchase of a home is the largest and most important financial transaction entered into by most individuals. Equity build-up in that home is the greatest contributor to the accumulated wealth of most individuals. The purchase and financing of a home are increasingly linked, both in the marketplace and in the consumer’s mind. And brokerage is an intermediary activity. However, I have never advocated that banks be allowed to engage in the ownership or development of real estate.

Q.10. As a Fed Governor you would have the ability and responsibility to increase competition in many industries, provided they were to the benefit of consumers and would not risk the safety and soundness of the financial system. You were also quoted saying that allowing banks to enter into real estate would mean, and I quote—“more competitors, which means a better deal for the consumer.” Is it your intention to advocate this position and others that you believe will benefit consumers, if you are appointed to the Fed Board of Governors?

A.10. I advocated that position as a banker and as Chairman of the American Bankers Association. If I am confirmed, I would not advocate this or any other position. If this decision came before me in my role as a Governor, I would decide it on the basis of the law. In this case, I believe Gramm-Leach-Bliley established a mechanism and criteria for such decisions. In any actions I took as a Governor, I would be guided by the responsibilities and authorities given to the Fed by Congress and by my best judgment of the public policy outcome, based on all of the evidence and public comments before me at the time.

Q.11. Ms. Duke, as Chairwoman of the American Bankers Association you wrote a regular column in the ABA Journal. You wrote a column entitled, “Singing the Regulatory Blues” in which you discussed Sarbanes-Oxley, the FACT Act, the Patriot Act and the GLB Act and stated, and I quote—“The goal, as John Byrne, the center’s director, put it, is ‘to roll back regulation.’” Ms. Duke, what specific regulations do you think ought to be rolled back?

A.11. I would first like to recognize the ongoing efforts of many to reduce and streamline our existing regulatory framework. The regulatory agencies have been engaged individually and collaboratively in reviewing existing regulations. This committee put much thought and effort into the regulatory relief bill that passed last year. The SEC and PCAOB have been engaged in an ongoing effort to reduce the burden of Sarbanes-Oxley Section 404 while retaining investor protection. I doubt that a year passes without at least one hearing in this committee related to regulatory burden.

And I would like to reiterate my earlier pledge that if I am confirmed, nothing would preclude me from proposing, enforcing or voting in favor of any regulation.

The cost of regulatory compliance has concerned bankers for as long as I have been in banking. It would be an easy fix if we could all point to one especially burdensome regulation as the source of the problem. Unfortunately, it is the sum of many different regulations that create the overall burden. When I was a community banker, I thought small banks had the true burden because we had such limited resources. When FDICA passed, the number of implementing regulations exceeded the number of employees in my bank by 2. When I was with larger banks, I realized that the compliance task was equally difficult, primarily due to operational complexity and long lines of communication.

Numerous studies have attempted to quantify regulatory compliance costs. However, in recent years, the discussion has turned from purely cost to regulatory risk and uncertainty. I’ll offer a few examples.

Smaller banks, in particular, struggled with Sarbanes-Oxley Section 404 compliance. And many who were not required to comply under the law felt examiner pressure to comply anyway.

The expanded anti-money laundering responsibilities created by the Patriot Act have elevated regulatory risk. All banks are committed to detecting and reporting suspicious activity, but few banks are certain they know how to do so adequately. One area where banks are particularly uncertain is in the servicing of money service businesses. As business types are identified as high risk, banks that feel unable to monitor the risk at a reasonable cost are stopping service to those businesses.

Finally, I mentioned payment system regulation in my testimony. Electronic payments are coming of age, surpassing paper payments in the last few years as the payment of choice. Check 21 and ACH conversion promise to accelerate this change. As each payment method has evolved, so has its body of regulation. The result is a complicated tangle of forward collection and return rules and timetables. If they are confusing to bankers, they must be even more confusing to consumers. The Federal Reserve System is at the heart of the payment system in this country. If confirmed, I would

like to devote time to studying the regulations and procedures surrounding payments with the goal of proposing changes that would make the payment system more efficient, understandable and predictable.

Q.12. Ms. Duke, I understand that you were President of a thrift when the OTS decided to increase its exemption to \$1 billion for streamlined CRA compliance. Do you agree with the OTS's decision? Do you think the Fed should consider something similar?

A.12. I was not President of a thrift. When I was President of a community bank, I did ask the Fed on numerous occasions to consider increasing the bank size for streamlined CRA exams. I did so out of concern for the resources required to meet the documentation requirements of the large bank exam. (As it turned out, soon after the community bank where I was President passed the \$250 million threshold, it was purchased by a \$50 billion bank.)

Q.13. Hedge funds perform an important role in the capital markets. Yet some have raised concerns about their potential impacts to pension funds and retirees. On February 22, 2007, the President's Working Group on Financial Markets, of which the Fed is a member, released a set of principles and guidelines "to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds." The agreement concentrates on investor protection and systemic risk concerns. The PWG determined that additional regulation was not needed. A recent column in The Chicago Tribune stated: "When the hedge fund Amaranth Advisors LLC flamed out last year after disastrous bets on energy prices, San Diego County's retirement fund was among those burned. Losses to its portfolio were estimated at \$100 million . . . [This] has, however, raised concerns about the safety of retirement money and stirred debate on whether more oversight is needed."

Last October, the then Chief Economist of the IMF observed that "a number of state pension funds were invested in a risky hedge fund like Amaranth. Diversification into such alternative investments can be a valuable component of an overall investment strategy, if it is carefully thought out. The problem is that all too often, it takes place as a form of herding and late in the game . . . when the good hedge- or commodity funds are closed to investment . . . new unseasoned hedge or commodity funds are started precisely to exploit the distorted incentives of the pension or insurance fund managers who queue like lemmings to dutifully place the public's money. Thus far losses from isolated failures have been washed away in diversified portfolios and the public has not noticed. Will this always continue?"

How would you respond to these concerns? Do you agree with the PWG position that further regulation is not needed? Would you closely monitor the implementation of this guidance, working with the other PWG members, to preclude systemic problems from being caused by hedge funds?

A.13. I think the PWG brings together the right expertise and the right authority to monitor and make recommendations about the regulation of hedge funds and private equity. I do believe this market will continue to require close monitoring.

I share the concern that the “sophisticated investors” may not turn out to be sophisticated enough. I actually sat on a university foundation investment committee when the question of investment in private equity was before us. We were being encouraged by the example of other foundations that were using private equity investments. My opinion was then, and is now, that the foundation shouldn’t invest in anything it couldn’t adequately monitor. I expect that conversation has been mirrored in foundation and pension board rooms around the country for years. While losses suffered by pension funds or foundations might not rise to the level of systemic risk, the losses might indeed require public policy action.

Q.14. The Committee recently passed legislation to improve the regulation and transparency of the private educational loan market—the fastest growing segment in the \$85 billion student loan market. Among the growing trends in the private student loan market is the practice of some lenders using non-individual data—like a school’s default and graduation rate—in the underwriting used to establish the rate a student borrower is offered. It’s a practice that is eerily reminiscent of mortgage “redlining”, when mortgage rates and products were denied to people based on where they lived rather than their individual creditworthiness. One of the ways Congress addressed mortgage redlining was through enactment of tough anti-discrimination laws and improving transparency of market practices in the form of HMDA (the Home Mortgage Disclosure Act), which the Federal Reserve oversees.

Do you think HMDA has been an important tool to promote transparency?

Do you think a disclosure, transparency regime for private student loans similar to HMDA is a more useful approach to addressing concerns about potential “redlining” in the private student loan market or do you believe we should prohibit the practice of underwriting based on factors such as the school one chooses to attend?

A.14. Most banks engage in real estate lending to some degree. HMDA data has made it possible to compare lending data across a wide spectrum of lenders. Also, the CRA assessment and examination process focuses on the geographic distribution of credit. The two have combined to eliminate geographic “redlining.”

Student lending is a specialty business engaged in by a smaller number of institutions. It is difficult to comment on the potential effectiveness of HMDA-type reporting without knowing the data that would be collected and reported and the intended use of the data. If the purpose is to eliminate a specific practice, prohibiting the practice and enforcing the prohibition may be more effective than reporting.

Q.15. Ms. Duke you served as a Director at the Federal Reserve Bank of Richmond. During that time, you worked closely with Richmond Bank President Broaddus. Mr. Broaddus was known as one of the Fed’s biggest inflation hawks. Do you share Mr. Broaddus’s views and concerns about inflation? Are there any examples in which your thoughts on monetary policy differ and if so, can you please inform the Committee of the specifics of those instances?

A.15. I learned more from my three years on the Richmond Board than from any other experience in my professional life. I learned about economics, monetary policy, corporate governance and management. I learned from Mr. Broaddus, from my fellow Directors, and from the Richmond bank staff.

At every meeting, the staff gave us a book of economic charts and an analysis of current economic conditions. Each Director gave a short presentation on observations from his or her industry or part of the district. Then we would discuss and vote on our recommendation for the discount rate. Mr. Broaddus would give us his opinions and his reasons for them, but I don't remember any specific comments. I only remember that we had lively discussions and that our votes were seldom unanimous.

What I took away from it was not a particular bias. I learned that my job was to pay attention to the information I had, seek any information I needed, formulate and express my own opinion and vote my best judgment. That was my observation of the way Mr. Broaddus approached his lifetime of service to the Fed. And that is the expectation I would have of myself if confirmed as a Fed Governor.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CASEY
FROM ELIZABETH A. DUKE**

Q.1. Earlier this year, Chairman Dodd sent a letter to the Federal Reserve Chairman, Mr. Bernanke, asking him to act on the Fed's authority and duty under HOEPA (the Home Ownership and Equity Protection Act) of 1994 to address predatory loans. We asked him to do three things:

- Require all mortgage originators to evaluate a borrower's ability to repay prior to making a mortgage loan and that the Fed create a presumption that a loan that requires a borrower to pay more than 50 percent of his or her income to cover the cost of principal, interest, taxes, and insurance is not a sustainable loan and fails to meet this test;
- Designate the failure to escrow taxes and insurance as an unfair and deceptive practice;
- Restrict the use of low- and no-documentation loans.

Do you support the Fed taking each of these three actions?

A.1. First, I would add to this list negative amortization loans. Negative amortization is dangerous to consumers and frequently misunderstood by them.

That being said, as I reviewed this list of loan practices, I was able to identify at least one specific real borrower who, in my experience, had a loan request that legitimately needed the feature that would be prohibited. But the legitimate need and acceptable risk would only have been apparent with full knowledge of the borrower circumstances. In the past these borrowers would not have had access to traditional mortgage loans. They would have required tailored bank lending.

What I don't know is whether the wholesale offering of loans with these features without detailed credit analysis is more often harmful than helpful to consumers. If, on balance, they are more

harmful, the Fed should restrict them knowing that some borrowers will be unable to obtain credit.

Q.2. A central goal of HOEPA is equity protection. Given the decline in homeownership rates among African-Americans over the past few years, and given the equity stripping that we have seen in the subprime mortgage market: Has the Federal Reserve done everything in its power to protect the home ownership and equity of these consumers? What, if anything, can be done differently?

A.2. A number of equity stripping practices are currently prohibited. Any practice that has the effect of taking equity without providing any commensurate benefit to the consumer should be prohibited.

Q.3. Congress is considering a number of measures to address some of the abuses in mortgage lending, including the Borrower's Protection Act. That bill would establish lender liability for the actions of associate appraisers and brokers. Do you support establishing that liability?

A.3. Any provision that increases the lender liability will increase the lender risk, which raises the cost and reduces the availability of credit. Lender and assignee liability legislation must be carefully crafted to be sure the enhanced consumer protection is balanced with the cost and availability of credit. A review of actual experience in states where lender liability provisions have been enacted could help predict the outcome of such provisions.

Q.4. There is a great deal of data on mortgage lending from the Home Mortgage Disclosure Act. That data shows unexplained racial disparities in mortgage lending, including interest rates and costs. Would you support using this data to identify banks and lenders with unexplained disparities, racial or otherwise, as a reason at the very least to open an investigation of those lenders?

A.4. I would support such investigation. I believe the banking regulators do use HMDA data as a "screen" to target banks with significant disparities for enhanced fair lending exams. Many banks also perform internal investigations using their own data.

Q.5. Two of you have worked for banks and Governor Krozner has been on the Federal Reserve Board for the past year. In your opinion, is it possible for banks or lenders to provide people with too much credit, so much that their financial situation is actually harmed? Have banks in the recent past been extending too much credit to consumers and if so, what should regulators do about that? And should regulators look for ways to ensure that too much credit is not provided?

A.5. Bankruptcy statistics would certainly indicate that some individuals have been provided with too much credit. But this would be a very difficult area to regulate. It is hard to determine accurately in advance how much credit is too much for any individual. And consumers do not obtain all credit from a single source. In the past, banks have been criticized more often for not lending enough than for lending too much.

Q.6. Do you believe that yield spread premiums, which financially reward mortgage brokers for steering borrowers to higher rate

loans than they might otherwise qualify for and prepayment penalties which trap borrowers in unfair loans, can distort competition?

A.6. Borrowers deserve to understand the terms and conditions of any loan being offered to them. If they are being placed into loans with terms worse than those they would qualify for in the competitive market, we should take the necessary actions to correct such a situation. In addition to specific practices such as yield spread premiums and prepayment penalties, I would look at advertising, promotion and the timing and adequacy of pricing disclosures.

Q.7. Last Thursday the Leadership Council on Civil Rights called upon the FRB to intervene in the subprime crisis, specifically noting that it is “glad that the nominees showed strong interest in getting rid of prepayment penalties and other abusive terms in subprime loans.”

What are you planning to do to combat the abusive practice of steering of borrowers (and specifically minorities) into loans that are more expensive than loans for which the borrowers could qualify?

What are you planning to do, as LCCR requests, to ensure that the FRB “uses [the keys to resolving the ongoing foreclosure crisis] as quickly as possible”?

What will you do to get rid of abusive terms and practices in the subprime market so that borrowers can remain in their homes and good, responsible lenders are not placed at a competitive disadvantage?

A.7. I share your concern about sub-prime loans and about current conditions in the mortgage market. The discussions held in this nomination hearing have only intensified my desire to delve more deeply into the issues and use my experience as a small business lender to help formulate changes that will have long term benefit for homeownership and the mortgage market in this country.

I would like to start with some observations about sub-prime lending generally and then comment on your bill.

First, I would like to emphasize that the growth of the secondary market—with non-traditional lenders making non-traditional loans—has resulted in higher levels of home ownership and an opportunity for building wealth in segments of the population that were closed out of traditional mortgage lending. So our challenge here is to reduce the cost in terms of financial difficulty and foreclosure while preserving flexibility and opportunity with mortgage products in the future.

Chairman Bernanke has discussed with this committee the Federal Reserve’s intention to propose rulemaking under HOEPA later this year. New regulations are a good first step, but we must also look to the enforcement of those regulations. We should encourage the joint state and federal regulatory discussions and pilot programs already underway to achieve this end.

Although banks are participants in the mortgage market, the market has expanded well beyond insured financial institutions. I think it is time to review the entire mortgage marketplace including prime, jumbo, alt-A as well as non-traditional mortgages. It is important that we consider all the players and all the regulators

in the marketplace to ensure uniformity across the full spectrum of originators, loan servicers, rating agencies and investors.

As the mortgage market expanded rapidly in recent years, competition led to breakdowns in risk assessment and risk pricing. Now, concerns about credit risk have caused liquidity to dry up. Consequently, very few loans with high risk features are being made today. Innovation in mortgage lending over the last few years has created loan structures and terms with which there was little experience when the loans were made. In designing the mortgage products of the future, statistical studies of the contribution of various risk features to actual credit loss will be quite helpful to all in assessing and pricing risk. Use of the Federal Reserve research capability to dissect the decisions and conditions that led us to this state could identify changes that can prevent a recurrence.

Stemming the tide of foreclosures may be the most pressing and the most difficult problem of the day. Foreclosure is the highest cost loan resolution option for the borrower, the lender, and the community. Successful loan work-outs require good communication between the borrower and the lender, and we should do everything possible to facilitate this, including support of trusted third party intermediaries. Workouts also require flexibility to match modifications to individual borrower circumstances. To this end, we should continue to investigate any legal, accounting or structural impediments to loan modifications. And we should be supportive of flexibility and creativity in providing responsible lending to fund restructured loans. We should recognize, however, some foreclosures will need to take place. In cases where there is no possibility of workout, the lender should be able to take responsibility for the property, including taxes and maintenance. The lender will also have the greatest incentive to re-sell the property so it can be reoccupied and the recovered funds can be invested in new loans.

Your legislation recognizes the immediacy of the current foreclosure problems and indicates the willingness of Congress to provide assistance to state, local and community based groups. Just as all real estate markets are local, so are real estate problems. It will take the commitment of many on the front lines supported by state and federal governments to resolve each loan individually. One way to make more private funds available might be to designate the circumstances under which refinance assistance could qualify for CRA credit.

Legislation governing mortgage standards and practices must be evaluated in light of the balance between consumer protection and credit availability. As lenders are increasingly separated from originators and borrowers, they will be unwilling to assume risks they can neither assess nor control. In evaluating the balance, I would look to the experience of the states that have already enacted similar legislation. And I would hope we would undertake the study of the full mortgage market that I proposed above and use the information from such a study to guide our regulatory changes impacting this important part of our economy.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ
FROM ELIZABETH A. DUKE**

Subprime

Q.1. How would you characterize the Federal Reserve's actions in response to the subprime crisis? Do you think the Federal Reserve has taken adequate action?

A.1. I am responding to these questions assuming you are referring to the recent credit contraction started by concerns over subprime. I do think the Fed's actions so far have been appropriate.

If you are referring to the Fed's actions regarding consumer protection, I think more action is needed and will be forthcoming.

Q.2. What do you think the role of the Federal Reserve should be for addressing crises in loan markets such as the subprime crash?

A.2. The Fed must stay focused on the dual mandate of full employment and stable prices. To the extent a credit contraction threatens the macroeconomy and real economic growth, the Fed might need to provide liquidity. In determining the amount of liquidity to provide, the Fed must weigh the relative risks to growth and inflation.

Q.3. Would you say the meltdown of the subprime market is contained at this point?

A.3. I don't think the participants in the sub-prime market have yet identified the magnitude of potential losses or where those losses are currently held. We do not yet know the extent to which problems in the housing market will spread to the economy as a whole.

Q.4. What would you recommend the Fed do moving forward to ensure that subprime market stabilizes?

A.4. I think the Fed is going to need to actively monitor all segments of the credit markets. Ultimately a reassessment and a repricing of risk is overdue. Institutions' losses resulting from reckless lending will go a long way toward ensuring such behavior and practices aren't repeated. And the part of the sub-prime market that ultimately emerges will likely be a much healthier market.

Q.5. Are other areas of the subprime crisis that the Fed has not yet addressed?

A.5. The Fed is monitoring events closely. As events unfold, additional action may be needed. I believe the Fed will act as necessary.

Credit Cards

Q.6. Do you think unscrupulous practices by credit card issuers is prevalent enough to generate concern or that necessitate taking a closer look?

A.6. I think practices such as double cycle billing and universal default are unfair and deserve attention.

Q.7. How would you characterize the prevalence of certain practices by credit card issuers that appear to either be misleading or

unfair? Is it a problem only among a few issuers, or a more widespread problem throughout the industry?

A.7. While some smaller institutions have small credit card portfolios, the business is scale intensive. The majority of the credit card market is concentrated in a small number of issuers. I would expect billing and pricing practices to be similarly concentrated.

Q.8. Do you have a position on legislation that would further regulate or limit some of these practices?

A.8. I do not have a position on any specific legislation.

Q.9. How do you view the role of the Federal Reserve in this area? Do you think the Federal Reserve is doing enough to improve disclosure and strengthen enforcement under TILA? Is there more to be done?

A.9. I think the work done by the Fed recently on credit card disclosures should serve as a model of disclosure review. I was particularly pleased to see the Fed use consumer testing to determine the effectiveness of disclosures. I look forward to the continuation of this review of disclosures in closed-end lending and mortgage lending. In light of the current mortgage market, review of mortgage disclosures is probably more pressing than that of other closed-end credit.

Access to Capital

Q.10. Over the last few years, the Federal Reserve, the Small Business Administration and others have conducted studies that reveal minorities have unequal access to credit for small business development, even when factors such as credit history and net worth are comparable to non-minorities. In your opinion, in addition to promoting financial education, how can we improve “access to capital” for minority-owned businesses?

A.10. Many years ago, I participated in a study of credit access conducted by the Virginia Legislature. We found then that the greatest need was for venture capital and equity capital. Start-up and small businesses that did not qualify for traditional bank lending were primarily funded with personal credit (often credit cards) and support from friends and family. At the time, there were some experimental state and SBA programs aimed at the credit needs of micro businesses, but I don’t know what the final results of those programs were.

In the last several years, many banks have tried to improve the overall efficiency of lending to small businesses using lessons from the consumer lending process. However, businesses are much less uniform than consumers in their characteristics, need for and use of credit. And small business lending blends the experience of consumer lending with the experience of commercial lending. I think the level of success with such programs has been quite uneven.

I haven’t seen the studies you reference, but I think we are still evolving in our understanding of the best way to meet small business needs, including minority-owned businesses. I would be quite interested in any of the recommendations or conclusions from those studies.

Q.11. What role can the Federal Reserve play to encourage institutions to engage in expanding access to capital, both for individuals and businesses?

A.11. I think all the banking regulators should encourage efficient, responsible, unbiased lending to all segments of the market.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR AKAKA
FROM ELIZABETH A. DUKE**

Q.1. Our modern, complex economy depends on the ability of consumers to make informed financial decisions. Without a sufficient understanding of economics and personal finance, individuals will not be able to appropriately manage their finances, evaluate credit opportunities, and successfully invest for long-term financial goals in an increasingly complex marketplace. What must be done to ensure that Americans have the knowledge and skills necessary to make informed financial decisions?

A.1. We must teach these skills in K–12 education. We need to be sure we have adequately prepared the teachers to teach these subjects, and the requirements must be deeply imbedded in core curricula. And we must test for these skills in our proficiency exams. Many groups are anxious to provide materials and resources, but we will need to build the infrastructure to use the tools effectively.

One of my favorite parts of my current job is serving as the executive sponsor for our management development program. In a few weeks, our young management associates will go into local high schools to participate in the ABA “Get Smart About Credit” program. They are extremely excited about the opportunity to talk about “what they wished they had known before.” We need to find and use every opportunity like this.

Q.2. Approximately 10 million households in the United States do not have accounts at mainstream financial institutions. Unfortunately, too many of these households depend on high-cost fringe financial services. They miss out on opportunities for saving, borrowing, and lower cost remittances found at credit unions and banks.

What must be done to bring these households into mainstream financial institutions?

A.2. We need to tackle the reasons why these households do not use mainstream financial institutions. I believe some of those reasons would include:

- Inability to manage a bank account resulting in overdrafts and overdraft fees;
- Inability or reluctance to produce documentation needed to open an account; and
- Distrust of mainstream financial institutions.

Q.3. I am deeply concerned that too many working families are taken advantage of by unscrupulous lenders through payday loans. What must be done to restrict payday loans and expand access to affordable, small loans?

A.3. Numerous state and federal regulations, including the new Talent amendment regulations on military loans, restrict payday

lending. Several banks are working with the FDIC on a pilot small loan program. Again, financial education would help consumers understand the expense of payday loans.

Q.4. Too many working families have their Earned Income Tax Credit benefits needlessly reduced by high cost-refund anticipation loans (RALs). What must be done to restrict these predatory loans and encourage alternatives to RALs?

A.4. We can restrict or eliminate the lending by restricting or eliminating the ability to use the refunds as collateral or by sending payments only to the taxpayer. It is difficult to restrict the allure of getting the money today rather than later.

Q.5. I am concerned that consumers are not provided with enough information about the long-term consequences of making only the minimum credit card payments.

What must be done to ensure that consumers are adequately informed of the true cost of making only the minimum payment?

A.5. The proposed new TILA credit card disclosures contain some new disclosures related to the consequences of only making minimum credit card payments. We could require additional disclosures, but disclosure alone is a poor substitute for financial understanding. This is another area where financial education could significantly improve financial health.

**RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM LARRY A. KLANE**

Q.1. Mr. Klane, at your confirmation hearing, you agreed to submit, in writing, a list of all credit card practices that you found abusive, in addition to universal default and double cycle billing. Please submit this list, and include what practices you think are clearly wrong, which merit further attention and whether it is disclosure, regulation or legislation that you believe is best suited to address the problem.

A.1. I would like to highlight two specific practices and two more general areas in credit card lending where I have concerns.

On the specific practices, as we discussed in the hearing, I share the Committee's concern with "universal default" and double-cycle billing. It is encouraging that a number of issuers who engaged in these practices have recently changed their approach, but to the extent some industry participants continue these practices, I remain concerned.

In addition, I believe that current credit card disclosures are not adequate. This is the first of the two more general areas I want to address. The complexity of current disclosures, along with the difficulty in using them to focus on the most consumer-relevant terms and conditions, leave consumers inadequately equipped to make informed choices among products and issuers. Disclosures must be made clearer and more consumer-relevant. In this regard, I am highly encouraged by the on-going work of the Federal Reserve in its efforts to revise Regulation Z. The use of consumer focus groups and the explicit effort to create simpler and more comprehensible disclosures is a strong step in the right direction. These proposed

regulations are out for public comment, and I look forward to the Federal Reserve's finalizing them. Once they are final, we will be able to judge, after some experience, whether further adjustments, amendments, or expansions need to be made.

My second general area of my concern is penalty repricing of accounts, which occurs when a customer breaks one or more of the rules embodied in the credit card contract's terms and conditions. While it is legitimate in general for an issuer to be able to change the price of credit on open-ended lines to customers who demonstrate higher levels of riskiness through such rule breaks, I am concerned about:

- Insufficient disclosures and/or notices to consumers on repricing actions (*e.g.*, initially when receiving the card, at the moment of rule break, and at the moment of repricing);
- the inclusion of multiple repricing rules that can be triggered by a single infraction; and
- the options available to consumers who have experienced repricing (*e.g.*, the ability to return to the prior rate based on good performance over time or the ability to pay off the existing balance at the prior rate over some time frame).

The Federal Reserve's proposed revisions to Regulation Z, including the 45-day notice provision, address some aspects of the concerns I have outlined. However, the general area of repricing deserves continued attention to ensure that consumers are adequately protected and able to make good decisions on their use of credit cards.

Q.2. Mr. Klane, at your confirmation hearing I raised some questions associated with Capital One's practice of not reporting customers' credit limits to the credit reporting bureau. Specifically, I raised the question as to what the ramifications to consumers would be if that had the effect of lowering their FICO score. I asked you, "But if, in fact, their credit rating under FICO were such that competitors would be less interested in them as customers is that not—aren't you advantaged to some degree as a result?" You responded: "I do not see why that would be the case, Senator." Can you please explain how a lower FICO score would not damage a consumer's ability to obtain a better interest rate? Can you also please explain how, if Capital One had proprietary information that allowed them to selectively market to consumers whose FICO scores appeared artificially lower to other lenders, how this would not be an advantage to Capital One? Finally, can you explain how that would not be a disadvantage to the consumer?

A.2. As mentioned at the confirmation hearing, I appear before the committee as a private citizen seeking to perform public service, not to represent Capital One. As I mentioned at the hearing, I was not engaged in Capital One's decisions concerning credit bureau reporting as I do not run the U.S. Credit Card business.

That said, I would like to provide as much perspective on the question as possible. As you are aware, Capital One has recently begun to report credit lines for all of its customers. While the company continues to believe that this information has strategic risk management value of a proprietary nature, it recognized that the

negative attention this practice has drawn from various external constituencies outweighed any benefits from keeping credit lines proprietary. Nevertheless, I would like to stress that the company's decision to withhold credit lines was driven by a desire to keep credit line information proprietary, not to deflate artificially individual customers' credit scores. Capital One has not sought, nor is it able, to unilaterally impact customers' credit scores negatively in this manner, nor is it able to selectively target individuals for non-competitive offers in the manner suggested. No legitimate business purpose would be served by that outcome, and there have been no marketing strategies or approaches I am aware of that tried to do so.

FICO's methodology is proprietary, and thus no institution knows what, if any, impact its line reporting policy may have on their scoring models. Nevertheless, Capital One is not aware of any statistically valid or conclusive evidence supporting the contention that a single issuer's policy has, or could have, any such effect.

Lower FICO scores impede all lenders' abilities to market to consumers, including Capital One's ability to increase customer's credit lines, offer them more competitive terms, or cross-sell mortgage, auto and other loan products to customers.

Q.3. Mr. Klane, can you share with the Committee your views on the separation between banking and commerce? Specifically, what are your views on Industrial Loan Companies?

A.3. There has long been a concern among legislators and regulators on the implications of mixing banking and commerce. Given the importance of a stable banking system and the existence of government deposit guarantees, special weight should be given to ensure that depositories remain safe and sound. Historically, there has been the view that this safety and soundness is easier to achieve by maintaining the separation between banking and commerce. If legislators were to allow a lesser degree of separation, then it would require a revised regulatory framework to ensure the safety and soundness of the depository institutions. This is true for Industrial Loan Companies as well as other charters that might in the future allow for a more "mixed" model. A clear and workable supervisory framework is a key element as Congress reassesses the appropriate degree of separation between banking and commerce.

Q.4. Mr. Klane, at your confirmation hearing I asked you and the other nominees: "whether or not you think the Fed acted in a timely fashion and could have done more, looking back." You responded: "All that being said, I think sitting here, with hindsight, I think we can say very clearly that if the Fed had acted somewhat earlier, we might have had to some extent a better outcome." Can you please elaborate on what actions the Fed should have taken that would have provided a better outcome? Can you please include in your answer when you believe those actions should have taken place?

A.4. Because I have not been on the Board, I have not been privy to the information and analysis that was available at the time. Policy needs to be made at the line of scrimmage, with only the available data at the time—so hindsight has important limitations. That said, I was pleased to hear Chairman Bernanke pledge to exercise

the Federal Reserve's authority under HOEPA to strengthen rules protecting customers from unfair and deceptive mortgage practices. If such rules were in place earlier, they might have provided a somewhat better outcome. If confirmed to the Board, I would look forward to working in this very important area.

Q.5. Mr. Klane, at your confirmation hearing, in response to a question from Senator Shelby about concerns about the credit quality of subprime mortgage that "it also underscores the importance going forward of having underwriting criteria that take into account rate reset." When you were in charge of Capital One's home mortgage division did your company take into account rate resets in the mortgages that it issued?

A.5. Given the recent events in the subprime mortgage market, all reflective participants involved in the mortgage industry have learned the importance of taking into account rate resets. The vast majority of mortgages issued by Capital One Home Loans were fixed rate and fully documented. All loans were rigorously underwritten to the investor's guidelines. Those guidelines, for the few adjustable rate mortgages issued, were consistent with industry norms at the time which focused principally on the initial rate.

Q.6. Mr. Klane, do you think that the 2001 Bush tax cuts have resulted in an increase or decrease in real federal revenue?

A.6. I do not have available in my current position all of the data and information required to undertake a full analysis of the real versus nominal impact on federal revenue of the 2001 changes to the tax code.

Q.7. Mr. Klane, in your appearance before the Committee, you stated that you are a strong believer in the Fed's dual mandate for maximum employment and price stability. Are there approximate figures for the nation's unemployment rate and inflation rate that match what you believe to be maximum employment and price stability? If so, can you share what those are?

A.7. Given the dynamic nature of the U.S. economy, underlying changes to productivity, and the impact of the global economy on our country, I do not believe there is a fixed relationship between the nation's unemployment and inflation rates in order to match maximum employment and price stability. My assessment of the relationship between these rates and the twin objectives would be informed by the specific environment at the time, along with all of the available information and analysis.

I would like to reiterate my strong support for the dual mandate. If confirmed, I would ensure that pursuit of both maximum sustained employment and price stability informed my thinking on monetary policy.

Q.8. Mr. Klane can you inform the Committee of any periods in American history where you believe that maximum employment was not being reached or that price stability was not achieved? During those periods, what actions do you believe the Fed should have undertaken to achieve its mandate?

A.8. Having recently read Timothy Egan's moving book, *The Worst Hard Time: The Untold Story of Those Who Survived the Great American Dust Bowl*, I would offer the Great Depression as a time

when America clearly did not achieve maximum employment or price stability. Many economists have written about this time period, and I think it is clear that the Federal Reserve, among other things, should have injected more liquidity into the banking system and should have stood more firmly as a lender of last resort for otherwise solvent institutions.

Q.9. Mr. Klane, how do you explain the Federal Reserve's findings from the HMDA data that in 2005, 54.7% of African-American borrowers and 46.1% of Hispanic borrowers got high-priced loans when buying a home compared to 17.2% of non-Hispanic whites?

A.9. On their face, these differences are worrisome and I agree that no borrower should suffer discrimination. All regulators, including the Federal Reserve, should vigorously monitor compliance and enforce fair lending laws to ensure there is no discrimination in lending.

Pricing outcomes on loans are driven by an array of considerations, some of them not included in HMDA data (e.g., FICO scores, debt-to-income ratios, etc.). Many factors, other than discrimination, could contribute to the differences cited. It is not possible to use HMDA data alone to draw firm conclusions on precisely what is driving pricing differentials. However, those data can and should be used, along with all the other data available to examiners concerning an institution's lending practices, to try to reach such conclusions in order to root out discrimination.

Q.10. In the Fed's analysis of the data, significant racial and ethnic differences remained unexplained even after accounting for other information reported in the HMDA data. The Fed found that borrower-related factors accounted for only about one-fifth of the disparity. Do you believe that there is racial discrimination in the mortgage market? If so, how do we root it out of the system? What specific additional steps should the Fed undertake to do so? If you do not believe that there is racial discrimination, how do you explain these racial disparities?

A.10. Discrimination has no place in lending. If confirmed to the Board, I would enforce fair lending laws vigorously. As mentioned in a prior answer, it is not possible to draw definitive conclusions about potential discrimination based on HMDA data alone because pricing outcomes are driven by an array of considerations, some of them outside the scope of HMDA data. However, regulators, in their supervisory capacity, have access to the full set of data around pricing decisions for regulated institutions. Regulators need to be vigilant in enforcing fair lending laws and investigate possible violations. HMDA data can be a useful starting point.

Q.11. As you know, only the Federal Reserve, the Office of Thrift Supervision, and the National Credit Union Administration currently have the authority to promulgate a rule dealing with unfair or deceptive acts or practices. In your view, should the other agencies be given the same authority? Please explain your reasoning.

A.11. Providing this authority is the prerogative of Congress. I do not feel it is appropriate for me as a nominee to opine on specific legislation. However, if confirmed to the Board, I would work to ex-

ercise the authority given to the Federal Reserve to the best of my ability.

Q.12. The Committee recently passed legislation to improve the regulation and transparency of the private educational loan market—the fastest growing segment in the \$85 billion student loan market. Among the growing trends in the private student loan market is the practice of some lenders using non-individual data—like a school’s default and graduation rate in the underwriting used to establish the rate a student borrower is offered. It’s a practice that is eerily reminiscent of mortgage “redlining”, when mortgage rates and products were denied to people based on where they lived rather than their individual creditworthiness. One of the ways Congress addressed mortgage redlining was through enactment of tough anti-discrimination laws and improving transparency of market practices in the form of HMDA (the Home Mortgage Disclosure Act), which the Federal Reserve oversees.

Do you think HMDA has been an important tool to promote transparency? Do you think a disclosure, transparency regime for private student loans similar to HMDA is a more useful approach to addressing concerns about potential “redlining” in the private student loan market or do you believe we should prohibit the practice of underwriting based on factors such as the school one chooses to attend?

A.12. The private student loan market is growing rapidly and, given demographics and other trends, looks like it will continue to grow for some time. The emergence of a private market should provide a positive additional choice for consumers needing to borrow to finance education. It is important in this market, as elsewhere in lending, to have clear and comprehensible disclosures. If confirmed to the Board, I would look forward to engaging—as appropriate—in the issue of the private student loan market. With the tools and perspectives available to a Board member, I would then be in a position to gather the full range of input on the topics of disclosures and whether additional measures should also be considered.

Q.13. Mr. Klane, as you know the FOMC voted unanimously in its August meeting to keep interest rates constant and in the accompanying statement that their “predominant policy concern remains the risk that inflation will fail to moderate as expected.” Over the next ten days there were significant disruption in the equity and bond markets that caused the Fed to reverse course, cut the rate at the discount window by 50 basis points and issue the following statement ten days after their August meeting: “Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. In these circumstances, although recent data suggest that the economy has continued to expand at a moderate pace, the Federal Open Market Committee judges that the downside risks to growth have increased appreciably. The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.”

Do you believe that the FOMC made a mistake at their original August meeting? Do you believe that the predominant policy concern remains the inflation in light of the events since the August meeting of the FOMC? If you had been a Fed Governor, what actions, if any, would you have taken that were different from those taken by the Fed Governors?

A.13. After my receiving this question, the FOMC met on September 18th and decided to lower both the Federal Funds and Discount Rate by 50 basis points. The FOMC clearly considered the recent disruptions to the credit markets and other related events to pose a broader risk to the economy and the goal of maximum sustainable employment than during the August meeting. Not sitting on the Board at the time of either of these meetings, and thus not having access to the information available at the moment of these policy decisions, I cannot speculate whether I would have taken a different position had I been a Fed Governor and member of the FOMC at the time.

Q.14. Hedge funds perform an important role in the capital markets. Yet some have raised concerns about their potential impacts to pension funds and retirees. On February 22, 2007, the President's Working Group on Financial Markets, of which the Fed is a member, released a set of principles and guidelines "to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds." The agreement concentrates on investor protection and systemic risk concerns. The PWG determined that additional regulation was not needed. A recent column in *The Chicago Tribune* stated: "When the hedge fund Amaranth Advisors LLC flamed out last year after disastrous bets on energy prices, San Diego County's retirement fund was among those burned. Losses to its portfolio were estimated at \$100 million . . . [This] has, however, raised concerns about the safety of retirement money and stirred debate on whether more oversight is needed."

Last October, the then Chief Economist of the IMF observed that "a number of state pension funds were invested in a risky hedge fund like Amaranth. Diversification into such alternative investments can be a valuable component of an overall investment strategy, if it is carefully thought out. The problem is that all too often, it takes place as a form of herding and late in the game . . . when the good hedge- or commodity funds are closed to investment . . . new unseasoned hedge or commodity funds are started precisely to exploit the distorted incentives of the pension or insurance fund managers who queue like lemmings to dutifully place the public's money. Thus far losses from isolated failures have been washed away in diversified portfolios and the public has not noticed. Will this always continue?"

How would you respond to these concerns? Do you agree with the PWG position that further regulation is not needed? Would you closely monitor the implementation of this guidance, working with the other PWG members, to preclude systemic problems from being caused by hedge funds?

A.14. The emergence of hedge funds and other private pools of capital is a significant development for the financial system. They can

have significant impact on the regulated banking sector, as well as on working American families via investments made by retirement funds. While I do not have grounded information that would cause me to disagree with the PWG on the current need for more regulation, I feel strongly that close monitoring of developments is well justified. If confirmed to the Board, I would work closely with other PWG members to monitor the situation, and develop appropriate actions as needed.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CASEY
FROM LARRY A. KLANE**

Q.1. Earlier this year Chairman Dodd sent a letter to the Federal Reserve Chairman, Mr. Bernanke, asking him to act on the Fed's authority and duty under HOEPA (The Home Ownership and Equity Protection Act) of 1994 to address predatory loans. We asked him to do three things:

- Require all mortgage originators to evaluate a borrower's ability to repay prior to making a mortgage loan and that the Fed create a presumption that a loan that requires a borrower to pay more than 50 percent of his or her income to cover the cost of principal, interest, taxes, and insurance is not a sustainable loan and fails to meet this test;
- Designate the failure to escrow taxes and insurance as an unfair and deceptive practice;
- Restrict the use of low- and no-documentation loans.

Do you support the Fed taking each of these three actions?

A.1. I support the Federal Reserve's acting on its authority and duty under HOEPA, and was pleased to hear Chairman Bernanke's intention in this regard. Further, I think each of the three areas highlighted justify concern. As I have not benefitted from the wide set of perspectives that current Board members would have on these particular points, I do not feel I can take a fully informed and balanced position these specific proposals. That said, if confirmed to the Board, I would certainly examine the issues of affordability, escrowing taxes and insurance (particularly in subprime loans), and the appropriate role of documentation to determine the best course of action.

Q.2. A central goal of HOEPA is equity protection. Given the decline in homeownership rates among African-Americans over the past few years, and given the equity stripping that we have seen in the subprime mortgage market: Has the Federal Reserve done everything in its power to protect the home ownership and equity of these consumers? What, if anything, can be done differently?

A.2. Increasing savings generally (one important component of which can be homeowner equity) is an important public policy goal. Achieving these increases is a multi-faceted challenge. On the specific issue of protecting home ownership and equity, the Federal Reserve has a role to help ensure borrowers are not prey to unfair and deceptive practices. The Federal Reserve's recently stated intent to write rules under HOEPA is a positive step in this regard.

Q.3. Congress is considering a number of measures to address some of the abuses in mortgage lending, including the Borrower's Protection Act. That bill would establish lender liability for the actions of associate appraisers and brokers. Do you support establishing that liability?

A.3. Please see the previously submitted response on the Borrower's Protection Act. On the specific issue of establishing lending liability around actions of appraisers and brokers, some forms of liability could play a constructive role. However, any liability needs to be very clearly delineated and financial damages reasonable in the context. One objective would be to maintain a vibrant, responsible mortgage market. Liability rules would need to be structured in such a way as to ensure that responsible lenders and brokers do not vacate the market. Otherwise, consumers and consumer choice would be unduly limited.

Q.4. There is a great deal of data on mortgage lending from the Home Mortgage Disclosure Act. That data shows unexplained racial disparities in mortgage lending, including interest rates and costs. Would you support using this data to identify banks and lenders with unexplained disparities, racial or otherwise, as a reason at the very least open an investigation of those lenders?

A.4. Discrimination has no place in lending. If confirmed to the Board, I would enforce fair lending laws vigorously. HMDA data can be a useful starting point for regulators when examining lending institutions. However, it is not possible to draw definitive conclusions about potential discrimination based on HMDA data alone because pricing outcomes are driven by an array of considerations, some of them outside the scope of HMDA data. However, regulators, in their supervisory capacity, have access to the full set of data around pricing decisions for regulated institutions. Through rigorous statistical analysis of the full set of data, regulators can determine whether or not an institution has engaged in actual discrimination. Regulators need to be vigilant in enforcing fair lending laws and investigate possible violations. HMDA data can certainly be a useful starting point.

Q.5. Two of you have worked for banks and governor Krozner has been on the Federal Reserve Board for the past year.

- In your opinion, is it possible for banks or lenders to provide people with too much credit, so much that their financial situation is actually harmed?
- Have banks in the recent past been extending too much credit to consumers and if so, what should regulators do about that?
- And should regulators look for ways to ensure that too much credit is not provided?

A.5. Lending institutions should make loans that are affordable to borrowers. This is good not only for the consumer, but also for the lending institution. A bank that systematically provides credit inappropriately will not be a safe and sound institution (in addition to burdening the underlying consumer). Regulators have a supervisory mandate to ensure safe and sound institutions. Regulators also must ensure that supervised institutions have appropriate risk management and associated underwriting processes. These proc-

esses will help ensure that borrowers receive appropriate loans. In addition of course, the role of financially informed consumers is critical in achieving overall good outcomes for borrowers. I strongly support the financial literacy efforts of the Federal Reserve and many other institutions.

Q.6. Do you believe that yield spread premiums, which financially reward mortgage brokers for steering borrowers to higher rate loans than they might otherwise qualify for and prepayment penalties which trap borrowers in unfair loans, can distort competition?

A.6. Brokers steering borrowers to bad loans is unacceptable. To the extent that incentive structures drive behavior that results in unfair loans, these incentive structures should be examined. If confirmed to the Board, I would help the Federal Reserve execute its responsibilities in this area.

Q.7. Last Thursday the Leadership Council on Civil Rights called upon the FRB to intervene in-the subprime crisis, specifically noting that it is “glad that the nominees showed strong interest in getting rid of prepayment penalties and other abusive terms in subprime loans.”

- What are you planning to do to combat the abusive practice of steering of borrowers (and specifically minorities) into loans that are more expensive than loans for which the borrowers could qualify?
- What are you planning to do, as LCCR requests, to ensure that the FRB “uses [the keys to resolving the ongoing foreclosure crisis] as quickly as possible”?
- What will you do to get rid of abusive terms and practices in the subprime market so that borrowers can remain in their homes and good, responsible lenders are not placed at a competitive disadvantage?

A.7. If confirmed to the Board, I would work diligently and urgently on these issues. I would support the effort to write rules under HOEPA which address unfair and deceptive practices across the entire mortgage industry—not just institutions regulated by the Federal Reserve. More generally, I would work to broaden the lending choices that consumers have through a blend of good regulations, informed consumers, and a competitive marketplace populated by responsible institutions.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER
FROM LARRY A. KLANE**

Q.1. I understand that Capital One, where you are currently a top executive, did a brisk business in subprime lending, particularly in the origination of exotic loans, such as 2/28 and 3/27 adjustable rate mortgages. Were you personally involved with this type of lending at Capital One, and if so, in what capacity? Do you believe that Capital One’s subprime lending practices were appropriate? Do you think, given the plethora of problems that have emerged out of the subprime lending industry, that Capital One should have taken a more active role in ensuring that responsible lending prin-

ciples were part of its subprime origination practice, including in its relationship with the mortgage broker industry?

A.1. I am responsible for Global Financial Services, a division at Capital One. This division serves approximately ten million consumers and small businesses, principally in the United States but also in Canada and the U.K. One of the businesses in this division is Capital One Home Loans.

I believe Capital One Home Loans is a highly responsible lender. It is a direct originator of loans, meaning that it does not rely on brokers in any way. All marketing is done directly to consumers, and every customer is handled by Capital One Home Loans' employees. The business thus avoids all of the issues and challenges of managing brokers. The entire process, from sales through underwriting and finally to settlement, is executed, controlled and monitored by the business itself.

From a product perspective, the vast majority of loans are fully documented and fixed rate. This is true for both prime and subprime loans. All loans are rigorously underwritten against strict guidelines. Subprime loans were only about 20% of overall originations and subprime adjustable rate mortgages—the focus of your question—were a tiny fraction (1% of loans in 2006 and 1/2 of 1% in 2007). As mentioned, virtually all loans were fully documented, thus avoiding the issues now evident in stated income loans. Finally, the business did not originate any option ARMs or other negatively amortizing products.

These elements—a direct model (i.e., no brokers), fully documented loans, predominantly fixed rate products, and strong underwriting—underlie the responsible lending practices of this business.

Q.2. As you know, many experts have criticized the Federal Reserve for not taking a more active role in exercising its authority under HOEPA to regulate the subprime mortgage lending industry. What is your position on the appropriate role of the Fed in regulating mortgage lenders? Do you believe that the mortgage lending industry should be robustly regulated?

A.2. I believe the mortgage industry needs to be regulated. Today, there is a mixed model. Some important participants in the industry are well regulated depository institutions (e.g., banks and thrifts), but there is a large part of the market that is either unregulated or lightly regulated. I think there is a public policy interest in bringing more consistency of standards across the industry, as well as higher levels of regulatory oversight to those participants currently outside of regulated depository institutions.

The Federal Reserve has an important role to play in at least three ways. First, it directly supervises many institutions. Second, it has authority under HOEPA to write regulations that apply to all participants in the mortgage market, not just those institutions whom it supervises. (Of course the Federal Reserve would not have the authority to enforce these rules for institutions it does not supervise. This means that states and other regulators will need to enforce these rules.)

The Federal Reserve has stated its intention to exercise its rule-writing authority under HOEPA. I welcome this step. If confirmed

to the Board, I would seek to be a driving and constructive force behind finalizing the rule and assuring that the mortgage market operates fairly and smoothly in the future.

Third, the Federal Reserve has a role to play working with other regulatory agencies. The recent joint regulatory guidances on non-traditional and subprime mortgages, in which the Federal Reserve participated, were appropriate. So too were the Federal Reserve's and other agencies' efforts to encourage lenders and services to work with troubled mortgage borrowers. It is also important for the Federal Reserve to coordinate with state regulators. The Federal Reserve has actively worked with state regulators at CSBS to encourage state adoption of the non-traditional and subprime guidances. Those guidances, encouraging underwriting of loans to the fully indexed, fully amortizing rate, have broad support as an important consumer protection making unaffordable loans less likely in the future. Finally, the Federal Reserve's pilot consumer compliance program with the states, the FTC, and the OTS to examine institutions for compliance with mortgage-related consumer protections also seems promising and appropriate.

Q.3. What is your opinion of the Fed's course of action to date in handling the subprime crisis? What other actions do you think the Fed should be taking?

A.3. During the past few months, and particularly at and shortly before the September 18th FOMC meeting, the Federal Reserve has reacted vigorously to the subprime crisis, its impact on credit markets, and the potential impact to the broader economy. These actions (including lowering both the discount and the target federal funds rate) seem appropriate and adequate at this time. However, the Federal Reserve will need to continue to monitor further developments closely. If warranted by future developments, the Federal Reserve should be willing to take further action.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ
FROM LARRY A. KLANE**

Subprime

Q.1. How would you characterize the Federal Reserve's actions in response to the subprime crisis? Do you think the Federal Reserve has taken adequate action?

A.1. During the past few months, and visibly at the September 18th FOMC meeting, the Federal Reserve has reacted vigorously to the subprime situation, its impact on the credit markets, and the potential impact to the broader economy. These actions seem appropriate and adequate at this stage, but the Federal Reserve will need to continue to monitor further developments closely.

Q.2. What do you think the role of the Federal Reserve should be for addressing crises in loan markets such as the subprime crash?

A.2. The Federal Reserve has a number of roles to play in crises in loan markets. These include ensuring liquidity in the financial system, standing as a lender (if necessary as last resort) to member banks via the discount window, and monitoring the implications of the crisis in case it threatens the broader economy. If the crisis

threatens to impact the broader economy, the Federal Reserve's role is to adjust monetary policy accordingly.

Q.3. Would you say the meltdown of the subprime market is contained at this point?

A.3. While the Federal Reserve has taken strong action, we are not yet at the end of the current turbulence. It would be premature to say that no further negative developments will occur, particularly with the large number of mortgages whose interest rate will reset over the upcoming months.

Q.4. What would you recommend the Fed do moving forward to ensure that the subprime market stabilizes?

A.4. The Federal Reserve has taken important actions to stabilize the current market disruptions. Going forward, the Federal Reserve should monitor the situation closely and take additional actions as are warranted as new information or developments materialize. It is important to assess the impact of the actions already taken prior to initiating additional actions.

Q.5. Are other areas of the subprime crisis that the Fed has not yet addressed?

A.5. Given the recent actions of the Federal Reserve and the rule-writing work they are undertaking under HOEPA, I have no important additional areas to suggest.

Credit Cards

Q.6. Do you think unscrupulous practices by credit card issuers are prevalent enough to generate concern or that necessitate taking a closer look?

How would you characterize the prevalence of certain practices by credit card issuers that appear to either be misleading or unfair? Is it a problem only among a few issuers, or a more widespread problem throughout the industry?

Do you have a position on legislation that would further regulate or limit some of these practices?

A.6. I would like to highlight two specific practices and two more general areas in credit card lending where I have concerns.

On the specific practices, as we discussed in the hearing, I share the Committee's concern with "universal default" and double-cycle billing. It is encouraging that a number of issuers who engaged in these practices have recently changed their approach, but to the extent some industry participants continue these practices, I remain concerned.

In addition, I believe that current credit card disclosures are not adequate. This is the first of the two more general areas I want to address. The complexity of current disclosures, along with the difficulty in using them to focus on the most consumer-relevant terms and conditions, leave consumers inadequately equipped to make informed choices among products and issuers. Disclosures must be made clearer and more consumer-relevant. In this regard, I am highly encouraged by the on-going work of the Federal Reserve in its efforts to revise Regulation Z. The use of consumer focus groups and the explicit effort to create simpler and more comprehensible disclosures is a strong step in the right direction. These proposed

regulations are out for public comment, and I look forward to the Federal Reserve's finalizing them. Once they are final, we will be able to judge, after some experience, whether further adjustments, amendments, or expansions need to be made.

My second general area of my concern is penalty repricing of accounts, which occurs when a customer breaks one or more of the rules embodied in the credit card contract's terms and conditions. While it is legitimate in general for an issuer to be able to change the price of credit on open-ended lines to customers who demonstrate higher levels of riskiness through such rule breaks, I am concerned about:

- insufficient disclosures and/or notices to consumers on repricing actions (*e.g.*, initially when receiving the card, at the moment of rule break, and at the moment of repricing);
- the inclusion of multiple repricing rules that can be triggered by a single infraction; and
- the options available to consumers who have experienced repricing (*e.g.*, the ability to return to the prior rate based on good performance over time or the ability to pay off the existing balance at the prior rate over some time frame).

The Federal Reserve's proposed revisions to Regulation Z, including the 45-day notice provision, address some aspects of the concerns I have outlined. However, the general area of repricing deserves continued attention to ensure that consumers are adequately protected and able to make good decisions on their use of credit cards.

Q.7. How do you view the role of the Federal Reserve in this area? Do you think the Federal Reserve is doing enough to improve disclosure and strengthen enforcement under TILA? Is there more to be done?

A.7. The Federal Reserve has important responsibilities with respect to implementing TILA. I have been very encouraged by the proposed revisions to Reg Z concerning credit cards and open-ended credit. This revision, the first in over twenty-five years, is a strong step forward to improve disclosures. In particular, I applaud the Federal Reserve's use of consumer focus groups to help ensure disclosures are understandable and address the key elements consumers need. If confirmed to the Board, I would look forward to help finalize these rules.

Access to Capital

Q.8. Over the last few years, the Federal Reserve, the Small Business Administration and others have conducted studies that reveal minorities have unequal access to credit for small business development, even when factors such as credit history and net worth are comparable to non-minorities.

In your opinion, in addition to promoting financial education, how can we improve "access to capital" for minority-owned businesses?

A.8. In addition to education, I would offer two avenues to help ensure access to capital for minority-owned business. First, fair lending laws must be enforced so no minority-owned business is dis-

criminated against. Second, legislation and regulation need to ensure that responsible lending institutions are encouraged to lend across the full credit spectrum. Minority-owned businesses will be among those hurt if there is a significant reduction in the willingness of lenders to extend credit across the full credit spectrum. Thus legislators and regulators need to ensure they do not inadvertently chill innovation and full credit spectrum lending that would be of benefit to these borrowers.

Q.9. What role can the Federal Reserve play to encourage institutions to engage in expanding access to capital, both for individuals and businesses?

A.9. The Federal Reserve System has an important role to play in educating individuals and small business owners on how to access capital and other financial matters. In addition, in connection with its supervisory role, the Federal Reserve has responsibility to enforce fair lending and other relevant laws. Supervised institutions may also benefit from interaction with the Federal Reserve which clarifies the positive role that prudent extension of credit to individuals and businesses can have on an institution's safety and soundness.

As an experienced banker (serving roughly ten million consumer and small business customers currently), I would look forward, if confirmed, to helping the Federal Reserve continue its important work in this area.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR AKAKA
FROM LARRY A. KLANE**

Q.1. Our modern, complex economy depends on the ability of consumers to make informed financial decisions. Without a sufficient understanding of economics and personal finance, individuals will not be able to appropriately manage their finances, evaluate credit opportunities, and successfully invest for long-term financial goals in an increasingly complex marketplace. What must be done to ensure that Americans have the knowledge and skills necessary to make informed financial decisions?

A.1. I fully agree with the critical importance of individuals having the information and the necessary financial education to make informed financial decisions. This is particularly critical to ensure good outcomes (for individuals and for the economy at large) in today's complex, competitive marketplace. As a current board member of America's Promise—a not-for-profit organization dedicated to underprivileged kids—I am constantly reminded of the tremendously beneficial impact of financial education. Achieving the goal of broad financial literacy will take the combined efforts of parents, schools, financial institutions, relevant government bodies, and not-for-profit organizations. Financial education must begin before college.

Q.2. Approximately 10 million households in the United States do not have accounts at mainstream financial institutions. Unfortunately, too many of these households depend on high-cost fringe financial services. They miss out on opportunities for saving, borrowing, and lower cost remittances found at credit unions and

banks. What must be done to bring these households into mainstream financial institutions?

A.2. First and foremost, these households must be made aware of the full range of options available to them. Today, many responsible financial institutions are developing products and services designed to meet the needs of the un- or under-banked. Community-based organizations have a very helpful role to play in providing education and directing these households to responsible institutions. Second, regulators have a role in encouraging the development of these programs in their supervised institutions. The stronger and more vibrant the participation of responsible institutions in providing services to these households, the better the outcome will be for these households and their communities. It is in the interest of these families that legislation and regulation do not prohibit or unduly restrict the responsible provision of banking services and the extension of credit across the full credit spectrum.

Q.3. I am deeply concerned that too many working families are taken advantage of by unscrupulous lenders through payday loans. What must be done to restrict payday loans and expand access to affordable, small loans?

A.3. Financial education and an awareness of available options from responsible lending institutions are two key elements to address this situation. In addition, it is in the interest of these families that legislation and regulation do not prohibit or unduly restrict the responsible extension of credit across the full credit spectrum.

Q.4. Too many working families have their Earned Income Tax Credit benefits needlessly reduced by high cost-refund anticipation loans (RALs). What must be done to restrict these predatory loans and encourage alternatives to RALs?

A.4. In my current position, I do not have access to all the information I would need to have about Refund Anticipation Loans. If confirmed to the Board, I would do whatever is required to fulfill the Federal Reserve's responsibilities—including protecting consumers—that exist in this area.

Q.5. I am concerned that consumers are not provided with enough information about the long-term consequences of making only the minimum credit card payments. What must be done to ensure that consumers are adequately informed of the true cost of making only the minimum payment?

A.5. I strongly support meaningful disclosure around the implications of minimum payments. The Federal Reserve's current proposal for revisions to Regulation Z seeks to implement the Bankruptcy Reform Act's significant requirements in this regard. Institutions should inform customers who consistently pay only the minimum of the consequences of their behavior. For those customers who pay the minimum for a number of consecutive months, it would be beneficial for the lending institution to provide a notice on their statement informing them of the consequences of doing so. In this statement, the institution could encourage consumers to pay more than the minimum in order to pay down their balance more quickly. Going further, an institution could also provide customers

with a web address for an online calculator, which allows them to enter specific information, customized to their situation, and receive real-time information about how long it will take to pay off their balance.