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# MODERNIZING BANK SUPERVISION AND REGULATION—PART II

# HEARING

BEFORE THE

## COMMITTEE ON
## BANKING, HOUSING, AND URBAN AFFAIRS
## UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

FURTHER EXAMINING WAYS TO MODERNIZE AND IMPROVE BANK REGULATION AND SUPERVISION, TO PROTECT CONSUMERS AND INVESTORS, AND HELP GROW OUR ECONOMY IN THE FUTURE

MARCH 24, 2009

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# C O N T E N T S

## TUESDAY, MARCH 24, 2009



## WITNESSES

# MODERNIZING BANK SUPERVISION AND REGULATION—PART II

**TUESDAY, MARCH 24, 2009**

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

The Committee met at 10:05 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. Good morning, everyone, and welcome to the Senate Banking Committee. Let me welcome my colleagues and our witnesses and the guests who are here in the audience. We appreciate your presence here this morning.

This morning we will hold what amounts to our eighth full Committee hearing on the subject matter of modernization of Federal regulations. Today, we are talking about the modernization of bank supervision and regulation. This morning I want to welcome our witnesses. We have got a very distinguished panel of witnesses who are here to share some thoughts with us.

We are going to again explore ways in which we will try to modernize and improve bank regulation and supervision to better protect consumers and restore confidence in our banking system. We do so at a time when our country's massive challenges loom very large indeed. All of us in the Congress of the United States, Democrats and Republicans alike, are trying to work together to meet these challenges and restore public confidence in our financial institutions.

In the coming weeks, we will be working on critical legislation to lay out a long-term budget blueprint to address our continuing financial crisis and to address the issue of executive compensation. As we continue to address the economic crisis going forward, I think it is important we recognize that not all banks are responsible for this crisis. Quite the contrary. And as Chairman Bernanke has said only recently, small bank lending might very well help lead the way out of this crisis in many places. None of this is to suggest that small banks do not face economic troubles of their own, of course. Some do, and on an almost weekly basis, we hear stories about how the FDIC takes over banks and works to reassure depositors that their money will be safe.

But it would be a mistake to paint every financial institution with the same broad brush, and as I have heard from community banks around my State of Connecticut, many of our community banks are in far better shape right now than the financial system is as a whole. Why? Well, in part because when the financial institutions align their practices and incentives with their long-term health, they are far less prone to engage in riskier behavior. They are far less likely to put their companies and the economic security of the American consumer at risk.

Former Fed Chairman Greenspan believes companies would not take such extraordinary risks, because their own survival could be in jeopardy. Clearly, he was wrong, and that assumption cost the American people dearly.

Some of that failure can be attributed to the prevailing ideology of the moment, ranging from the abusive terms mortgage lenders offered to the practices credit card companies still engage in. Many of us believe that if we had failed to protect the consumer, we failed to protect our economy. Others felt, of course, just the opposite.

Many of us believed that if we had skin in the game, we would all take the consequences of our actions more seriously. Others were confident risk could be managed.

Today, it is clear that consistent regulation across our financial architecture is paramount, and that with strong cops on the beat in every neighborhood, institutions would be far less likely to push risk onto the consumer. Regulators are the first line of defense for consumers and depositors, which is why we need to end the practice of shopping for the most lenient regulator and consider creating a single coordinated prudential regulator.

In a crisis created first and foremost by our failure to protect consumers, we cannot afford to consider a so-called systemic risk regulator without also considering how we can better protect the consumers. All too often in this crisis, we saw that the relationship between the consumer and their financial institutions was, in effect, severed because of a lack of incentives to ensure loans are paid off down the road. That was not true of smaller institutions like those in my State and those of my colleagues' here. Like so many credit unions and community banks, they recognized something very simple: that your company reaps the benefits when you treat your customers fairly.

With this hearing, I hope we can take a close look at how these values can be the building blocks for a modernized 21st century financial architecture in our country. That must be our goal, not only today but in the coming weeks, as we are charged with the responsibility of modernizing the Federal financial regulations.

With that, let me turn to Senator Shelby, and then I will quickly turn to my colleagues for any comments they want, and then we will go to our witnesses.

## STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Mr. Chairman, thank you for calling this hearing. I know we are holding a series of hearings here to build a record, and I think you are leading the way.

I have an opening statement I would like to be made part of the record, and with that, I would like to, as soon as we can, get to the witnesses.

Thank you, Mr. Chairman.
Chairman DODD. Thank you very much.
Senator Johnson.
Senator JOHNSON. I will pass and submit my written statement for the record.
Chairman DODD. Senator Bunning.

**STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. I will be brief, but I wanted to highlight a few points I made in the statement I put in the record for Thursday's hearing last Thursday.

We all want to make changes that will make failure less likely to happen and the system strong enough to survive when failures do happen. I was impressed by Mr. Whalen's written testimony today. Among other things, it supports the concerns that I have stated many times, and I believe the Chairman and others on this Committee share, about the Fed's willingness and ability to regulate banks or overall risk. We do not need to give the Fed more power.

I am going to repeat that: We do not need to give the Fed more power because they are no longer an independent agency. They are just part of the big group that is overseeing financial institutions along with writing legislation with the Treasury Secretary.

Just creating a new regulator or two will not really add to stability. In fact, it just might create a false sense of security and a whole new class of firms that will expect Government bailouts if they make bad decisions.

Congress and regulators cannot stop bad decisions or economic problems. Banks and other financial firms will fail in the future. While we want to try to prevent failure, it is at least as important to make sure the system can handle failure so there will be no temptation to bail out firms in the future.

As Mr. Whalen points out, probably the most important thing we can do for stability is make sure regulators have the rules and powers in place to close failing firms in a quick but controlled manner. If we do not do that, markets will know the future Citigroups and AIGs of the world will not bring down the entire system. And market participants will act more responsibly because they know they will bear the consequences of their action. That will go a long way in creating a more stable system.

Thank you.
Chairman DODD. Thank you very much, Senator.
Senator Tester.

**STATEMENT OF SENATOR JON TESTER**

Senator TESTER. Yes, thank you, Mr. Chairman.

Quickly, first, I appreciate the hearing and appreciate you folks coming. I look forward to hearing your suggestions as we look for ways to instill consumer confidence and to promise stability in the—not in the marketplace, but in the banking institutions themselves.

I would just say this: My main concern with modernization at this point in time is the impact, if handled improperly, on community banks and credit unions. I think that these folks are the lifeblood, especially where I come from in rural America.

Last Saturday, as almost on a weekly basis personally, on a daily basis with my staff, we hear from community banks and credit unions about the issues that are impacting them right now, like premiums on deposit insurance, additional regulation on loan standards that really cuts back on their flexibility to get money out the door to local communities. And I would hope that whatever regulation we come up with will do what it is intended to do and not really hinder the folks who have really played by the rules and done a good job protecting their depositors and the folks they lend money to.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Tester.

Senator Johanns—Senator Corker. I am sorry, Bob.

Senator CORKER. As usual, I will pass and wait to hear from the witnesses, which I think will be a beneficial thing to do.

Thank you.

Chairman DODD. I appreciate that very much.

Senator Warner.

## STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Thank you, Mr. Chairman. I just want to echo what some of my colleagues have quickly said so we can get to the witnesses. But I appreciate you holding this hearing because I sometimes think particularly the media paints with a broad brush that everybody in the financial industry has been taking inappropriate actions. And the fact that today we are going to highlight some of the folks who are continuing to work through these challenging economic times and have not taken on some of the actions that got the industry in trouble is a good hearing for us, but it is also a good hearing for the public at large. So thank you for holding this.

Chairman DODD. Thank you very much.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, I will just indicate I did get the testimony yesterday. That is so helpful and so very, very appreciated. So to all of you who worked to make that happen, I just want to express my appreciation.

Other than that, I will pass and wait to hear from the witnesses.

Chairman DODD. Thank you very much.

Senator Bennet.

Senator BENNET. Mr. Chairman, I will pass. Thank you very much for holding this hearing.

Chairman DODD. Senator Bennett.

Senator BENNETT. I will pass.

Chairman DODD. Senator Schumer.

## STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. I would ask that my entire statement be put in the record. I just want to make three quick points in reference to some of the testimonies.

First, in reference to Mr. Mica's testimony, I think it is really important we look for more places for small businesses to get loans.

Banks are not doing it right now. And one of the things I will be asking you to comment upon is legislation that we are putting in. I think it was in 1996 we said that credit unions could only do 12 percent of their lending to small business. I have scores, maybe hundreds, probably thousands of businesses in my area that cannot get loans or are actually having lines of credit pulled from them by banking institutions. I have credit unions that would like to lend to these businesses and prevent them—they are profitable, ongoing businesses—from going under, and the credit unions cannot lend because of the cap. I think we ought to lift it, and I will be putting in legislation on that.

In reference to Mr. Whalen, having a unitary regulator makes a great deal of sense. Right now, banks can choose their regulators, oftentimes. You know, that is sort of like picking the umpire, and then having the umpire get paid more the more he is picked. We know what would happen. Senator Bunning knows best of all. The strike zone would expand. The calls would be different. And it would not work.

And, finally, Ms. Hillebrand, I just wanted to point out Senator Durbin and I have introduced legislation to have a Financial Product Safety Commission. I think that is really important. That avoids the cracks in regulation that Mr. Whalen has talked about because if the product is regulated, not who issues it, you are not going to have mortgage brokers getting around the banks, which is what happened before. So I think that is important to do, and with that I would just ask that my entire statement be entered into the record.

Chairman DODD. That will certainly be the case, and true of all of our colleagues here and true of our witnesses as well. Any supporting documents or information you think would be helpful to the Committee will be included in the record.

Let me welcome our witnesses this morning. Our first witness is Dan Mica, a former colleague of ours, a former U.S. Member from the House, currently President and CEO of the Credit Union National Association.

Our next witness is William Attridge, and I welcome my constituent to the Banking Committee. Mr. Attridge is the President and CEO of the Connecticut River Community Bank. We are pleased to have you before the Committee this morning. Thank you for being here.

Mr. Aubrey Patterson, is the Executive Chairman and CEO of BancorpSouth. He serves as Chairman of the American Bankers Association, and we welcome you as well to the Committee.

Mr. Richard Christopher Whalen is Senior Vice President and Managing Director of Institutional Risk Analytics. Mr. Whalen has worked in a variety of capacities, including the Federal Reserve Bank of New York, where he worked in the Bank Supervision and Foreign Exchange Departments.

And, last, we will hear from Gail Hillebrand, who is a senior attorney at the West Coast office of Consumers Union where she manages credit and finance advocacy teams and leads the Consumers Union Financial Services Campaign.

We thank all five of you for being with us this morning. We will begin with you, Congressman Mica, and we would ask each of you to try and keep your remarks to about 5 or 6 minutes, if you can, so we can get to the questions. Welcome to the Banking Committee, Congressman Mica.

**STATEMENT OF DANIEL A. MICA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CREDIT UNION NATIONAL ASSOCIATION**

Mr. MICA. Thank you very much, Mr. Chairman and Ranking Member Shelby and Members of the Committee. Let me just say that I will dispense with my written and oral testimony, try to summarize it to give you plenty of time for questions. I have heard in advance that several have to leave, so I am going to try to summarize very quickly.

First and foremost, we believe in strong, fair, competent, tough Federal regulators for all financial institutions. It does no good to the industry to have a regulator that rolls over. We all pay. Taxpayers pay, the consumers pay, and ultimately industry pays. So we start out that we do need some good, solid, tough, fair, and competent regulation.

And before I go into the other points, I think I need to hit a major point that is facing us right now, and you may have read the headlines over the weekend. Our Federal regulator took over two—into conservatorship two of our corporate credit unions. And I want to put this in perspective. We have 8,000 credit unions in the United States with 90 million members—8,000, 90 million members. We have 28 corporates where they put excess funds for liquidity and so on, a liquidity facility. One of those is a central corporate where the other corporates put money. And it was two of those corporates that the regulator took over.

And it is interesting. Some people said, well, they should not have put money into these mortgage-backed securities. According to what the regulators have advised me just the other day when they took this over, all those securities were AAA or AA when they bought them. So the surrounding economy has created a problem for two of our wholesale credit unions, and that will impact all of us. And we will back to you and I know the regulator will be back to you to deal with the waterfall of that. We will probably be seeking, much like the banks, an 8-year period of payback. We are not looking for a bailout but a payback. So we can pay that amount back that we have to refund the insurance fund over a period of time rather than in 1 year. Our legislation for credit unions, unlike the banks, makes us pay in 1 year.

But I want to say this very clearly, that all of you here and anybody that is writing about credit unions, or talking: The 8,000 credit unions, the 90 million members, they are safe, they are sound. They have almost 11 percent capital, and every account is insured up to $250,000—every federally insured account. There are about 100, 200 credit unions that have private insurance. But the best institutions in the United States, we think, to put your money in right now, and the safest. But I wanted to address that because I know there were some concerns.

So back to the fair, competent, strong, independent regulator. Essentially, the bottom line is credit unions are different than other institutions. We are not-for-profit. This is what you wrote in the law that defines a credit union, five things. You have to be not-for-profit, that is, 100 percent. And we are not like banks. We do not have shareholder stockholders. We are democratically operated 100 percent. We have volunteer boards, not paid boards like the banks. We have a special mission to provide consumers, and especially those of modest means, with credit and savings needs, consumers and those of modest means, not just those with modest means.

We are virtually 100 percent on all of those. Our regulator does a good job. We have come out of this worst crisis since the Depression. And, by the way, credit unions were born of the Depression in the 1930s because everybody else was failing.

We have a good regulator who understands the nuances and the problems that are attendant and much different than the for-profit system.

If we had a separate regulator—and we have tried that in the past, in the 1930s, in the 1960s and 1970s. Each time we are essentially being put into the—it would be the chicken being put into the fox lair because the banking industry, the for-profit industry has either been oblivious to the needs of credit unions or, as you all know, they are very harsh about our existence. They feel that we may not have a place in our financial services system, and they try to write our rules.

So you all know that, and we feel that unless we keep a separate Federal regulator—and that does not mean we love everything our regulator does, by any means. But if we keep a separate Federal regulator, we indeed would have a future in this country.

So there are many things we can do, Chairman. Mr. Schumer mentioned member business lending. If we could get that cap raised, we could $10 billion with no Government assistance in small business loans and little America Main Street tomorrow.

So, Mr. Chairman, I believe I am about out of time. I would just simply say this: I know there are questions about a consumer provision that was mentioned here. We again think that credit unions should not have to bear an undue burden, because we are not a part of that problem. Our members own our institutions. We do not abuse ourselves. And we think that all that needs to be taken into account as we look at what we are doing here.

Yes, systemic regulation needs to be looked at, and while you are doing it, you might look at the rating agencies, too, and the "too big to fail" policy, because all those have played a part that we have all suffered collateral damage in.

But we think you are on the right course. We look forward to working with you, and we thank you for the opportunity.

Chairman DODD. Thank you very much.

Mr. Attridge, welcome.

**STATEMENT OF WILLIAM R. ATTRIDGE, PRESIDENT, CHIEF EXECUTIVE OFFICER, AND CHIEF OPERATING OFFICER, CONNECTICUT RIVER COMMUNITY BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA**

Mr. ATTRIDGE. Mr. Chairman, Ranking Member Shelby, and Members of the Committee, my name is Bill Attridge. I am President and Chief Executive Officer of Connecticut River Community Bank. My bank is located in Wethersfield, Connecticut, a 375-year-old town with about 27,000 people. Our bank opened in 2002 and has offices in Wethersfield, Glastonbury, and West Hartford—all suburbs of Hartford. We have 30 employees and about $185 million in total assets at this time. We are a full-service bank, but the bank's focus is on lending to the business community. I am also a former President of the Connecticut Community Bankers Association.

I am here to represent the Independent Community Bankers of America and its 5,000 member banks. ICBA is pleased to have this opportunity to testify today, and ICBA commends your bold action to address the current issues.

Mr. Chairman, community bankers are dismayed by the current situation. We have spent the past 25 years warning policymakers of the systemic risk by the unbridled growth of the Nation's largest banks and financial firms. But we were told we did not get it, that we didn't understand the new global economy, that we were protectionist, that we were afraid of competition, and that we needed to get with the "modern" times.

However, our financial system is now imploding around us. It is important for us to ask: How did this happen? And what must Congress do to fix the problem.

For over three generations, the U.S. banking regulatory structure has served this Nation well. Our banking sector was the envy of the world and the strongest and most resilient financial system ever created. But we got off track. Our system has allowed—and even encouraged—the establishment of financial institutions that threaten our entire economy. Nonbank financial regulation has been lax.

The crisis illustrates the dangerous overconcentration of financial resources in too few hands. To address this core issue, we recommend the following.

Congress should require the financial agencies to identify, regulate, assess, and eventually break up institutions posing a risk to our entire economy. This is the only way to protect taxpayers and maintain a vibrant banking system where small and large institutions are able to fairly compete.

Congress should reduce the 10-percent cap on deposit concentration.

Congress should direct the systemic risk regulator to block any merger that would result in the creation of a systemic risk institution. An effective systemic risk regulator must have the duty and authority to block activity that threatens systemic risk.

Congress should not establish a single, monolithic regulator for the financial system. The current structure provides valuable regulatory checks and balances and promotes best practices among those agencies. The dual banking system should be maintained. Multiple charter options, both Federal and State, are essential preserve an innovative and resilient regulatory system.

Mr. Chairman, we do not make these recommendations lightly, but unless you take bold action, you will again be faced with a financial crisis brought on by mistakes made by banks that are too big to fail, too big to regulate, and too big to manage. Breaking up systemic risk institutions while maintaining the current regulatory system for community banks recognizes two key facts: first, our current problems stem from overconcentration; and, second, community banks have performed well and did not cause the crisis.

ICBA also believe nonbank providers of financial services, such as mortgage companies and mortgage brokers, should be subject to greater oversight for consumer protection. The incidence of abuse was much less pronounced in the highly regulated banking sector.

Many of the proposals in our testimony are controversial, but we feel they are necessary to safeguard America's great financial system and make it stronger coming out of this crisis.

Congress should avoid doing damage to the regulatory system for community banks, a system that has been tremendously effective. However, Congress should take a number of steps to regulate, assess, and ultimately break up institutions that pose unacceptable systemic risks to the Nation's financial system.

ICBA looks forward to working with you on this very important issue, and we appreciate this opportunity to testify.

Chairman DODD. Thank you very much, and you have raised some very challenging questions, good questions. We thank you for that as well.

Mr. Patterson, welcome to the Committee.

**STATEMENT OF AUBREY B. PATTERSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BANCORPSOUTH, INC., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION**

Mr. PATTERSON. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Aubrey Patterson, Chairman and CEO of BancorpSouth, Inc. Our company operates over 300 commercial banking, mortgage, insurance, trust and broker-dealer locations throughout six Southern States. I am pleased to testify on ABA's recommendations for a modernized regulatory framework. I might add that ABA does represent over 95 percent of the assets of the industry.

Recently, Chairman Bernanke gave a speech which focused on three main areas: first, the need for a systemic risk regulator; second, the need for a method for orderly resolution of a systemically important financial firm; and, third, the need to address gaps in our regulatory system. We agree that those three issues should be the priorities. This terrible crisis should not have been allowed to happen again, and addressing these three areas is critical to ensure that it does not.

ABA strongly supports the creation of a systemic regulator. In retrospect, it is inexplicable that we have not had such a regulator. If I could use a simple analogy, think of the systemic regulator as sitting on top of Mount Olympus looking out over all of our land. From that highest point, the regulator is charged with surveying the land looking for fires. Instead, we currently have had a number of regulators each of which sits on top of a smaller mountain and only sees its relative part of the land. Even worse, no one is looking over some areas, creating gaps in the process.

While there are various proposals as to who should be the systemic regulator, much of the focus has been on giving the authority to the Federal Reserve. There are good arguments for looking to the Fed. This could be done by giving the authority to the Fed or by creating an oversight committee chaired by the Fed. ABA's one concern in using the Fed relates to what it may mean for the independence of that organization. We strongly believe in the importance of Federal Reserve independence in its role in setting and managing monetary policy.

ABA believes that systemic regulation cannot be effective if accounting policy is not in some fashion part of the equation. To continue my analogy, the systemic regulator on Mount Olympus cannot function well if part of the land is strictly off limits and under the rule of some other body, a body that can act in a way that contradicts the systemic regulator's policies. That is, in fact, exactly what has happened with mark-to-market accounting.

ABA also supports creating a mechanism for the orderly resolution of systemically important nonbank firms. Our regulatory bodies should never again be in the position of making up an impromptu solution to a Bear Stearns or an AIG or not being able to resolve a Lehman Brothers. The inability to deal with these situations in a predetermined way greatly exacerbated the crisis.

A critical issue in this regard is "too big to fail." The decision about the systemic regulator and a failure resolution system will help determine the parameters of "too big to fail." In an ideal world, there would be no such thing as too big to fail, but we all know that the concept not only exists it has, in fact, broadened over the last few months. This concept has profound moral hazard and competitive effects that are very important to address.

The third area for focus is where there are gaps in regulation. Those gaps have proven to be major factors in this crisis, particularly the role of unregulated mortgage lenders. Credit default swaps and hedge funds also should be addressed in legislation to close gaps.

There seems to be a broad consensus to address these three areas. The specifics will be complex and, in some cases, contentious. But at this very important time, with Americans losing their jobs, their homes, and their retirement savings, all of us should work together to develop a stronger, more effective regulatory structure. ABA pledges to be an active and constructive participant in this critical effort.

I would be happy to answer any questions, Mr. Chairman.

Chairman DODD. Thank you very much, Mr. Patterson. We appreciate your testimony.

Mr. Whalen, welcome.

**STATEMENT OF RICHARD CHRISTOPHER WHALEN, SENIOR VICE PRESIDENT AND MANAGING DIRECTOR, INSTITUTIONAL RISK ANALYTICS**

Mr. WHALEN. Chairman Dodd, Senator Shelby, Members of the Committee, I am going to summarize my written comments and go down a list in bullet fashion, if you will, to respond to some of your comments and some of the other testimony.

Systemic risk—does it exist? I am not sure. I used to work for Gerry Corrigan. I watched it in its early formations. Read the paper on my Web site called "Gone Fishing," by the way. It is an allusion to his pastime with Chairman Volcker.

What I would urge you to do is talk about systemic risks, make it plural, because then you are going to focus everybody on what we need to focus on, which are what the components that cause people to talk about systemic risk. A synonym for "system risk" is "fear." If you go back to the Corrigan Group's work, you will see they differentiate between market disturbances and systemic events. Market disturbances are when people are upset, unsure about pricing, stop answering the phone. Systemic risk is when you are not getting paid. That is the difference. And if the Congress would focus on what are the components that cause us to talk about systemic risk, then I think we will make progress.

The role of the Fed: I have great admiration and respect for every one of my colleagues in the Federal Reserve System, especially for the people in bank supervision. But the Congress has to accept and understand that monetary economists are entirely unsuited to supervise financial institutions. In fact, they cannot even work in the financial services industry unless they work as economists. So when you understand their prejudices, when you understand their love and their devotion to monetary policy and economic thought, economic theory, you understand why it is hard for them to take apart large banks. They recoil in horror at the notion that we are not going to have lots of big dealer banks in New York City. Well, folks, they are gone. They are gone. We cannot put Humpty-Dumpty back together again.

So my sense is we have to excuse the people at the Fed from all direct responsibility for bank supervision. We give them a seat at the table by giving them responsibility for the things they do well, which is market liquidity risk management, market surveillance, *et cetera*. Do not ask them to do too many things. In my opinion—I worked on the Hill for Democrats and Republicans, and the thing you constantly do over and over again is give agencies too much to do. Let us give each one of these agencies ownership of the specific area: market liquidity risk for the Fed; supervision and even consumer protection in terms of the unified regulator; and then, finally, resolution and insurance for the FDIC separate from the supervisory activities.

Why? Well, really, if I had my druthers—and I loved the comments from the community bankers before—I would like to see the FDIC evolve into a rating agency where we could look at the premium they charge banks not just for their deposits but for all of their liabilities, and use that rating, use that premium charge as a basis for the public to understand the risks that that bank takes.

I am delighted to hear people talk about small banks. My company rates little banks. Most little banks are just fine. We have got 3,000-plus institutions in our rating system that are A or A-plus. The problem is we have got 2,000, as of the end of 2008, that we rate F. Half of those are victims of mark-to-market accounting; about a quarter of those banks have stopped lending entirely. You can tell because they are running off. They are shrinking. Their revenue is falling. They just are not in a position to lend.

So I think what we have to do is ask ourselves a basic question: What do we want to achieve with the future regulatory framework? And who are going to be the owners of each piece? I have provided a little graphic here, and the one thing I would urge you to consider both with respect to consumer protection and all other areas is let us see if we cannot partner with the States. Why can't the

Federal Government set consistent rules for all of the banking markets in the U.S.? Leave different types of charters in place, let us have diversity in terms of charts, but then we have to come up with a way of unifying capital requirements, unifying safety and soundness, and having a level playing field. I would love, by the way, to have better data on credit unions. I get calls about credit unions every day, but I cannot rate them because the data they put through the National Credit Union Administration is not organized properly. You guys have to go spend some time with the FDIC. Copy their methodology. I can get a bank call report off their Web site in real time now. It comes out at the same time as the EDGAR filing for public banks. That is what investors need.

Finally, let me just make one other comment, and I look forward to your questions. The reason little banks are not in trouble as much as big banks is because the State and FDIC regulatory personnel did not let them get in trouble. They did not let them build a financial market that is based on notional, fanciful, speculative contracts that have no connection to the real economy.

The biggest indictment of the Federal Reserve Board is that they have countenanced and encouraged renters to become equal with owners. That is what we have with AIG. The speculators, the dealers in New York, have leveraged the real world with these speculative "gaming contracts." That is the only thing you can call them.

If I want home insurance, do I go to the corner grocery store and pay him a premium every month? No. I go to a reputable insurance company. Everybody on the street knew that AIG was the dumbest guy in the room. They all knew, and they sucked that firm's blood for almost 7 years. Now we have to pay for it? No. I disagree.

I will be happy to answer your questions.

Chairman DODD. Thank you very much.

Ms. Hillebrand, thank you very much for coming.

**STATEMENT OF GAIL HILLEBRAND, FINANCIAL SERVICES CAMPAIGN MANAGER, CONSUMERS UNION OF UNITED STATES, INC.**

Ms. HILLEBRAND. Thank you, Mr. Chairman, Ranking Member Shelby, and Senators. I am Gail Hillebrand, Financial Services Campaign Manager for Consumers Union. You know us as the nonprofit publisher of Consumer Reports magazine, and we also work on consumer advocacy. I am happy to be here today to discuss how we are going to fix what is broken in our bank regulatory structure.

Americans are feeling the pain of the failures in the financial markets. We are worried about whether our employers will get credit so that they can keep us in our jobs. Many households have lost home equity because someone else pumped up housing values by loaning money to people who could not afford to pay it back and made loans that no sensible lender would have made if they were lending their own money rather than putting the money out, taking the fee, and passing on the risk. We also have pain in households because of the abrupt increases in credit card interest rates.

We have to start with consumer protection because the spark that caused our meltdown was a lack of consumer protection in mortgages. I am not going to talk generally about credit reform, but it will not be enough if we do stronger regulation and systemic risk regulation and we do not also do real credit reform. That would be like replacing all the pipes in your house and then letting poison water run through those pipes. We are going to have to deal with credit reform.

We have two structural recommendations in consumer protection. The first one is for better Federal standards, and the second one is to acknowledge that the Federal Government cannot do it all and to let the States come back into consumer protection in enforcement and in the development of standards.

We do not have one Federal banking agency whose sole job is protecting the financial services consumer, and we believe that the Financial Product Safety Commission will serve that role. It does not involve moving oversight of securities. That would stay where it is. But for credit, deposit accounts, and these new payment products, the Financial Product Safety Commission could set basic rules, and then the States could go further.

Consumers know we have to pay for financial products, but we want to get rid of the tricks, the traps, and the "gotcha's" that make it very hard to evaluate the product and that make the price of the product change after we buy it.

Our second structural recommendation in consumer protection is for Congress to recognize that the Feds cannot do it all and to bring States back into consumer protection in financial services regardless of the nature of the charter held by the financial institution. We have 50 State Attorneys General. That is a powerful army for enforcement of both State and Federal standards, and we have State legislatures who often will hear about a problem when it is developing in one corner of the country or one segment of consumers, before it is big enough to come to the attention of unelected bank regulators, and even before it is big enough to come to your attention.

At the very time that States were beginning to try to address subprime lending by legislation in the early 2000s, the OCC was actively issuing interpretations in 2003, and then in 2004 a rule that said to national banks, "You are exempt from whatever consumer protections States want to apply in the credit markets."

We have to get rid of that form of Federal preemption; including the OCC preemption rule. Congress needs to clarify that the National Bank Act really just means "do not discriminate against national banks," but not give them a free pass to do whatever they like in your State; and to eliminate the field preemption for thrifts in the Homeowners Loan Act. Those are going to have to go.

We have already tried the system where Feds regulated Federal institutions and States regulated State institutions, and it did not work partly because these institutions are competing in the same market, and a State legislature cannot regulate just some of the players in the market.

Turning to systemic risk, we do believe the most important step is to close all the regulatory gaps and to strengthen both the powers and the attitudes—the skepticism, if you will—of the direct prudential regulators. Every gap is a vulnerability for the whole system, as we have learned the hard way, and more attention needs to be paid to risk.

We agree with many others who have said we need an orderly resolution process for nondepository institutions. There should be clear rules on who is going to get paid and who is not going to get paid. These institutions should pay an insurance premium in some way to pay for that program themselves.

We do agree there will be a need for a systemic risk regulator. No matter who gets that job, it must involve a responsible and phased transition to get rid of "too big to fail." Either regulation has to make these complex institutions too strong to fail, or if private capital does not want to put their money in these complex institutions, then we have to phase them into smaller institutions that do not threaten our system.

In closing, we have got to get the taxpayer out of the systemic risk equation, and we have got to put consumer protection back into the center of bank regulation.

Thank you.

Chairman DODD. Thank you very, very much. I appreciate again your testimony here this morning. It has been very helpful.

Let me start the questioning. First of all, while I haven't cosponsored the bill that Senator Schumer and Senator Durbin have on financial product safety, I think there is some real value in the idea.

I also think there is general consensus among our colleagues that we need to fix regulatory arbitrage, where banks shopping around for the regulator of least resistance. I am trying to sort of sense just in conversations where our commonality of interest is.

I think there is general consensus in the community banks, Mr. Attridge. I hear that all the time here—That people appreciate it when they speak to their own community banks. We should be more careful about how we characterize banking generally and look through what has been going on at the community level.

Let me get to the issue of systemic risk. Mr. Whalen, your point about systemic risks is not a bad idea, that is, using the plural to talk about it, and also the issue of resolution management for nondepository institutions. I have some real reservations about the idea of the Federal Reserve. I just don't like the idea of a systemic risks regulator talking to itself. I think there is a danger when you are not listening to other voices when it comes to systemic risks, then you only hear your own voice.

And as you are examining the issue of systemic risks, whether it is just by the size of the institution or the products and practices they are engaging in, there are various ideas that one ought to apply. Dan Tarullo, I thought, was very good the other day before this committee talking about how he would define systemic risk and the importance of looking at it from various perspectives.

I, for one, would be intrigued with looking at alternative ideas, one of which has been raised by Gene Ludwig, who I think all of us are familiar with here. He raised the idea of a council, where it would be made up of the Fed, the OCC, the FDIC, possibly others, and where you would have a professional staff that would be analyzing systemic risk and rotating chairmanships with Treasury and others, so no one agency would necessarily dominate it. This is an idea that is interesting as an alternative to the Fed or some others that have been suggested.

I would like, if you might, Mr. Whalen, to comment on this concept and if you think it has any value.

Mr. WHALEN. Well, I am kind of old fashioned. I start with the U.S. Constitution, and in the Constitution, it told the Congress you will have Federal Bankruptcy Courts, and in the 18th century, that basically meant that bankruptcy was remote from politics. Over the last two centuries, we have politicized insolvency. In the 1930s, we had the Federal Deposit Insurance Act, which is, if you think about it, an extra chapter of bankruptcy, special to deal with financial depositories.

But at the end of the day, we have the mechanisms today to deal with these issues. We just don't have the political will. And you hear excuses coming from various quarters that say, oh, you can't resolve these big entities. They have complex financial relationships with other entities, dah, dah, dah, dah, dah. Well, if that is the case, then private property is gone. We have socialized our entire society and we might as well just dispense with it, nationalize the banks, and get on with ordering them in an efficient manner in a socialist sense.

But that is not American. Americans are meant to be impractical because the Founders knew that inefficiency is a good thing. So how do we, on the one hand, keep our efficient market, keep markets disciplined, but don't destroy ourselves, and I think it comes back to limiting the activities and the behavior of the institutions.

Don't think about systemic risk as a separate entity. It grows out of the activities of the institutions. And I will tell you honestly that our work, we did a lot of research on the profitability of banks, on the behavior of banks, their business model characteristics. The larger banks are not very profitable. I mean, they are almost utilities now.

So what was the answer by the Fed? Let us take more risk. The Fed wants to keep their constituents profitable, healthy, liquid. They would push them up the risk curve in terms of trading activities, over-the-counter derivatives, what have you. But then you look at the little bank that has 80 percent assets and loans and they are more profitable. In fact, on a risk-adjusted basis, they are three times more profitable than a big bank.

So what I am saying to you is that if you want to fix systemic, look at the particular.

Chairman DODD. That is a very valid point.

Mr. Patterson, how about you? I would like to hear from the other witnesses quickly on the systemic risks regulator, the idea of an alternative to the Fed.

Mr. PATTERSON. The concern, as I indicated in my prepared testimony, there has been a lot of focus on the Fed performing that function and there are pros and cons to it, but clearly they have been suggested. The major concern that I think my colleagues and I at the ABA would have is any interference with or encroachment on their primary duty, which is as an independent central bank responsible for monetary policy. That doesn't mean that they are not capable of performing that function, and I would respectfully say that I don't think the Fed has pursued a policy of encouraging riskier activities by larger institutions, but we do think their primary function is and should continue to be as an independent central bank primarily responsible for monetary policies.

Chairman DODD. So an alternative idea to the Fed is something that you would be inclined, or willing to look at.

Mr. PATTERSON. Yes, sir.

Chairman DODD. Mr. Attridge.

Mr. ATTRIDGE. I don't have a problem with the——

Chairman DODD. The microphone, please.

Mr. ATTRIDGE. I am sorry. I guess I have to bring it back to where I am in terms of running a community bank, and speaking on behalf of our bank and other banks in Connecticut, most of those that have been damaged—and most are doing well.

Chairman DODD. I agree.

Mr. ATTRIDGE. Their operating earnings are fine. Where they have been damaged is in the hits they have been taking to capital and those hits are coming from government-sponsored enterprises. A lot of them invested in Fannie Mae or Freddie Mac preferred stock over the years. They were encouraged to do so, and how could it be a bad investment? It was a government-sponsored enterprise.

Fannie and Freddie, when you mention mortgages that are made by Fannie and Freddie, that is basically the gold seal. If you are buying Fannie and Freddie mortgages, they are appropriately underwritten and loan-to-values are good, people are rated to determine whether they can pay them back, and that is all fine. But someplace along the line, that failed, and for whatever reasons, Fannie Mae and Freddie Mac went out and bought private securities that didn't fit their own standards for underwriting.

The same thing has happened with the Federal Home Loan Bank, where banks are now concerned about the investment they have in the Federal Home Loan Bank, and most banks have basically said, well, we are not going to continue to borrow from the Federal Home Loan Bank until that gets resolved because we don't want to have any exposure. When is the other shoe going to drop with the Federal Home Loan Bank? They have cut their dividend. They said they are not going to buy back stock for those that are repaying off their loans and in the past would have had the right to offer their stock back. The Federal Home Loan Bank is not doing that for the same reason. They went out and bought so-called toxic securities.

So whatever the regulator is has to look at not just the banks, they have to look at the kind of financial instruments that are basically everywhere and are being purchased by banks, others, insurance companies, *et cetera*. They are not being rated right by the rating agencies. I don't know whose job that is, whether it is the Fed or a council, as you mentioned, Senator. Someone has to look at all the instruments that are involved in our system.

And someplace back in Economics 101, Wall Street was there to allow the average citizen to participate in the capitalistic society, a place where you could purchase stocks. I think a majority of Wall Street now, or a good part of it, is basically a casino, and the financial instruments are nothing more than gambling, in my opinion, and I am not sure that is——

Chairman DODD. But the notion of the Federal Reserve, do you share the concerns expressed by Mr. Patterson and others about the Federal Reserve, given its responsibilities already in monetary policy and others——

Mr. ATTRIDGE. I don't share that concern. I just think they probably are sitting at—or of any institution we have now that is in the appropriate spot to look at the ramifications of what is going on from the highest part—from the top of the mountain, I think they are probably in that position.

Chairman DODD. Senator Shelby.

Senator SHELBY. Thank you.

Mr. Whalen, I want to pick up on something I understood you to be saying, and you can correct me if my impression is wrong. The Federal Reserve is and was the primary regulator of our holding companies, is that correct?

Mr. WHALEN. Yes.

Senator SHELBY. Where were they, if they were a bank regulator, where were they as a bank regulator, their role there as all these big banks got in such awful trouble? Where were they? That is the question. And if they were the primary regulator, gosh, you would have to give them an "F." You would have to give them an "F" if you were a teacher on their ability to regulate the banks.

Now, as you mentioned, they are economists, basically, and so that is troubling to me and I think it is also to Senator Dodd, Senator Bunning, and others. A lot of people have been saying, gosh, we are going to have to give the Fed the power as we go down the road because maybe by default. I don't believe that. I think whatever we do here, we have got to do it right. We have got to be comprehensive about it. But gosh, I see the Fed as a bank regulator big-time failing the American people. Do you want to comment on that.

Mr. WHALEN. Well, I think it is a failure born out of distraction. The Fed, as I mentioned before, the senior levels are populated by academic economists primarily. We occasionally let a banker in there or a generalist, but it has primarily become a place for patronage appointments of economists.

And frankly, if you look at the history of financial economics, the development of innovation, as we call it, derivatives, *et cetera,* these are all the intellectual playthings of the economists. So they promoted all of this innovation that we have heard from the other witnesses that is, in fact, now killing the little banks who weren't involved in it in the first place.

Senator SHELBY. Promoted the consolidation of the whole banking system, didn't it.

Mr. WHALEN. Well, yes, in a sense. I mean, if you look at Wells-Wachovia, the solution to a large bank insolvency was to slam it together with another large bank. This is a bad idea. We should resolve institutions as they are. You know, they were about to merge Citi with Wachovia. What do the people at the Fed think of? They have the data. They know what the profitability and the internal risk numbers are for these banks.

So I think culturally, they are ill equipped to put to the sword the dealers who enable their monetary policy. If you want to really simplify it, they just can't bring themselves to be tough on the very institutions with which they depend on implementing monetary policy.

You know, Bank of America and Merrill, I think is a classic example of this. Here was a horrible transaction that should never have been approved by the application side of the Fed, but the monetary policy people and the primary dealer folks said, oh, we have to keep this primary dealer intact. We have to sell Treasury bonds. Of course, it is a good point. I think we should have restructured the dealer and sold it to new investors. That is what we should have done. And the Fed can't do that. They are just completely incapable of making a decision like that, in my opinion.

Senator SHELBY. What is the end game with AIG, as you see it? More taxpayers' money floating their business and——

Mr. WHALEN. No. I pray to God that we find the courage to put that company out of its misery and put it into bankruptcy, where it should have been 6 months ago, because if we don't do that, then we are holding the people of the United States and the world hostage to the credit default swap market. If you put AIG into bankruptcy, you are not going to end the world, but you are going to end the credit default swap market as we know it, and I think that would be a beneficial thing for everybody.

Senator SHELBY. There is no end game, is there.

Mr. WHALEN. Well, if we have the courage, there is——

Senator SHELBY. No, but there is not right at the moment.

Mr. WHALEN. No, not at the moment. No. Absolutely not.

Senator SHELBY. Credit rating agencies—while many banks did not engage, as you said, in substandard underwriting for the loans they originated, many of these institutions bought and held so-called AAA-rated securities that were backed by the poorly underwritten mortgages.

Mr. Patterson, I want to ask you this question. Why was it inappropriate for these institutions to originate these loans, but it was acceptable for them to hold the securities collateralized by them.

Mr. PATTERSON. If I understand the question, Senator Shelby, the ability to hold is based on the policies and the oversight of what the securities are backed by. If I could add to this just a little bit, one of the things that I think has exacerbated the problems we deal with enormously has been—and it is not unrelated to the question, I think—has been the fact that illiquid markets have resulted in an application by FASB and by the accounting fraternity in taking illiquid markets where there were no willing buyers and sellers and creating the necessity for an inappropriate write-down of the value of the assets which are otherwise still performing or at least are performing to a greater extent than the required write-down to a nonfunctioning marketplace.

That is the subject of a broader discussion which I hope we have as to what a better solution would be with the role of the general primary regulator, the prudential regulator, and the systemic regulator as to ensuring that the current unresponsiveness, or at least the previous unresponsiveness of FASB and the SEC to find a reasonable solution to this problem that fits the business model of the institutions that are holding those investments is something that can and will be dealt with promptly.

Senator SHELBY. Mr. Whalen, do you envision a powerful regulator of all of our financial institutions, in a sense, including insurance, because of the risk that some companies like AIG have caused in the marketplace.

Mr. WHALEN. Well, as I said in my remarks, I think the Congress needs to mandate a level playing field as far as disclosure goes, because that way, companies like mine can rate insurance companies, too. It is very difficult to do insurance companies right now because the industry sits on the data. The NAIC will not do what they need to do to get that data really usable like the FDIC.

Let us remember, the FDIC is the gold standard when it comes to public disclosure of financial data. They have done tremendous things as far as making really useful portfolio-level data on banks available to analysts.

Senator SHELBY. Mr. Whalen, where did the doctrine of "too big to fail" that our Fed Chairman is all wrapped around now come from and how flawed is that.

Mr. WHALEN. Oh, it is hideously flawed. It goes against everything that Americans stand for. I think Andrew Jackson was right. The Fed, the central bank is a source of evil and we have to fence it.

But having said all that, the bottom line is that since the LDC debt crisis and the real estate problems in the 1980s, the central bank has taken the view that certain large financial services companies cannot be subject to traditional bankruptcy, like WAMU, like Lehman Brothers. I would tell you that Lehman is the model. You should invite the U.S. Trustee for the Southern District of New York to come sit here all day and talk to you about the resolution of Lehman, because that is what we should do with AIG.

Senator SHELBY. If an institution is too big to manage, and a lot of them seem to be——

Mr. WHALEN. Yes.

Senator SHELBY. ——then it would follow that they are probably too big to regulate——

Mr. WHALEN. Oh, absolutely.

Senator SHELBY. ——so we have created a monster among ourselves, have we not.

Mr. WHALEN. Our colleagues talked about the mountaintop, the God's eye view. There is no such thing, my friends. I work in analytics. I worked in finance my whole life. There is no God's eye view. And even when you give people information, they don't necessarily act on it. One of my best friends wrote a piece about AIG in 2001 that was covered in The Economist. Herb Greenberg threatened to sue him, and he didn't back down and eventually AIG had to go away. He was right, but nobody paid attention.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Senator Johnson.

Senator JOHNSON. Mr. Mica, would you care to comment about Mr. Whalen's criticism of your industry and its ratings.

Mr. MICA. I am not here to defend our regulator in that sense, but I will tell you this. We do have a call report and that call report does give data that we look at. It gives us a good picture of how a credit union is doing. Could it be better? Could the technology be better? Certainly.

I don't know how he does his ratings, but let me just mention, the Chairman mentioned rating agencies earlier. I, 15 or 20 years ago, sat on the other side of this table and the largest insurance company failure in America happened and the day before, it was AAA ratings. So we are starting to see that all over again. We see it again, and it is not just one agency, it is others.

So I do think that there are some areas that need to be looked at other than just the regulation of the industry, because you have to turn to others to get a sense of what you are investing in, and the public and the commercial enterprises of this Nation have looked there. So I don't have the answer. I just think it is something that needs to be looked at.

And again, with regard to our regulator, our call report is good. It probably could be better.

Senator JOHNSON. Does CUNA support a systemic risk regulator? If not, please elaborate.

Mr. MICA. We would support the concept of a systemic regulator. Again, we think that NCUA, because of the special nature of credit unions—credit unions are very unique in our financial services system—that they should continue, and we don't shop regulators. We have a dual-charter system, but we have lived and all federally insured credit unions all deal with the NCUA, but they have a special niche in our society. We are 6 percent of the market. And in every case we have seen historically—we were in the Farm Credit Administration, we are in the FDIC—wherever we get put, we get put down if we don't have some separate interest looking after us.

So we do think the concept is worthy of discussion. The Chairman mentioned earlier about bringing together the three major entities that now regulate, and I don't know if that is the answer or not. I do tend to agree with one thing, not everything that Mr. Whalen said by any means, but the fact is that when it gets to the systemic risk level, the other agencies have already failed, the regulators, and if you are going to call on the ones who have already failed, you may have a problem with a little self-defensive feeling. But we are open to any concept because we don't ever want to see what is happening to this country happen again. We are willing to discuss it.

Senator JOHNSON. Mr. Attridge, in your testimony you suggest that depository institutions' withholding companies should have a systemic risk fee imposed on them by the FDIC. Can you expand on this idea? How much would this fee be in addition to regular premiums.

Mr. ATTRIDGE. I don't know exactly how much the fee would be, but basically, right now, I disagree with the statement that the FDIC has failed in picking up systemic risk. I don't think that was their job. I am not sure their definition—they have done an excellent job in administering and regulating and resolving problems with the banks. I don't know what the details of their charter is, but I don't think that they were given the responsibility of regulating systemic risk.

Mr. MICA. And I agree with that. I agree with that.

Mr. ATTRIDGE. As far as our belief that some sort of premium should be paid, it basically just comes from the fact that right now, if you look at what is going on, a major problem for the community banks is the potential one-time assessment to refund the Insurance Fund, the FDIC Insurance Fund, and get the reserves back up to where they should be. Yet it is not really coming from problems that were in the community banks. It is coming from the systemic issues. At least that is my belief.

So I don't know what the number would be. Certainly, whoever analyzes this could come up with a number that said, all right, in this holding company you have a bank. The bank would pay the FDIC insurance rates, but there is another part of that, of the risk in that holding company that will demand another premium that they would fund. And the amount of that, someone would have to really determine by analyzing the past history of the failures.

Senator JOHNSON. Mr. Patterson, currently, there are resolution mechanisms for depository institutions that fail, but not for holding companies of the depository institutions. Who should be in charge of unwinding failed holding companies.

Mr. PATTERSON. I think, if I could respond and expand on that just a bit, I do think that the FDIC has the primary function in the insurance of deposits and the regulation of banks themselves. When we look at holding companies, we are looking at an evolving type of holding company, obviously, as a result of the crisis that we have gone through. We have a new cadre of holding companies that have entered that structure and have a period of time to come into compliance with it. They obviously are under the current law.

But it does seem to me that this goes also to the issue of the nonbank financial companies that are, whether we agree that it should be or not, the reality is there is a "too big to fail" reality, at least in the present and soon-to-be-future instance. That to me calls for a solution that resolution, to your point, that is not the proper role for the FDIC, which ought to be focused on deposit insurance and the regulation of banks.

I know that the Treasury has recently come with some ideas on this. I don't have a suggestion other than the fact that the resolution of those failures, particularly in the cases that I have described, should certainly be outside, in my opinion, be outside the realm of the FDIC's normal processes.

Senator JOHNSON. My time is up. Thank you.

Chairman DODD. Thank you very much.

Senator Bunning.

Senator BUNNING. Yes. A general question for everybody. Of you sitting at the table, how many believe that the Federal Reserve is an independent agency, since they have been involved with Treasury and others in making up all these bailout policies that we have been dealing with? And yesterday, according to the Secretary of the Treasury, they are responsible for the $1 trillion-plus that are going to buy up these supposedly illiquid assets. So if they aren't in bed with the administration and the Treasury, where are they as far as independence as their charter, the 1930-some, or whatever year it was written, charter for the Federal Reserve made them? Anybody.

Ms. HILLEBRAND. Senator Bunning, it is very hard, not being in the room, to know who should have done what differently. We are concerned about two other encroaches on the——

Senator BUNNING. No, answer my question, ma'am.

Ms. HILLEBRAND. I think that they have opened the credit window in a way that has created some expectations it will remain open and we have to worry about closing that. We are also concerned——

Senator BUNNING. Are they an independent agency? That is the question.

Ms. HILLEBRAND. So far.

Senator BUNNING. So far, they are an independent agency? Next.

Mr. WHALEN. No.

Senator BUNNING. No.

Mr. WHALEN. I think they have abdicated all of their statutory responsibilities.

Senator BUNNING. Responsibilities? Mr. Patterson.

Mr. PATTERSON. Clearly, it has become fuzzy of necessity. They have acted out of necessity, but——

Senator BUNNING. Necessity? In other words, saving AIG was a necessity.

Mr. PATTERSON. Was determined to be a necessity.

Senator BUNNING. OK. Mr. Attridge.

Mr. ATTRIDGE. I don't know the degree of their independence, as to how political they are, but I think I would say that if they are given the responsibility for overseeing financial risk, it would seem to me that they could bring on the kind of people that they need to do that job.

Senator BUNNING. Are they or aren't they independent is the question.

Mr. ATTRIDGE. Senator, I don't think I can answer that question.

Senator BUNNING. OK. Dan.

Mr. MICA. Yes. Legally, they are. Actually, they are not as what they are doing——

Senator BUNNING. OK, that is——

Mr. MICA. May I clarify an earlier statement, though? It was——

Senator BUNNING. No. I have got limited time and you can't.

Mr. MICA. I will come back later. Thank you.

Senator BUNNING. OK. Mr. Whalen, do you think there is anything that credit default swap add to the system that is worth the risk they pose.

Mr. WHALEN. Only if you restrict the purchase of protection to those who have an economic interest in the underlying basis, the company, the instrument. When you let derivatives settle in cash so that the buyer of protection doesn't have to deliver a bond or a loan or whatever else is used to define the terms of the contract, then you have loosed the bounds of earth and you allow people to multiply risk infinitely, and this is what we have with AIG.

Senator BUNNING. How many here at this table think that the new plan that the Secretary of the Treasury expressed yesterday in conjunction with the Fed—you know the reason they used the Fed is they don't want to come back to the Congress and ask for new TARP money because they know the answer will be, "No." So they are going to have the Fed print the money and the American taxpayers be on the hook for the money, over $1 trillion again. Do you know how much money that is since last September? Seven trillion. That is more than our whole national debt was just, like, 5 years ago.

Now, if you think that the Fed is an independent agency, you are smoking something that is illegal, because I have sat here in this same seat and asked Chairman Bernanke questions about "too big to fail," and he said, yes, there are institutions too big to fail. And I asked him, who allowed that to happen, and he couldn't answer. And his only job at the time was to regulate mortgages and set monetary policy, failing in both.

Mr. Whalen.

Mr. WHALEN. I think the key failing of the Fed was their inability to say no, much like Moody's and S&P not saying no when the Street brought them toxic——

Senator BUNNING. Yes, but they were getting paid huge sums of money for those AAA ratings and AA ratings, because I know, my son was involved with Moody's and Standard & Poor for his company, and when he got finished getting his BB rating, he had to pay $250,000 to those two entities.

Mr. WHALEN. A very important point, if I can interrupt you. When Moody's and S&P were doing that, they were operating in the primary market for securities, before the securities are offered to the public. This is the key issue. When a rating agency is following a security in the secondary market, they are acting as journalists. But when they are in the conference room with the lawyers and the bankers structuring the liabilities of a brand new Delaware corporation that is going to issue securities to the public, they are acting as a banker.

I was a supervisor of investment bankers, and this is why I get so enraged by this point. They were across the line. That is where we have a problem.

Senator BUNNING. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Bunning.

Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

In these questions, I hope we can keep the answers fairly concise, but this first one is to Mr. Whalen. AIG, and all the banks that are too big to fail, if we allow them to fail, can you give me a short, very short synopsis on what the impacts are if AIG goes away.

Mr. WHALEN. The bondholders will take a loss. We are subsidizing the bondholders and the counterparties of AIG right now with public funds. And we are doing this with Citi, we are doing this with Fannie and Freddie, and apparently we are prepared to do this with other banks so the taxpayer is going to subsidize the loss so that the bondholder does not take——

Senator TESTER. What impact does it have on my operating loan as a farmer.

Mr. WHALEN. I think very little at the end of the day, if it is handled correctly.

Senator TESTER. What impact does it have on the loan of the homeowner.

Mr. WHALEN. I think at the end of the day it would be beneficial. If an adult stands up and says I am going to resolve this, I am going to give you finality, I think the markets would rally.

Senator TESTER. Short term and long term.

Mr. WHALEN. Yes.

Senator TESTER. And what about if all 17 that are too big to fail—I think that is how many there are. Say there are 10.

Mr. WHALEN. Oh, I do not expect that to happen. Look, the top couple may need to be really restructured, but I am hopeful that if we turn the direction of the economy around we can deal with the others in a reasonable fashion.

Senator TESTER. All right. And I do not want to put words in your mouth but—and I appreciate that perspective, by the way. You had said that you rate banks. There are 3,000 of them that are A; there are 2,000 of them that are F mainly due to mark-to-market.

Mr. WHALEN. About half of the 2,000 at the bottom are mark-to-market, and the way we tell this is that they are not showing big loan losses. They have minus signs in their return on equity.

Senator TESTER. OK. How do we solve that.

Mr. WHALEN. You modify the FASB rule. But here is the thing, as I have been telling my clients: We may dodge the bullet by changing the accounting rules, but the underlying economics are still going to make us charge off these assets. So you are not getting anything. It is already baked into the pie. Whether we change the accounting rules or not, we are still going to see impairment on these assets as we go forward this year.

Senator TESTER. OK. So in the end, end of story, those 2,000 are still in trouble.

Mr. WHALEN. They are in trouble, but, you see, it is a very different thing when a bank is simply writing off assets that are still performing versus charging off loans that are lost. That is the difference.

Senator TESTER. I understand. This is directed to Mr. Patterson or Mr. Attridge. I am hearing from my community bankers in the State of Montana—I do not think it is singular to them, because you guys addressed part of it—that the regulators are coming in, and even though the community banks for the most part, at least in my State, have done a great job, are coming in and putting the squeeze on them from a regulatory standpoint so they cannot loan money maybe because they are saying you either have to write down some of these loans or the mark-to-market issue comes up, or just the fact that they want to make sure that nobody fails or nobody gets in a situation where they have to shut them down, they are pinching them hard. And it is having some real negative effects in the economy because money is not available to be loaned for a whole different reason and all the other stuff.

Could you kind of respond on that, Mr. Patterson or Mr. Attridge—Mr. Patterson first—if that is real and if you think it is necessary.

Mr. PATTERSON. Certainly, there is at least some discussion that there may be a mixed message. But the fact is that the vast majority of banks are lending, do have lendable funds, do have strong capital ratios. And regulators in the field are always going to be focused on safety and soundness of the performance of the individual bank.

Senator TESTER. But I am hearing from the banks right now they are more concerned about that than they were a year ago.

Mr. PATTERSON. Well, I have been in this business 40 years at the same bank, and we have grown to be a rather large institution. And every time there is a down cycle in the industry, regulators focus a bit more on safety and soundness, and should. But I——

Senator TESTER. Mr. Attridge, do you—go ahead.

Mr. PATTERSON. Could I just comment on something Mr. Whalen said? Just a slight disagreement on mark-to-market accounting and the impact on the books of the banks.

Senator TESTER. OK.

Mr. PATTERSON. His comment referred to an end loss, but I think the important thing is to understand that the role of FASB and the SEC, or whatever group, hopefully, succeeds in that responsibility to them, is such that the business model of the institution has an effect on the way that the new rules are promulgated.

There is no reason for a bank whose business model is to buy and hold securities to have to take a loss that erodes their capital and inhibits their ability to make loans.

Senator TESTER. I understand.

Mr. Attridge, I want to go back to the regulation question. Does increased regulation for the community banks in particular by the OCC have negative impacts on those banks' ability to make loans? And is their increased regulation something you think is proper.

Mr. ATTRIDGE. I have not experienced that. My particular bank—or my bank gets reviewed every 18 months, ultimately by the State of Connecticut as well as the FDIC. We are due for an exam at the end of April by the FDIC.

I am hearing from other banks that have been reviewed more recently, and a mixed message: Some of them saying there is really no significant difference from their past exams; a couple have said, yes, they have been asked to basically rate-shock or adjust the values on some of their larger loans to——

Senator TESTER. Do you hear it from any banks that are being regulated by the OCC.

Mr. ATTRIDGE. Yes, and I would say it was probably more pronounced there in terms of the OCC's request that they look at the banks with a more—excuse me, look at the loans with a more jaundiced eye, look at real estate values, and look at how those loans would perform if there was deterioration, further deterioration in the economy.

Senator TESTER. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Tester, very much.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you.

Let me start out, if I might, and actually thank the Chairman for his comments about the Federal Reserve as the super-regulator, if you will. I have not liked that idea from the beginning. It would seem to me to be just an enormous conflict of interest, that you would have the policymaker, the monetary policymaker then regulating the very entities that implement the policy. And I think that would just be all tied around the axle very, very quickly, and as you point out, they are finding it hard to regulate.

So I am glad that idea has surfaced and been discussed, but I am hoping at some point here we put that to bed quickly because

I think it is just the wrong direction, and I want to say that to start out.

If I could, Mr. Whalen, a couple of questions for you. When you talk about systemic risk and the need to focus on that, do you include in the definition of that risk just the sheer fact that an institution, if you were to look at their books, may look good, may even look great, but they have just gotten so darn big that if anything happens, the threat of bringing the Nation's economy down is real and exists? Is that something we should be looking at, just the bigness, the magnitude of the organization? I would like to hear your thoughts on that.

Mr. WHALEN. I think there are two aspects to that. It is a very good question. One is size and the other is complexity. If you look at Citi, for example, a quarter of their liabilities actually contribute to the deposit insurance fund now, the domestic deposits. The foreign deposits do not contribute and all of the bonds, which fund the other half of the company, do not contribute. So if you look at Citi, really they are actually contributing on a dollar of assets basis less than the community bankers are, because most of their deposits are domestic. The little guys are pulling the train.

So I think that Congress has to look at market share and has to look at complexity, and based on those two, if it were up to me, I would break up the top four banks and have them end up maybe a third of their current size. If I had 10 or 20 or 30 banks the size of U.S. Bankcorp, instead of four, which now predominate over the entire industry, I think we would have a more stable system.

Let me give you a number that will probably scare you a little bit. My maximum probable loss for the banks in the country above $10 billion in assets is $1.7 trillion. That is what we call "economic capital." It is a worst-case loss number. But $1.4 trillion of that is top four institutions. There are a lot of banks in that list that actually subtract from that number because they are so much less risky than the big guys.

We need a market share limit that looks at liabilities instead of deposits, in my opinion, and then as I said before, I would love to see the FDIC, as part of the systemic risk solution, rate banks based on their risk. Their premium, the contribution, the tax that they pay toward bank resolution costs should reflect their riskiness. And many of the institutions at this table would obviously be at the low end of that scale, as they should be.

Senator JOHANNS. Your thoughts on this tend to lend some support, in my judgment, to this concept of maybe it is almost a group sort of approach, because you are looking at a number of different factors, and I wanted to throw that out.

The second thing that I wanted to ask you—and this is maybe a little bit at the edges, but maybe not. When I think about systemic risk and I think about what has happened in the last 6 months, I think about the money that has been put into AIG and others, and I recognize it is all borrowed money. And I ask Chairman Bernanke about this, and he thoughtfully answered that, you know, this is a very difficult time for the economy, we probably need to solve the deficit issue at a later date.

Next week, we will start debating a budget with massive deficits, as far as the eye can see, new programs, Government expansion, on and on and on. How big of a risk is that to our economy? I see China's comments. I see economists starting to opine about the threat that this is creating. How big of a risk is our inability to manage our deficits to our Nation's economy.

Mr. WHALEN. Well, I think it is a horrible risk, and what I have said to people in the administration and to my clients and the readers of our public newsletters is that I do not think we can fund it. Does anybody really believe that we can go to market looking for $200 or $250 billion at a shot in new money and roll the existing paper that is coming due in that period? I do not think we can fund it.

We have to go look for ways to limit the cash cost of subsidies for our financial institutions so that we can focus on the economy. And the way you do that is by resolving these companies in the traditional fashion. Otherwise, these zombies will keep eating cash as long as we leave them alive. That is the issue. If you want to stop giving money to AIG, push it into bankruptcy. Let the State of New York Insurance Commissioner deal with the underwriters, and then the rest of it gets resolved by the U.S. Trustee. And I will say it again: That man should be sitting here. I would spend a whole week with him.

Senator JOHANNS. Mr. Chairman, thank you.

Chairman DODD. Thank you.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I want to continue a little bit on the line of my colleague from Nebraska on the "too big to fail" component.

Mr. Whalen, I thought some of your comments were very telling in terms of the amount of exposure we have from the top four banks. I guess I would ask Mr. Patterson, perhaps wearing more of your ABA hat than just your Bancorp hat, whether, one, you agree with Mr. Whalen's comments; and, two, some argument meant that if we were to try to look at size and complexity and draw the line, how that would position our industry with our foreign competitors that may or may not take similar actions.

Mr. PATTERSON. Senator, I think that is an excellent point to raise about the fact that we are not isolated from foreign competitors and we are in a global economy.

The fact is, whether we like it or not, we have arrived at a situation where too big to fail is a reality, whether it is a desirable circumstance or not or whether there is an available short-term solution to that or not. Be that as it may, that is where we are. And I think what it does is it speaks eloquently to the need for a systemic regulator, whether it be the Fed or whether it be a committee approach or a new entity that the Fed has some involvement with or not.

The problem here is not bank regulation. The problem is gaps in regulation, and excessive leverage by institutions, both banks and others in that large category, and lack of understanding of the types of risks that were being taken by management and by regulators.

But I do think this: I think that we have got to realize that it takes large, complex organizations to operate in a global economy, and I think there is a role for the community banks, there is a role for the regional banks like mine, and I think there is a role for these very large, complex money center organizations that perform multiple functions. Indeed, they are hard to manage. Some people say they cannot be well managed. Some people say the Fed should focus on its management of monetary policy and its independence and not be the prudential regulator of overall responsibility. Whether it is or should not does not obviate the need for it, that there be some control that these gaps be filled.

And I would suggest at least the hypothesis that if these institutions were broken up, others would evolve to develop to fill their place over time.

Senator WARNER. Mr. Chairman, I have got a couple more questions. Can I go ahead and——

Chairman DODD. Absolutely. Please do.

Senator WARNER. I guess one thing we have had under the Chairman's leadership, we have had a lot of folk come by on this issue of too big to fail, and we have one camp who has kind of said too big to fail, although oftentimes we have not had anyone take us through what that failure would actually look like, and other than this kind of cataclysmic event that would somehow unwind and have enormous negative ramifications. And then, on the other hand, we have regulators who come here and say it is not that they are too big to fail, but we just do not have a resolution authority for bank holding companies.

So one thing, Mr. Chairman, I would love to have, whether in this session or elsewhere, is at some point perhaps almost some tutorial on what would an unwinding of one of these top four institutions look like.

Mr. WHALEN. I could give you one right now.

Senator WARNER. If you could do that quickly, because I want to come back around to the products question as well.

Mr. WHALEN. Well, very simply, if it were up to me, with Citi I would roll the entire organization into a national bank. I would get rid of the holding company, and I would convert all the debt into equity, because then you would have a bank with 50-percent tangible common equity, and you could put Government money in and work through the bad assets, and they would no longer be an issue. We would not hear about them anymore. That is how you deal with this with finality, because they have a choice. You go to Citi and say, look, form a creditors committee, I want to talk to you in a week; otherwise, I let Sheila resolve the holding companies—the banks, and the holding company goes into bankruptcy. It is a very short conversation.

Senator WARNER. I wish it was that simple. Perhaps it is, but I would love to hear that thorough debate because I think many of us up here, we hear the frustration with "too big to fail" comments, yet at times other than perhaps the comparison is always made to the disorderly dissolution of Lehman and what happened in that case and how we do not want prevent that again, but——

Mr. WHALEN. Nobody does not want to get paid. But Lehman Brothers to me is a classic example of why the good people in the U.S. Federal Bankruptcy Court should be the first folks you talk to about this. You do not need another layer of politics to deal with holding companies, because once the bank is gone, what do you have? You have a Delaware corporation that belongs in front of the U.S. Bankruptcy Court. The moment the FDIC becomes receiver of the banks, it is no longer a regulated entity. They are gone. The deposits are gone. The loans are gone. That is the point.

Senator WARNER. Let me come at this from a different way, and I am going to thank the Chairman for giving me a little more time.

We look at size, we look at complexity. Another approach which I have been thinking about for some time is on the financial products end. Again, my premise is—and I would like to hear from a number of you, if you want to comment. And I spent 20 years around financing more in the venture capital end, but, you know, under the guise of innovation, it appears to me that over the last 10 years we have created a whole series of financial products that at some level have been argued that they have been about better pricing risk. I think on reflection it may be the marginal societal value of better pricing risk versus the type of systemic exposure that it has created and that many of these financial products may have been more about short-term fee generation than they have been about long-term value to the system.

But if we were to—and I know Senator Schumer has mentioned an approach he has taken, and I would love to see what would be the—what kind of thinking any of you have done in terms of the criteria of how we might on a going-forward basis evaluate financial products. Is there an underlying theory? Is it just the risk they bring to the system? Would there be some effort to try to make an evaluation of a macrolevel societal value added for these new financial products? How do you do that, and how do you—you know, I am a little bit afraid that we closed the door on certain products from the last crisis, but with the amount of intellectual fire power going into financial engineering, how are we going to preclude the next generation of financial products kind of getting beyond our control or oversight? Ms. Hillebrand, or anyone else on that comment.

Ms. HILLEBRAND. Thank you, Senator Warner. I think there are two things.

One is the Financial Product Safety Commission would be charged not with minimizing all risk but with minimizing undue risk to consumers, including keeping up with those new practices and those new products, so that the consumer who overdraws by 85 cents does not face $126 in bank fees, as happened to a consumer who we talked to earlier this month, and keeping up, looking at the practices. This is not to say banks cannot charge fees, cannot do anything, but to try to watch the practices and to outlaw those products that just do not fit with the nature of the product. Your checking account should be a service you pay for and not a fee machine for the bank. We need to get back to that kind of common sense. We think a Financial Product Safety Commission could do it on the consumer financial product side. In the mortgage and credit area, we also need to create accountability structures so that everybody who has a piece of that loan has responsibility going forward. That means a suitability requirement for those who are selling, a fiduciary requirement for those who are advising, and as people talk about "skin in the game," a responsibility going forward if there are later problems with that loan. That is a beginning.

Senator WARNER. Well, my time has expired. I know Senator Menendez—but I would like to hear from others, perhaps, if you could get back to us on what would be that—I still did not hear what would be the underlying theory of how we would evaluate financial products on a going-forward basis. We do not want to stem innovation and, clearly, some level of responsibility and higher minimum investment requires qualified investor criteria and other things I get. But what would be the underlying theory of how we should regulate or evaluate financial products.

Thank you for allowing me a little additional time, Mr. Chairman.

Chairman DODD. Well, it is a great question, Senator Warner, and we will come back to it because I think it is an important point.

One of the arguments I have made on this is you have got to begin with an overriding principle and concept. Just very briefly I would just say what happened over the years is, because some either promoted this idea very aggressively or acquiesced to it, is that we believed that consumer protection was antithetical to economic growth. If you were involved in consumer protection, this was somehow going to stifle creativity and imagination in wealth creation. And I think that was the fundamental flaw.

When you begin any of this discussion, it is important to point out that the reason my community banks in Connecticut and Montana and elsewhere have done well over the years is because they deal with customers every day. When you are dealing with investment banks and others, they just do not have that portal. When you have got to have a customer making a choice whether or not to go to your bank in Connecticut, the Connecticut River Bank, or to Liberty or to some other community bank, local bankers, as yours do in New Jersey and Virginia, better keep that consumer in mind. And if you do not, you are going to be in trouble. And when you abandon that notion, what happens to that depositor, what happens to that person who buys a share, what happens to that person who buys an insurance policy, what happens to that person who takes their hard-earned money and deposits it in a bank, there are different expectations about what they can have.

But, nonetheless, you begin with the notion of that investor, that depositor, that consumer, that shareholder, and you have a whole different perspective on this issue.

I am sorry. I did not mean to digress, but to me, if you begin from that point, it seems to me then you can begin to start making sense of all this.

Do you want to comment on that, Mr. Patterson?

Mr. PATTERSON. Yes, Mr. Chairman, if I may. I think your points go directly to the issue and the truth of the matter as you related to your Connecticut colleagues and I to my banks throughout the mid-South, is that our prudential regulator looks at the entire organization and ought to have a key role, and I think does have a key role, in the basic commercial bank system to not only ensure safety and soundness and compliance with other regulations, but also consumer protection. And that is why the problems generally that we are talking about today came from the nonregulated sector where those gaps are.

Chairman DODD. Yes. As Mr. Attridge knows we have a lot of competition in Connecticut when it comes to community banking.

Mr. ATTRIDGE. Right. Banking is a risk business, and in dealing with our customers, we can assess the risk. We get their financial information and make a decision whether they are a good loan or not.

The problem is there are a lot of other investments that we have to make. All banks have an investment portfolio that is partly for liquidity, partly for investment purposes. And we are relying or have been relying in the past that a rating agency and others, brokerage firms, have assessed the quality of the investments we are buying. And that has kind of broken down, to the point where we are asking people, you know, are you sure that there is nothing in this package of, you know, mortgage-backed securities that we are buying—even though they are Fannie Mae/Freddie Mac rated, are you sure that there are no nonqualifying assets. And that is where the system is broken. I think that is what a systemic regulator has to oversee.

Chairman DODD. I can just tell you that up here around this table, having been now through eight hearings and a lot of individual conversations with my colleagues on both sides, I mentioned earlier certain things, regulatory arbitrage being one. I can also promise you rating agencies are going to be very much a part of our overall effort. There is commonality at certain points here and there will be points where we will have some debate about which way to go. But on rating agencies, I will bet there will be an answer, other than what we presently are dealing with.

Mr. WHALEN. Could I make a quick point.

Chairman DODD. Senator Menendez, I apologize.

Mr. WHALEN. Just to answer Senator Warner's question, it comes down to suitability when you are talking about complex institutional products that could hurt a bank or hurt a pension fund or a public agency that has to invest on behalf—these are nonprofessionals, oftentimes, as I describe them. These people cannot model the risks in these securities, so they should not be shown them in the first place. And I say this as a reformed investment banker. Ninety-nine percent of the people in this world cannot possibly understand complex structured assets or over-the-counter derivatives. They are not suitable. They should not be sold to these people in any case.

Senator WARNER. But haven't we proven the case that even in some cases the uppermost levels——

Mr. WHALEN. Yes.

Senator WARNER. ——at these very financial institutions——

Mr. WHALEN. Absolutely.

Senator WARNER. ——that are supposed to be the most sophisticated borrowers did not even understand these products.

Mr. WHALEN. That is right.

Senator WARNER. And the risk exposure they were taking on.

Mr. WHALEN. So why does the Fed, and particularly the Fed, go out of its way to promote and extend the over-the-counter market? It boggles my mind.

Chairman DODD. Well, this is where the clearinghouse notion comes in. So you get these exotic instruments; you just cannot have them being pushed out the door without——

Mr. WHALEN. Well, clearing only gets you so far, though, because, remember, the issue is a central counterparty who is holding the money. It is like playing poker. If you were playing poker with somebody who did not have to put chips on the table, you would not be very happy with that, would you.

Chairman DODD. You are maligning gamblers.

[Laughter.]

Mr. WHALEN. I agree. The Nevada Gaming Commission would——

Chairman DODD. Gamblers lay off debts.

Mr. WHALEN. Absolutely. If the New York Lottery——

Chairman DODD. A good bookie will lay off a debt. This was not even good gambling.

Mr. WHALEN. The Nevada Gaming Commission could do a better job.

Chairman DODD. A good bookie will lay off a debt. They do not assume all that risk.

Senator WARNER. AIG did not do any downside hedging.

Chairman DODD. Yes. This was worse than that, my sense.

Anyway, Senator Menendez, I apologize for that digression.

Senator MENENDEZ. Coming from New Jersey, I know what a good bookie does.

[Laughter.]

Senator MENENDEZ. But in terms of the legitimate industry that exists in Atlantic City, so I just want to make that clear.

You know, I have been listening to a lot of what we have been doing here, Mr. Chairman, for several hearings now, and it seems to me one of the primary questions—and I would like to ask Mr. Patterson, since you are here on behalf of the American Bankers Association. Isn't it—when an entity is too big to fail, haven't we failed already.

Mr. PATTERSON. Certainly, if an entity cannot be properly regulated, then that is obviously a positive response to your question.

Senator MENENDEZ. Well, it seems to me that when we get to, whether it be in AIG or certain banking institutions that have been defined, that they create systemic risks to our overall economy because they are too big to fail, that we have already failed when they have become too big to fail because, in essence, we are saying that the risk comes to us as a society because should they make bad mistakes—and I agree that certainly if we had the regulators being the cop on the beat instead of asleep at the switch, that we may not have been totally headed to the directions we are, even though in many respects the regulators not only were asleep at the switch, but you had a whole universe of new financial instruments that they were not even engaged in.

But at the end of the day, it just seems to me that the consolidation took place in such a way that entities became so big that they are too big to fail, and therefore the risk goes to the society should they fail. And in doing so, that is a pretty significant shift. And the question is, should you allow entities, whether they be an insurance company or a financial institution, to grow to the point that they are too big to fail.

Mr. PATTERSON. Well, I think philosophically we would all agree that that is a bad proposition.

Senator MENENDEZ. We see how bad a proposition it is right now.

Mr. PATTERSON. That is correct. And in my opening oral comments, I made the comment that we all agree that "too big to fail" is an issue and it is a problem and it shouldn't exist. We also agree that in the present instance, it does, so we have a twofold task here, and that is to deal with it. Our suggestion is that we have a prudential regulator that has overall systemic risk responsibility.

Senator MENENDEZ. But up until now, to be honest, wasn't the drive to basically say, leave the marketplace to act on its own, and if consolidation took place, so be it, under the presumption that the regulators were going to keep it in check.

Mr. PATTERSON. I think that is a reasonable presumption and it obviously has——

Senator MENENDEZ. Has not worked.

Mr. PATTERSON. ——the issues that it has created.

Senator MENENDEZ. Ms. Hillebrand, if you want to comment on this. I also want to ask you, much of our discussion of regulatory reform has talked about systemic risk. It has talked about complicated financial instruments that pose a threat to institutions and investors. But isn't it equally important to recognize that maybe the earliest and most fundamental failure that led to our current crisis in which—and it was a much simpler failure—is a lack of consumer protection.

Ms. HILLEBRAND. Yes, Senator, absolutely. These bad mortgages—the bad practices in subprime were not new. They used to be called hard money loans. The theory was you could make money by loaning to someone who you had no reasonable expectation they would be able to repay. When that migrated into securitization, then it started to touch the whole economy, and we certainly saw it in nonprime with the no-doc loans. This little failure that first affected poor people and working class people and their neighborhoods suddenly kind of took off because it wasn't stamped out early. We don't know what the next little failure that could grow into a forest fire will be, but we know there will be one. Some innovation is toxic and early is the time when we need to address it.

On the issue of have we already failed if an entity is too big to fail, I think the answer is yes and the question is what do we do from here. Part of it is we have to figure out how to make these entities whose complexity creates a risk for those of us who don't own them and are not their bond holders, but just taxpayers, to carry that risk themselves, to put that into their cost structure. If it is too expensive to internalize those risks, then that means that we need smaller institutions.

And I am very intrigued by the ICBA suggestion that no further mergers be approved that involve institutions—involve or would create institutions—that are too big to fail.

Senator MENENDEZ. To some degree, in this present market that we are in, where we see one of the first things that happened in the first tranche of TARP was, in fact, the purchase of other institutions, and therefore more consolidation in the marketplace. Isn't that something that we should be concerned about as we look forward in terms of these set of circumstances.

Mr. WHALEN. With healthy institutions, no. As it was, I think, alluded to before, the industry can't shoulder the burden of the losses that are coming toward us. The Treasury is going to have to be involved. So if you go to a strong institution that is well managed and you say, we are going to give you more capital. We want you to eat everything that Sheila is cooking coming out of the resolution process with the FDIC. I think that makes sense, but I wouldn't allow any further combinations for the top 15, 20 banks. Why? Until we know how they are. Call me in 18 months and then maybe we will revisit this issue.

But I don't want to see any more large bank mergers until we know what their loss rates are going to look like and we know what their capital needs are. I think that is a reasonable position on large banks. Small banks, it is case by case because you have a lot of strong entities. You want them to buy troubled institutions to help the public. You want there to be continuity.

I mean, the FDIC does this every Friday and they are expanding their capacity so they can do more resolutions. It is a beautiful thing. When they close a bank on a Friday, there is a new owner over the weekend and on Monday morning they open and the public is served.

Senator MENENDEZ. That, I understand. I was talking about large institutions purchasing other——

Mr. WHALEN. Oh, I wouldn't allow it. In fact, you know, there is a moratorium now on de novos. They are not approving de novos applications now. They are basically telling all investors, focus on the troubled banks.

Senator MENENDEZ. One final question. With reference to the credit rating agencies, Mr. Attridge, you referenced them. Do you all have views as to how we, since you deal with them all the time and rely upon them to a great deal in terms of going ahead and making your loans, you know, do you have views on eliminating conflicts of interest that many of us consider pervade the credit rating industry, or have you anything that you think the SEC has done or should do.

Mr. ATTRIDGE. Well, all banks are asked to risk assess virtually everything they do, every kind of an investment they make. But the reality is, community banks, and even larger banks, do not have the wherewithal to risk assess every single investment, especially any kind of package of mortgages that have been packaged either by Fannie Mae, Freddie Mac, *et cetera*. Someone has to do that. I think what we are missing is the oversight of whoever it is that is putting those packages together, and that would include the brokerage firms that are packaging them as well as the rating agencies.

And clearly, AAA doesn't necessarily mean AAA anymore and that is a major problem for banks that are trying to make reasonable decisions when you have brokers calling you to say, you have got to buy this instrument. It is a great piece.

We have been very fortunate in getting good advice from our brokers and we have avoided all of these, mainly just out of sheer maybe just sheer fear. We are saying, you know what? We are just not going to take a chance unless we are absolutely sure that it is Fannie Mae, Freddie Mac quality investments, and that is what we have invested in. We stayed away from auction rate preferreds and things of that nature that I think very few people understand. But it is because we just don't have the confidence at this point in the institutions that are putting ratings on those investments.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Menendez.

Senator Schumer.

Senator SCHUMER. Thank you, and I thank all the witnesses.

First, to Mr. Mica, I want to come back to the legislation that I proposed to remove the business cap. Are your membership hearing from small businesses on an accelerated basis.

Mr. MICA. Absolutely, and it is being reported throughout the country, and you have heard it here today. Banks and institutions are not lending the way they used to. They have withdrawn. Just the other day, the President made a comment that 70 percent of all jobs in America come from small businesses. We have a cap of 12.5 percent. We do the job well. Our portfolio, by the way, is less than 1 percent default. And I know I get some criticism from some of our opponents who say, well, they don't know how to do it. They made a bad loan in Texas. Tell me about making a bad loan.

Senator SCHUMER. Yes.

Mr. MICA. I mean, we have——

Senator SCHUMER. So you think there would be significant desire——

Mr. MICA. We could put $10 billion on Main Street, $10 billion into Main Street small loans almost immediately if they lifted that cap.

Senator SCHUMER. Mr. Attridge, let me just ask you, why at this time—we can debate whether this should be done permanently—but why at this time when so many banks, big and small, are not lending for a variety of reasons, and I hear about it regularly—I have several instances in my State where a small business is going to go under because they can't get bank lending. The existing bank has pulled the line of credit. They don't think the value of the inventory is as great as it used to be. Credit unions want to lend and they can't because they are at the cap. Give me a reason why we shouldn't, at the very least, temporarily lift the cap, given the state of our economy.

Mr. ATTRIDGE. Well, first of all, Senator, I haven't experienced that. I keep hearing——

Senator SCHUMER. Assume it is true.

Mr. ATTRIDGE. Most——

Senator SCHUMER. Give me an argument against doing it, but just assume it is true, because I am telling you, I have come up against those instances.

Mr. ATTRIDGE. Of removing what cap now, Senator.

Senator SCHUMER. Removing the 12.5 percent limit on credit unions lending to small businesses. I mean, I understand it gives your membership more competition, but I am talking about now where we are desperately short of credit in the economy and lending to small businesses.

Mr. ATTRIDGE. Well, Senator, I guess from the community banks' point of view, at least the community banks in Connecticut and I know there are some in other parts of the country that are more stressed out because of the real estate issues in the area they are in, but we are well capitalized. We have the money to lend. We are lending and we are looking for loans and there is competition out there for good loans.

The problem is on the other side. The small businesses are not looking for——

Senator SCHUMER. Let me tell you a story I heard, and this is a Connecticut story. It is about a gentleman who applied for a job with me, OK. His father owns a small home heating oil delivery business. It has, I don't know, about 50 employees, ten trucks, I don't know how many. It had a $4 million line of credit with one of the larger banks, not a community bank, probably one of—I am certain it is one of Mr. Patterson's members. They pulled the line of credit. He has gone everywhere under the sun to try to find a substitute line of credit. This business is profitable. People are still buying home heating oil in Southwestern Connecticut. He can't find it.

So you tell me your people are lending. Mr. Patterson tells me his people are lending. Every one of us at the table has had businesses calling us and saying they can't find the lending.

Mr. ATTRIDGE. Well, Senator, we haven't——

Senator SCHUMER. And I know——

Mr. ATTRIDGE. We haven't changed our underwriting criteria. What has changed is the economic environment we are lending in.

Senator SCHUMER. So if a credit union would want to lend to this small business and the local community banker for whatever reason wouldn't, why not let them? Mr. Whalen.

Mr. WHALEN. You want to first make sure that that credit union understands what they are getting into and that they have the ability to create and manage small business credits——

Senator SCHUMER. Right.

Mr. WHALEN. ——because the reason for the cap was to protect them.

Senator SCHUMER. Well, some would say that is the reason for the cap. Mr. Mica is saying the other way. He is saying the reason is to protect the people who didn't want the cap. Ms. Hillebrand is acknowledging. I think the history shows this was pushed not by the regulators, but by the bankers, and I have—community banks do a great job in New York. I have a very good relationship with them.

Mr. WHALEN. Just make sure they have the capability to——

Senator SCHUMER. Well, that is a different issue, but most of them—I mean, the record of the 12.5 percent is good, so they know how to do it.

Yes, Mr. Patterson.

Mr. PATTERSON. Yes, Senator Schumer. You asked for facts. I am reasonably certain that most of the credit unions are well within the cap that exists today already, so I am not sure to what degree that is a limitation. I know they would like to have the cap raised, but I am quite sure that almost all of them are well within it.

Senator SCHUMER. Is that true, Mr. Mica.

Mr. MICA. Some are below, but many are pushing it. But worse, we have credit union after credit unions that come to me and say, I can get in this business and do this today, but I am not going to get in when there is only a 12.5 percent cap. So we are restricting loans, too.

Mr. PATTERSON. I had a follow-up.

Senator SCHUMER. Please.

Mr. PATTERSON. You made a reference to the fact that in the example you used, the line of credit was pulled by one of the large metropolitan banks.

Senator SCHUMER. Yes.

Mr. PATTERSON. Those institutions obviously in the present environment are capital constrained by the assets that are on their books, the difficult things that they are having to deal with——

Senator SCHUMER. Yes, I know that.

Mr. PATTERSON. ——as a result of all this. So they clearly are capital constrained. The vast majority of commercial banks are looking for loans, have the equity to support continuing to expand loans. And I think if you would survey throughout the membership of the ABA, the availability of credit is not an issue, except possibly in metropolitan areas such as where the money center banks had their——

Senator SCHUMER. Well, let me tell you, I have found in New York, and I compared this to my colleagues—my time is up—that that is not the case, that we not only have a failure for people to get new lending, but you have lines of credit being pulled regularly from institutions that are still profitable, and it is because of what you said. They have an asset on their books that is valued at 80. It was once 100. It is at 80, but they are worried it might go to 50. They are not making a new loan. They are holding their capital in case it falls to 50. I am not right now criticizing the bank that does that. They are looking for their own survival. I am just saying we have to find new ways of lending.

One quick last question just to Mr. Patterson. Do you think the TALF will expand more lending, particularly to small business.

Mr. PATTERSON. Based on what I know about it, which is somewhat limited, it seems that it does have that capacity.

Senator SCHUMER. OK.

Chairman DODD. Thank you very much, Senator. Interesting questions.

Let me ask, and I realize this is new and so I don't expect you to have a detailed answer, but I wonder if I might just get a reaction to the proposal made yesterday by the Secretary of the Treasury and the White House on the public–private partnership idea. I realize I am—just a general reaction. I don't expect you to have necessarily detailed information about it.

Congressman Mica, do you have a reaction.

Mr. MICA. Well, our reaction is we hope it works.

[Laughter.]

Chairman DODD. But we all do that.

Mr. MICA. You know, the details are very slim for us. We are taking a look at it right now. I do think the concept of getting the private sector involved in this is very creative and helpful, because obviously it hasn't worked the other way. Beyond that, I think I had better withhold.

Chairman DODD. Mr. Attridge, any reaction to this, as someone who watches this stuff.

Mr. ATTRIDGE. I still don't know what happens to the underlying value. I mean, there are losses there and they are going to have to be recognized someplace. You can buy all the toxic assets back, but you are buying from someone who is going to have to write them off.

Chairman DODD. Well, you just hit the right question, because I think everyone—they have asked the question, will buyers buy. I think buyers are going to buy. The question is, will the sellers sell.

Mr. ATTRIDGE. They will buy it at a price. That is right.

Chairman DODD. The question is whether or not sellers sell. And so the issue is whether or not the banks are going to want to have an adverse effect on their balance sheets by selling or being forced to sell something for far less than they think it is worth.

Mr. ATTRIDGE. A perfect example, I think, is the Federal Home Loan Bank right now. One of them wrote off about $329 million——

Chairman DODD. Yes.

Mr. ATTRIDGE. ——marking it to market. Their claim is that if they hold it to maturity, they will probably only have to write off $40 million. So if you go to them now and say, we are going to pay you market value and basically reaffirm the fact that they should have written off the 399, because that is what it is worth today, I don't think they are going to do it because they are going to take that hit to capital.

Chairman DODD. Just chatting with you here, I see the other side of the coin is that obviously we are all better off if these assets are off the balance sheets and markets can start functioning again. So there is that potential value, as well. And I understand your point clearly, because it does have an adverse effect on the balance sheet. But the upside is credit begins to flow again, to some extent.

Do you want to comment on this, Mr. Patterson.

Mr. PATTERSON. Yes, please. It underscores the importance of an effective mark-to-market accounting. If we have got a willing buyer, a willing seller, we are going to establish a bid-ask price, the transactions can be effective and they can achieve the intended results. What we don't need to have is an extension of the FASB approach that winds up with unintended write-downs for everyone with similar types of assets. If these institutions, even though they have absorbed the write-down, have the capital to support maintaining them on their books, then they are going to have an incentive to keep them.

Chairman DODD. Do you have any comment, Mr. Whalen.

Mr. WHALEN. Just two points. I think the key flaw in the Fed-Treasury approach is that they still want to recreate the old securitization market. They want to breathe life into securities that are dead. These are busted deals. No buy-side investor, other than the vulture community, is ever going to care about these deals again, regardless of what they were rated initially. They are gone. So the audience is small for this proposal.

The other thing I worry about is that I still don't think investors are going to care, because people in my industry know that whereas we are getting relief on the accounting side, as I said before, the cash-flows are still falling. So it is very likely that we are going to see economic impairment to these assets as opposed to accounting rule-driven markdowns that we have seen before.

And so my question is that if you are assuming that these assets are worth 80 cents, which I think is the core assumption by Fed and Treasury, and that all we need is time to help the markets recover back up to that intrinsic economic value of the security, I think that is a false assumption. I think we should be liquidating these instruments.

In other words, Treasury should buy them. I would like them to give them to the FDIC, make them an asset of the Deposit Insurance Fund, and then I would like to see FDIC walk into court in Delaware, after they talk to the trustee, of course, and say, Your Honor, we are liquidating the trust on behalf of the holders. We are going to give them notice, the ones who haven't responded yet, and then we are going to extinguish the trust and get the loans, sell them to the community bankers, let them deal with it, because they are the only ones with the people to deal with this problem. The money centers with a call center in Colorado somewhere cannot restructure loans. You have got to get the customer in front of the banker.

Chairman DODD. Mr. Patterson.

Mr. PATTERSON. I think we need to be very cautious about considering the role of the FDIC as an intermediary in that process. The Deposit Insurance Fund is funded by the commercial banks. We need to maintain the integrity of that system. The FDIC, obviously in collaboration with the leadership in Congress, is looking at ways to work with their working capital, but whether it has to do with the resolution of a nonbank major systemically important institution and the cost of that resolution or whether it has to do with such an intermediary role, the Deposit Insurance Fund does not need to be a part of that process.

Chairman DODD. Yes.

Mr. WHALEN. I disagree, Mr. Chairman, and let me just jump in here. It is all run off the Treasury. Whether we are talking about the FDIC Fund or any other Federal agency other than Pension Benefit Guaranty, it is all running out of the Treasury's general fund. So let us just dispense with this distinction.

Ms. HILLEBRAND. Mr. Chairman, there is one other issue on the new program——

Chairman DODD. I will come right to you. Go ahead. I just want to finish this.

Mr. PATTERSON. I have to respond to that. The Deposit Insurance Fund has always been completely funded by the commercial banks. It is and it needs to continue to be. It is not a Treasury function.

Mr. WHALEN. It is part of the general fund.

Chairman DODD. Yes.

Ms. HILLEBRAND. Mr. Chairman, there is one other issue that will need to be looked at in how this is done, and it will be in the details that come out after today. If these assets are bought and held until they are paid off, it won't be an issue. But if they are bought by people who intend to liquidate them promptly, there will be some significant questions about responsibilities in debt collection, so that we don't get the kinds of problems that we already have when very old debts are bought by someone who hasn't got the paperwork, can't prove what was owed, and doesn't have the records. That puts the consumer in an impossible situation.

Chairman DODD. OK.

Mr. MICA. Mr. Chairman.

Chairman DODD. Yes.

Mr. MICA. If I may, I know we are the small ones at the table, but the way this legislation and previous legislation has been written, all the remnants of these big problems are being left certainly on the big institutions, but we end up with some of those, too, and we should not be discriminated against and left out. If there are going to be opportunities to offload some of these difficult problems that were created by others, we should be included in that.

So I appreciate your consideration as you move forward on that and you look at that legislation, but to date, wherever there has been an indication to help us, the regulations have essentially ended up saying, we haven't taken you into consideration, possibly because you are too small, or possibly because we think you are doing so well. But we shouldn't be left with the remnants of everybody else's problem and no exit, either.

Chairman DODD. Thank you very much.

Let me come back, if I can, to this consumer protection notion. Let me start with you, Mr. Attridge, as a community banker. Sometimes the consumer protection notions have been secondary thoughts, at least that is my impression. I am speaking very generically now. And the issue of safety and soundness trumps every other consideration, including consumer protection. At least that is the impression I have had.

What is your reaction to a Financial Product Safety Commission idea that has been articulated by the Consumer Union and others? Elizabeth Warren at the Harvard Law School has been, I think, probably the leading advocate of the idea. But how do you react to that.

Mr. ATTRIDGE. Well, my experience has been, and I believe the experience of most of the community banks in Connecticut is the compliance section of the FDIC and the CRA section of the FDIC, as well as the State of Connecticut and our Banking Department, are very diligent and determined and I would tell you we spend an incredible amount of time on CRA and compliance issues. We all have CRA policies, compliance policies. It is basically built into every job.

We just took on a compliance officer, and we are a bank of 30 people now and we brought in a compliance officer because you need the experience and just the ability to deliver all the reports to prove, even though you have never been accused or you have never had a complaint from your marketplace that you were discriminating in any way, you need the proof. You need to fill out the HMDA reports. It is a massive process and it is very detailed.

So I think the job that is being done by the FDIC in that area is more than adequate, to the point where sometimes you step back and you say, the safety and soundness issues are more important to the longevity and soundness of the bank, as well as profitability of the bank, but we are spending an awful lot of time on just proving to people that we are doing things appropriately for the consumer.

Chairman DODD. Mr. Patterson.

Mr. PATTERSON. First, I would like to say that the Congress has been very helpful in looking at the issue of regulatory burden and testing the efficiencies and the effectiveness of regulations and giving us relief where you could and we are appreciative of that.

Two points, simply. One is most of what we are here to talk about today was in the nonregulated area, and the commercial banks have not been the source of the problem and are not today and will not be in the future.

But the second reason is I have a concern that if there is a separate agency that has that responsibility and the prudential agency has the overall responsibility, that you don't have the opportunity to look at the entity as one affects the other in a holistic way.

Chairman DODD. How about if you build into the prudential regulator the idea of the Financial Product Safety Commissioner so it is part of it and they are not a separate entities.

Mr. PATTERSON. I believe it already is the prudential regulator's role and I think that is where it should be, and I think it can be very effective and I think it has been. That is not where the problem has been.

Chairman DODD. Ms. Hillebrand, how do you respond to this? You are already involved in consumer protection, and know about these functions that are required of our community banks and regional banks and the like. In fact, I remember the CRA debate. During the largest debate, which was over Gramm-Leach-Bliley, I was not sitting in this chair. I was sitting several chairs down from here in that debate. We stayed up all night on Gramm-Leach-Bliley. People were going back and forth and talking about the whole notion of commerce and banking, and that is a legitimate question to have raised with that legislation. But the debate all night was, as we resolved those matters, was over CRA. That is how we came to the conclusion as to whether or not we could have a Community Reinvestment Act and how it would work, and ultimately resolved in favor of one.

I love to point out to people, because I know there is an argument to the contrary, that if you look at institutions that follow CRA guidelines on mortgage lending and underwriting standards, only about 6 percent ended up in foreclosure. Where CRA was being followed and where the underwriting standards were adhered to, poorer people were actually getting into homes on terms they could afford. It is when you stepped out of that process with the no-doc loans, the liar loans, and the like, that this whole system fell apart. That, to me, is always going to be the root cause of all of this, in a sense.

That was not a community banking issue, that was a different matter. But I wonder if you might respond to this point that Mr. Attridge and my community bankers raised. We are already doing this. We are working our heads off every single day at this stuff. You are going to overload us with some additional burdens here we can't possibly comply with.

Ms. HILLEBRAND. Mr. Chairman, thank you for your earlier remarks about the Financial Product Safety Commission. We don't believe we will overload anyone who is treating their customer fairly and responsibly. This would create rules that apply across the board to make the products simple enough for the customer to use without those "gotchas" and tricks. Credit unions and community banks came very late to some of those tricks and traps, but when everyone else is doing it, it does create a pressure and it is a profit center for your competitors if they are doing it and you are not. That can be a problem. In addition, the bank regulatory model of supervision will still exist. There will still be safety and soundness regulation. Of course, consumer protection will still be a piece of safety and soundness. But what bank regulators look at is compliance. Was a current law broken? What the Financial Product Safety Commission would do is be an "unfairness practices regulator" where no current law has been broken. As the *Wall Street Journal* said recently about some hedge fund conduct, "it was perfectly legal when it occurred." It would be those things the Financial Product Safety Commission would make rules about, not all of them, but the ones that go too far.

Chairman DODD. Mr. Whalen, do you want to comment on this.

Mr. WHALEN. If one was creative, you might lessen the burden on institutions by going to a product-focused regulatory regime. In other words, don't make it a compliance checklist sort of exercise for the bank. Take that away from the bank management having to go through that as part of their exam process and instead just have a product focus by another agency. That might be a *quid pro quo* for the industry.

Chairman DODD. Let me ask you—I am jumping around here, but trying to wrap up. Forgive me for not remembering exactly which one of you embraced this view, but I mentioned Gramm-Leach-Bliley going back a number of years ago and the issue of whether or not you could create firewalls between traditional commercial activities and banking activities. One of you has advocated that actually the distinction between commerce and banking doesn't have much validity. Is that your opinion.

Mr. WHALEN. If we live in the age of "too big to fail," why bother with the Bank Holding Company Act? What is the point? That was supposed to be the firewall between the insured depository, where we have limits. I remember when I first——

Chairman DODD. It doesn't have any authority. I mean, that was the Federal Reserve failing to regulate.

Mr. WHALEN. When I first started working at the Fed, we had to memorize Section (4)(c)(8) of the Bank Holding Company Act so we knew what banks were allowed to sell credit insurance. The Congress had many such restrictions on bank activities and that limited their risk.

Chairman DODD. Yes. Are you still an advocate that we shouldn't have any distinction between commerce and banking.

Mr. WHALEN. I am because I think we are here now. I think we may have to invite the industrial sector into the financial sector at some point to provide new capital.

But let me put it to you this way. There is a tension that has been illustrated in the last few months between the creditors of a bank holding company and the counterparties of the subsidiary bank. One could argue that the counterparties to the subsidiary bank, all of them, are now senior to the creditors of the parent bank holding company. I don't think that serves any public policy purpose. I would rather see the bank at the top issuing debt, issuing equity, issuing deposits, and paying a full load to the FDIC or whoever is the systemic risk regulator to contribute to the Resolution Fund.

Chairman DODD. Let me ask Mr. Patterson about that.

Mr. PATTERSON. I do think in response to your direct comment that—and by the way, the encroachment by industrial firms raises a whole new set of issues as to——

Chairman DODD. The ISCs, you are talking about.

Mr. PATTERSON. Yes, how we can reach that arena. But the problems we are dealing with came from the nonbanks in great number. If it weren't for Gramm-Leach-Bliley, if you had not passed Gramm-Leach-Bliley, you wouldn't have had the availability of the solutions that we have had with B of A assuming the responsibility for Merrill Lynch, with Goldman Sachs and Morgan Stanley achieving bank holding company status. I am not saying that that was not in response to a crisis. It obviously was. But had there not been—had Gramm-Leach-Bliley not been on the books, those solutions would not have been available to us.

Chairman DODD. Any comment on that, Mr. Attridge.

Mr. ATTRIDGE. I agree. It is complex enough now without allowing commercial enterprises to intermingle with the financial institutions. I just think it adds an additional level of risk. I think they have experienced that in Japan and that was one of the problems.

Chairman DODD. Well, you have been very patient. We have had you almost two-and-a-half hours here, and I apologize for taking that long. There are some additional questions we will submit for the record for you, and I am sure my colleagues will too.

I want to apologize to my Republican colleagues. They had a meeting that they were asked to attend at 11. It came up at the last minute, and so they felt obligated, but I know they will have some questions. Of course, several of them stayed, but nonetheless, the rest of them could not be here this morning.

We will have another hearing later this week on the subject matter relating to the issue of the regulatory architecture.

This has been very helpful this morning. I want to stay in touch with you, as well. This has helped define the conversation. I am very intrigued. Mr. Attridge had some very provocative ideas, as well as Mr. Whalen, and the advice and counsel of Consumers Union, we always appreciate it. The ABA has been very active in participating over the years with us in this. We have moved our way through this, and, of course, the credit unions. We have 142 of them in Connecticut, so I want you to know, I am not unmindful of that. I bet Mr. Attridge could have told you exactly how many credit unions there are.

I thank you all very, very much, and this Committee will stand adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you, Mr. Chairman. I think the events of the last few days have made it clear that our efforts must remain directed at dealing with the problems in the financial system. As we have seen from the huge swings in the markets with each announcement coming from Washington, the situation remains extremely volatile. Until we effectively deal with our financial system our efforts may, at best, be misguided and, at worst, damaging. After we deal with the financial crisis, we will then have to focus on correcting the weaknesses in the existing regulatory framework.

I look forward to continuing the examination we began last week at our hearing with the banking regulators. Among the other issues that emerged from our hearing, I think it is clear that we need to have a better understanding about the nature and causes of systemic risk. With greater knowledge regarding this very difficult problem, we will have a better chance at fashioning the necessary measures to deal with it in the future.

As I stated last week, it should be our goal to create a durable, flexible and robust regime that can grow with markets while still protecting consumers and market stability. This can only be done through a serious and considered effort on the part of the Committee.

Once more, getting this done right is more important than getting it done quickly.

Thank you Mr. Chairman.

## PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you Chairman Dodd and Ranking Member Shelby for holding today's hearing. As we now know, the regulatory structure overseeing U.S. financial markets has proven dangerously unable to keep pace with innovative, but risky, financial products; this has had disastrous consequences. Congress is now faced with the urgent task of looking at the role and effectiveness of the current regulators and fashioning a more responsive system.

I share my colleagues' great interest in a systemic risk regulator. I am interested in how that entity would interact with existing bank regulators. I also think it is vitally important that we address the "too big to fail" issue. How do the regulators unwind these institutions without causing economic harm? In addition, I share the interest in proposals to enhance consumer protections—particularly whether this should include a separate regulatory body specifically designed to protect consumers. I look forward to hearing the views of today's witnesses on these topics and a variety of other topics that they believe we should consider as we look for solutions.

I will continue working to fashion good, effective regulations that balance consumer protection and allow for sustainable economic growth. Today's hearing is an important piece in the development of proposals to modernize the bank regulatory structure. Any proposal must create the kind of transparency, accountability, and consumer protection that is lacking in our system of regulation.

Thank you, Mr. Chairman.

## PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER

Mr. Chairman, thank you for holding this important hearing. Modernizing our balkanized bank regulatory structure is critical to restoring confidence in our financial sector. It is an accident of history that we have so many different banking regulators with so many different jurisdictions, and there is no good reason that it should continue.

It is especially nonsensical that we have allowed banks to choose their own regulator. With all due respect to the regulators, it's like if major league baseball announced tomorrow that from now on, pitchers could choose their umpires, and on top of that, the umpires' salaries would go up the more they were chosen. I think we know what would happen. You'd get a bigger strike zone and a lot more called strike threes. And that's basically what we've done. I am not impugning the motives of anyone here. But I think we've created a set of perverse regulatory incentives that have contributed to our current crisis.

Bank regulators need to remember that their "clients" are not the regulated banks, but those banks' customers, and, more broadly, the health of the banking system at large.

With that in mind, it is also important that we address the issue of consumer protections (or lack thereof) developed by the federal regulators.

We gave the Federal Reserve the power to regulate the mortgage market, the power to end abusive lending practices, way back in 1994. Yet the Fed, and the rest of the regulators did not utilize these powers until 2007, when it was already far too late. The damage had already been done, and the economy was careening towards the disaster that we now face.

From this example, and others, such as the failure to rein in abusive credit card practices, it seems clear that the regulators have become captive to the regulated entities, especially when it comes to consumer protections, just as financial institutions have engaged in "trip wire pricing", designed to induce mistakes by consumers so that the companies can jack up fees and drive up revenues.

To address this failure, Senator Durbin and I have introduced a bill that would create a Financial Products Safety commission, similar to the Consumer Products Safety Commission, whose primary goal will be to ensure that consumers' interests are made paramount.

Thank you for holding this hearing Mr. Chairman. I look forward to working with you and my colleagues on this Committee on these important issues.

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## PREPARED STATEMENT OF DANIEL A. MICA

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
CREDIT UNION NATIONAL ASSOCIATION

MARCH 24, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, on behalf of the Credit Union National Association (CUNA), I appreciate the opportunity to appear before you to express the need for maintaining an independent federal regulatory agency for federally insured credit unions.

I am Dan Mica, the President and CEO of CUNA. CUNA is the largest credit union advocacy organization in this country, representing approximately 90 percent of our Nation's 8,000 state and federal credit unions and their 92 million members.

Mr. Chairman, I applaud you for addressing this pressing issue. The collapse of the financial system has exposed flaws in the regulation of U.S. financial institutions, and these flaws absolutely must be addressed. I suggest, however, that most of the current crisis was caused by the actions of relatively unregulated financial institutions, and by compensation practices at even regulated institutions that encouraged excessive risk taking. I can assure you that neither of these two factors exists at credit unions. Credit unions did not in any way contribute to the current financial debacle and their current regulatory regime coupled with the cooperative structure militates against credit unions ever contributing to a financial crisis. Therefore it is imperative that credit unions not be swept up in the tide of regulatory reform that is so essential for some other parts of the financial system.

Credit unions' unique mission, governance structure, and ownership structure necessitate an independent federal regulator in order to ensure that the credit union model is not eroded as a result of the misapplication of bank regulations to credit union operations. Unlike for-profit banks, credit unions are not-for-profit institutions that exist to serve their member-owners rather than to profit from them. Also unlike banks, the members of the credit union own their institutions, which are subject to a democratic, one-member–one-vote system irrespective of members' account balances or any other factor.

I am aware that, on Friday, March 21, NCUA did place two wholesale, or "corporate," credit unions into conservatorship. Those institutions serve only other credit unions, not people, and are completely different from the 8,000 retail, or "natural person," credit unions in this country. Natural person credit unions have very narrow investment powers and very conservative investment policies, whereas corporate credit unions enjoy broader investment powers. Essentially, what created losses at the two corporate credit unions were declines in the values of mortgage-backed securities in which they had invested. Although these securities were originally AAA-rated and appeared prudent when they were made, market developments provide to the contrary. Let me emphasize two points here: first, few, if any, of the mortgages backing the securities were originated by credit unions; and second, the credit union system itself is funding the losses on these investments. That is not to say that we would reject some government help with the problem; we would prefer some help, which we would pay back, spreading the losses over time. But we expect to pay for the problem ourselves, and the problem says nothing about the condition or operations of credit unions that you and I can join.

Getting back to the current discussion of regulatory restructuring, let me call your attention to the fact that, for decades, the banking industry has sought the extinction of credit unions in this country. Rather than pursue this goal in the marketplace, banks often seek to leverage legislation and regulations against credit unions through intense, well-funded lobbying and litigation. We urge Congress not to allow its deliberations about financial regulatory restructuring regulatory to become a vehicle for more of these tactics. The loss of the diversity, conservative management, and consumer ownership of credit unions through the creation of inappropriate regulatory mechanisms would be tragic not only for credit unions, but also for the 92 million consumers who take advantage of credit union service. As I explain in more detail below, regulatory restructuring could force credit unions into the mold of the banks if restructuring is not approached with care.

**Changes to the Credit Union Regulatory Structure Should Be Tailored to the Need**

Although the causes of the current economic crisis are complex, few can doubt that the skyrocketing rates of mortgage loan defaults and foreclosures of the past few years were the catalyst, with the resulting drop in housing values serving to exacerbate these problems. The primary culprits were subprime mortgage loans characterized by high rates with large interest-rate re-sets, negative amortization, lack of sufficient underwriting, or other indicators of fraud.

Unlike other types of financial institutions, credit unions originated few if any of the subprime mortgage loans with these characteristics and have not otherwise been the cause of our current economic circumstances. Credit unions' generally conservative lending practices and ongoing efforts to place the needs of members over profits have distinguished them from those who made unscrupulous loans in recent years.

This distinction has been recognized by many in Congress. For example, Congressman Barney Frank (D-MA) has publicly stated that the economic crisis would never have occurred if all lenders originated loans in the same manner as credit unions.

Unfortunately, the high rates of mortgage defaults and foreclosures have affected credit unions and their members as the current recession has deepened. Increased unemployment and other factors have affected the ability of some members to keep current on their mortgage, auto loan, and other obligations. Notwithstanding these difficulties, credit unions have been able to continue making loans, while other types of financial institutions have curtailed lending, and these efforts have been noted by the mainstream media. According to a March 15 *Wall Street Journal* article, as banks cut back on lending, credit union loans rose by 7 percent in 2008 to over $575 billion, up $35 billion from the previous year. The article also noted that bank loans in the country declined about $31 billion during this time.

We certainly recognize that the current economic circumstances highlight the need to restructure the financial regulatory system. However, we believe these efforts should focus on protecting consumers, preserving their financial choices—including through dual chartering—and limiting the systemic risk that is currently posed by institutions within the financial system which present disproportionate risk and have not been subject to sufficient regulatory oversight.

Although we recognize that there are many suggestions to address these issues, such as creating a centralized systemic risk regulator or perhaps by enhancing the Federal Reserve Board's authority in the area of systemic risks, we urge Congress to exclude from the scope of such regulation smaller institutions that have shunned undue risk. Credit unions are among those in this category. By focusing on institutions whose operations and actions present the greatest risk, Congress will avoid the danger that credit unions—the very institutions that observed conservative lending and underwriting practices—could find themselves deprived not only of a voice, but even an audience, at a regulator dominated by larger, riskier institutions. We look forward to reviewing from this perspective the specific proposals and bills that will be introduced in the near future.

Another caution comes from our experience with the Treasury under the past Administration and at times, the Federal Reserve Board. More specifically, credit unions and their regulator have not always had opportunities to provide input on the development of rules and policies that impact their operations to the same extent as banks. For instance, credit unions often have difficulty getting appointments with key Federal Reserve officials, and those officials routinely decline requests to appear before credit union audiences. A previous head of the Federal Deposit Insurance Corporation (FDIC) publicly called for taxation of credit unions, and the Office of Thrift Supervision, which has sometimes been short on institutions to regulate, has encouraged credit unions to convert to thrift charters. This should come as no surprise because those agencies' bank stakeholders view credit unions as their competition and spend a great deal of time, money, and effort lobbying against credit union interests, suing the National Credit Union Administration (NCUA), and using any other available means to try to put credit unions out of business.

While we are hopeful that this is changing, past practices from these agencies help to illustrate why including small institutions, such as credit unions, under a large regulator focused on banks and/or other major market players would be detrimental to the interests of credit unions and their members.

Since credit unions have not posed any systemic risks to the financial system or otherwise been the cause of the current economic crisis, we believe that only minimal changes need to be made to the regulatory structure of credit unions, including federally insured credit unions that are regulated by NCUA. The goal of these changes should be to enhance the quality of NCUA's regulatory structure and supervisory oversight.

**Credit Unions Need an Independent Federal Regulator**

Not-for-profit credit unions' unique mission, democratic governance, and cooperative ownership structure necessitate an independent federal regulator for credit unions. The U.S. credit union system should continue to be regulated and supervised by an independent federal agency for the following three reasons:

1. *Inherent risk aversion.* The cooperative structure of credit unions presents management with very different incentives related to risk taking than at for-profit institutions. These differences require a correspondingly different system of prudential regulation and deposit insurance than that which is appropriate for-profit institutions.
2. *Preservation of member benefits.* The cooperative structure produces substantial benefits to credit union members, which should be preserved.
3. *Long-term viability.* If the prudential regulation of credit unions were merged with that of for-profit depository institutions, credit unions would be transformed into for-profit institutions.

The credit union way of doing business is significantly different even from mutual savings associations' because mutual thrifts are for-profit, rely heavily on proxy voting, have self-perpetuating and management-controlled boards, and almost always base their member-depositors' voting power on their account balances giving, for example, one vote for every $100 in a depositor's account. As the 105th Congress noted in the findings to the Credit Union Membership Access Act in 1998:

> Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

The unique cooperative structure of credit unions entails a set of incentives for managers that differ markedly from those presented to managers of for-profit institutions. The not-for-profit, democratically controlled, and member focused orientation of credit unions has a significant effect on the behavior of credit union managers. Credit unions must over time earn a positive bottom line to retain earnings to build capital, which is crucial to federally insured depository institutions. However, credit unions operate in a mode of merely generating adequate net income to build capital, rather than profit maximization. They are driven instead to maximize member satisfaction. The managers and boards of credit unions do not own stock in the credit union (there is no such thing) and they have no stock options. They therefore have much less incentive to pursue risky initiatives that might increase the stock price and hence their own wealth. One of the very driving forces that led to the current financial crisis is completely absent from credit unions.

In the words of Edward Kane of Boston College Finance Department, who correctly foresaw and analyzed the savings and loan debacle of the late 1980s: "The cooperative structure of human-person credit unions creates reservoirs for firm value and systems for distributing claims to future cash flows that differ markedly from those of other deposit institutions. These differences make it less feasible for managers to pursue and to benefit from either corrupt lending or go-for-broke strategies of risk-taking."

The table that follows starkly illustrates Kane's point in terms of one of the most basic risks that financial institutions take on: the risk of lending. Credit union loan losses are consistently lower than at banks, across all loan types. Although credit unions and banks make similar types of loans, the credit union record of relatively conservative lending is striking. Over the past decade, bank loan charge-offs ranged from eight times higher than the credit union norm (for business loans) to nearly two times higher than the credit union norm (for non-credit-card consumer loans).

**Financial Institution Chargeoffs Net of Recoveries (as a % of Loans Outstanding)**

| | Credit Card Loans | | Other Consumer Loans | | Mortgage Loans | | Business Loans | |
|---|---|---|---|---|---|---|---|---|
| Year | Banking Institutions | Credit Unions | Banking Institutions | Credit Unions | Banking Institutions | Credit Unions | Banking Institutions | Credit Unions |
| **1999** | 4.40 | 1.85 | 1.01 | 0.59 | 0.07 | 0.03 | 0.57 | 0.12 |
| **2000** | 4.36 | 1.57 | 1.15 | 0.52 | 0.08 | 0.02 | 0.81 | 0.05 |
| **2001** | 5.15 | 1.76 | 1.26 | 0.60 | 0.15 | 0.02 | 1.43 | 0.10 |
| **2002** | 6.22 | 1.98 | 1.45 | 0.72 | 0.13 | 0.02 | 1.76 | 0.09 |
| **2003** | 5.61 | 2.14 | 1.47 | 0.81 | 0.13 | 0.02 | 1.25 | 0.08 |
| **2004** | 4.99 | 2.01 | 1.28 | 0.80 | 0.07 | 0.03 | 0.54 | 0.10 |
| **2005** | 4.74 | 2.13 | 1.35 | 0.83 | 0.05 | 0.02 | 0.32 | 0.05 |
| **2006** | 3.44 | 1.49 | 1.06 | 0.75 | 0.08 | 0.03 | 0.32 | 0.08 |
| **2007** | 4.06 | 1.62 | 1.52 | 0.83 | 0.23 | 0.08 | 0.54 | 0.09 |
| **2008** | 5.44 | 2.84 | 2.13 | 1.28 | 0.99 | 0.29 | 1.01 | 0.34 |
| **10-Yr. Average** | **4.84** | **1.94** | **1.37** | **0.77** | **0.20** | **0.06** | **0.86** | **0.11** |
| **Bank as a % of CU** | **2.50** | | **1.77** | | **3.57** | | **7.79** | |

Sources: FDIC, NCUA, and CUNA Policy Analysis.

These differences in loan losses stem from the natural tendency toward risk aversion induced by the cooperative structure. Further, credit unions lending is virtually exclusively consumer and small business oriented. The Treasury Department found in 2001 that: "Over 50 percent of the [credit union business] loans reported to us by survey respondents were made for businesses with assets under $100,000 and about 86 percent of those made were to businesses with total assets less than $500,000." Obviously, such striking differences in natural behavior and market orientation require a different form of prudential regulation and deposit insurance.

The behavioral differences seen in cooperative financial institutions also produce large societal advantages that are worth promoting and preserving. Some of these benefits are nonfinancial, such as the ability to exert control of the institution through the democratic process, access to large cooperative ATM networks, financial counseling, auto buying services, and the like. Significant financial benefits also are obvious. The credit union difference provides consumers with consistently favorable interest rates on loans and savings accounts and also gives rise to the imposition of fewer and lower fees. The table that follows highlights some of the financial advantages that were available in 2008. The 1.73 percentage point average rate differential on 4-year used car loans translates into nearly $600 in savings to the consumer who uses a credit union to finance a $15,000 vehicle.

In the aggregate, CUNA economists estimate that credit unions provided $8 billion in direct financial benefits to the Nation's 92 million credit union members in the year ending June 2008. These benefits are equivalent to approximately $90 per credit union member or approximately $170 per member household. Loyal credit union members—those who use their credit union extensively—receive total financial benefits that are much greater than this average.

The continued existence of these substantial societal benefits would be seriously jeopardized were the credit union regulator or credit union regulations merged into those focused on for-profit institutions. Credit unions represent just 6 percent of total depository institution assets. If the credit union regulator were merged into a for-profit regulatory body, the views, attitudes, and philosophy of the not-for-profit cooperative sector would undoubtedly be swamped and credit union behaviors would almost certainly "morph" into behaviors similar to those found in the for-profit sector.

The not-for-profit mission and democratic governance structure of credit unions as cooperatives necessitate a fundamentally different supervisory approach at the federal level than banking supervision does. This fundamentally different approach to supervision requires an independent federal regulator that understands the unique nature of credit unions and will not become hostile to credit unions, as the FDIC and Farm Credit Administration were when they regulated federal credit unions. The United States is also far from the only country to recognize that credit unions, as not-for-profit cooperatives, require an independent credit union regulator. Most G20 countries—including Canada, Mexico, Germany, France, South Korea, Argentina, and Brazil—have recognized that having bank regulators supervise credit unions at the national level just does not work, and so have many non-G20 nations. It also worth noting that the establishment of a super-regulator in the United Kingdom, the Financial Services Authority, has failed to save British financial institutions from substantial entanglement and dislocation in the current crisis.

## 2008 Average Monthly Interest Rates on Loans and Savings Accounts at Credit Unions and Banking Institutions

| | 48M CAR 2YR OLD | | HOME EQ LOC 80% | | UNSECRD FIX36 | | CREDITCRD CLASC | | 30YR FIX MTG | | REG SAVINGS | | MONEY MARKET | | 1 YR CD | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Month | CU | Bank | CU | Bank | CU | Bank | CU | Bank | CU | Bank | CU | Bank | CU | Bank | CU | Bank |
| January | 6.31 | 7.87 | 6.98 | 7.19 | 10.96 | 12.71 | 12.02 | 14.62 | 5.81 | 5.86 | 0.89 | 0.66 | 1.81 | 1.04 | 4.1 | 3.25 |
| February | 6.09 | 7.64 | 6.32 | 6.30 | 10.85 | 12.61 | 11.93 | 14.22 | 6.28 | 6.28 | 0.86 | 0.61 | 2.44 | 1.82 | 3.6 | 2.81 |
| March | 5.94 | 7.48 | 6.04 | 6.01 | 10.78 | 12.53 | 11.90 | 13.90 | 6.05 | 6.04 | 0.82 | 0.55 | 2.26 | 1.59 | 3.18 | 2.45 |
| April | 5.76 | 7.42 | 5.52 | 5.60 | 10.70 | 12.41 | 11.86 | 13.60 | 6.11 | 6.18 | 0.77 | 0.53 | 2.3 | 1.64 | 2.94 | 2.36 |
| May | 5.67 | 7.41 | 5.33 | 5.33 | 10.63 | 12.48 | 11.79 | 13.49 | 6.26 | 6.26 | 0.75 | 0.51 | 2.21 | 1.53 | 2.87 | 2.39 |
| June | 5.64 | 7.45 | 5.28 | 5.29 | 10.64 | 12.47 | 11.75 | 13.16 | 6.53 | 6.53 | 0.74 | 0.51 | 1.93 | 1.36 | 2.87 | 2.51 |
| July | 5.65 | 7.46 | 5.22 | 5.30 | 10.62 | 12.50 | 11.72 | 13.14 | 6.61 | 6.67 | 0.73 | 0.51 | 2.14 | 1.57 | 2.91 | 2.59 |
| August | 5.64 | 7.47 | 5.18 | 5.33 | 10.58 | 12.44 | 11.68 | 13.05 | 6.55 | 6.57 | 0.73 | 0.5 | 2.14 | 1.62 | 2.98 | 2.65 |
| September | 5.67 | 7.47 | 5.17 | 5.36 | 10.57 | 12.46 | 11.64 | 13.01 | 6.22 | 6.27 | 0.72 | 0.5 | 2.14 | 1.62 | 3.04 | 2.69 |
| October | 5.69 | 7.54 | 4.97 | 5.15 | 10.62 | 12.51 | 11.68 | 13.03 | 6.66 | 6.60 | 0.71 | 0.48 | 2.1 | 1.56 | 3.07 | 2.65 |
| November | 5.71 | 7.54 | 4.82 | 4.95 | 10.61 | 12.51 | 11.66 | 12.80 | 6.13 | 6.08 | 0.7 | 0.47 | 2.07 | 1.49 | 3.04 | 2.56 |
| December | 5.72 | 7.50 | 4.68 | 4.87 | 10.59 | 12.46 | 11.64 | 12.74 | 5.48 | 5.59 | 0.68 | 0.43 | 1.99 | 1.27 | 2.9 | 2.19 |
| 2008 Avg. | 5.79 | 7.52 | 5.46 | 5.56 | 10.68 | 12.51 | 11.77 | 13.40 | 6.22 | 6.24 | 0.76 | 0.52 | 2.13 | 1.51 | 3.13 | 2.59 |
| Bank-CU | | 1.73 | | 0.10 | | 1.83 | | 1.62 | | 0.02 | | -0.24 | | -0.62 | | -0.53 |

Source: Datatrac.

**CUNA Supports Specific, Modest Changes To Improve NCUA Operations**

We agree that a review of the operations of all federal financial institution regulators is certainly in order, including review of NCUA. We certainly do not mean to suggest that NCUA is a perfect regulator. Some of NCUA's issues stem from legislation. For instance, the Federal Credit Union Act limits to one the number of members of the NCUA Board who can come from credit unions. None of the other bank regulators has a similar restriction, and this one can promote an NCUA Board that has little relevant experience outside the government. Even more significant is the absence from the Act of any express authority for NCUA to address systemic risk within the credit union system. This lack has significantly restricted NCUA from doing what it needs to do to address the current crisis, and sharply contrasts with similar, but broader authority delegated to the FDIC. The fundamental point, however, as outlined above, is that it is paramount that credit unions be regulated independently.

Although an independent credit union regulator is essential, we believe that there are commonalities among all financial institution regulators and that these synergies should be used to facilitate improved operations among all of these agencies. In that connection, we urged the previous Administration that the President's Working Group, which includes the Federal Reserve Board, the Federal Deposit Insurance Corporation and others, include NCUA as well. We intend to renew this request to the current Administration.

We recognize that coordination among the regulators already occurs in a number of contexts. For example, the Federal Financial Institutions Examination Council (FFIEC) is a formal interagency body that prescribes uniform standards and forms for financial institution examinations. Also, the Financial Crimes Enforcement Network (FinCen) regularly convenes meetings of the Bank Secrecy Act Advisory Group (BSAAG), of which CUNA is a member. The BSAAG performs an important function by providing a forum for discussing how Bank Secrecy Act requirements can be used more effectively to combat terrorist financing. Another noteworthy example is the Financial Literacy and Education Commission, which is comprised of twenty federal agencies with the goal of developing and monitoring a national strategy to improve financial literacy in the United States. We also think that the coordination of training opportunities for the staffs of the financial regulatory agencies could help enhance efficiencies and contain agency costs.

A means to facilitate these goals could be the creation of an additional interagency committee or task force to oversee these efforts and which would include equal representation from all the relevant agencies, including NCUA. This will help ensure a consistent approach to rulemaking while recognizing that the differences among financial institution charters may require different rules in specific areas.

**Separate Regulator for Consumer Protection**

Most financial transactions involving consumers are currently covered by federal consumer protection laws. These include transactions involving credit and debit cards, automated teller machine transactions and other electronic fund transfers, deposit account transactions, mortgages and home equity loans, and other unsecured credit transactions.

There has been significant debate as to whether a separate agency should be established with the mission of providing consumer protections with regard to credit and other financial transactions. The Federal Reserve Board currently issues the rules to implement many of the major consumer protection laws, most of which apply to credit unions. Enforcement of these rules is shared by both NCUA and the Federal Trade Commission.

Other agencies also issue rules that protect consumers in financial transactions. Notable examples are in the area of privacy and fair credit reporting. These are often joint rulemaking efforts by all of the financial institution regulators, including NCUA. Significant exceptions include the rules issued under the Real Estate Settlement Procedures Act, which imposes disclosure and other requirements for mortgage lending and are implemented by the Department of Housing and Urban Development.

Much of the impetus for consolidating consumer protection regulation in a single agency comes from the desire to stop certain financial institutions from making "unsafe" products available to unwitting consumers. Credit unions do not have much history of selling unsafe products to their members, although there can be healthy debates about whether some products, such as overdraft protection and payday-loan equivalents, are good for consumers or not. Sometimes the same product can be pro- or anti-consumer, depending on its terms and on how it is serviced. Since the managers of firms tend to serve the interests of owners, and credit unions are owned by their members who are represented by democratically elected boards with authority over managers, consumers do not typically need much protection from their credit unions. However, inadvertent errors can occur, and comparative disclosures are important.

Although we certainly see the appeal in creating a separate agency that would issue and implement consumer protection rules as this would centralize this important function, we would want to make sure that there is no net increase in the regulatory burden imposed on credit unions. Since we have not contributed to the problem, we would like not to pay a big price for the answer to a question that barely exists in our industry. In particular, enforcement and examination should remain primarily in the hands of NCUA; unleashing a new army of enforcers and examiners would add little to consumer well-being except costs, in the case of credit unions.

However, we would be concerned that shifting rulemaking power from NCUA to a separate agency would curtail NCUA's authority. NCUA has had responsibility in implementing many consumer protection rules, often as a joint effort with other agencies. We believe that the creation of a separate agency should not limit NCUA's ability to continue to provide input and ensure that new rules address specific credit union concerns. We would also be concerned with any changes that would limit NCUA's current enforcement authority in this area.

**History Teaches Lessons About Supervision of Credit Unions**

Although the first credit unions in the United States were state-chartered credit unions established in New Hampshire and Massachusetts around 1909—we will be celebrating the centenary of U.S. credit unions in Boston later this year—federal regulation of credit unions did not begin until 1934.

That year, at the height of the Great Depression, Congress passed the Federal Credit Union Act and created the federal credit union charter. (Federal deposit insurance—or, as we call it, share insurance—for federal- and state-chartered credit unions did not come into being until 1970.) Congress created the federal credit union charter in large part because the financially troubled banks of the time were not able to meet the public demand for consumer and small business credit. The troubles of those times were not so different from our current problems. Foreclosures abounded. Banks—many of which had significant numbers of uncollectible loans on their books, as well as other bad assets—were unable or unwilling to extend necessary credit. Not-for-profit credit unions were encouraged to step up and do what for-profit banks could or would not do.

The passage of the Federal Credit Union Act marked the beginning of a long period in which federal credit union regulation was something of a wandering orphan.

The first stop, from 1934 to 1942, was at the Farm Credit Administration, perhaps because the Farm Credit Administration regulated Farm Credit System cooperatives rather than for-profit banks. While the relationship between credit unions and the Farm Credit Administration was initially good, by the late 1930s many Farm Credit Administration officials had become indifferent or openly hostile to credit unions since the agency was overburdened and federal credit union supervision had no real connection to the Farm Credit Administration's basic functions.

The second stop, beginning in 1942, was the FDIC. There, the hazards of being regulated by an agency primarily dedicated to the banking industry soon became apparent. Only weeks after federal credit unions came under FDIC supervision, then-CUNA President R.A. West said "we are very much of an orphan in the [FDIC] and . . . steps must be taken to relieve this situation as quickly as possible." In various statements, the FDIC denigrated the importance of credit unions, urged Congress to give them low priority, and dismissed the importance of credit unions in the FDIC's own work.

By 1947, it was clear that federal credit unions needed a regulator of their own in order to prosper, and CUNA began to seek such an arrangement. That wish was partially fulfilled when Congress created the Bureau of Federal Credit Unions in 1948. The Bureau wandered between the now-dissolved Federal Security Agency and the Department of Health, Education and Welfare before evolving into the completely independent NCUA we know today.

Admittedly, federal credit unions' experience with regulation by FDIC and other multi-jurisdictional agencies occurred decades ago, but Congress has wisely not repeated the mistake of having credit unions supervised at the federal level by a bank regulator or another multi-jurisdictional agency. As discussed earlier in this statement, anti-credit union bias periodically manifests itself today within federal banking regulatory agencies. History teaches that credit union regulation should not be entrusted to a multifunctional regulator, and especially not one whose primary constituency is the banking industry.

**Conclusion**

Mr. Chairman, thank you again for the opportunity to testify on this important issue. The issues you are examining are important. Once they are settled, we believe it will be appropriate for Congress to take a hard look at some other long-postponed issues, such as whether the current powers of credit unions are sufficient to serve their members, or whether they have been limited for the benefit of the banking industry. Meanwhile, we urge Congress to maintain the independent federal regulator for credit unions not only for the well-being of credit unions, but also for the well-being of the 92 million consumers who benefit from credit union membership.

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## PREPARED STATEMENT OF WILLIAM R. ATTRIDGE

PRESIDENT, CHIEF EXECUTIVE OFFICER, AND CHIEF OPERATING OFFICER, CONNECTICUT RIVER COMMUNITY BANK

MARCH 24, 2009

Mr. Chairman, Ranking Member Shelby, and Members of the Committee, my name is William Attridge, I am President and Chief Executive Officer of Connecticut River Community Bank. I am also a member of the Congressional Affairs Committee of the Independent Community Bankers of America.[1] My bank is located in Wethersfield, Connecticut, a 350-year-old town of over 27,000 people. ICBA is pleased to have this opportunity to testify today on the modernization of our financial system regulatory structure.

**Summary of ICBA Recommendation**

ICBA commends the Chairman and the Committee for tackling this issue quickly. The current crisis demands bold action, and we recommend the following:

- *Address Systemic Risk Institutions.* The only way to maintain a vibrant banking system where small and large institutions are able to fairly compete—and to protect taxpayers—is to aggressively regulate, assess, and eventually break up institutions posing a risk to our entire economy.
- *Support Multiple Federal Banking Regulators.* Having more than a single federal agency regulating depository institutions provides valuable regulatory checks-and-balances and promotes "best practices" among those agencies—much like having multiple branches of government.
- *Maintain the Dual Banking System.* Having multiple charter options—both federal and state—is essential for maintaining an innovative and resilient regulatory system.
- *Access to FDIC Deposit Insurance for All Commercial Banks, Both Federal and State Chartered.* Deposit insurance as an explicit government guarantee has been the stabilizing force of our Nation's banking system for 75 years.
- *Sufficient Protection for Consumer Customers of Depository Institutions in the Current Federal Bank Regulatory Structure.* One benefit of the current regulatory structure is that the federal banking agencies have coordinated their efforts and developed consistent approaches to enforcement of consumer regulations, both informally and formally, as they do through the Federal Financial Institutions Examination Council (FFIEC).
- *Reduce the Ten Percent Deposit Concentration Cap.* The current economic crisis illustrates the dangerous overconcentration of financial resources in too few hands.
- *Support the Savings Institutions Charter and the OTS.* Savings institutions play an essential role in providing residential mortgage credit in the U.S. The thrift charter should not be eliminated and the Office of Thrift Supervision should not be merged into the Office of the Comptroller of the Currency.

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[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's Web site at *www.icba.org*.

- *Maintain GSEs Liquidity Role.* Many community bankers rely on Federal Home Loan Banks for liquidity and asset/liability management through the advance window.

The following will elaborate on these concepts and provide ICBA's reasons for advocating these principles.

**State of Community Banking Is Strong**

Despite the challenges we face, the community bank segment of the financial system is still working and working well. We are open for business, we are making loans, and we are ready to help all Americans weather these difficult times.

Community banks are strong, common sense lenders that largely did not engage in the practices that led to the current crisis. Most community banks take the prudent approach of providing loans that customers can repay, which best serves both banks and customers alike. As a result of this common sense approach to banking, the community banking industry, in general, is well-capitalized and has fewer problem assets than other segments of the financial services industry.

That is not to suggest community banks are unaffected by the recent financial crisis. The general decline in the economy has caused many consumers to tighten their belts thus reducing the demand for credit. Commercial real estate markets in some areas are stressed. Many bank examiners are overreacting, sending a message contradicting recommendations from Washington that banks maintain and increase lending. For these reasons, it is essential the government continue its efforts to stabilize the financial system.

But, Congress must recognize these efforts are blatantly unfair. Almost every Monday morning for months, community banks have awakened to news the government has bailed out yet another too-big-to-fail institution. On many Saturdays, they hear the FDIC has summarily closed one or two too-small-to-save institutions. And, just recently, the FDIC proposed a huge special premium to shore up the Deposit Insurance Fund (DIF) to pay for losses caused by large institutions. This inequity must end, and only Congress can do it. The current situation—if left uncorrected—will damage community banks and the consumers and small businesses we serve.

**Congress Must Address Excessive Concentration**

ICBA remains deeply concerned about the continued concentration of banking assets in the U.S. The current crisis has made it painfully obvious the financial system has become too concentrated, and—for many institutions—too loosely regulated.

Today, the four largest banking companies control more than 40 percent of the Nation's deposits and more than 50 percent of the assets held by U.S. banks. We do not believe it is in the public interest to have four institutions controlling most of the assets of the banking industry. A more diverse financial system would reduce risk, and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

Our Nation is going through an agonizing series of bankruptcies, failures and forced buy-outs or mergers of some of the Nation's largest banking and investment houses that is costing American taxpayers hundreds of billions of dollars and destabilizing our economy. The doctrine of too big—or too interconnected—to fail, has finally come home to roost, to the detriment of American taxpayers. Our Nation cannot afford to go through this again. Systemic risk institutions that are too big or inter-connected to manage, regulate or fail should either be broken up or required to divest sufficient assets so they no longer pose a systemic risk.

In a recent speech Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> [T]he belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem. [2]

FDIC Chairman Sheila Bair, in remarks before the ICBA annual convention last Friday said, "What we really need to do is end too-big-to-fail. We need to reduce systemic risk by limiting the size, complexity and concentration of our financial in-

[2] Financial Reform To Address Systemic Risk, at the Council of Foreign Relations, March 10, 2009.

stitutions."[3] The Group of 30 report on financial reform stated, "To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries."[4]

The 10 percent nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 should be immediately reduced and strengthened. The current cap is insufficient to control the growth of systemic risk institutions the failure of which will cost taxpayers dearly and destabilize our economy.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger.

Congress should not only consider breaking up the largest institutions, but order it to take place. It is clearly not in the public interest to have so much power and concentrated wealth in the hands of so few, giving them the ability to destabilize our entire economy.

**Banking and Antitrust Laws Have Failed To Prevent Undue Concentration; Large Institutions Must Be Regulated and Broken Up**

Community bankers have spent the past 25 years warning policy makers of the systemic risk that was being created in our Nation by the unbridled growth of the Nation's largest banks and financial firms. But, we were told we didn't get it, that we didn't understand the new global economy, that we were protectionist, that we were afraid of competition, and that we needed to get with the "modern" times.

Sadly, we now know what modern times look like and the picture isn't pretty. Our financial system is imploding around us. Why is this the case, and why must Congress take bold action?

One important reason is that banking and antitrust laws fail to address the systemic risks posed by excessive financial concentration. Their focus is too narrow. Antitrust laws are designed to maintain competitive geographic and product markets. So long as the courts and agencies can discern that there are enough competitors in a particular market that is the end of the inquiry.

This type of analysis often prevents local banks from merging. But, it has done nothing to prevent the creation of giant nationwide franchises competing with each other in various local markets. No one asked, is the Nation's banking industry becoming too concentrated and are individual firms becoming too powerful both economically and politically.

The banking laws are also subject to misguided tunnel vision. The question is always whether a given merger will enhance the safety and soundness of an individual firm. The answer has been that "bigger" is almost necessarily "stronger." A bigger firm can—many said—spread its risk across geographic areas and business lines. No one wondered what would happen if one firm, or a group of firms, decides to jump off a cliff as they did in the subprime mortgage market. Now we know.

It is time for Congress to change the laws and direct that the Nation's regulatory system take systemic risk into account and take steps to reduce and eventually eliminate it. These are ICBA specific recommendations to deal with this issue:

*Summary of Systemic Risk Recommendations*

- Congress should direct a fully staffed interagency task force to immediately identify financial institutions that pose a systemic risk to the economy.
- These institutions should be put immediately under prudential supervision by a Federal agency—most likely the Federal Reserve.
- The Federal systemic risk agency should impose two fees on these institutions that would:
  - compensate the agency for the cost of supervision; and
  - capitalize a systemic risk fund comparable to the FDIC's Deposit Insurance Fund.
- The FDIC should impose a systemic risk premium on any insured bank that is affiliated with a firm designated as a systemic risk institution.
- The systemic risk regulator should impose higher capital charges to provide a cushion against systemic risk.

[3] March 20, 2009.
[4] "Financial Reform; A Framework for Financial Stability," January 15, 2009, p. 8.

- The Congress should direct the systemic risk regulator and the FDIC to develop procedures to resolve the failure of a systemic risk institution.
- The Congress should direct the interagency systemic risk task force to order the break up of systemic risk institutions over a 5-year period.
- Congress should direct the systemic risk regulator to review all proposed mergers of major financial institutions and to block any merger that would result in the creation of a systemic risk institution.
- Congress should direct the systemic risk regulator to block any financial activity that threatens to impose a systemic risk.

The only way to maintain a vibrant banking system where small and large institutions are able to fairly compete—and to protect taxpayers—is to aggressively regulate, assess, and eventually break up those institutions posing a risk to our entire economy.

*Identification and Regulation of Systemic Risk Institutions*

ICBA recommends Congress establish an interagency task force to identify institutions that pose a systemic financial risk. At a minimum, this task force should include the agencies that regulate and supervise FDIC-insured banks—including the Federal Reserve—plus the Treasury and Securities and Exchange Commission. This task force would be fully staffed by individuals from those agencies, and should be charged with identifying specific institutions that pose a systemic risk. The task force should be directed by an individual appointed by the President and confirmed by the Senate.

Once the task force has identified systemic risk institutions, they should be referred to the systemic risk regulator. Chairman Bernanke's March 10 speech provides a good description of the systemic risk regulator's duties: "Any firm whose failure would pose a systemic risk must receive especially close supervisory oversight of its risk-taking, risk management, and financial condition, and be held to high capital and liquidity standards." Bernanke continued: "The consolidated supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of the organization, not just the holding company."

Of course, capital is the first line of defense against losses. Community banks have known this all along and generally maintain higher than required levels. This practice has helped many of our colleagues weather the current storm. The new systemic risk regulator should adopt this same philosophy for the too-big-to-fail institutions that it regulates.

Clearly, the systemic risk regulator should also have the authority to step in and order the institution to cease activities that impose a systemic risk. Many observers warned that many players in the Nation's mortgage market were taking too many risks. Unfortunately, no one agency attempted to intervene and stop imprudent lending practices across the board. An effective systemic risk regulator must have the unambiguous duty and authority to block any financial activity that threatens to impose a systemic risk.

*Assessment of Systemic Risk Regulatory Fees*

The identification, regulation, and supervision of these institutions will impose significant costs to the systemic risk task force and systemic risk regulator. Systemic risk institutions must be assessed the full costs of these government expenses. This would entail a fee, similar to the examination fees banks must pay to their chartering agencies.

*Resolving Systemic Risk Institutions*

Chairman Bair and Chairman Bernanke have each recommended the United States develop a mechanism for resolving systemic risk institutions. This is essential to avoid a repeat of the series of the *ad hoc* weekend bailouts that have proven so costly and infuriating to the public and unfair to institutions that are too-small-to-save.

Again, Bernanke's March 10 speech outlined some key considerations:

> The new resolution regime would need to be carefully crafted. For example, clear guidelines must define which firms could be subject to the alternative regime and the process for invoking that regime, analogous perhaps to the procedures for invoking the so-called systemic risk exception under the FDIA. In addition, given the global operations of many large and complex financial firms and the complex regulatory structures under which they operate, any new regime must be structured to work as seamlessly as possible with other domestic or foreign insolvency regimes that might apply to one or more parts of the consolidated organization.

This resolution process will, obviously, be expensive. Therefore, Congress should direct the systemic risk regulator to establish a fund to bear these costs. The FDIC provides a good model. Congress has designated a minimum reserve ratio for the FDIC's Deposit Insurance Fund (DIF) and directed the agency to assess risk-based premiums to maintain that ratio. Instead of deposits, the ratio for the systemic risk fund should apply as broadly as possible to ensure all the risks covered are assessed.

Some of the systemic risk institutions will include FDIC-insured banks within their holding companies. These banks would certainly not be resolved in the same way as a stand-alone community bank; all depositors would be protected beyond the statutory limits. Therefore, Congress should direct the FDIC to impose a systemic risk fee on these institutions in addition to their regular premiums.

The news AIG was required by contract to pay hundreds of millions of dollars in bonuses to the very people that ruined the company point to another requirement for an effective systemic risk regulator. Once a systemic risk institution becomes a candidate for open-institution assistance or resolution, the regulator should have the same authority to abrogate contracts as the FDIC does when it is appointed conservator and receiver of a bank. If the executives and other highly paid employees of these institutions understood they could not design employment contracts that harmed the public interest, their willingness to take unjustified risk might diminish.

*Breaking Up Systemic Risk Institutions and Preventing Establishing New Threats*

ICBA believes compelling systemic risk regulation and imposing systemic risk fees and premiums will provide incentives to firms to voluntarily divest activities or not become too big to fail. However, these incentives may not be adequate. Therefore, Congress should direct the systemic risk task force to order the break up of systemic risk institutions over a 5-year period. These steps will reverse the long-standing regulatory policy favoring the creation of ever-larger financial institutions.

ICBA understands this will be a controversial recommendation, and many firms will object. We do not advocate liquidation of ongoing, profitable activities. Huge conglomerate holding companies should be separated into business units that make sense. This could be done on the basis of business lines or geographical divisions. Parts of larger institutions could be sold to other institutions. The goal is to reduce systemic risk, not to reduce jobs or services to consumers and businesses.

**Maintain a Diversified Financial Regulatory System**

While ICBA strongly supports creation of an effective systemic risk regulator, we oppose the establishment of a single, monolithic regulator for the financial system. Having more than a single federal agency regulating depository institutions provides valuable regulatory checks-and-balances and promotes "best practices" among those agencies—much like having multiple branches of government. The collaboration required by multiple federal agencies on each interagency regulation insures all perspectives and interests are represented, that no one type of institution will benefit over another, and the resulting regulatory or supervisory product is superior.

A monolithic federal regulator such as the UK's Financial Service Authority would be dangerous and unwise in a country with a financial services sector as diverse as the United States, with tens of thousands of banks and other financial services providers. Efficiency must be balanced against good public policy. With the enormous power of bank regulators and the critical role of banks in the health and vitality of the national economy, it is imperative the bank regulatory system preserves real choice, and preserves both state and federal regulation.

For over three generations, the U.S. banking regulatory structure has served this Nation well. Our banking sector was the envy of the world and the strongest and most resilient financial system ever created. But we have gotten off the track. Nonbank financial regulation has been lax and our system has allowed—and even encouraged—the establishment of financial institutions that are too big to manage, too big to regulate, and too big to fail.

ICBA supports a system of tiered regulation that subjects large, complex institutions that pose the highest risks to more rigorous supervision and regulation than less complex community banks. Large banks should be subject to continuous examination, and more rigorous capital and other safety and soundness requirements than community banks in recognition of the size and complexity and the amount of risk they pose. They should pay a "systemic risk premium" in addition to their regular deposit insurance premiums to the FDIC.

Community banks should be examined on a less intrusive schedule and should be subject to a more flexible set of safety and soundness restrictions in recognition of their less complex operations and the fact that community banks are not "systemic risk" institutions. Public policy should promote a diversified economic and financial system upon which our Nation's prosperity and consumer choice is built and not encourage further consolidation and concentration of the banking industry by discouraging current community banking operations or new bank formation.

Congress need not waste time rearranging the regulatory boxes to change the system of community bank regulation. The system has worked, is working, and will work in the future. The failure occurred in the too-big-to-fail sector. That is the sector Congress must fix.

**Maintain and Strengthen the Separation of Banking and Commerce**

Congress has consistently followed one policy that has prevented the creation of some systemic risk institutions. The long-standing policy prohibiting affiliations or combinations between banks and nonfinancial commercial firms (such as Wal-Mart and Home Depot) has served our Nation well. ICBA opposes any regulatory restructuring that would allow commercial entities to own a bank. If it is generally agreed that the current financial crisis is the worst crisis to strike the United States since the Great Depression, how much worse would this crisis have been had the commercial sector been intertwined with banks as well? Regulators are unable to properly regulate the existing mega-financial firms, how much worse would it be to attempt to regulate business combinations many times larger than those that exist today?

This issue has become more prominent with recent Federal Reserve encouragement of greater equity investments by commercial companies in financial firms. This is a very dangerous path.

Mixing banking and commerce is bad public policy because it creates conflicts of interest, skews credit decisions, and produces dangerous concentrations of economic power. It raises serious safety and soundness concerns because the companies operate outside the consolidated supervisory framework Congress established for owners of insured banks. It exposes the bank to risks not normally associated with banking. And it extends the FDIC safety net putting taxpayers at greater risk. Mixing banking and commerce was at the core of a prolonged and painful recession in Japan.

Congress has voted on numerous occasions to close loopholes that permitted the mixing of banking and commerce, including the nonbank bank loophole in 1987 and the unitary thrift holding company loophole in 1999. However, the Industrial Loan Company loophole remains open.

Creating greater opportunities to widen this loophole would be a serious public policy mistake, potentially depriving local communities of capital, local ownership, and civic leadership.

**Maintain the Dual Banking System**

ICBA believes strongly in the dual banking system. Having multiple charter options—both federal and state—that financial institutions can choose from is essential for maintaining an innovative and resilient regulatory system. The dual banking system has served our Nation well for nearly 150 years. While the lines of distinction between state and federally chartered banks have blurred in the last 20 years, community banks continue to value the productive tension between state and federal regulators. One of the distinct advantages to the current dual banking system is that it ensures community banks have a choice of charters and the supervisory authority that oversees their operations. In many cases over the years the system of state regulation has worked better than its federal counterparts. State regulators bring a wealth of local market knowledge and state and regional insight to their examinations of the banks they supervise.

**The Current Federal Bank Regulatory Structure Provides Sufficient Protections for Consumer Customers of Depository Institutions**

One benefit of the current regulatory structure is the federal banking agencies have coordinated their efforts and developed consistent approaches to enforcement of consumer regulations, both informally and formally, as they do through the Federal Financial Institutions Examination Council (FFIEC). This interagency cooperation has created a system that ensures a breadth of input and discussion that has produced a number of beneficial interagency guidelines, including guidelines on nontraditional mortgages and subprime lending, as well as overdraft protection, community reinvestment and other areas of concern to consumers.

Perhaps more important for consumer interests than interagency cooperation is the fact that depository institutions are closely supervised and regularly examined. This examination process ensures consumer financial products and services offered by banks, savings associations and credit unions are regularly and carefully reviewed for compliance.

ICBA believes nonbank providers of financial services, such as mortgage companies, mortgage brokers, *etc.,* should be subject to greater oversight for consumer protection. For the most part, unscrupulous and in some cases illegal lending practices that led directly to the subprime housing crisis originated with nonbank mortgage providers. The incidence of abuse was much less pronounced in the highly regulated banking sector.

**Retain the Savings Institutions Charter and the OTS**

Savings institutions play an essential role in providing residential mortgage credit in the United States. The thrift charter should not be eliminated and the Office of Thrift Supervision should not be merged into the Office of the Comptroller of the Currency. The OTS has expertise and proficiency in supervising those financial institutions choosing to operate with a savings institution charter with a business focus on housing finance and other consumer lending.

**Government-Sponsored Enterprises Play an Important Role**

Many community bankers rely on Federal Home Loan Banks for liquidity and asset/liability management through the advance window. Community banks place tremendous reliance upon the FLHBs as a source of liquidity and an important partner in growth. Community banks also have been able to provide mortgage services to our customers by selling mortgages to Fannie Mae and Freddie Mac.

ICBA strongly supported congressional efforts to strengthen the regulation of the housing GSEs to ensure the ongoing availability of these services. We urge the Congress to ensure these enterprises continue their vital services to the community banking industry in a way that protects taxpayers and ensures their long-term viability.

There are few “rules of the road” for the unprecedented government takeover of institutions the size of Fannie and Freddie, and the outcome is uncertain. Community banks are concerned that the ultimate disposition of the GSEs by the government may fundamentally alter the housing finance system in ways that disadvantage consumers and community bank mortgage lenders alike.

The GSEs have performed their central task and served our Nation well. Their current challenges do not mean the mission they were created to serve is flawed. ICBA firmly believes the government must preserve the historic mission of the GSEs, that is, to provide capital and liquidity for mortgages to promote homeownership and affordable housing in both good times and bad.

Community banks need an impartial outlet in the secondary market such as Fannie and Freddie—one that doesn’t compete with community banks for their customers. Such an impartial outlet must be maintained. This is the only way to ensure community banks can fully serve their customers and their communities and to ensure their customers continue to have access to affordable credit.

As the future structure of the GSEs is considered, ICBA is concerned about the impact on their effectiveness of either an elimination of the implied government guarantee for their debt or limits on their asset portfolios. These are two extremely important issues. The implied government guarantee is necessary to maintain affordable 30-year, fixed rate mortgage loans. Flexible portfolio limits should be allowed so the GSEs can respond to market needs. Without an institutionalized mortgage-backed securities market such as the one Freddie and Fannie provide, mortgage capital will be less predictable and more expensive, and adjustable rate mortgages could become the standard loan for home buyers, as could higher down payment requirements.

**Conclusion**

Mr. Chairman, to say this is a complex and complicated undertaking would be a great understatement. Current circumstances demand our utmost attention and consideration. Many of the principles laid out in our testimony are controversial, but we feel they are necessary to preserve and maintain America’s great financial system and make it stronger coming out of this crisis.

ICBA greatly appreciates this opportunity to testify. Congress should avoid doing damage to the regulatory system for community banks, a system that has been tremendously effective. However, Congress should take a number of steps to regulate, assess, and ultimately break up institutions that pose unacceptable systemic risks to the Nation’s financial system. The current crisis provides an opportunity to strengthen our Nation’s financial system and economy by taking these important steps. ICBA looks forward to working with this Committee on these very important issues.

## PREPARED STATEMENT OF AUBREY B. PATTERSON

CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
BANCORPSOUTH, INC.

MARCH 24, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Aubrey Patterson. I am Chairman and Chief Executive Officer of BancorpSouth, Inc., a $13.3 billion-asset bank financial holding company whose subsidiary bank operates over 300 commercial banking, mortgage, insurance, trust and broker dealer locations in Mississippi, Tennessee, Alabama, Arkansas, Texas, Florida, Louisiana, and Missouri. I currently serve as co-chair of the Future Regulatory Reform Task Force at the American Bankers Association (ABA) and was a former chairman of ABA's Board of Directors. ABA works to enhance the competitiveness of the Nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than $125 million in assets—represent over 95 percent of the industry's $13.9 trillion in assets and employ over 2.2 million men and women.

ABA congratulates the Committee on the approach it is taking to respond to the financial crisis. There is a great need to act, but to do so in a thoughtful and thorough manner, and with the right priorities. That is what this Committee is doing. On March 10, Federal Reserve Board Chairman Bernanke gave an important speech laying out his thoughts on regulatory reform. He laid out an outline of what needs to be addressed in the near term and why, along with general recommendations. We are in broad agreement with the points Chairman Bernanke made in that speech.

Chairman Bernanke focused on three main areas: first, the need for a systemic regulator; second, the need for a preexisting method for an orderly resolution of a systemically important nonbank financial firm; and third, the need to address gaps in our regulatory system. Statements by the leadership of this Committee have also focused on a legislative plan to address these three areas. We agree that these three issues—a systemic regulator, a new resolution mechanism, and addressing gaps—should be the priorities. This terrible crisis should not be allowed to happen again, and addressing these three areas is critical to making sure it does not.

ABA strongly supports the creation of a systemic regulator. In retrospect, it is inexplicable that we have not had a regulator that has the explicit mandate and the needed authority to anticipate, identify, and correct, where appropriate, systemic problems.

To use a simple analogy, think of the systemic regulator as sitting on top of Mount Olympus looking out over all the land. From that highest point the regulator is charged with surveying the land, looking for fires. Instead, we have had a number of regulators, each of which sits on top of a smaller mountain and only sees its part of the land. Even worse, no one is effectively looking over some areas.

This needs to be addressed. While there are various proposals as to who should be the systemic regulator, most of the focus has been on giving the authority to the Federal Reserve. It does make sense to look for the answer within the parameters of the current regulatory system. It is doubtful that we have the luxury, in the midst of this crisis, to build a new system from scratch, however appealing that might be in theory. There are good arguments for looking to the Federal Reserve, as outlined in the Bernanke speech. This could be done by giving the authority to the Federal Reserve or by creating an oversight committee chaired by the Federal Reserve. ABA's concern in this area relates to what it may mean for the independence of the Federal Reserve in the future. We strongly believe that Federal Reserve independence in setting monetary policy is of utmost importance.

ABA believes that systemic regulation cannot be effective if accounting policy is not part of the equation. To continue my analogy, the systemic regulator on Mount Olympus cannot function if part of the land is held strictly off limits and under the rule of some other body that can act in a way that contradicts the systemic regulator's policies. That is, in fact, exactly what happened with mark-to-market accounting.

As Chairman Bernanke pointed out, as part of a systemic approach, the Federal Reserve should be given comprehensive regulatory authority over the payments system, broadly defined. ABA agrees. We should not run the risk of a systemic implosion instigated by gaps in payment system regulations.

ABA also supports creating a mechanism for the orderly resolution of systemically important nonbank firms. Our regulatory bodies should never again be in the position of making up a solution on the fly to a Bear Stearns or AIG, of not being able to solve a Lehman Brothers. The inability to deal with those situations in a predetermined way greatly exacerbated the crisis. Indeed, many experts believe the Lehman Brothers failure was the event that greatly accelerated the crisis. We believe that existing models for resolving troubled or failed institutions provide an appropriate starting point—particularly the FDIC model, but also the more recent handling of Fannie Mae and Freddie Mac.

A critical issue in this regard is too-big-to-fail. Whatever is done on the systemic regulator and on a resolution system will set the parameters of too-big-to-fail. In an ideal world, no institution would be too big to fail, and that is ABA's goal; but we all know how difficult that is to accomplish, particularly with the events of the last few months. This too-big-to-fail concept has profound moral hazard implications and competitive effects that are very important to address. We note Chairman Bernanke's statement: "Improved resolution procedures . . . would help reduce the too-big-to-fail problem by narrowing the range of circumstances that might be expected to prompt government action." [1]

The third area for focus is where there are gaps in regulation. These gaps have proven to be major factors in the crisis, particularly the role of largely unregulated mortgage lenders. Credit default swaps and hedge funds also should be addressed in legislation to close gaps.

There seems to be a broad consensus to address these three areas. The specifics will be complex and, in some cases, contentious. But at this very important time, with Americans losing their jobs, their homes, and their retirement savings, all of us should work together to develop a stronger regulatory structure. ABA pledges to be an active and constructive participant in this critical effort.

In fact, even before the turmoil of last fall, ABA's board of directors recognized this need to address the difficult questions about regulatory reform and the desirability of a systemic risk regulator. As a consequence, Brad Rock, ABA's chairman at that time, and chairman, president, and CEO of Bank of Smithtown, Smithtown, New York, appointed a task force to develop principles and recommendations for change. I am co-chair of that task force. I will highlight many of the principles developed by this group—and adopted by ABA's board of directors—throughout my statement today.

In the rest of my statement today, I would like to expand on the priorities for change:

- Establish a regulatory structure that provides a mechanism to oversee and address systemic risks. Included under this authority is the ability to mitigate risk-taking from systemically important institutions, authority over how accounting rules are developed and applied, and protections to maintain the integrity of the payments system.
- Establish a method to handle the failure of nonbank institutions that threaten systemic risk.
- Close the gaps in regulation. This might include the regulation of hedge funds, credit default swaps, and particularly nonbank mortgage brokers.

I would like to touch briefly on each of these priorities to highlight issues that underlie them.

**I. Establish a Regulatory Structure That Provides a Mechanism To Oversee and Address Systemic Risks**

ABA supports the formation of a systemic risk regulator. There are many aspects to consider related to the authority of this regulator, including the ability to mitigate risk-taking from systemically important institutions, authority over how accounting rules are developed and applied, and the protections needed to maintain the integrity of the payments system. I will discuss and highlight ABA's guiding principles on each of these.

*A. There is a need for a regulator with explicit systemic risk responsibility*

A systemic risk regulator would strengthen the financial infrastructure. As Chairman Bernanke noted: "[I]t would help make the financial system as a whole better able to withstand future shocks, but also to mitigate moral hazard and the problems of too big to fail by reducing the range of circumstances in which systemic stability concerns might prompt government intervention." ABA believes the following principles should apply to any systemic risk regulator:

[1] Ben Bernanke, speech to the Council on Foreign Relations, Washington, DC, March 10, 2009.

- Systemic risk oversight should utilize existing regulatory structures to the maximum extent possible and involve a limited number of large market participants, both bank and nonbank.
- The primary responsibility of the systemic risk regulator should be to protect the economy from major shocks. The systemic risk regulator should pursue this objective by gathering information, monitoring exposures throughout the system and taking action in coordination with other domestic and international supervisors to reduce the risk of shocks to the economy.
- The systemic risk regulator should work with supervisors to avoid pro-cyclical reactions and directives in the supervisory process.
- There should not be a new consumer regulator for financial institutions. Safety and soundness implications, financial risk, consumer protection, and other relevant issues need to be considered together by the regulator of each institution.

It is clear we need a systemic regulator that looks across the economy and identifies problems. To fulfill that role, the systemic regulator would need broad access to information. It may well make sense to have that same regulator have necessary powers, alone or in conjunction with the Treasury, and a set of tools to address major systemic problems. (Although based on the precedents set over the past few months, it is clear that those tools are already very broad.)

At this point, there seems to be a strong feeling that the Federal Reserve should take on this role in a more robust, explicit fashion. That may well make sense, as the Federal Reserve has been generally thought to be looking over the economy. We are concerned, however, that any expansion of the role of the Federal Reserve could interfere with the independence required when setting monetary policy. One of the great strengths of our economic infrastructure has been our independent Federal Reserve. We urge Congress to carefully consider the long-term impact of changes in the role of the Federal Reserve and the potential for undermining its effectiveness on monetary policy.

Thus, ABA offers these guiding principles:

- An independent central bank is essential.
- The Federal Reserve's primary focus should be the conduct of monetary policy.

*B. To be effective, the systemic risk regulator must have some authority over the development and implementation of accounting rules*

Accounting standards are not only measurements designed to ensure accurate financial reporting, but they also have an increasingly profound impact on the financial system—so profound that they must now be part of any systemic risk calculation. No systemic risk regulator can do its job if it cannot have some input into accounting standards—standards that have the potential to undermine any action taken by a systemic regulator. Thus, a new system for the establishment of accounting rules—one that considers the real-world effects of accounting rules—needs to be created in recognition of the critical importance of accounting rules to systemic risk and economic activity. Thus, ABA sets forth the following principles to guide the development of a new system:

- The setting of accounting standards needs to be strengthened and expanded to include oversight from the regulators responsible for systemic risk.
- Accounting should be a reflection of economic reality, not a driver.
- Accounting rules, such as loan-loss reserves and fair value accounting, should minimize pro-cyclical effects that reinforce booms and busts.
- Clearer guidance is urgently needed on the use of judgment and alternative methods, such as estimating discounted cash flows when determining fair value in cases where asset markets are not functioning and for recording impairment based on expectations of loss.

For several years, long before the current downturn, ABA argued that mark-to-market was pro-cyclical and should not be the model used for financial institutions as required by the Financial Accounting Standards Board (FASB). Even now, the FASB's stated goal is to continue to expand the use of mark-to-market accounting for all financial instruments. For months, we have specifically asked FASB to address the problem of marking assets to markets that were dysfunctional.

Our voice has been joined by more and more people who have been calling for FASB and the Securities and Exchange Commission to address this issue, including Federal Reserve Chairman Bernanke and, as noted below, former Federal Reserve Chairman Paul Volcker. For example, in his recent speech, Chairman Bernanke stated: "[R]eview of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their pro-cyclical effects without compromising the goals of disclosure and transparency."[2] Action is needed, and quickly, so that first quarter reports can be better aligned with economic realities. We hope that FASB and SEC will take the significant action that is needed; this is not the time to merely tinker with the current rules.

In creating a new oversight structure for accounting, independence from outside influence should be an important component, as should the critical role in the capital markets of ensuring that accounting standards result in financial reporting that is credible and transparent. But accounting policy can no longer be divorced from its impact; the results on the economy and on the financial system must be considered.

We are very much in agreement with the recommendations of Group of 30, headed by Paul Volcker and Jacob Frenkel on fair value accounting in its Financial Reform: A Framework for Financial Stability. That report stated: "The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions." The Group of 30 suggests that accounting standards be reviewed:

1. to develop "more realistic guidelines for dealing with less-liquid instruments and distressed markets";
2. by "prudential regulators to ensure application in a fashion consistent with safe and sound operation of [financial] institutions"; and
3. to be more flexible "in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves".

Thus, ABA recommends the creation of a board that could stand in place of the functions currently served by the SEC.

*C. Uniform standards are needed to maintain the reliability of the payments system*

An important part of the conduct of monetary policy is the reliability of the payments system, including the efficiency, security, and integrity of the payments system. Therefore, ABA offers these three principles:

- The Federal Reserve should have the duty to set the standards for the reliability of the payments system, and have a leading role in the oversight of the efficiency, integrity, and security thereof.
- Reforms of the payments system must recognize that merchants and merchant payment processors have been the source of the largest number of abuses and lost customer information. All parts of the payments system must be responsible for its reliability.
- Ensuring the integrity of the payments system against financial crime and abuse should be an integral part of the supervisory structure that oversees system reliability.

Banks have long been the primary players in the payments system ensuring safe, secure, and efficient funds transfers for consumers and businesses. Banks are subject to a well-defined regulatory structure and are examined to ensure compliance with the standards. Unfortunately, the current regulatory scheme does not apply comparable standards for nonbanks that participate in the payments system. This is a significant gap that needs to be filled.

In recent years, nonbanks have begun offering "nontraditional" payment services in greater numbers. Internet technological advances combined with the increase in consumer access to the Internet have contributed to growth in these alternative payment options. These activities introduce new risks to the system. Another key difference between banks and nonbanks in the payments system is the level of protection granted to consumers in case of a failure to perform. It is important to know the level of capital held by a payment provider where funds are held, and what the effect of a failure would be on customers using the service. This information is not always as apparent as it might be.

The nonbanks are not subject to the same standards of performance and financial soundness as banks, nor are they subject to regular examinations to ensure the reliability of their payments operations. In other words, this is yet another gap in our regulatory structure, and one that is growing. This imbalance in standards becomes

[2] *Ibid.*

a competitive problem when customers do not recognize the difference between banks and nonbanks when seeking payment services.

In addition, the current standard designed to provide security to the retail payment system, the Payment Card Industry Data Security Standard, compels merchants and merchant payment processors to implement important information security controls, yet tends to be checklist and point-in-time driven, as opposed to the risk-based approach to information security required of banks pursuant to the Gramm-Leach-Bliley Act.[3] Through the Bank Service Company Act, federal bank regulatory agencies can examine larger core payment processors and other technology service providers for GLB compliance.[4] We would encourage the Federal Reserve to use this power more aggressively going forward, and examine an increased number of payment processors and other technology providers.

In order to ensure that consumers are protected from financial, reputational, and systemic risk, all banks and nonbank entities providing significant payment services should be subject to similar standards. This is particularly important for the operation of the payments system, where uninterrupted flow of funds is expected and relied upon by customers. Thus, ABA believes that the Federal Reserve should develop standards for reliability of the payments system that would apply to all payments services providers, comparable to the standards that today apply to payments services provided by banks. The Federal Reserve should review its own authority to supervise nonbank service providers in the payments system and should request from Congress those legislative changes that may be needed to clarify the authority of the Federal Reserve to apply comparable standards for all payments system providers. We support the statement made by Chairman Bernanke: "Given how important robust payment and settlement systems are to financial stability, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems."[5]

**II. Establish a Method To Handle the Failure of Nonbank Institutions That Threaten Systemic Risk**

We fully agree with Chairman Bernanke when he said: "[T]he United States also needs improved tools to allow the orderly resolution of a systemically important nonbank financial firm, including a mechanism to cover the costs of the resolution."[6] Recent government actions have clearly demonstrated a policy to treat certain financial institutions as if they were too big or too complex to fail. Such a policy can have serious competitive consequences for the banking industry as a whole. Without accepting the inevitability of such a policy, clear actions must be taken to address and ameliorate negative consequences of such a policy, including efforts to strengthen the competitive position of banks of all sizes.

The current *ad hoc* approach, used with Bear Stearns and Lehman Brothers, has led to significant unintended consequences and needs to be replaced with a concrete, well-understood method of resolution. There is such a system for banks, and that system can serve as a model. However, the system for banks is based in an elaborate system of bank regulation and the bank safety net. The system for nonbanks should not extend the safety net, but rather should provide a mechanism for failure designed to limit contagion of problems in the financial system.

These concerns should inform the debate about the appropriate actor to resolve systemically significant nonbanks. While some suggest that the FDIC should have broader authority to resolve all systemically significant financial institutions, we respectfully submit that the FDIC's mission must not be compromised by a dilution of resources or focus. Confidence in federal deposit insurance is essential to the health of the banking system. Our system of deposit insurance is paid for by insured depository institutions and, until very recently, has been focused exclusively on insured depository institutions. The costs of resolving nonbanks must not be imposed on insured depository institutions; rather, institutions subject to the new resolution authority should pay the costs of its execution. Given that these costs are likely to be very high, it is doubtful that institutions that would be subject to the new resolution authority would be able to pay premiums large enough to fully fund the resolution costs. In that case, the FDIC would need to turn to the taxpayer and, thereby, jeopardize confidence in the banking industry as a whole.

Even if systemically significant nonbanks could fully fund the new resolution authority, one agency serving as both deposit insurer and the agency that resolves nondepository institutions creates the risk of a conflict of interest, as Comptroller

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[3] 16 C.F.R. 314.
[4] 12 U.S.C. 1861–1867(c).
[5] *Ibid.*
[6] *Ibid.*

Dugan recently observed in testimony before this Committee.[7] The FDIC must remain focused on preserving the insurance fund and, by extension, the public's confidence in our Nation's depository institutions. Any competing role that distracts from that focus must be avoided.

Thus, ABA offers several principles to guide this discussion:

- Financial regulators should develop a program to watch for, monitor, and respond effectively to market developments relating to perceptions of institutions being too big or too complex to fail—particularly in times of financial stress.
- Specific authorities and programs must be developed that allow for the orderly transition of the operations of any systemically significant financial institution.

The creation of a systemic regulator and of a mechanism for addressing the resolution of entities, of course, raises the important and difficult question of what institutions should be considered systemically important, or in other terms, too-big-to-fail. The theory of too-big-to-fail (TBTF) has in this crisis been expanded to include institutions that are too intertwined with other important institutions to be allowed to fail. We agree with Chairman Bernanke when he said that the "clear guidelines must define which firms could be subject to the alternative [resolution] regime and the process for invoking that regime."[8]

ABA has always sought the tightest possible language for the systemic risk exception in order to limit the TBTF concept as much as possible. We did this for two reasons, reasons that still apply today: first, TBTF presents the classic moral hazard problem—it can encourage excess risk-taking by an entity because the government will not allow it to fail; second, TBTF presents profound competitive fairness issues—TBTF entities will have an advantage—particularly in funding, through deposits and otherwise—over institutions that are not too big to fail.

Our country has now stretched the systemic risk exception beyond what could have been anticipated when it was created. In fact, we have gone well beyond its application to banks, as we have made nonbanks TBTF. Ideally, we would go back and strictly limit its application, but that may not be possible. Therefore, we need to adopt a series of policies that will address the moral hazard and unfair competition issues while protecting our financial system and the taxpayers. This may be the most difficult question Congress will face as it reforms our financial system.

For one thing, this cannot be done in isolation from what is being done in other countries. Systemic risk clearly does not stop at the border. In addition, the ability to compete internationally will be a continuing factor in designing and evolving our regulatory system. Our largest financial institutions compete around the world, and many foreign institutions have a large presence in the United States.

This is also a huge issue for the thousands of U.S. banks that will not be considered too big to fail. As ABA has noted on many occasions, these are institutions that never made a subprime loan, are well capitalized, and are lending. Yet we have been deeply and negatively affected by this crisis—a crisis caused primarily by less regulated or unregulated entities like mortgage brokers and by Wall Street firms. We have seen the name "bank" sullied as it is used very broadly; we have seen our local economies hurt, and sometimes devastated, which has led to loan losses; and we have seen deposit insurance premiums drastically increased to pay for the excessive risk-taking of institutions that have failed. At the same time, there is a clear unfairness in that many depositors believe their funds, above the insurance limit, are safer in a TBTF institution than other banks. And, in fact, this notion is reinforced when large uninsured depositors lose money—take a "haircut"—when the FDIC closes some not-too-big-to-fail banks.

There are many difficult questions. How will a determination be made that an institution is systemically important? When will it be made? What extra regulations will apply? Will additional capital and risk management requirements be imposed? How will management issues be addressed? Some have argued that the largest, most complex institutions are too big to manage. Which activities will be put off-limits and which will require special treatment, such as extra capital to protect against losses? How do we avoid another AIG situation, where, it is widely agreed, what amounted to a risky hedge fund was attached to a strong insurance company and brought the whole entity down? And, importantly, how do we make sure we maintain the highly diversified financial system that is unique to the United States?

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[7] Testimony of John C. Dugan, Comptroller of the Currency, before the Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2009.

[8] *Ibid.*

**III. Close the Gaps in Regulation**

A major cause of our current problems is the regulatory gaps that allowed some entities to completely escape effective regulation. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Questions are also being raised with respect to credit derivatives, hedge funds, and others.

Given the causes of the current problem, there has been a logical move to begin applying more bank-like regulation to the less-regulated and un-regulated parts of the financial system. For example, when certain securities firms were granted access to the discount window, they were quickly subjected to bank-like leverage and capital requirements. Moreover, as regulatory change points more toward the banking model, so too has the marketplace. The biggest example, of course, is the movement of Goldman Sachs and Morgan Stanley to Federal Reserve holding company regulation.

As these gaps are being addressed, Congress should be careful not to impose new, unnecessary regulations on the traditional banking sector, which was not the source of the crisis and continues to provide credit. Thousands of banks of all sizes, in communities across the country, are scared to death that their already crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to nonbanks while they will be rigorously applied—down to the last comma—to banks.

This Committee has worked hard in recent years to temper the impact of regulation on banks. You have passed bills to remove unnecessary regulation, and you have made existing regulation more efficient and less costly. As you contemplate major changes in regulation—and change is needed—ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again?

There are so many issues related to closing the regulatory gaps that it would be impossible to cover each in detail in this statement. Therefore, let me summarize the important issues by providing the key principles that should guide any discussion about filling the regulatory gaps:

- The current system of bank regulators has many advantages. These advantages should be preserved as the system is enhanced to address systemic risk and nonbank resolutions.
  - Regulatory restructuring should incorporate systemic checks and balances among equals and a federalist system that respects the jurisdictions of state and federal powers. These are essential elements of American law and governance.
  - We support the roles of the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Federal Reserve, the Office of Thrift Supervision (OTS) and the state banking commissioners with regard to their diverse responsibilities and charters within the U.S. banking system.
  - Bank regulators should focus on bank supervision. They should not be in the business of running banks or managing bank assets and liabilities.
- The dual banking system is essential to promote an efficient and competitive banking sector.
  - The role of the dual banking system as incubator for advancements in products and services, such as NOW and checking accounts, is vital to the continued evolution of the U.S. banking sector.
  - Close coordination between federal bank regulators and state banking commissioners within Federal Financial Institutions Examination Council (FFIEC) as well as during joint bank examinations is an essential and dynamic element of the dual banking system.
- Charter choice and choice of ownership structure are essential to a dynamic, innovative banking sector that responds to changing consumer needs, customer preferences, and economic conditions.
  - Choice of charter and form of ownership should be fully protected.
  - ABA strongly opposes charter consolidation. Unlike the flexibility and business options available under charter choice, a consolidated universal charter would be unlikely to serve evolving customer needs or encourage market innovation.
  - Diversity of ownership, including S corporations, limited liability corporations, mutual ownership, and other forms of privately held and publicly traded banks, should be strengthened.

- Diversity of business models is a distinctive feature of American banking that should be fostered.
  - Full and fair competition within a robust banking sector requires a diversity of participants of all sizes and business models with comparable banking powers and appropriate oversight.
  - Community banks, development banks, and niche-focused financial institutions are vital components of the financial services sector.
  - A housing-focused banking system based on time-tested underwriting practices and disciplined borrower qualification is essential to sustained homeownership and community development.
- An optional federal insurance charter should be created.
- Similar activities should be subject to similar regulation and capital requirements. These regulations and requirements should minimize pro-cyclical effects.
  - Consumer confidence in the financial sector as a whole suffers when nonbank actors offer bank-like services while operating under substandard guidelines for safety and soundness.
  - Credit unions that act like banks should be required to convert to a bank charter.
  - Capital requirements should be universally and consistently applied to all institutions offering bank-like products and services.
  - Credit default swaps and other products that pose potential systemic risk should be subject to supervision and oversight that increase transparency, without unduly limiting innovation and the operation of markets.
  - Where possible, regulations should avoid adding burdens during times of stress. Thus, for instance, deposit insurance premium rates need to reflect a balance between the need to strengthen the fund and the need of banks to have funds available to meet the credit needs of their communities in the midst of an economic downturn.
- The FDIC should remain focused on its primary mission of ensuring the safety of insured deposits.
  - The FDIC plays a crucial role in maintaining the stability and public confidence in the Nation's financial system by insuring deposits, and in conducting activities directly related to that mission, including examination and supervision of financial institutions as well as managing receiverships and assets of failed banking institutions so as to minimize the costs to FDIC resources.
- To coordinate anti-money laundering oversight and compliance, a Bank Secrecy Act "gatekeeper," independent from law enforcement and with a nexus to the payments system, should be incorporated into the financial regulatory structure.

**Conclusion**

Thank you for the opportunity to present the ABA's views on the regulation of systemic risk and restructuring of the financial services marketplace. The financial turmoil over the last year, and particularly the protection provided to institutions deemed to be "systemically important," require a system that will more efficiently and effectively prevent such problems from arising in the first place and a procedure to deal with any problems that do arise. Clearly, it is time to make changes in the financial regulatory structure. We hope that the principles laid out in this statement will help guide the discussion. We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our Nation's banks.

## PREPARED STATEMENT OF RICHARD CHRISTOPHER WHALEN

SENIOR VICE PRESIDENT AND MANAGING DIRECTOR,
INSTITUTIONAL RISK ANALYTICS

MARCH 24, 2009

Chairman Dodd, Senator Shelby, and Members of the Committee, My name is Christopher Whalen and I live in the State of New York. [1] Thank you for requesting my testimony today regarding "Modernizing Bank Supervision and Regulation."

Before I address the areas that you have specified, let me suggest some broad themes and questions for further investigation, questions which I believe the Committee should consider before diving into the detail of actual legislative changes to current law and regulation. Simply stated, we need to do some basic diligence about our financial institutions, our markets and our economy, both generally and with respect to the present financial crisis, before we can attack the task of remaking the current supervision and regulation of financial institutions.

### Financial Institutions Structure

- What is a financial institution in terms of the reality today in the marketplace vs. the stated intent of law and regulation? What tasks do financial institutions perform that actually require public regulation? What tasks do not?
- What activities should be permitted for federally insured depositories? What capital is required to support these regulated activities in a safe and sound manner?
- How much capital must an insured depository institution have in order for (a) markets and (b) the public to have confidence in that institution's ability to function? Are regulatory measures even meaningful to the public today?
- How do regulatory regimes such as fair-value accounting and Basel II, and market-driven measures such as EBITDA or tangible common equity ("TCE"), affect the real and perceived need for more capital in financial institutions? Is the marketplace a better arbiter of capital adequacy, particularly from a public interest perspective, than the private internal bank models and equally inconsistent, nonpublic regulatory process enshrined in the Basel II accord?

### Financial Market Structure

- What is "systemic risk?" Is systemic risk a symptom of other risk factors or an independent risk measure in and of itself? If the latter, how is it measured? [2]
- How do government policies either increase or decrease systemic risk? For example, has the growth of Over-the-Counter ("OTC") market structures increased perceived systemic risk hurt investors and negatively affected the safety and soundness of financial markets?
- Does the fact of cash settlement for credit default contracts increase system leverage and therefore risk? Does the rescue of AIG illustrate how OTC cash settlement credit default contracts multiply the systemic risk of a given cash market credit basis? [3]
- Should the Congress mandate SEC registration for all investment instruments that are eligible for investment by smaller banks, insurers, pensions and public agencies? Should the Congress place limits on the ability of securities dealers to sell complex OTC structured assets and derivatives to relatively unsophisti-

[1] Mr. Whalen is a co-founder of Institutional Risk Analytics, a Los Angeles unit of Lord, Whalen LLC that publishes risk ratings and provides customized financial analysis and valuation tools.

[2] My personal view is that systemic risk is a political concept akin to fear and not something measurable via scientific methods. See also "What Is To Be Done With Credit Default Swaps?" *American Enterprise Institute,* February 23, 2009. See: ***http://www.rcwhalen.com/pdf/cds_aei.pdf.***

[3] In classical terms, a legal contract recognized as such under common law requires the exchange of value between parties, but a credit default swap ("CDS") fails this test. Instead, a CDS is better viewed as a "barrier option" in insurance industry terms or a gaming instrument like the New York Lottery. Because the buyer of protection does not need to deliver the underlying asset to collect the insurance payment, the parties may settle in cash and there is no limit on the number of open positions written against this basis—save the collateral requirements for such positions, if any. Because the effective collateral posted by dealers of CDS heretofore was low compared to effective end-user collateral requirements, the dealer leverage in the system was almost infinite and thus the systemic risk increased by an order of magnitude. In economic terms, CDS equates renters with owners, risk is increased and regulation is rendered at best irrelevant.

cated "end users" such as pension funds, public agencies and insurance companies?

- Should the Congress place an effective, absolute limit on size and complexity of banks? What measures ought to be used to gauge market share?

**Political Economy**

- Does the inability of the Congress to govern its spending behavior and the related monetary policy accommodation by the Federal Reserve Board add to systemic risk for global financial institutions and markets?
- Does the fact of twin budget and current account deficits by the U.S. add to the market/liquidity risk facing all global financial institutions? That is, is the heavily indebted U.S. economy unstable and thus an engine for creating systemic events?

**Prudential Regulation**

Our Nation's Founders tended to favor competition over monopoly, inefficiency and conflict, in the form of checks and balances, over efficiency and short-run practicality. The challenge for the national Congress remains, as it always has been, reconciling the need to be more efficient to achieve current public policy goals while remaining true to the legacy of deliberate inefficiency given to us by the framers of the Constitution.

Or to put it another way, the Founders addressed the systemic risk of popular rule by placing deliberately mechanical, inefficient checks and balances in our path. Similar checks are present in any well managed government or enterprise to prevent bad outcomes. In Sarbanes-Oxley risk terms, this is what we call "systems and controls."

For example, when the House of Representatives, reflecting current popular anger and indignation, passes tax legislation encouraging the cancelation of state law contracts and the effective confiscating of monies lawfully paid to executives at AIG, it falls to the Senate to withhold its support for the action by the lower chamber and instead counsel a more deliberate approach to advancing the public interest.

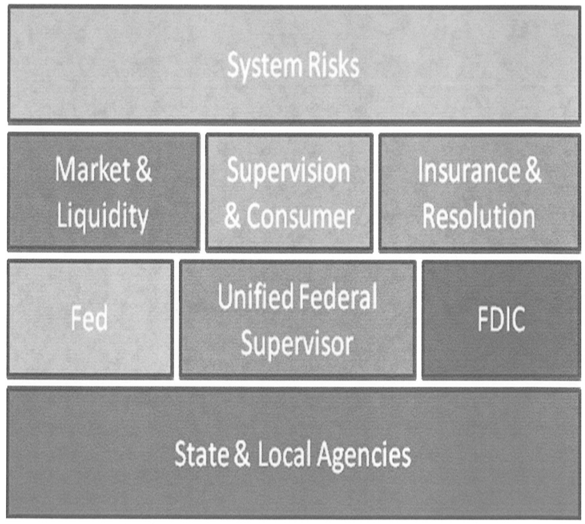
For example, were the Senate to put aside the House-passed measure and instead pass legislation that forces the Fed and Treasury push AIG into bankruptcy to forestall further public subsidies for this apparently insolvent company, the U.S. Trustee for the Federal Bankruptcy Court arguably could seek to recover the bonuses paid to executives.

The Bankruptcy Trustee might also be able to recover the tens of billions of dollars in payments to counterparties such as Goldman Sachs (NYSE:GS), which has so far reportedly received $20 billion in public funds paid and pledged. One might argue that the immediate bankruptcy of AIG is now in the best interest of the public because it provides the only effective way to (a) claw-back bonuses and counterparty payments, and (b) end further subsidies for this insolvent corporation.[4]

In my view, it serves the public interest to have multiple regulators sitting at the table in terms of managing what might be called "systemic risk," including both state and federal regulators. In the same way that the federal government has forced a cooperative relationship between local, state and federal law enforcement when it comes to anti-terrorism efforts, so too the Congress should end the competition between federal and state regulators illustrated by the legal battle over state-law preemption and instead mandate cooperation. In areas from prudential regulation to consumer protection, why cannot the federal government mandate broad standards to achieve policy objectives, then empower/compel state and federal agencies to cooperate in making these goals a reality?

What makes no sense about the current system of regulation is having the various federal and state regulators compete amongst themselves over shared portions of the different components of risk as viewed from a public policy perspective, including market and liquidity risk, safety and soundness, and regulatory enforcement and consumer protection. Were I to have the opportunity to rearrange the map of the U.S. regulatory system, here is how I would divide the areas of responsibility:

[4] For a discussion of the true purposes of the AIG rescue by the Fed, See Morgenson, Gretchen, "A.I.G.'s bailout priorities are in critics' cross hairs," *The New York Times,* March 17, 2009. Also, it must be noted that analysts in the risk management community such as Tim Freestone identified possible instability in the AIG business as early as 2001. AIG threatened to sue Freestone when he published his findings, which were documented at the time by the *Economist* magazine. Notables such as Henry Kissinger questioned the *Economist* story and said "I just want you to know that Hank Greenberg has more integrity than any person I have ever known in my life."




Seen from the perspective of the public, the risks facing the financial system can be divided into three large areas: (a) market and liquidity risk management, (b) regulatory enforcement and consumer protection, and (c) deposit insurance and the resolution of insolvent institutions. Each area has implications for systemic stability. Let me briefly comment on each of these buckets and the agencies I believe should be tasked with responsibility for these areas in a restructured U.S. regulatory system.

**Market and Liquidity Risk**

As the bank of issue and the provider of credit to the financial system, the Fed must clearly be given the lead with respect to providing market and liquidity risk management, and general market oversight and surveillance. The Fed's chief area of competency is in the area of monetary policy and financial market supervision. But I strongly urge the Congress to strip the Fed of its current, direct responsibility for financial institution supervision and consumer protection to help the agency better focus on its monetary and economic policy responsibilities, as well as an enhanced market surveillance effort.

The United States needs a single safety-and-soundness regulator for all financial institutions, even if they retain diversity in terms of charters and activities. Consider that no other major industrial nation in the world gives its central bank paramount responsibility for bank safety and soundness, and for good reason. Over the past decade, the Fed has demonstrated an inability to manage the internal conflict between its role as monetary authority and its partial responsibility for supervising bank holding companies and their subsidiary banks.

While some people claim that the Glass-Steagall Act law dividing banking and commerce has been repealed, I remind you that the Bank Holding Company Act of 1956 is still extant. I urge the Congress to delete this statute in its entirety as part of any new financial services legislation. Indeed, given the size of the capital deficit facing the larger players in the banking industry, AIG, and the GSEs, it seems inevitable that the Congress will be compelled to allow industrial companies to enter the U.S. banking sector. [5]

The Fed's internal culture, in my view, is dominated by academic economists whose primary focus is monetary policy and who view bank supervision as a troublesome, secondary task. The Fed economists to whom I particularly refer believe

[5] The subsidies for the GSEs, AIG, and Citigroup amounts to a transfer of wealth from American taxpayers to the institutional investors who hold the bonds and derivative obligations tied to these zombie institutions. All of these companies will require continuing cash subsidies if they are not resolved in bankruptcy. My firm estimates that the maximum probable loss for the top U.S. banks with assets above $10 billion, also known as Economic Capital, will be $1.7 trillion through the cycle, of which $1.4 trillion is attributable to the top four money center banks. With the operating loss subsidy required for the GSEs and AIG, the U.S. Treasury could face a collective, worst-case funding requirement of $4 trillion through the cycle.

that markets are efficient, that investors are rational, and that encouraging products such as subprime securitizations and OTC derivative contracts are consistent with bank safety and soundness. The same Fed economists believe that big is better in the banking industry, even though the overwhelming data and statistical evidence suggests otherwise.[6]

Critics of the Fed are right to say that under Alan Greenspan, the central helped cause the subprime mortgage debacle, but not for the reasons most people think. Yes, the expansive monetary policy followed by the Fed earlier this decade was a big factor, but equally important was the active encouragement by Fed staff and other global regulators of over-the-counter derivatives and the use by banks of off-balance-sheet vehicles such as collateralized debt obligations ("CDOs") for liability management.[7]

The combination of OTC derivatives, risk-based capital requirements championed by the Fed and authorized by Congress, and favorable accounting rules for off-balance sheet vehicles blessed by the SEC and the FASB, enabled Wall Street to create a de facto assembly line for purchasing, packaging, and selling unregistered, high-risk securities, such as subprime collateralized CDOs, to a wide variety of institutional investors around the world. These illiquid, opaque securities now threaten the solvency of banks in the United States, Europe, and Asia.

Observers describe the literally thousands of structured investment vehicles created during the past decade as the "shadow banking system." But few appreciate that this deliberately opaque, unregulated market came into existence and grew with the direct approval and encouragement of the Fed's leadership and the academic research community from which many Fed officials are drawn to this day. For every economist nominated to the Fed Board, the Senate should insist on a non-economist candidate!

Simply stated, in my view monetary economists are not competent to supervise financial institutions nor to set policy for regulating these institutions, yet successive Presidents and Congresses have populated the Fed's board with precisely such skilled professionals. While the more conservative bank supervision personnel at the 12 regional Federal Reserve banks and within agencies such as the OCC, OTS, and FDIC often opposed ill-considered liberalization efforts such as OTC derivatives and the abortive Basel II accord, the Fed's powerful, isolated Washington staff of academic economists almost always had its way—and the Congress supported and encouraged the Fed even as that agency's policies undermined the safety and soundness of our financial markets.

The result of our overly generous tolerance for economist dabbling in the real world of banking and finance is a marketplace where some of the largest U.S. banks are in danger of insolvency, because their balance sheets are laden with illiquid, opaque and thus toxic OTC instruments that nobody can value or trade—instruments which the academic economists who populate the Fed actively encouraged for many years. Remember that comments by Fed officials made over the years to the Congress lauding these very same OTC cash and derivative instruments are a matter of public record. Given the Fed's manifest failure to put bank safety and soundness first, I believe that the Congress needs to rethink the role of the Fed and reject any proposal to give the Fed more authority to supervise investment banks and hedge funds, for example, not to mention the latest economist policy infatuation, "systemic risk."

We can place considerable blame on the Fed for the subprime crisis, but it must be said that an equally important factor was the tendency of Congress to use financial regulatory and housing policy to raise money and win elections. Members of Congress in both parties have freely used the threat of new regulation to extort contributions from the banking and other financial industries, often with little pretense as to their true agenda. Likewise, the Congress has been generous in providing with new loopholes and opportunities for regulatory arbitrage, enabling the very unsafe

[6] Given the magnitude of the losses incurred over the past several years due to financial innovation, it is worth asking if economists or at least those economists involved in the securities industry and financial economics more generally should be licensed and regulated in some way. Several observers have suggested that rating agencies ought to be compelled to publish models used for rating OTC structured asset, thus it seems reasonable to ask economists and analysts to stand behind their work when it is used to create securities. For an excellent discussion of the misuse of mathematics and other quantitative tools expropriated from the physical sciences by economists, regulators, and investment professionals, see "New Hope for Financial Economics: Interview with Bill Janeway," *The Institutional Risk Analyst,* November 17, 2008.

[7] I recommend that the Committee study Martin Mayer's 2001 book, "The Fed: The Inside Story of How the World's Most Powerful Financial Institution Drives the Markets," particularly Chapter 13, "Supervisions," on the Fed's role in bank regulation.

and unsound practices in terms of mortgage lending, securitization and the derivatives markets that has pushed the global economy into a deflationary spiral.

Let us never forget that the subprime housing bubble that began the present crisis came about with the active support of the Congress, two different political administrations, the GSEs, the mortgage, real estate, banking, securities and homebuilding industries, and many other state and local organizations. It should also be recalled that the 1991 amendment to the Federal Reserve Act which allowed the Fed of New York to make the ill-advised bailout loans to AIG and other companies was added to the FDICIA legislation in the eleventh hour, with no debate, by members of this Committee and at the behest of officials of the Federal Reserve. The FDICIA legislation, let's recall, was intended to protect the taxpayer from loss due to bailouts for large financial institutions. [8]

**Supervision and Consumer Protection**

A unified federal supervisor should combine the regulatory resources of the Federal Reserve Banks, SEC, the OCC, and the Office of Thrift Supervision, to create a new safety-and-soundness agency explicitly insulated from meddling by the Executive Branch and the Congress. This agency should be responsible for setting broad federal standards for compliance with law and regulation, capital adequacy and consumer protection, and be accountable to both the Congress and the various states whose people it serves. As I mentioned before, the agency should be tasked to form cooperative alliances with state agencies to secure the objectives in each area of regulation. America has neither the time nor the money for regulatory turf battles.

As the Congress assembles the unified federal supervisor, it should include enhanced disclosure by all types of financial services entities, including hedge funds, nonbank mortgage origination firms and insurers, to name a few, so that regulators understand the contribution of these entities to the overall risk to the system, even if there is no actual prudential oversight of these entities at the federal level.

**Insurance and Resolution**

The Congress does not need to disturb existing state law regulation on insurance or mortgage origination in order to ensure that the unified federal regulator and FDIC have the power to reorganize or even liquidate the parents of insolvent banks. What is needed is a systemic rule so that all participants know what happens to firms that are mismanaged, take imprudent risks and become insolvent. So long as the Congress fashions a clear, unambiguous systemic rule regarding how and when the FDIC can act as the government's fully empowered receiver to resolve financial market insolvency, the markets will be reassured and the systemic stresses to the system reduced in the process. [9]

The primary responsibility for insuring deposits and other liabilities of banks, and resolving troubled banks and their affiliates, should be given to the FDIC. Whereas the unified federal regulator will be responsible for oversight and supervision of all institutions, the FDIC should be given authority to (a) publicly rate all financial institutions via the pricing of liability risk insurance, (b) make the determination of insolvency of an insured depository institution, in consultation with the unified regulator and the Fed, and (c) to reorganize any organization or company that is affiliated with an insolvent insured depository.

The cost of membership to the financial services club must be to either maintain the safety and soundness of regulated bank depositories or submit unconditionally to prompt corrective action by the FDIC to quickly resolve the insolvency. The Founders placed a federal mechanism for bankruptcy in the U.S. Constitution for many reasons, but chief among them was the overriding need for finality to help society avoid prolonged damage due to insolvencies.

By focusing the FDIC on its role as the insurer of deposits and receiver for failed banks, and expanding its legal authority to restructure affiliates of failed banks, the

[8] When the amendment to Section 13 of the FRA was adopted by the Senate, Fed Vice Chairman Don Kohn, then a senior Federal Reserve Board staffer, reportedly was present and approved the amendment for the Fed, with the knowledge and support of Gerry Corrigan, who was then President of the Federal Reserve Bank of New York and Vice Chairman of the FOMC. See also "IndyMac, FDICIA and the Mirrors of Wall Street," *The Institutional Risk Analyst,* January 6, 2009.

[9] While the commercial banking industry is required to provide extensive disclosure to the public, insurance companies have long dragged their feet when it comes to providing data to the public at a reasonable cost. Whereas members of the public can access machine-readable financial information about banks from portals such as the FDIC and FFIEC, in real time, comparable data on the U.S. insurance industry is available only from private vendors and at great cost, meaning that the public has no effective, direct way to track the soundness of insurers.

Congress could solve many of the political and jurisdictional issues that now plague the approach to the financial crisis.

By giving the FDIC the primary authority to determine insolvency and the legal tools to restructure an entire organization in or out of formal receivership, situations such as the problems at Citigroup or AIG could more easily be resolved or even avoided. And by ending the doubt and ambiguity as to how insolvency is resolved, an enhanced role for the FDIC would reduce perceived systemic risk.

For example, if the FDIC had the legal authority to direct the restructuring of all of the units of Citigroup, the agency could collapse the entire Citigroup organization into a single national bank unit, mark the assets to market, wipe out the common and preferred equity, convert all of the parent company debt into new common equity, and contribute new government equity funds as well. The resulting bank would have 40–50 percent TCE vs. assets and would no longer be a source of systemic risk to the markets. Problem solved.

While the FDIC probably has the moral and legal authority to compel Citigroup to restructure along these lines (or face a traditional bank resolution), Congress needs to give the FDIC the power as receiver to make these type of changes unilaterally. In the case of a bankruptcy by AIG, FDIC could play a similar role, managing the insolvency process and assisting as the state insurance regulators take control of the company's insurance units. The remaining company would then be placed into bankruptcy.

In addition to giving the FDIC paramount authority as the guardian of safety and soundness and thus a key partner in managing the factors that comprise systemic risk, the Congress should give the FDIC the power to impose a fee on all bank liabilities, including foreign deposits and debt issued by companies that own insured depository institutions. All of the liabilities of a regulated depository must support the Deposit Insurance Fund and the Congress should also modify its market share limitations to include liabilities, not merely deposits, for limiting size and thus the ability of a single institutions to destabilize the global financial system.

**Systemic Risk Regulation**

As I stated above, systemic risk is a symptom of other factors, a sort of odd political term spawned under the equally dubious rubric of identifying certain banks as being "Too Big To Fail." When issues such as market structure and prudential regulation of institutions are dealt with adequately, the perceived "problem" of systemic risk will disappear. [10]

**Consumer Protection and Credit Access**

I believe that the Congress should give the unified federal regulator primary responsibility for enforcement of consumer protection and credit access laws. That said, however, I believe that the Congress should revisit the issue of federal preemption of state consumer fraud and credit laws. While there is no doubt that the federal government should set consistent regulations for all banks, there is no reason why federal and state agencies cannot cooperate to achieve these ends. The notion that consumer regulation must be an either or proposition is wrong.

As this Congress looks to reform the larger regulatory framework, a way must be found to allow for cooperation between state and federal agencies tasked with financial regulation and in all areas, including consumer and enforcement. There is no federal tort law, after all, so if consumers are to have effective redress of grievance for bad acts such as fraud or predatory lending, then the agencies and courts of the various states must be part of the solution.

**Risk Management**

In terms of risk management priorities, I believe that the Congress must take steps to resolve the market structure and bank activities problems suggested in the questions at the start of my remarks. Specifically, I believe that the Congress should:

- Require that all OTC derivatives be traded on organized exchanges, that the terms of most contracts be standardized, and that the exchange act as counterparty to all trades and enforce all margin requirements equally on dealers and end users alike. The notion that merely creating automated clearing solutions for CDS contracts, for example, will address the systemic risk issues is mistaken, in my view. [11]

[10] For a discussion of the origins of "Too Big To Fail," see "Gone Fishing: E. Gerald Corrigan and the Era of Managed Markets," *The Herbert Gold Society,* February 1993.

[11] See Pirrong, Craig, "The Clearinghouse Cure," *Regulation,* Winter 2008–2009.

- Require that all structured assets such as mortgage securitizations be registered with the SEC. It is worth noting that an affiliate of the NASDAQ currently quotes public prices on all of the covered mortgage bonds traded in Denmark. Such a system could be easily adapted for the U.S. markets and almost overnight create a new legal template for private mortgage securitization.
- In terms of "originate to distribute" lending, the covered bond model may be the only means to "distribute" mortgage paper for some time to come. The idea currently popular inside the Fed and Treasury that now moribund securitization markets will revive is not even worthy of comment. The key issue for the future of securitizations is whether regulators can craft an explicit recognition of the legacy risk involved in "good sales." It may be that, when actually described accurately, the risks involved in securitization outweigh the economic rewards.
- In terms of mark-to-market accounting, the fact that markets have focused on bank TCE, which like EBITDA is not a defined accounting term, illustrates the folly of trying to define and thereby constrain the preferences of investors and analysts via accounting rules.
  - Using TCE and CDS as valuation indicators, the market concludes that all large banks are insolvent. This is not just a matter of being "pro-cyclical" as is fashionable to say in economist circles, but rather of multiplying the already distorted, "market efficiency" perspective on value provided by mark-to-market into a short sellers bonanza. The Chicago School is wrong; short-term price is not equal to value.
  - If you make every financial firm on the planet operate under the same rules as a broker-dealer for market risk positions, then capital levels must rise and leverage ratios for all types of financial disintermediation must fall. Everything will be held to maturity, securitization will become exclusively a government activity and the U.S. economy will stagnate. Mark-to-market implies a net reduction in credit to U.S. consumer and the global economy that is causing and will continue to cause asset price deflation and a related political firestorm.
  - While the changes now proposed by the FASB to mark-to-market accounting may give financial institutions some relief in terms of rules-driven losses, falling cash flows behind many assets classes are likely to force additional losses by banks, insurers and other investors.

Finally, regarding credit ratings, I urge the Congress to remove from federal law any language suggesting or compelling a bank, agency or other investor to utilize ratings from a particular agency. There is no public policy good to be gained from creating a government monopoly for rating agencies. The best way to keep the rating agencies honest is to let them compete and be sued when their opinions are tainted by conflicts. [12]

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## PREPARED STATEMENT OF GAIL HILLEBRAND

FINANCIAL SERVICES CAMPAIGN MANAGER,
CONSUMERS UNION OF UNITED STATES, INC.,

MARCH 24, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to testify on behalf of Consumers Union, the nonprofit publisher of Consumer Reports, [1] on the important topic of reforming and modernizing

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[12] See "Reassessing Ratings: What Went Wrong, and How Can We Fix the Problem?," *GARP Risk Review,* October/November 2008.

[1] Consumers Union of United States, Inc., publisher of Consumer Reports and Consumer Reports Online, is a nonprofit membership organization chartered in 1936 to provide consumers with information, education, and counsel about goods, services, health and personal finance. Consumers Union's print and online publications have a combined paid circulation of approximately 8.5 million. These publications regularly carry articles on Consumers Union's own product testing; on health, product safety, financial products and services, and marketplace economics; and on legislative, judicial, and regulatory actions that affect consumer welfare. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and services, and noncommercial contributions, grants, and fees. Consumers Union's publications and services carry no outside advertising and receive no commercial support. Consumers Union's mission is "to work for a fair, just, and safe marketplace for all consumers and to empower consumers to protect themselves." Our Financial Services Campaign engages with consumers and

the regulation and oversight of financial institutions and financial markets in the United States.

**Introduction and Summary**

The job of modernizing the U.S. system of financial markets oversight and financial products regulation will involve much more than the addition of a layer of systemic risk oversight. The regulatory system must provide for effective household risk regulation as well as systemic risk regulation. Regulators must exercise their existing and any new powers more vigorously, so that routine, day to day supervision becomes much more effective. Gaps that allow unregulated financial products and sectors must be closed. This includes an end to unregulated status for the "shadow" financial sector. Regulators must place a much higher value on the prevention of harm to consumers. This new infrastructure, and the public servants who staff it, must protect individuals as consumers, workers, small business owners, investors, and taxpayers.

A reformed financial regulatory structure must include:

- Strong consumer protections to reduce household risk;
- A changed regulatory culture;
- A federal agency independent of the banking industry that focuses on the safety of consumer financial products;
- An active role for state consumer protection;
- Credit reform leading to suitable and sustainable credit;
- An approach to systemic risk that includes systemic oversight addressing more than large financial institutions, stronger prudential regulation for risk, and closing regulatory gaps; and
- Increased accountability by all who offer financial products.

**1. Strong, effective, preventative consumer protection can reduce systemic risk**

Proactive, affirmative consumer protection is essential to modernizing financial system oversight and to reducing risk. The current crisis illustrates the high costs of a failure to provide effective consumer protection. The complex financial instruments that sparked the financial crisis were based on home loans that were poorly underwritten; unsuitable to the borrower; arranged by persons not bound to act in the best interest of the borrower; or contained terms so complex that many individual homeowners had little opportunity to fully understand the nature or magnitude of the risks of these loans. The crisis was magnified by highly leveraged, largely unregulated financial instruments and inadequate risk management. The resulting crisis of confidence led to reduced credibility for the U.S. financial system, gridlocked credit markets, loss of equity for homeowners who accepted nonprime mortgages and for their neighbors who did not, empty houses, declining neighborhoods and reduced property tax revenue. All of this started with a failure to protect consumers.

Effective consumer protection is a key part of a safe and sound financial system. As FDIC Chairman Bair testified before this Committee, "There can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy." [2]

Effective consumer protection will require:

- Changing the regulatory culture so that every existing federal financial regulatory agency places a high priority on consumer protection and the prevention of consumer harm;
- Creating an agency charged with requiring safety in financial products across all types of financial services providers (holding concurrent jurisdiction with the existing banking agencies); and
- Restoring to the states the full ability to develop and enforce consumer protection standards in financial services.

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policymakers to seek strong consumer protection, vigorous law enforcement, and an end to practices that impede capital formation for low and moderate income households.

[2] Bair, Sheila C., Chairman, Federal Deposit Insurance Corporation, Testimony before the Senate Committee on Banking, Housing and Urban Affairs on Modernizing Bank Supervision and Regulation, March 19, 2009, *http://www.fdic.gov/news/news/speeches/chairman/spmar0319.html.*

**2. A change in federal regulatory culture is essential**

Consumer advocates have long noted that federal banking agencies give insufficient attention to achieving effective consumer protection.[3] Perhaps this stems partly from undue confidence in the regulated industry or an assumption that problems for consumers are created by just a few "bad apples." One federal bank regulator has even attempted to weaken efforts by another federal agency to protect consumers from increases in credit card interest rates on funds already borrowed.[4] Consumers Union believes that federal banking regulators have placed too much confidence in the private choices of bank management and too much unquestioning faith in the benefits of financial innovation. Too often, the perceived value of financial innovation has not been weighed against the value of preventing harm to individuals. The Option ARM, as sold to a broad swath of ordinary homeowners, has shown that the harm from some types and uses of financial services innovation can far outweigh the benefits.

We need a fundamental change in regulatory culture at most of the federal banking regulatory agencies. Financial regulators must place a much higher value on preventing harm to individuals and to the public. Comptroller Dugan's testimony to this Committee on March 19, 2009, may have unintentionally illustrated the regulatory culture problem when he described the "sole mission" of the OCC as "bank supervision."[5]

The purpose of this hearing is to build for a better future, not to assign blame for the current crisis. However, the missed opportunities to slow or stop the products and practices that led to the current crisis should inform the decisions about the types of changes needed in future regulatory oversight. Consumer groups warned federal banking agencies about the harms of predatory practices in subprime lending long before it exploded in volume. For example, Consumers Union asked the Federal Reserve Board in 2000 to reinterpret the triggers for the application of the Home Ownership and Equity Protection Act (HOEPA) in a variety of ways that would have expanded its coverage.[6] Other consumer groups, such as the National Consumer Law Center, had been seeking similar reforms for some time. In the year 2000, the New York Times reported on how securitization was fueling the growth in subprime loans with abusive features.[7] While the current mortgage meltdown involves practices in loan types beyond subprime and high cost mortgages, we will never know if stamping out some of the abusive practices that consumer advocates sought to end in 2000 would have prevented more of those practices from spreading.

Some have claimed that poor quality loans and abusive lender practices were primarily an issue only for state-chartered, solely state-overseen lenders, but the GAO found that a significant volume of nonprime loans were originated by banks and by

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[3] Improving Federal Consumer Protections in Financial Services, Testimony of Travis Plunkett, before the Committee on Financial Services of the U.S. House of Representatives, July 25, 2007, available at *http://www.consumerfed.org/pdfs/Financial_Services_Regulation_House_Testimony_072507.pdf.*

[4] The OCC unsuccessfully asked the Federal Reserve Board to add significant exemptions to the Fed's proposed rule to limit the raising of interest rates on existing credit card balances. See the OCC's comment letter: *http://www.occ.treas.gov/foia/OCC%20Reg%20AA%20Comment%20Letter%20to%20FRB_8%2018%2008.pdf.*

[5] The Comptroller stated: "Most important, moving all supervision to the Board would lose the very real benefit of having an agency whose sole mission is bank supervision. That is, of course, the sole mission of the OCC . . . " Dugan, John C., Comptroller of the Currency, Testimony before the Senate Committee on Banking, Housing and Urban Affairs on Modernizing Bank Supervision and Regulation, March 19, 2009, p.11, available at: *http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=494666d8-9660-439f82fa-b4e012fe9c0f&Witness_D=845ef046-9190-4996-8214-949f47a096bd.* Other parts of the testimony indicate that the Comptroller was including compliance with existing consumer laws within "supervision."

[6] Garcia, Norma Paz, Senior Attorney, Consumers Union, Testimony before the Federal Reserve Board of Governors regarding Predatory Lending Practices, Docket No. R-1075, San Francisco, CA, September 7, 2000, available at: *www.defendyourdollars.org/2000/09/cus_history_of_against_predato.html.* In that testimony, Consumers Union asked the Federal Reserve Board to adjust the HOEPA triggers to include additional costs within the points and fees calculation, which would have brought more loans under the basic HOEPA prohibition on a pattern or practice of extending credit based on the collateral—that is, that the consumer is not expected to be able to repay from income. We also asked the Board to issue a maximum debt to income guideline to further shape industry practice in complying with the affordability standard.

[7] Henriques, D., and Bergman, L., Mortgaged Lives: A Special Report.; Profiting from Fine Print with Wall Street's Help, New York Times, March 20, 2000, available at: *http://www.nytimes.com/2000/03/15/business/mortgagedlives-special-report-profiting-fine-print-with-wall-street-s-help.html.*

subsidiaries of nationally chartered banks, thrifts or holding companies. The GAO analyzed nonprime originations for 2006. That report covers the top 25 originators of nonprime loans, who had 90 percent of the volume. The GAO report shows that the combined nonprime home mortgage volume of all banks and of subsidiaries of federally chartered banks, thrifts, and bank holding companies actually exceeded the nonprime origination volume of independent lenders subject only to state oversight. The GAO reported these volumes for nonprime originations: $102 billion for all banks, $203 billion for subsidiaries of nationally chartered entities, and $239 billion for independent lenders. Banks had a significant presence, and subsidiaries of federally chartered entities had a volume of nonprime originations nearly as high as the volume for state-only-supervised lenders. [8]

It is too easy for a bank regulator to see its job as complete if the bank is solvent and no laws are being violated. The current crisis doesn't seem to have brought about a fundamental change in this regulatory perspective. Comptroller Dugan told this Committee just last week: "Finally, I do not agree that the banking agencies have failed to give adequate attention to the consumer protection laws that they have been charged with implementing." [9] Clearly, the public thinks that bank regulation has failed. Homeowners in distress, as well as their neighbors who are suffering a loss in home values, think that bank regulation has failed. Taxpayers who are footing the bill for the purchase of bank capital think that bank regulation has failed.

**3. Consumers need a Financial Product Safety Commission (FPSC)**

The bank supervision model lends itself to the view that the regulator's job is finished if existing laws are followed. Unfortunately, a compliance-focused mentality leaves no one with the primary job of thinking about how evolving, perhaps currently legal, business practices and product features may pose undue harm to consumers. A strong Financial Product Safety Commission can fill the gap left by compliance-focused bank regulators. The Financial Product Safety Commission would set a federal floor for consumer protection without displacing stronger state laws. It would essentially be an "unfair practices regulator" for consumer credit, deposit and payment products. [10] Investor protection would remain elsewhere. [11]

The Financial Product Safety Commission would not remove the obligation on existing regulators to ensure compliance with current laws and regulations. Instead, the Commission would promulgate rules that would apply regardless of the chartering status of the product provider. This would insulate consumers from some of the harmful effects of "charter choice," because chartering would be irrelevant to the application of rules designed to minimize unreasonable risks to consumers. Only across the board standards can eliminate a "race to the bottom" in consumer protection.

Without endorsing the FPSC, FDIC Chairman Bair has emphasized the need for standards that apply across types of providers of financial products, stating:

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[8] Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, GAO 09-216, January 2009, at 24, available at: *http://www.gao.gov/new.items/d09216.pdf.*

[9] Dugan, John C., Comptroller of the Currency, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs. U.S. Senate, March 19, 2009. p 11, available at: *http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=494666d8-9660-439f82fa-b4e012fe9c0f&Witness_ID=845ef046-9190-4996-8214-949f47a096bd.*

[10] Payment products include prepaid cards, which increasingly are marketed as account substitutes, including to the unbanked. For a discussion of the holes in current consumer law with respect to these cards, see: G. Hillebrand, Before the Grand Rethinking, 83 Chicago-Kent L. Rev. No. 2, 769 (2008), available at: *http://www.consumersunion.org/pdf/WhereisMyMoney08.pdf.* Consumers Union and other consumer and community groups asked the Federal Reserve Board to expand Regulation E to more clearly cover these cards, including cards on which unemployment benefits are delivered, in 2004. Consumer Comment letter to Federal Reserve Board in Docket R-1210, October 24, 2004, available at: *http://www.consumersunion.org/pdf/payroll1004.pdf.* That protection is still lacking. In February 2009, the Associated Press reported on consumer difficulties with the use of prepaid cards to deliver unemployment benefits. Leonard, C., Jobless Hit with Bank Fees on Benefits, Associated Press, Feb. 19, 2009.

[11] Investor protection has long been important to Consumers Union. In May 1939, Consumer Reports said: "I know it is quite impossible for the average investor to examine and judge the real security that stands behind mere promises of security, and that unless one has expert knowledge and disinterested judgment available, he must shun all such plans, no matter how attractive they seem. We cannot wait for the next depression to tell us that these financial plans—appealing and reasonable in print—failed and created such widespread havoc, not because of the depression, but because they were not safeguarded to weather a depression."

> Whether or not Congress creates a new commission, it is essential that there be uniform standards for financial products whether they are offered by banks or nonbanks. These standards must apply across all jurisdictions and issuers, otherwise gaps create competitive pressures to reduce standards, as we saw with mortgage lending standards. Clear standards also permit consistent enforcement that protects consumers and the broader financial system. [12]

The Financial Product Safety Commission is part of a larger shift we must make in consumer protection to move away from failed "disclosure-only" approaches. Financial products which are too complex for the intended consumer carry special risks that no amount of additional disclosure or information will fix. Many of the homeowners who accepted predatory mortgages did not understand the nature of their loan terms. The over 60,000 individuals who filed comments in the Federal Reserve Board's Regulation AA docket on unfair or deceptive credit card practices described many instances in which they experienced unfair surprise because the fine print details of the credit arrangement did not match their understanding of the product that they were currently using. The Financial Product Safety Commission can pay special attention to practices that make financial products difficult for consumers to use safely.

**4. State power to protect financial services consumers, regardless of the chartering of the financial services provider, must be fully restored**

The Financial Product Safety Commission would set a federal floor, not a federal cap, on consumer protection in financial services products. No agency can foresee all of the potentially harmful consequences of new practices and products. A strong concurrent role for state law and state agencies is essential to provide more and earlier enforcement of existing standards and to provide places to develop new standards for addressing emerging practices. Harmful financial practices often start in one region or are first targeted to one subgroup of consumers. When those practices go unchallenged, others feel a competitive pressure to adopt similar practices. State legislatures should be in a unique position to spot and stop bad practices before they spread. However, federal preemption has seriously compromised the ability of states to play this role.

Some might ask why states can't just regulate state-chartered entities, while federal regulators address the conduct of federally chartered entities. There are several reasons. First, federal bank regulators aren't well-suited to address conduct issues of operating subsidiaries of national banks in local and state markets. Second, assertions of federal preemption for nationally chartered entities and their subsidiaries interfere with the ability of states to restrict the conduct of state-chartered entities. The reason for this is simple: if national financial institutions or their operating subsidiaries have a sizable percentage of any market, this creates a barrier to state reforms applicable only to state-only entities. The state-chartered entities argue strongly against the reforms on the grounds that their direct competitors would be exempt.

As FDIC Chairman Bair told the Committee on March 19, 2009:

> Finally, in the ongoing process to improve consumer protections, it is time to examine curtailing federal preemption of state consumer protection laws. Federal preemption of state laws was seen as a way to improve efficiencies for financial firms who argued that it lowered costs for consumers. While that may have been true in the short run, it has now become clear that abrogating sound state laws, particularly regarding consumer protection, created an opportunity for regulatory arbitrage that frankly resulted in a "race-to-the-bottom" mentality. Creating a "floor" for consumer protection, based on either appropriate state or federal law, rather than the current system that establishes a ceiling on protections would significantly improve consumer protection. [13]

The Home Owners' Loan Act stymies application of state consumer protection laws to federally chartered thrifts due to its field preemption, which should be changed by statute. State standards for lender conduct and state enforcement against national banks and their operating subsidiaries have been severely com-

[12] Bair, Sheila C., Chairman, Federal Deposit Insurance Corporation, Testimony before the Committee on Banking, Housing, and Urban Affairs on Modernizing Bank Supervision and Regulation, March 19, 2009.

[13] Bair, Sheila C., Chairman, Federal Deposit Insurance Corporation. Testimony before the Senate Committee on Banking, Housing, and Urban Affairs on Modernizing Bank Supervision and Regulation, March 19, 2009.

promised by the OCC's preemption rules and operating subsidiary rule.[14] The OCC has even taken the position that state law enforcement cannot investigate violations of non-preempted state laws against a national bank or its operating subsidiaries.[15] That latter issue is now pending in the U.S. Supreme Court.

The OCC is an agency under the U.S. Treasury Department. The Administration should take immediate steps to repeal the OCC's package of preemption and visitorial powers rules.[16] This would remove the agency's thumb from the scale as courts determine the meaning of the National Bank Act. Further, because the OCC's broad view of preemption has influenced the Courts' views on the scope of preemption under the National Bank Act, Congress should amend the National Bank Act to make it crystal clear that state laws requiring stronger consumer protections for financial services consumers are not preempted; state law enforcement is not "visitation" of a national bank; and any visitorial limitation has no application to operating subsidiaries of national banks.

Once the preemption barrier is removed, state legislation can provide an early remedy for problems that are serious for one subgroup of consumers or region of the country. State legislation can also develop solutions that may later be adopted at the federal level. Prior to the overbroad preemption rules, as well as in the regulation of credit reporting agencies which falls outside of OCC preemption, states have pioneered such consumer protections as mandatory limits on check hold times, the free credit report, the right to see the credit score, and the security freeze for use by consumers to stop the opening of new accounts by identity thieves.[17] Congress later adopted three of these four developments into statute for the benefit of consumers nationwide.

**5. Credit reform can provide access to suitable and sustainable credit**

Attempts to protect consumers in financial services are often met with assertions that protections will cause a reduction in access to credit. Consumers Union disputes the accuracy of those assertions in many contexts. However, we also note that not every type of credit is of net positive value to consumers. For example, the homeowner with a zero interest Habitat for Humanity loan who was refinanced into a high cost subprime mortgage would have been much better off without that

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[14] In 2004, the Office of the Comptroller of the Currency promulgated regulations to preempt state laws, state oversight, and consumer enforcement in the broad areas of deposits, real-estate loans, non-real estate loans, and the oversight of operating subsidiaries of national banks. 12 CFR §§7.4000, 7.4007, 7.4008, 7.4009, and 34.4. These regulations interpret portions of the National Bank Act that consumer advocates believe were designed to prevent states from imposing harsher conditions on national banks than on state banks, not to give national banks an exemption from state laws governing financial products and services.

The OCC has repeatedly sided in court with banks seeking to invalidate state consumer protection laws. One example is the case of *Linda A. Watters, Commissioner, Michigan Office of Insurance and Financial Services v. Wachovia Bank, N.A.,* 550 U.S. 1 (2007). The OCC filed an amicus brief in support of Wachovia in the United States Supreme Court to prevent Michigan from regulating the practices of a Wachovia mortgage subsidiary. The OCC argued that its regulations and the National Bank Act preempt state oversight and enforcement and prevented state mortgage lending protections from applying to a national bank's operating subsidiary. The Supreme Court then held that Michigan's licensing, reporting, and investigative powers were preempted. Wachovia is no longer in business, and many observers attribute that to its mortgage business.

[15] In *Office of the Comptroller of the Currency v. Spitzer,* 396 F. Supp. 2d 383 (S.D.N.Y., 2005), aff'd in part, vacated in part on other grounds and remanded in part on other grounds sub nom. *The Clearing House Ass'n v. Cuomo,* 510 F.3d 105 (2d Cir., 2007), cert. granted, Case No. 08-453, New York's Attorney General sought to investigate whether the residential mortgage lending practices of several national banks doing business in New York were racially discriminatory because the banks were issuing high-interest home mortgage loans in significantly higher percentages to African-American and Latino borrowers than to White borrowers. The OCC and a consortium of national banks sued to prevent the Attorney General from investigating and enforcing the anti-discrimination and fair lending laws against national banks. The OCC claimed that only it could enforce these state laws against a national bank. The district court granted declaratory and injunctive relief, and the Second Circuit affirmed. (See *http://www.ca2.uscourts.gov:8080/isysnative/RDpcT3BpbnNcT1BOXDA1LTU5OTYtY3Zfb3BuLnBkZg==/055996-cv__opn.pdf.)* The case is now being briefed in the U.S. Supreme Court.

[16] Those rules are 12 CFR §§7.4000, 7.4007, 7.4008, 7.4009, and 34.4.

[17] The first two of these developments were described by Consumers Union in its comment letter to the OCC opposing its broad preemption rule before adoption. Consumers Union letter of Oct. 1, 2003, in OCC Docket 03-16, available at: *http://www.consumersunion.org/pub/core__financial__services/000770.html.* The free credit report and the right to a free credit score if the score is used in a home-secured loan application process were both made part of the FACT Act. For information on the security freeze, which is available in 46 states by statute and the remaining states through an industry program, see: *http://www.consumersunion.org/campaigns//learn__more/003484indiv.html.*

subprime loan.[18] The same is true for countless other homeowners with fixed rate, fully amortizing home loans who were persuaded to refinance into loans that contained rate resets, balloon payments, Option ARMs, and other adverse features of variable rate subprime loans.

Creating access to sustainable credit will require substantial credit reform. This will have to include steps such as: outlawing pricing structures that mislead; requiring underwriting to the highest rate the loan payment may reach; requiring that the "shelter rule" which ends purchaser responsibility for problems with the loan be waived by the purchaser of any federally related mortgage loan; requiring borrower income to be verified; ending complex pricing structures that obscure the true cost of the loan; requiring suitability and fiduciary duties; and ending steering payments and negative amortization abuses.

**6. Systemic risk regulation, prudential risk regulation, and closing regulatory gaps**

*A. Scope of systemic risk regulation*

There has been discussion about whether the systemic risk regulator should focus on institutions which are "too big to fail." Federal Reserve Board Chairman Bernanke has noted that the incentives, capital requirements, and other risk management requirements must be tight for any institution so large that its failure would pose a systemic risk.[19]

FDIC Chairman Bair's recent testimony posed the larger question about whether any value to the economy of extremely large and complex financial institutions outweighs the risk to the system should such institutions fail, or the cost to the taxpayer if policymakers decide that these institutions cannot be permitted to fail. Consumers Union suggests that one goal of systemic risk regulation should be to internalize to large and complex financial market participants the costs to the system that the risks created by their size and complexity impose on the financial system. "Too big to fail" institutions either have to become "smaller and less complex" or they have to become "too strong to fail" despite their size and complexity—without future expectations of public assistance.

There are many ideas in development with respect to what a systemic risk oversight function would entail, who should perform it, and what powers it should have. Systemic risk oversight should focus on protecting the markets, not specific financial institutions. Systemic risk oversight probably cannot be limited to the largest firms. It will have to also focus on practices used by bank and nonbank entities that create or magnify risk through interdependencies with both insured depository institutions and with other entities which hold important funds such as retirement savings and the money to fund future pensions.

The mortgage crisis has shown that a nonfinancial institution, such as a rating agency or a bond insurer, can adopt a practice that has consequences throughout the entire financial system. Toxic mortgage securitizations which initially received solid gold ratings are an example of the widespread consequences of practices of nonfinancial institutions.

*B. Who should undertake the job of systemic risk regulation?*

There are many technical questions about the exact structure for a systemic risk regulator and its powers. Like other groups, Consumers Union looks forward to learning from the debate. Accordingly we do not offer a recommendation as between giving the job to the Federal Reserve Board, the Treasury, the FDIC, the new agency, or to a panel, committee, or college of regulators. However, we offer the following comments on some of the proposal. We agree with the proposition put forth by the AFL–CIO that the systemic risk regulator should not be governed by, or do its work through, any body that is industry-dominated or uses a self-regulatory model. We question whether the same agency should be responsible for both ongoing prudential oversight of bank holding companies and systemic risk oversight involving those same companies. If part of the idea of the systemic risk regulator is a second pair of eyes, that can't be accomplished if one regulator has both duties for a key segment of the risk-producers.

The panel or committee approach has other problems. A panel made up of multiple regulators would be composed of persons who have a shared allegiance to the

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[18] Center for Responsible Lending founder Martin Eakes described this homeowner as the reason he become involved in anti-predatory lending work in a speech to the CFA Consumer Assembly.

[19] Bernanke, Ben S., Chairman, Federal Reserve Board. Speech to the Council on Foreign Relations. Washington, DC, March 10, 2009, available at: *http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm#f4.*

systemic risk regulator and to another agency. It could become a forum for time-wasting turf battles. In addition, systemic risk oversight should not be a part-time job. We also are concerned with the proposal made by some industry groups that the systemic risk regulator be limited in most cases to acting through or with the primary regulator. This could recreate the type of cumbersome and slow interagency process that the GAO discussed in the context of mortgage regulation.[20]

Consumers Union supports a clear, predictable, rules-based process for overseeing the orderly resolution of nondepository institutions. However, it is not clear that the systemic risk regulator should oversee the unwinding. That job could be given to the FDIC, which has deep experience in resolving banks. Assigning the resolution job to the FDIC might leave the systemic risk regulator more energy to focus on risk, rather than the many important details in a well-run resolution.

*C. Relationship of systemic risk regulation to stronger across the board prudential regulation and to closing regulatory gaps*

Federal financial regulators must have new powers and new obligations. How much of the job is assigned to the systemic risk regulator may depend in part on how effectively Congress and the regulators close existing loopholes and by how much the regulators improve the quality and sophistication of day to day prudential regulation. For example, if the primary regulator sees and considers all liabilities, including those now treated as off-balance sheet, that will change what remains to the done by the systemic oversight body. Thus, each of the powers described in the next subsection for a systemic risk regulator should also be held, and used, by primary prudential regulators. The more effectively they do so, the more the systemic risk regulator will be able to focus on new and emerging practices and risks.

Closing the gaps that have allowed some entities to offer financial products, impose counterparty risk on insured institutions, engage in bank-like activities, or otherwise impinge on the health of the financial system without regulation is at least as important, if not more important, than the creation and powers of a systemic risk regulator. Gaps in regulation must be closed and kept closed. Gaps can permit small corners of the law to become safe harbors from the types of oversight applicable to similar practices and products.

The theory that some investors don't require protection, due to their level of sophistication, has been proved tragically wrong for those investors, with adverse consequences for millions of ordinary people. The conduct of sophisticated investors and the shadow market sector contributed to the crisis of confidence and thus to the credit crunch. The costs of that crunch are being paid, in part, by individuals facing tighter credit limits and loss of jobs as their employers are unable to get needed business credit.

*D. Powers of a systemic risk regulator*

Consumers Union suggests these powers for a systemic risk regulator. Other powers may also be needed. As already discussed, we also believe that the primary regulator should be exercising all or most of these powers in its routine prudential supervision.

*Power to set capital, liquidity, and other regulatory requirements directly related to risk and risk management:* It is essential to ensuring that all the players whose interconnections create risk for others in the financial system are well capitalized and well-managed for risk.

*Power to act by rule, corrective action, information, examination, and enforcement:* The systemic risk regulator must have the power to act with respect to entities or practices that pose systemic risk, including emerging practices that could fall in this category if they remain unchecked. This should include the power to require information, take corrective action, examine, order a halt to specific practices by a single entity, define specific practices as inappropriate using a generally applicable rule, and engage in enforcement.

*Power to publicize:* The recent bailout will be paid for by U.S. taxpayers. Even if some types of risks might have to be handled quietly at some stages of the process, the systemic risk regulator must have the power and the obligation to make public the nature of too-risky practices, and the identities of those who use those practices.

*Power and obligation to evaluate emerging practices, predict risks, and recommend changes in law:* Even the best-designed set of regulations can develop unintended loopholes as financial products, practices and industry structure change. Part of the

[20] Government Accountability Office. Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, January 2009, GAO 09-216, p. 43, available at: *http://www.gao.gov/new.items/d09314t.pdf.*

failure of the existing regulatory structure has been that financial products and practices regularly outpace existing legal requirements, so that new products fit into regulatory gaps. For this reason, every financial services regulator, including the systemic risk regulator, should be required to make an annual, public evaluation of emerging practices, the risks that those emerging practices may pose, and any recommendations for legislation or regulation to address those practices and risks.

*Power to impose receivership, conservatorship, or liquidation on an entity which is systemically important, for orderly resolution:* Consumers Union agrees with many others who have endorsed developing a method for predictable, orderly resolution of certain types of nonbank entities. There will have to be a required insurance premium, paid in advance, for the costs of resolution. Such an insurance program is unlikely to work if it is voluntary, since those engaged in the riskiest practices might also be those least likely to choose to opt in to a voluntary insurance system.

*Undermining of confidence from a power to modify or suspend accounting requirements:* Some have recommended that the systemic risk regulator be given the power to suspend, or modify the implementation of, accounting standards. Consumers Union believes that this could lead to a serious undermining of confidence. As the past year has shown, confidence is an essential element in sustaining financial markets.

**7. Promoting increased accountability**

Consumers Union strongly agrees with President Obama's statement that market players must be held accountable for their actions, starting at the top.[21] There are many elements to accountability. Here is a nonexclusive list.

Consumers Union believes that accountability must include making every entity receiving a fee in connection with a financial instrument responsible for future problems with that instrument. This would help to end the "keep the fee, pass the risk" phenomenon which helped to fuel poor underwriting of nonprime mortgages. Moreover, everyone who sells a financial product to an individual should have an enforceable legal obligation to ensure that the product is suitable. Likewise, everyone who advises individuals about financial products should have an enforceable fiduciary duty to those individuals.

Executive compensation structures should be changed to avoid overemphasis on short term returns rather than the long term health and stability of the financial institution. We also agree with the recommendation which has been made by regulators that they should engage in a thorough review of regulatory rules to identify any rules which may permit or encourage overreliance on ratings or risk modeling.

Consumers Union also supports more accountability for financial institutions who receive public support. Companies that choose to accept taxpayer funds or the benefit of taxpayer-backed programs or guarantees should be required to abandon anti-consumer practices and be held to a high standard of conduct.[22]

A stronger role for state law and state law enforcement also will enhance accountability. Regulatory oversight and strict enforcement at all levels of government can stop harmful products and practices before they spread. "All hands on deck," including state legislatures, state Attorneys General and state banking supervisors, will help to enforce existing standards, identify problems, and develop new solutions.

**Conclusion**

Even the best possible regulatory structure will be inadequate unless we also achieve a change in regulatory culture, better day to day regulation, an end to gaps in regulation, real credit reform, accountability, and effective consumer protection. Creating a systemic risk regulator without reducing household risk through effective consumer protection would be like replacing the plumbing of our financial system with all new pipes and then still allowing poisoned water into those new pipes. The challenges in regulatory reform and modernization are formidable and the stakes are high. We look forward to working with you toward reforming the oversight of financial markets and financial products.

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[21] Overhaul, post to the White House blog on Feb. 25, 2009, available at *http://www.whitehouse.gov/blog/09/02/25/Overhaul/.*

[22] For example, in connection with the Consumer and Business Lending Initiative, which is to be managed through the Term Asset Backed Securities Facility (TALF), Consumers Union and 26 other groups asked Secretary Geithner on Jan. 29, 2009, to impose eligibility restrictions on program participants to ensure that the TALF would not support the taxpayer financed purchase of credit card debt with unfair terms. That request was made before the program's size was increased from $200 billion to $1 trillion. *http://www.consumersunion.org/pdf/TALF.pdf.*

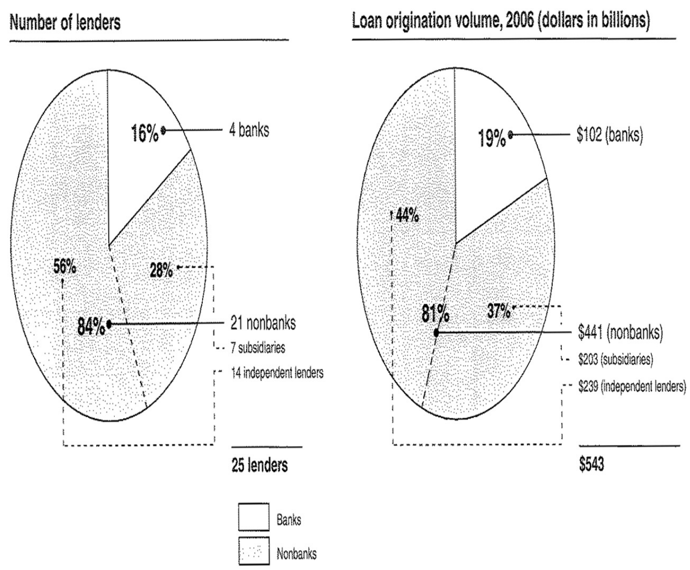
**LIST OF APPENDICES**

1. General Accountability Office figure showing 2006 nonprime mortgage volume of banks ($102 billion), subsidiaries of nationally chartered financial institutions ($203 billion) and independent lenders ($239 billion).
2. Consumers Union's Principles for Regulatory Reform in Consumer Financial Services.
3. Consumers Union's Platform on Mortgage Reform.

**Appendix 1**

Page 24 from GAO Report, GAO 09-0216, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System. Also found at: *http://www.gao.gov/new.items/d09216.pdf.*

**Figure 3: Status of Top 25 Subprime and Nonprime Mortgage Lenders (2006)**




Source: GAO.

Although these lenders were subject to certain federal consumer protection and fair lending laws, they were generally not subject to the same routine monitoring and oversight by federal agencies that their bank counterparts were. From 2003 to 2006, subprime lending grew from about 9 percent to 24 percent of mortgage originations (excluding home equity loans), and Alt-A lending (nonprime loans considered less risky than subprime) grew from about 2 percent to almost 16 percent, according to data from the trade publication *Inside Mortgage Finance.* The resulting sharp rise in defaults and foreclosures that occurred as subprime and other homeowners were unable to make mortgage payments led to the collapse of the subprime mortgage market and set off a series of events that led to today's financial turmoil.

## Appendix 2

*Consumers Union Principles for Regulatory Reform in Consumer Financial Services*

1. Every financial regulatory agency must make consumer protection as important as safety and soundness. The crisis shows how closely linked they are.
2. Consumers must have the additional protection of a Financial Product Safety agency whose sole job is their protection, and whose rules create baseline federal standards that apply regardless of the nature of the provider. This agency would have dual jurisdiction along with the functional regulator. States would remain free to set higher standards.
3. State innovation in financial services consumer protection and state enforcement of both federal and state laws must be honored and encouraged. This will require repeal of the OCC's preemption regulations and its rule exempting operating subsidiaries of national banks from state supervision. The OCC should also immediately cease to intervene in cases, or to file amicus briefs, against the enforceability of state consumer protection laws.
4. Every financial services regulator must have: a proactive attitude to find and stop risky, harmful, or unfair practices; prompt, robust, effective complaint handling for individuals; and an active and public enforcement program.
5. Financial restructuring will be incomplete without real credit reform, including: outlawing pricing structures that mislead; requiring underwriting for the ability to repay the loan at the highest interest rate and highest payment that the loan may reach; a requirement that the "shelter rule" that ends most purchaser responsibility for problems with a loan be waived by the purchaser of any federally related mortgage loan; a requirement that borrower income be verified; an end to complex pricing structures that obscure the true cost of credit; suitability and fiduciary duties on credit sellers and credit advisors; and an end to steering payments and negative amortization abuses.

## Appendix 3

*Consumers Union Mortgage Reform Platform*

We need strong new laws to make all loans fair. This should include these requirements for every home mortgage:

- Require underwriting: Every lender should be required to decide if the borrower will be able to repay the loan and all related housing costs at the highest interest rate and the highest payment allowed under the loan.
- Lenders should be required to verify all income on the loan application.
- End complex pricing structures that obscure the true cost of the loan.
- Brokers and lenders should be required to offer only those types of loans that are suitable to the borrower.
- Brokers and lenders should have a fiduciary obligation to act in the best interest of the borrower.
- Stop payments to brokers to place consumers in higher cost loans.
- End the use of negative amortization to hide the real cost of a loan.
- Require translation of loan documents into the language in which the loan was negotiated.
- Hold investors accountable through assignee liability for the loans they purchase.
- Require that everyone who gets a fee for making or arranging a loan is responsible later if something goes wrong with that loan.
- Adopt extra protections for higher-cost loans.
- Restore state powers to develop and enforce consumer protections that apply to all consumers and all providers.
- For more information, see: *http://www.defendyourdollars.org/topic/mortgages.*

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DANIEL A. MICA**

**Q.1.** *Corporate Credit Unions*—Mr. Mica, last Friday the National Credit Union Administration placed two corporate credit unions, U.S. Central and Western Corporate, into conservatorship. Both of these corporate credit unions have suffered significant losses on their investments in mortgage-backed securities.

What is your view on the reasons for the financial problems at these corporate credit unions?

**A.1.** It is our understanding that the National Credit Union Administration Board was concerned about the level of estimated losses the two corporate credit unions could have on their mortgage backed securities. These legal investments, most of which were AAA rated, were attractive and performing well when made. However, due to the economy and problems in the mortgage market, the value of these securities has been affected by the market and by concerns about potential credit losses relating to the underlying mortgage loans.

**Q.2.** Do you believe there was adequate oversight of the investment portfolios of corporate credit unions?

**A.2.** The National Credit Union Administration Board had examination staff that operated in each of these corporate credit unions and both were subject to examinations and financial reporting requirements on their investments. We do believe it is appropriate to review the regulatory process as it relates to the corporate credit unions, particularly with an eye toward proper regulation of concentration limits and whether longer-term investments should be limited for corporate credit unions.

**Q.3.** What measures should be taken to restructure corporate credit unions?

**A.3.** CUNA is attaching the comment letter we filed April 6, 2009, with NCUA on our recommendations for restructuring the corporate credit union system. While we support restructuring the corporate system, our comments focused on furthering the interests of natural person credit unions. Many credit unions rely on corporate credit unions for core services such as settlement, payments, and liquidity. These services should be continued and facilitated. At the same time, appropriate capital, corporate governance, supervisory and regulatory requirements should be developed that will enhance economies of scale and permit appropriate innovations that will help meet the needs of natural person credit unions into the future.

VIA E-MAIL—*regcomments@ncua.gov*
*April 6, 2009*

Ms. Mary F. Rupp,
Secretary of the Board,
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

RE: CUNA's Comments on Advanced Notice of Proposed Rulemaking for Part 704, Corporate Credit Unions

Dear Ms. Rupp:

On behalf of the Credit Union National Association, we are filing this letter with the National Credit Union Administration to address the future of the corporate credit union system, in response to NCUA's Advance Notice of Proposed Rulemaking (ANPR) on the corporate credit unions. By way of background, CUNA is the largest credit union advocacy organization in this country, representing approximately 90% of our Nation's 8,000 state and federal credit unions, which serve 92 million members.

This letter was developed under the auspices of CUNA's Corporate Credit Union Task Force (CCUTF), which is chaired by Terry West, President and CEO of VyStar Credit Union in Jacksonville, FL. The other members of the Task Force are: Robert Allen, President and CEO of Teachers FCU in Farmingville, NY; Dale Dalbey, President and CEO of Mutual Savings Credit Union in Birmingham, AL; Tom Gaines, President and CEO of the Tennessee Credit Union League; Frank Michael, President and CEO of Allied Credit Union in Stockton, CA; David Rhamy, President and CEO of Silver State Schools CU in Las Vegas, NV; and Jane Watkins, President and CEO of Virginia Credit Union in Richmond, VA. Kris Mecham, CUNA Chairman and President and CEO of Deseret First FCU in Salt Lake City, UT; Tom Dorety, Immediate Past CUNA Chairman and President and CEO of Suncoast Schools FCU in Tampa, FL; and Harriet May, CUNA Vice Chairman and President and CEO of GECU in El Paso, TX, serve as ex officio members.

While the restructuring of the corporate credit union system is very significant, most federally insured credit unions have been focused on, and are extremely concerned about, the costs they must bear in connection with the National Credit Union Share Insurance Fund's (NCUSIF) assistance for corporate credit unions. These include the write down and replenishment of their 1% NCUSIF deposit, their insurance premium costs, and the impairment of their capital in their corporate credit unions that many credit unions must reflect. This letter addresses both the immediate issues related to NCUA's recent actions on corporate credit unions and the longer-term restructuring questions, beginning with a summary of the issues and our responses.

**I. Summary of CUNA's Views**

*A. Costs of NCUA's Assistance for Corporate CUs*

- The costs associated with the NCUSIF's assistance to the corporate credit unions, along with the impairment of credit unions' capital in their corporate credit union, will have a deleterious impact on the credit union system if they must be absorbed in one year.
- CUNA and the Corporate Credit Union Task Force have urged NCUA since January 28th, when it announced the NCUA Corporate Credit Union Stabilization Plan, to provide a mechanism to allow credit unions to spread out their costs, as the Federal Deposit Insurance Corporation (FDIC) has done for banks. Most in the credit union system feel the Board should not have announced the Corporate Stabilization Plan in January without having developed a mechanism to spread out the costs to credit unions.
- CUNA will continue to do all we can to attain a better outcome for credit unions than the current situation, including through assistance from the U.S. Treasury.
- However, CUNA strongly commends the Board for its work on its new legislative proposal, which is addressed below, and we want to continue to work with NCUA and others to achieve amendments that will help mitigate the impact of the costs on credit unions.
- We particularly support NCUA's proposal to establish a Stabilization Fund that, if approved by Congress, could borrow from the Treasury to fund assistance to corporate credit unions, which will help spread out the costs to federally insured credit unions.

- NCUA's proposed amendment calls for $6 billion in borrowing authority for the new Stabilization Fund—a figure very close to NCUA's estimated $5.9 billion in insurance costs to fund the assistance to the corporate credit unions. Additional authority for NCUA to borrow up to $18 billion in emergencies, with approval from the Treasury and others, is also pending. CUNA agrees these changes are an improvement over the current $100 million in borrowing authority for the agency. However, we support seeking greater borrowing authority for the NCUSIF or the new Stabilization Fund, to give NCUA and credit unions even more flexibility in dealing with insurance costs, to the extent efforts to pursue higher borrowing authority do not jeopardize our ability to achieve legislation that will mitigate the impact of the costs on the credit union system.
- CUNA also supports statutory amendments that will give credit unions up to eight years to pay for insurance costs.
- In addition, we are advocating an amendment that will allow the Central Liquidity Facility to provide liquidity directly to the corporate credit unions, as another tool to assist NCUA and the credit union system.
- From the time NCUA announced it had contracted with PIMCO to analyze the securities held by corporate credit unions, CUNA has been urging NCUA to provide adequate information to credit unions from the report, particularly the assumptions and analyses regarding losses.
- Credit unions need the information so they can determine the reasonableness of the agency's cost estimates relating to the losses within the corporate credit unions and the resulting insurance assessments to credit unions. These assumptions have an additional negative impact on many credit unions because of the impairment of their capital in their corporate, which will not be addressed by the new legislation.
- Until now, credit unions have had no way to assess the agency's assumptions regarding these costs.
- On April 3, 2009, NCUA Board Chairman Michael Fryzel announced that key information from the PIMCO report will be provided to the members of the two corporate credit unions placed into conservatorship, WesCorp and U.S. Central, and the state regulators. A summary of significant information from the report will be provided to others. He also announced that the two corporate credit unions are each obtaining an independent, third-party assessment of the credit losses for their asset-backed securities.
- CUNA commends this NCUA Board action and wants to continue to work with NCUA to achieve transparency regarding the agency's corporate credit union actions to the fullest extent possible and appropriate. This includes providing sufficient information regarding the PIMCO report and other key information to the entire credit union system so that credit unions will be able to evaluate whether the agency's credit loss evaluations and the various agency decisions, which were based on those evaluations, are reasonable.
- The actual losses that credit unions will ultimately have to bear from the asset- and mortgage-backed securities in corporate credit union portfolios will depend in large part on those securities being held until they have been largely amortized. While NCUA has indicated it plans to hold the securities to maturity, we believe it is imperative that NCUA take additional steps to assure credit unions that, unless it can work with Treasury to obtain a favorable price well above the current market value for the securities before they mature, these securities will not be sold prior to almost complete amortization.
- A number of accounting issues have arisen since the announcement of the assistance to the corporate credit unions and the two corporate credit union conservatorships. The issues generally relate to when and to what extent natural person credit unions must report the impairments of their NCUSIF deposits and capital in their corporate credit unions. While credit unions have raised concerns about NCUA's accounting guidance in Accounting Bulletin (AB 09-2) CUNA appreciates the latest agency memorandum to examiners, which indicates credit unions will not be dealt with harshly if they do not report their NCUSIF deposit impairment on their March 31, 2009 statements. CUNA wants to continue working with NCUA to achieve as much clarity for credit unions on these issues as possible.

*B. Corporate CU Services*

- Corporate credit unions should focus on core services of settlement, payment systems, and meeting the short-term investment and liquidity needs of their member credit unions.

- Long-term investments have created serious problems for the corporate credit union system that natural person credit unions are now having to pay for.
- Corporate credit unions should not be permitted to concentrate their assets in long-term, on-balance sheet investments because such activities have resulted in some corporate credit unions taking on more risk than they could reasonably manage or mitigate.

*C. Corporate CU Structure*

- The current two-tier corporate system has outlived its utility and characteristics of the system that have facilitated undue risk taking, reduced credit unions' capital, and created inefficiencies must be eliminated.
- Requiring corporate credit unions to focus on payments, settlement and short-term investments and liquidity will reduce the number of corporate credit unions.
- CUNA is not advancing a specific number of corporate credit unions, and it is not recommending that NCUA determine the appropriate number.
- However, the number of corporate credit unions should be small enough to reflect operational efficiencies that benefit natural person credit union members.
- Further, a single interface between the corporate credit union system and key payment and settlement entities could be extremely beneficial as it could combine and strengthen credit unions' ability to influence governmental and private sector decisions in these areas that impact credit unions' operations.
- At the same time, having more than one corporate credit union to provide one or more of the core services for natural person credit unions could prove to be beneficial.
- In any event, the number of corporate credit unions should be sufficient to promote innovation among the remaining corporate credit unions and avoid a potential single point of failure that could arise if only one corporate credit union survives.

*D. Capital of Corporate CUs*

- Corporate credit unions' Tier 1 capital requirement should be at least 4% and could be as high as 6%. Risk-based capital should also be required.
- Natural person credit unions that use corporate credit unions should be required to maintain contributed capital in their corporate.

*E. Corporate Governance*

- Corporate credit unions should be permitted to have outside, nonmember directors who can contribute diverse experiences to a corporate credit union's board.
- A corporate should be permitted to have up to 20 percent of its board comprised of nonmembers and also be permitted to pay a nonmember director a reasonable director's fee.
- Such fees should be comparable to those paid by federally insured depository institutions of similar asset size, so long as the amount of this fee and any other director compensation is fully disclosed to the corporate credit union's members.

*F. Fields of Membership*

- CUNA supports allowing corporate credit unions to have national fields of membership.

**II. Discussion of CUNA's Recommendations and Key Points**

*A. NCUA's Corporate Credit Union Stabilization Program*

Few, if any, issues confronting the credit union system are of greater significance than the National Credit Union Administration's handling of the financial predicament that has confronted the corporate credit union system. That is because the economic, political, and member/public relations issues associated with NCUA's decision to place U.S. Central Corporate Federal Credit Union and Western Corporate Federal Credit Union into conservatorship, as well as the NCUSIF assistance to corporate credit unions announced in January which combined are now estimated to cost federally insured credit unions $5.9 billion, will have serious ramifications now and well into the future—particularly if credit unions have to write down these costs all in one year.

While issues relating to the funding of the assistance to the corporate credit unions are not part of the ANPR, our members have urged us to address these matters in the context of this comment letter.

Our members feel strongly that they should be able to spread out as much of their insurance costs as possible over time, particularly in light of the fact that the FDIC determined that a special insurance premium amounting to 20 basis points of insured deposits, on top of the regular 12 to 16 basis point premium, was too much for the banks to fund in one year. Following complaints from the banks, the FDIC reduced this year's special assessment to 10 basis points, for a total of 22 to 26 basis points—far less than the insurance costs credit unions are expected to pay.

Since January 28, 2009, when NCUA announced the corporate assistance, CUNA and its Corporate Credit Union Task Force have been urging NCUA to adopt alternative approaches for funding the assistance that will help spread out the program's insurance costs to credit unions. [1] As we have discussed with the agency, while some options would take time to implement, in our view NCUA has the legal authority to spread out all premium costs that restore the NCUSIF equity to over 1 percent of insured shares. [2] NCUA does not need approval from Congress or Treasury to take this action.

We do applaud NCUA's efforts to develop legislation that will help spread out all the insurance costs for credit unions, and we want to work with the agency as well as the National Association of State Credit Union Supervisors, the National Association of Federal Credit Unions, and the National Federation of Community Development Credit Unions to achieve its passage as quickly as possible. In particular, CUNA supports:

- The new proposal developed by NCUA to establish a Stabilization Fund that could borrow from the U.S. Treasury to fund assistance to corporate credit unions; and
- Legislation that will give credit unions up to seven or eight years to pay for insurance costs and increase the authority of the NCUSIF to borrow from the Treasury in exigent circumstances.

NCUA's new proposal calls for $6 billion in borrowing authority for the Stabilization Fund, absent exigent circumstances. This level is very close to the $5.9 billion estimate NCUA has indicated the insurance costs to credit unions will e as a result of the corporate credit union assistance. Pending legislation will allow NCUA to borrow up to another $12 billion from Treasury in emergencies, but only with the approval of Treasury and others. These proposed limits are improvement over the current $100 million borrowing authority, and we appreciate efforts to expand NCUA's borrowing authority. However, we hope to partner with NCUA to pursue even higher borrowing authority for the NCUSIF or the new Stabilization Fund, as long as such efforts will not place the legislation to mitigate the impact of the costs on the credit union system at risk.

We also support an amendment to allow the Central Liquidity Facility to provide short-term loans directly to corporate credit unions, and we would welcome NCUA's support to include this amendment in the Stabilization Fund legislation.

While CUNA commends the Board for its work on this proposal, our members feel the Board should not have announced the assistance for the corporate credit unions without providing an acceptable mechanism to spread out the costs credit unions will bear—particularly given the impact of these costs on credit unions in some areas, which have already been weakened by the current economic crisis.

The decisions NCUA has made this year regarding the corporate credit union system are among the most monumental the agency has ever made and will continue to impact the entire system for years to come. Since NCUA announced it had contracted with PIMCO to analyze the securities held by corporate credit unions, CUNA has been urging NCUA to provide adequate information to credit unions so they could determine the reasonableness of the agency's cost estimates relating to losses within the corporate credit unions and the resulting insurance assessments to credit unions. These assumptions will have an additional negative impact on many credit unions because of the impairment of their capital in their corporate credit unions, which will not be addressed by the new legislation.

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[1] In addition to spreading out the insurance costs, CUNA has urged NCUA to pursue other means to mitigate credit unions' costs associated with the Corporate Stabilization Program, including funds from the Treasury's TARP, amendments to the FCU Act to allow the CLF to provide loans and capital to corporate credit unions, and options consistent with accounting rules that allow the agency to deviate from GAAP in recognizing its own costs to the NCUSIF.

[2] The 1 percent deposit is required to be replenished in the year the NCUSIF incurs an impairment that would reduce the Fund balance to below 1 percent, under the Federal Credit Union Act. However, for the premium costs which fund the .30 percent balance in the Fund, NCUA has authority under the FCUA to spread those costs out over time. 12 U.S.C. §§1782(c)(1)(A), (c)(2).

Until now, credit unions have had no way to assess the validity of the agency's assumptions regarding these costs. On April 3, 2009, NCUA Board Chairman Michael Fryzel announced that key information from the PIMCO report will be provided to the members of the two corporate credit unions placed into conservatorship, WesCorp and U.S. Central, as well as to the state regulators. A summary of significant information from the report will be provided to others. He also announced that the two corporate credit unions are each obtaining an independent, third-party assessment of the credit losses for their asset-backed securities.

CUNA commends this NCUA Board response and wants to continue to work with NCUA to achieve transparency regarding the agency's corporate credit union actions to the fullest extent possible and appropriate. We are hopeful that sufficient information regarding the PIMCO report will be provided to the entire credit union system so that credit unions will be able to evaluate whether the agency's credit loss evaluations and the various agency decisions, which were based on those evaluations, are reasonable.

The estimate of the costs to the share insurance fund for the Corporate Stabilization Program ($5.9 billion as of this writing) is indeed just that, an estimate. The ultimate losses derived from the portfolio of securities held by the corporate credit unions depends on two factors: the actual credit losses on the securities (determined by various and complicated future economic events), and the extent to which the securities might be sold prior to full amortization, resulting in market losses that could exceed the eventual credit losses.

Credit unions understand that they will eventually be responsible through the share insurance fund for the actual credit losses in the portfolio, and that the extent of these losses is currently unknowable. They are, however, very concerned that they might be forced to pay additional market losses resulting from premature sales of the securities.

Credit unions understand that the agency would not be in a position to sell the securities so long as the market losses exceed the available reserves (including the $5.9 billion added to available funds). Yet they are anxious that once the Fund is "in the money," counting existing capital and the additional $5.9 billion, the pressure on the agency to sell the remaining securities and lock out any future increases in losses could become acute.

NCUA has released a statement and Board members have indicated the agency's intent to hold the securities until maturity, which is positive. However, credit unions continue to seek assurances that the agency will be able to withstand pressure and hold the securities until they are largely amortized or essentially back to par, unless it is able to work with the Treasury to sell corporate credit unions' assets before they mature at favorable prices well above their current market values.

Finally, a number of accounting issues have arisen since the announcement of the assistance to the corporate credit unions and the two corporate credit union conservatorships. These relate to when and to what extent natural person credit unions must report the impairments of their NCUSIF deposit and capital in their corporate credit unions. These are not easy issues and questions remain concerning appropriate accounting treatments. The latest agency memorandum to examiners indicates credit unions will not be dealt with harshly if they do not report their NCUSIF deposit impairment on their March 31, 2009 statements. CUNA appreciates this development and wants to continue working with NCUA to achieve as much clarity for credit unions on these accounting issues as possible in a timely fashion.

*B. CUNA's Corporate Credit Union Task Force*

Prior to NCUA's issuance of the ANPR, in recognition of the serious issues facing corporate credit unions, CUNA formed the Corporate Credit Union Task Force (CCUTF) earlier this year.[3] The CCUTF has met a number of times to consider the issues outlined in the ANPR. The role of the Task Force has been to review the current corporate credit union network, assess the nature and scope of the problems within the network, and to develop forward thinking, feasible recommendations to address those problems responsibly.

A key objective for the Task Force in crafting its recommendations for reform of the corporate system has been to ensure the interests and needs of natural person credit unions for payment and settlement services as well as short-term liquidity are met. The Task Force also sought to develop recommendations that would mitigate the risks associated with corporate credit union operations. This letter reflects their

[3] Members of the Task Force are Terry West, chair, Robert Allen, Dale Dalbey, Tom Gaines, Frank Michael, David Rhamy, and Jane Watkins; Kris Mecham, Tom Dorety, and Harriet May serve as *ex officio* members.

views, as well as those of numerous credit unions and Leagues that responded to this request for comments. It has also been reviewed by CUNA's Governmental Affairs Committee as well as our Board of Directors, and it represents CUNA's official positions. CUNA's GAC and Board reflect a broad cross-section of American's credit unions by size, region, and charter types.

*C. The Future Structure of the Corporate System*

CUNA is aware that the first task the Board must deal with regarding corporate credit unions is stabilizing the system in the near-term. Once that has been accomplished, a transition to a revised system will be necessary. In our comments that follow, we deal only with what the optimal system should be, not with the mechanism of how to transform the current system to its future form.

Corporate credit unions have historically fulfilled an important role by providing natural person credit unions with settlement and payment services. In addition, corporate credit unions have played a major role in meeting both the short- and long-term investment needs of credit unions, and in providing short- and medium-term loans to credit unions.

As a result of the current economic crisis, many corporate credit unions have experienced a dramatic reduction in the market value of their investments. These reductions have been exacerbated by the virtual shutdown of the market for mortgage-backed securities and other investments. This series of events has severely undermined the stability of the corporate credit union system.

CUNA believes that the future structure of the corporate credit union system must be very different from the one that has evolved over the past three decades, if it is going to be well positioned to meet the needs of member credit unions while successfully managing risk. Changes must be made to the number of tiers within the system, the number of corporate credit unions, the services they provide, their capitalization, and governance. Ultimately, the driving factor must be the set of services that it is essential for credit unions to receive from a corporate system. Once those services are established, the remaining issues concerning the future of the corporate system can be determined.

*D. Services Provided by the Restructured Corporate System*

Services currently provided by corporate credit unions can be divided into the following mutually exclusive categories:

- *Payment processing, such as checks, ACH, Wire Transfers, ATM and debit, etc.* Payment processing involves transferring information about financial transactions (payments) so that the financial institutions of both the payor and payee know when to debit or credit whose account by how much. In addition to corporate credit unions, a number of other vendors provide various types of payment processing to credit unions.
- *Settlement.* This function involves transferring money among financial institutions to settle out the net effect of inflows and outflows resulting from payments and other credit union transactions. Settlement requires a financial institution charter, and maintaining accounts at a Federal Reserve Bank and other financial institutions to execute and manage the transfer of funds.
- *Short-term investments.* This function involves investments credit unions make with overnight funds, and other short-term investments. The limit for short-term investments could be as short as three months, but no longer than one year.
- *Short-term liquidity.* This function involves providing short-term lending to credit unions. This could be for as short as overnight to facilitate a credit union's settlement accounts, to slightly longer to allow credit unions to adjust to monthly or seasonal liquidity flows.
- *Long-term investing.* This involves portfolio investing for credit unions with longer maturities than defined as short-term investing.
- *Long-term liquidity.* This involves longer term lending to credit unions. Credit unions typically undertake such borrowing not to adjust to net loan and savings inflows, but instead for asset/liability management purposes such as holding longer term loans.

Among these services, the core function that credit unions require from a corporate credit union system is settlement. Settlement provides the point of contact of the credit union movement with the rest of the financial system, and we believe that credit unions would be placed at a significant disadvantage if they had to individually arrange for settlement services with correspondent or Federal Reserve banks. Settlement is a function that can be performed efficiently at scale by a very few endpoints for the entire credit union system.

Whatever institution provides settlement services must also be able to provide short-term investing and liquidity. A credit union's settlement account is its overnight, interest-earning account. Access to overnight or very short-term loans is also necessary for settlement.

These then comprise the core functions that the future corporate system must be designed to offer: settlement, short-term investments, and short-term liquidity.

Payment processing is often linked to settlement and short-term liquidity and investment, and there can be efficiencies in a corporate credit union offering various types of payment processing. CUNA supports payment processing as a permissible activity for corporate credit unions because it is often so closely related to settlement.

*E. Long-Term Investments and Concentrations in Such Investments for Corporate Credit Unions Should Be Curtailed and Managed*

Many believe that, in the future, corporate credit unions should not be engaged in longer-term investing (on the corporate credit union's balance sheet). Long-term investments and liquidity are not crucial to the settlement function, and longer-term investing has been the source of most of the serious problems in the corporate system, such as the failure of CapCorp and the current problem of unrealized losses on illiquid securities. Corporate credit unions could in theory successfully and safely engage in providing term investment services on their own balance sheets, but permissible investment activities would need to be more restrictive than current regulations, and corporate credit unions would have to be required to hold capital levels far in excess of what credit unions would likely be willing to provide. A number of credit unions believe there is not enough capital in the credit union movement to fund long-term investments on the balance sheets of both natural person and corporate credit unions. Another consideration in removing long-term investing from corporate credit unions is the fact that it is feasible for credit unions to meet their long-term investing needs through means already available outside corporate credit union balance sheets: securities purchases, mutual funds, investment advisory services, and deposits in other financial institutions.

Corporate credit unions have traditionally held relatively broad authority to engage in long-term (greater than one year) investing. Absent such authority, corporate credit unions likely would not have been able to obtain the favorable yields they have been able to garner and pass on to their member credit unions. Obtaining such yields, however, has not been without substantial risk for the corporate credit union system. Furthermore, as the system is currently structured, losses stemming from these long-term investments can have a direct, detrimental affect on natural person credit unions and on other aspects of the corporate credit unions' operations, including payment, settlement, and liquidity services.

Part 12 C.F.R. 704.5(c), Investments, of NCUA's Rules and Regulations, describes corporate credit unions' current basic investment activities, which CUNA supports for corporate credit unions going forward. These include investments in:

- Securities, deposits, and obligations set fort in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act;
- Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and certain mutual savings banks;
- Corporate CUSOs;
- Marketable debt obligations of certain corporations; and
- Domestically issued asset-backed securities.

Additionally, Appendix B to Part 704, Expanded Authorities and Requirements, details the riskier investments that qualifying corporate credit unions can purchase, such as long-term investments rated no lower than BBB. NCUA attempts, in Appendix B, to mitigate the risk involved with these investments by mandating that participating corporate credit unions fulfill "additional management, infrastructure, and asset and liability requirements." Corporate credit unions seeking to purchase long-term, Appendix B investments must first be granted prior approval—which can subsequently be removed at any time—by NCUA.

Even with the above-mentioned safeguards, the risk to the entire credit union system associated with certain short-term investments, such as asset-backed securities, and long-term investments in Appendix B may be too great. The possible long-term investments enumerated under the appendix include those that have resulted in much of the corporate credit unions' unrealized losses and other-than-temporarily impaired assets.

However, while removing the authority to invest in riskier long-term investments will reduce the risk to the entire credit union system, such limitations will also have the consequence of reducing the earning potential of natural person credit unions. Many of these credit unions have already been heavily invested in their corporate credit unions.

In light of these concerns about investments and concentrations of assets in a limited number of investment vehicles, CUNA encourages NCUA to consider the extent to which longer-term, riskier investments for corporate credit unions should be dramatically curtailed and whether alternative means for natural person credit unions to invest in some additional investments should be pursued.

To be clear, CUNA encourages NCUA to consider supporting natural person, not corporate, credit unions to have the option to purchase alternative investments vehicles, such as those authorized under the proposed Credit Union Regulatory Improvement Act (CURIA). Section 301, Investments in Securities by FCUs, of CURIA, for example, would authorize the Board to permit natural person credit unions to purchase certain investment securities as the Board sees appropriate. Allowing natural person credit unions to make such investments through providers outside the credit union system would have the effect of moving some of the risk away from the National Credit Union Share Insurance Fund (NCUSIF). Any investment losses suffered by natural person credit unions would affect the NCUSIF only if they substantially reduce the credit unions' net worth, and even then might be covered by FDIC insurance if the investment provider were a federally insured bank.

*F. The Number of Corporate Credit Unions and Their Tiers*

Once the primary function of corporate credit unions has been determined to be the provision of settlement services and closely related activities, the issue of the appropriate number of corporate credit unions can be addressed. Processing payments and handing settlement are scale businesses, so the number of corporate credit unions can be sharply reduced to a very small number. With only a few, large corporate credit unions serving natural person credit unions, there would no longer be the need for a two-tiered structure.

Achieving economies of scale and enhancing the ability of the credit union system to influence and interface with the settlement process supports a good case for having only one corporate credit union. Under this approach, the remaining corporate credit union would serve as the settlement gateway from the entire credit union movement to the rest of the financial system on settlement and related issues. The principles and recommendations outlined in this letter would not preclude that outcome.

However, economies of scale are not the only considerations regarding the number of corporate credit unions into the future. Beneficial effects on pricing and innovation are also needed, which may be harder to attain without some direct credit union-market competition.

In any event, CUNA does not support having NCUA determine the appropriate number of corporate credit unions. Rather, we believe that as a result of capital requirements and limits on services and investments, member credit union owners should contemplate no more than a very limited number of corporate credit unions—small enough to take advantage of economies of scale, but large enough to foster innovation and competition.

*G. Corporate Credit Union Capital*

CUNA believes that a corporate credit union's minimum Tier 1 capital ratio should be at least 4 percent and possibly higher, up to 6 percent over a reasonable period of time. If NCUA chooses to institute risk-based capital requirements for corporate credit unions, such risk-based capital should be comparable to those applicable to similarly situated FDIC-insured depository institutions. CUNA believes that market factors, such as corporate credit unions' payments system counterparties' concerns about counterparty risk, will generally encourage corporate credit unions to maintain higher net worth ratios of up to 6 percent.

CUNA believes, however, that risk-based capital requirements are likely unnecessary for corporate credit unions if NCUA adopts CUNA's recommendations for limitations on corporate credit unions' business and investment activities, as outlined above. CUNA believes that if NCUA has concerns regarding the amount of capital necessary to cover corporate credit unions' payment and settlement risks, it should consider requiring a payment and settlement risk reserve that would be deducted from Tier 1 capital but included in Tier 2 capital to some degree, as discussed below under "4."

*1. Components of Corporate Credit Union Capital and Capital Ratios.* CUNA believes that a corporate credit union's regulatory capital should consist of Tier 1 capital-reserves and undivided earnings (RUDE) as well as paid-in capital (PIC)-and Tier 2 capital. Corporate credit union Tier 2 capital should include member capital shares (MCS) as well as subordinated term debt and general reserves such as the "Reserve for Payment and Settlement Risk" discussed below.

CUNA also believes that Tier 2 capital for corporate credit unions could include subordinated term debt because U.S. low-income credit unions count subordinated debt—in the form of a "secondary capital account"—as regulatory capital, because Canadian credit unions count subordinated debt as regulatory capital, and because U.S. federal banking regulators and the Basel Committee on Banking Supervision also consider subordinated debt to be Tier 2 capital.[4]

*2. Require PIC Investments for Access to Corporate Services and Lengthen MCS.* CUNA believes that natural-person credit unions should make meaningful PIC investments in a corporate in order to use that corporate credit union's services, that the callable period of member capital shares (MCS) should be extended to five years from three years, and that corporate credit unions should be permitted to write down called MCS over five years rather than two.

In general, a natural person credit union's required PIC investment in a corporate credit union should be calculated based on the investing credit union's asset size, and its required MCS balance should be based upon its usage of the corporate credit union's services.

Requiring natural person credit unions to contribute perpetual or 20-year-callable PIC to their corporate and extending the callablility and write-down periods for MCS will strengthen the corporate credit unions' capital positions. In addition, required PIC subscriptions by a corporate credit union's natural person credit unions members would give all users of a corporate credit union's services an increased incentive to monitor their corporate credit union's management and business activities.

CUNA also believes that NCUA should consider making natural person credit unions' PIC investments transferable from one corporate to another, so long as the PIC of state-chartered corporate credit unions would not be considered "capital stock" within the meaning of 26 U.S.C. §501(c)(14)(A). CUNA believes that transferable PIC would not likely qualify as "capital stock" so long as it is clearly designated as a form of deposit.

*3. Risk-Based Capital.* If NCUA restricts corporate credit union business and investment in the manner suggested by CUNA, above, risk-based capital requirements for the corporate credit unions would likely not be necessary. However, if such investments are not restricted, then risk-based capital for corporate credit unions engaging in those activities is essential.

If the Basel II risk-based capital rules developed by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the FDIC applied to corporate credit unions,[5] a corporate credit union that is invested solely in U.S. Treasury securities and other highly-rated fixed-income investments[6] would have an 8 percent risk-based capital ratio requirement that would generally be lower than the amount of capital required by a 4 percent net worth ratio.

Stated another way, risk-based capital requirements for corporate credit unions would generally be irrelevant-if corporate credit unions were subject to a minimum 4 percent net worth ratio and a minimum 8 percent risk-based capital ratio—until a corporate made significant investments in assets in the Basel II 50 percent risk category or the 100 percent or 150 percent risk-weight categories. Most potential corporate credit union investments would be placed in the 50 percent (or a higher) risk-weight category if they are rated below AA-.

*4. Reserves for Payment and Settlement Risk.* CUNA believes that corporate credit unions should hold sufficient capital to be insulated from operational risk arising from payment and settlement activities, possibly including a capital charge deducted

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[4] See, *e.g.,* 12 C.F.R. Appendix A to part 325.

[5] See, *e.g.,* Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 Fed. Reg. 43982 (proposed July 29, 2008). FDIC-insured depository institutions are subject to a 3 percent absolute leverage ratio on Tier 1 capital and a risk-based capital ratio of 8 percent. See 12 C.F.R. §325.3; see also, *e.g.,* 12 C.F.R. §§3.6, Appendix A to 12 C.F.R. pt. 3 (national banks).

[6] *I.e.,* generally AAA to AA-rated investments. These investments are typically assigned a risk-weighting of 20 percent, meaning that their value for risk-based capital calculation purposes is discounted to 20 percent of face value. See, *e.g.,* Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 Fed. Reg. 43982, 43991-98 (proposed July 29, 2008).

from Tier 1 capital to establish appropriate reserves for payment and settlement risk.

Under the Basel II standardized approach to controlling for payment and settlement operational risk, a corporate credit union's payments and settlement risk capital charge would be 18 percent of the three-year average of the corporate credit union's annual gross income from payment and settlement activities.

CUNA believes that this reserve for payment and settlement risk should be deducted from Tier 1 capital but should be included in Tier 2 capital (possibly subject to a percentage of assets limitation, such as 1% of assets) because, under Basel II rules, this reserve would qualify as Tier 2 capital. This reserve qualifies under Basel II as Tier 2 capital because it is a general reserve that does not reflect a known loss or deterioration in a particular asset, and would be available to meet unidentified losses that may subsequently arise.

*H. Corporate Credit Union Governance*

CUNA believes that the boards of directors of corporate credit unions should generally consist of representatives of their member natural person credit unions, but that a corporate credit union should have the option of having up to 20 percent of its board consist of nonmember directors if its members so choose.

CUNA wishes to note that most current corporate credit union directors are "outside directors" or "independent directors" within the common definitions of those terms, since they are not officers of the corporate credit union and, as individuals, have no direct financial interest in the corporate.[7] These directors are typically representatives of the corporate credit unions' member natural person credit unions, none of which are individually able to exert control over a corporate because credit unions' one-member-one-vote voting structure prevents the concentration of voting power in the hands of a few. CUNA believes, therefore, that comparisons between the governance of corporate credit unions and that of for-profit, stock corporations with significant numbers of "inside directors"—*i.e.,* those who are also officers of the corporation and/or who represent the interests of controlling stockholders—are inapt.

Outside directors "are considered important because they are presumed to bring unbiased opinions to major corporate decisions and also can contribute diverse experience to the decision-making process."[8] CUNA believes that the outside directors representing the interests of corporate credit unions' member natural person credit unions currently serving on corporate credit unions' boards already bring unbiased opinions to major corporate decisions. CUNA does not believe that corporate credit unions should be required to have outside, nonmember directors because most current corporate directors already qualify as "outside directors" and because nonmembers may have interests that do not align with those of the corporate, or with the interests of credit unions generally.

CUNA believes, however, that corporate credit unions should be permitted the option to have nonmember directors who can contribute diverse experience to a corporate credit union's board, if the corporate credit union's member natural person credit unions so choose. A corporate should be permitted to have up to 20 percent of its board be composed of non-members and also be permitted to offer a non-member director a reasonable director's fee comparable to that paid by federally insured depository institutions of similar asset size, so long as the amount of this fee and any other director compensation is disclosed to the corporate credit union's members. The NCUA Board has authority under section 120(a) of the Federal Credit Union Act to authorize a corporate to have nonmember outside directors and to pay those nonmember directors a reasonable fee.

*I. National Fields of Membership*

CUNA believes that the small number of corporate credit unions that operate in the future should continue to have national fields of membership. Without overlapping fields of membership, there would be no competition among corporate credit unions, and therefore, no need to have more than one. CUNA understands that competition among corporate credit unions may have in the past contributed to thinly capitalized institutions, operating on very low margins, taking significant investment risks. However, with sufficient capital requirements and with investments restricted to only those necessary to perform short-term investing and liquidity for

[7] *E.g.,* "Outside Director," John Downes and Jordan Elliot Goodman, Dictionary of Finance and Investment Terms (Barron's, 7th ed. 2006) ("[A] member of a company's board of directors who is not an employee of the company."); *id.* at "Independent Director" ("Independent Director: same as Outside Director"); Black's Law Dictionary 473 (7th ed., 1999) ("A nonemployee director with little or no direct interest in the corporation.").

[8] "Outside Director", Dictionary of Finance and Investment Terms.

credit unions, CUNA believes that competition among corporate credit unions would provide for better service to credit unions in a context of full safety and soundness.

**III. Conclusion**

Thank you for the opportunity to comment on the ANPR regarding the structure and operations of corporate credit unions. The issues raised in the ANPR are critical for all credit unions, and changes to the current corporate credit union structure, as outlined above, are imperative to ensure the continued vitality of both corporate and natural person credit unions.

The entire credit union system is now in the process of absorbing the recent losses associated with corporate credit union investments. Although these losses will never be fully recovered, we strongly believe that adopting the principles and recommendations outlined in this letter will demonstrate the resiliency of the credit union system while helping to help ensure the unfortunate events involving the corporate credit unions are never, ever repeated.

As stated above, CUNA supports NCUA's efforts to help spread out credit unions' costs associated with the Corporate Credit Union Stabilization Plan, including the proposed legislation, and to address related issues. We hope NCUA will work with us to:

- Seek statutory authority for the CLF to provide liquidity directly to corporate credit unions;
- Achieve higher statutory borrower authority for the agency beyond current proposals, to the extent such an effort does not jeopardize the success of any other aspect of the legislations;
- Reassure credit unions it plans to hold asset-backed securities of the two conserved corporate credit unions until maturity; and
- Help clarify remaining accounting issues concerning the reporting of impaired capital in corporate credit unions and the write-down of the NCUSIF deposit.

We also welcome NCUA's announcement that a separate review of the securities of U.S. Central and WesCorp has been undertaken, and that the agency will make critical information from the PIMCO available to the credit union system. We look forward to reviewing the data.

We also recognize that the restructuring of the corporate credit union system will continue to be a difficult process. CUNA and the CCUTF will be available throughout this process to meet with NCUA to work through these very complex issues. Meanwhile, please do not hesitate to contact us at (202) 638–5777 if you have any questions about our comments.

Sincerely,

DANIEL A. MICA,
*President and CEO*

TERRY WEST,
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*and CUNA Corporate Credit Union Task Force Chairman*