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UNREGULATED MARKETS: HOW REGULATORY REFORM WILL SHINE A LIGHT IN THE FINANCIAL SECTOR

HEARING

BEFORE THE

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UNREGULATED MARKETS: HOW REGULATORY REFORM WILL SHINE A LIGHT IN THE FINANCIAL SECTOR

WEDNESDAY, DECEMBER 2, 2009

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:38 a.m., in Room 210, Cannon House Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

Representatives present: Maloney, Hinchey, Cummings, Snyder, Brady, and Burgess.

Senators present: Brownback.

Staff present: Paul Chen, Gail Cohen, Colleen Healy, Michael Neal, Annabelle Tamerjan, Andrew Wilson, Rachel Greszler, Jeff Schlagenhauf, Ted Boll, and Robert O'Quinn.

OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Chair Maloney. I would like to call the meeting to order and thank all the participants for coming.

I want to, first of all, welcome our distinguished panel of witnesses today as we discuss proposals to regulate the over-the-counter derivatives market and underregulated credit markets. The financial crisis and the recession were triggered in part by the collapse in the price of homes and the resulting defaults in the mortgages used to purchase them.

In the absence of regulation, financial institutions aggressively purchased over-the-counter derivatives, such as mortgage-backed securities, with the expectation that they would generate high returns with minimal risk. To hedge against any risk, they also purchased unregulated credit default swaps that would pay them if the mortgage underlying the derivatives defaulted. This created an illusion that the assets were risk-free and a tangled web of counterparties. At its peak this unregulated market was tied to $680 trillion in assets, an astonishing amount equal to 50 times U.S. GDP, putting the stability of the U.S. and the world economy at risk.

This crisis did not have to happen. Many years earlier one of our distinguished witnesses, Brooksley Born, then Chair of the CFTC, had the foresight to recognize the dangers of unchecked growth, lack of transparency, and overleveraging in the over-the-counter derivatives. Some have called her "The Woman Who Knew." However, she was ignored by a chorus of critics who hailed over-the-

counter derivatives as the greatest financial innovation of the decade because they would spread risk efficiently among market participants.

With the economy booming, regulatory attempts were voted down. I know this from personal experience, having introduced two amendments that would have taken steps to regulate this market; they were roundly and strongly defeated, both of them. Siding with her critics, Congress passed the Commodity Futures Modernization Act of 2000, which literally prevented the CFTC from regulating over-the-counter derivatives. This was a mistake, and we are acknowledging it now.

Next week on the floor of the House, we will be voting on a regulatory reform bill that will regulate over-the-counter derivatives to bring transparency to these complex financial products and expand the authority of the CFTC and the SEC to regulate counterparties in derivative transactions.

Many have argued that derivative contracts were the prime reason AIG needed to be bailed out with taxpayer funds because the quantity and value of the contracts were never disclosed, so that the impact of breaking these contracts via possible bankruptcy was unknowable.

I have confidence that this bill will pass next week. It should have passed years earlier when Mrs. Born pointed out the real challenge and danger of not regulating these derivatives. The House Financial Services Committee and the House Agriculture Committee are meeting this week to merge their two versions of the bill that will finally regulate over-the-counter derivatives and bring the dark market into the light. The merged bill will promote transparency by requiring that these previously unregulated derivatives be traded on exchanges or clearinghouses. Capital and margin requirements will be established so that financial institutions can no longer make risky bets. And information about prices and trading values and volumes will be publicized so that market participants will no longer be uncertain of the value of their securities. Although these bills exempt some derivatives from regulation, the exemptions are an attempt to balance concerns of some businesses that need customized derivatives and the potential risk to the financial system.

The House Financial Services Committee has also passed a bill establishing the Consumer Financial Protection Agency to shield consumers from deceptive financial practices.

Although our economic recovery is far from complete, the economy is moving back on track, helped along by the Recovery Act. Third quarter GDP grew 2.8 percent after contracting for four consecutive quarters, financial markets have recovered substantially, and interbank lending is back to its precrisis level.

Now is the time to act to pass these reforms. The financial crisis has made clear the need for common-sense regulation of the financial services industry to ensure stability, safety and soundness of the system.

I want to thank the witnesses for coming, and I look forward to hearing their testimony. And I do also want to acknowledge Mr. Steel, with whom I had the privilege of working with on many important initiatives for our government. Welcome to all of you.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 34.]

Chair Maloney. The Chair recognizes Mr. Brady for 5 minutes.

OPENING STATEMENT OF THE HONORABLE KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

Representative Brady. Thank you, Madam Chairwoman. Thank you for hosting this important hearing. Just preparing for it and reading the testimony was informative in and of itself, so I am pleased to join you in welcoming today's witnesses.

Many policy mistakes contributed to the global financial crisis that began on August 9, 2007, and triggered a recession 4 months later. These include the Federal Reserve's overly accommodative monetary policy from 2002 to 2006; international imbalances arising largely from China's exchange rate policy since 1998; President Clinton's initiative to increase homeownership among low-income families by reducing down payment requirements and interest costs by making terms more flexible, increasing the availability of alternative financing products without sufficient consideration of the ability of low-income families to meet their nontraditional mortgage obligations, as well as the continuation of this policy by President George W. Bush; abuse of the Community Reinvestment Act through the filing of frivolous objections to bank acquisitions and mergers by ACORN-affiliated groups to extort banks into making a large number of risky subprime residential mortgage loans to low-income families; and finally, inadequate supervision of the alternative financial system based on loan securitization and highly leveraged nondepository financial institutions, especially Fannie Mae and Freddie Mac.

Banks perform the economically valuable, but inherently risky functions of intermediation and liquidity transformation by accepting deposits payable on demand and making term loans to families and small businesses that can't issue commercial paper and corporate bonds. Due to the nature of their activities, banks are subject to runs. Runs often become contagious and may trigger financial panics.

To minimize the risk of financial contagion, while retaining the enormous economic benefits from intermediation and liquidity transformation, Congress mandated supervision, created the Federal Reserve in 1913 to serve as the lender of last resort, and established Federal deposit insurance in 1933.

By the fall of 2007, the alternative financial system, which you referenced, composed of Fannie Mae, Freddie Mac, independent investment banks, finance companies, hedge funds and off-balance-sheet entities, had assets totaling $12.7 trillion and was essentially performing intermediation and liquidity transformation functions similar to banks without any of the safeguards that Congress had established for banks.

Since the financial crisis began, a number of major banks and other financial institutions have failed, were acquired at fire sale prices, were placed into conservatorships, or needed massive Federal assistance to survive. These include AIG, Bank of America, Bear Stearns, Citigroup, Fannie Mae, Freddie Mac, Lehman Brothers and Merrill Lynch.

And what are the common threads to these failures or quasi failures? First, these institutions made bad investment decisions. Second, these institutions were overly dependent on short-term liabilities outside of insured deposits to fund their investments; consequently, these institutions suffered liquidity crises when their creditors became aware of the magnitude of the investment losses. These liquidity crises were essentially the modern version of bank runs in which computer clicks replaced queues of depositors withdrawing their money. However, the underwriting of corporate securities and municipal revenue bonds, which Glass-Steagall had prohibited commercial banks to do, was not a significant factor in the failures or near failures.

So for the witnesses today, you have raised so many great points in testimony. I will have a number of questions for the panel, such as, what changes should be made to the risk-based capital standards for banks? Should Congress require all U.S. banks to adopt a system of dynamic provisioning for loss reserves that proved so successful in maintaining the solvency of Spanish banks during the financial crisis? Should liquidity standards be established for banks and other highly leveraged financial institutions? Should all banks and other highly leveraged financial institutions be subject to simple limits on leverage in addition to any risk-based capital standard? Should Fannie and Freddie be restructured and fully privatized? Shouldn't any housing subsidy functions that Fannie and Freddie now perform be transferred to the Federal Housing Administration and be placed transparently on the Federal budget? Should highly leveraged, nondepository financial institutions have access to the Federal Reserve's discount window; and if so, under what circumstances? And finally, how should financial derivatives be regulated? Are credit default swaps uniquely risky, and do they need to be regulated differently than other financial derivatives?

Members of the panel, I look forward to hearing from your testimony today.

Thank you, Madam Chairman.

Chair Maloney. Mr. Hinchey.

OPENING STATEMENT OF THE HONORABLE MAURICE D. HINCHEY, A U.S. REPRESENTATIVE FROM NEW YORK

Representative Hinchey. Thank you very much, Madam Chairman. And thank you very much, all four of you, gentlemen and ladies, for being here with us. I very much appreciate the opportunity to listen to the things that you are going to say. I am not going to take up very much time here, but I just want to express that appreciation for you.

As we all know, this country is dealing with one of the most difficult and damaging economic circumstances that it has experienced over the course of our history. It is the worst set of circumstances that we have experienced since 1929. The unemployment rate itself in this country is now up above 10 percent, and that is just the official unemployment rate. There are a lot more people who would love to have jobs but can't get them because of the economic conditions that we are dealing with. And a lot of that has to do with the sharp decline in the economy which had to do, in large measure, with the manipulation of commercial and invest-

ment banking and the elimination by the past Congress to prevent that combination, that manipulation to take place.

So these are some of the things that we are dealing with, including a number of other things in regard to the way in which investment operations are engaged in, including the effect it has had on the price of oil and gasoline. And so the price that people have to pay for the necessities that they are required to have in the context of growing unemployment makes this situation much more difficult and damaging and even dangerous to address. But it needs to be addressed, and it needs to be addressed very, very effectively.

So all of the things that you are going to have to say I am sure are going to be very important to our ability to engage this situation in a much more effective way. So I thank you all very much for being here, and I am anxious to hear what you have to say.

Chair Maloney. Thank you so very much.

I, too, would like to welcome all the witnesses and to introduce the panel.

Brooksley Born practiced law for many years in Washington and was a partner in the firm of Arnold & Porter. From 1996 to 1999, she was Chair of the U.S. Commodity Futures Trading Commission (CFTC), the Federal Government agency that oversees the futures and commodity option markets and futures professionals. While at the CFTC, Ms. Born served as a member of the President's Working Group on Financial Markets.

Ms. Born is a 2009 recipient of the John F. Kennedy Library Foundation's Profile in Courage Award presented annually to public servants who have made courageous decisions of conscience without regard for the personal or professional consequences. She received the award in recognition of her efforts as Chair of the CFTC to urge that the over-the-counter derivatives market should be subject to Federal oversight and regulation. The failure to regulate that market is now seen to be a major cause of the recent financial crisis.

Among other awards, she was recognized as a champion in the Legal Times' list of the 90 greatest Washington lawyers of the last 30 years. In 2008, she was the recipient of the American Lawyer Lifetime Achievement Award for her career-long leadership in private practice and public service.

She is a graduate of Stanford University and Stanford Law School, where she was president of the Stanford Law Review and received the Outstanding Senior Award.

Robert Litan is a senior fellow in economic studies at the Brookings Institution, where he was previously vice president and director of economic studies. He is also the vice president for research and policy at the Kauffman Foundation in Kansas City, where he oversees the foundation's extensive program for funding data collection and research relating to economic growth.

He previously served as the Associate Director of the Office of Management and Budget, and Deputy Assistant Attorney General. From 1977 to 1979, he was the regulatory and legal staff specialist at the President's Council of Economic Advisors. He holds a B.S. in finance from Wharton. He also has a law degree from Yale, and a Ph.D. in economics from Yale University.

James Carr is chief operating officer for the National Community Reinvestment Coalition, an association of 600 local development organizations across the Nation dedicated to improving the flow of capital to communities and promoting economic mobility. He is also a visiting professor at Columbia University in the great city of New York. And prior to his appointment to NCRC, he was senior vice president for financial innovation, planning and research for the Fannie Mae Foundation. He has also held positions as Assistant Director for Tax Policy with the U.S. Senate Budget Committee. He holds a degree in architecture from Hampton University, a master's of planning degree from Columbia, and a master's of city and regional planning from the University of Pennsylvania.

Robert Steel is a former president and CEO of Wachovia. He served as Under Secretary of the Treasury for Domestic Finance from 2006 to 2008. Previously he spent almost 30 years at Goldman Sachs, founding the firm's Equity Capital Markets Group. He is currently chairman of the board of the Aspen Institute. He served on the board of Barclay's Bank and currently serves on the board of Wells Fargo. He is also a past chairman of the Duke University board of trustees. He holds a degree from Duke University and an M.B.A. from the University of Chicago.

I want to thank all of you for coming. I will first recognize Ms. Born, and then go down the line. You are recognized for as much time as you may consume.

STATEMENT OF BROOKSLEY BORN, FORMER CHAIR, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Ms. Born. Thank you very much.

Madam Chairman and members of the committee, thank you very much for inviting me to appear before you to discuss over-the-counter derivatives.

We have experienced the most significant financial crisis since the Great Depression, and regulatory gaps, including the failure to regulate over-the-counter derivatives, have played an important role in the crisis.

As a result of pressures from a number of the country's largest financial institutions, Congress passed a statute in 2000 that eliminated virtually all government regulation of the over-the-counter derivatives market. It was called the Commodity Futures Modernization Act of 2000. Because of that statute, no Federal or State regulator currently has oversight responsibilities or regulatory powers over this market.

The market is totally opaque and is often referred to as "the dark market." It is enormous. In June of this year, the reported size of the market exceeded $680 trillion in notional value.

While over-the-counter derivatives have been justified as vehicles to manage financial risk, they have, in practice, spread and multiplied risk throughout the economy and caused great financial harm. Lack of transparency and price discovery, excessive leverage, rampant speculation, lack of adequate capital and prudential controls, and a web of interconnections among counterparties have made the market extremely dangerous. Warren Buffett has appropriately dubbed over-the-counter derivatives as "financial weapons of mass destruction." They include the credit default swaps disas-

trously sold by AIG and many of the toxic assets held by our biggest banks. It is critically important for Congress to act swiftly to impose the rules necessary to close this regulatory gap and to protect the American public.

The Commodity Futures Trading Commission and the Securities and Exchange Commission should be granted primary regulatory responsibilities for derivatives trading, both on and off exchange. All standardized and standardizable derivatives contracts should be traded on regulated derivatives exchanges and cleared through regulated clearinghouses. These requirements would allow effective regulatory oversight and enforcement efforts. They would ensure price discovery, openness and transparency; reduce leverage and speculation; and limit counterparty risk.

If any trading in the over-the-counter derivatives is permitted to continue, such trading should be limited to truly customized contracts between highly sophisticated parties, at least one of which requires such a customized contract in order to hedge its actual business risk.

Furthermore, any continuing over-the-counter derivatives market should be subject to a robust Federal regulatory regime requiring transparency. There should be registration, recordkeeping and reporting requirements for all over-the-counter derivatives dealers, and they should be subject to business conduct standards. All over-the-counter trades should be subject to margin requirements, and all large market participants should be subject to capital requirements. Transaction prices and volumes of over-the-counter derivatives should be publicly reported on an aggregated and timely basis. And the market should be subject to effective prohibitions against fraud, manipulation, and other abusive practices.

These measures would go far toward bringing this enormous and dangerous market under control. They should be adopted and implemented if we hope to avoid future financial crises caused by this market. The country cannot afford to delay or weaken our response to the crisis. If we as a people do not learn from our experiences and respond appropriately, we will be doomed to repeat them.

Thank you very much.

[The prepared statement of Brooksley Born appears in the Submissions for the Record on page 34.]

Chair Maloney. Thank you very much.

Dr. Litan.

STATEMENT OF ROBERT LITAN, SENIOR FELLOW IN ECONOMIC STUDIES, BROOKINGS INSTITUTION, VICE PRESIDENT OF RESEARCH AND POLICY, EWING MARION KAUFFMAN FOUNDATION, AND MEMBER OF THE PEW TASK FORCE ON FINANCIAL REFORM, WASHINGTON, DC

Mr. Litan. Thank you, Chair Maloney and members of the committee, for inviting me to testify today. I will hit the highlights of my prepared testimony and the material that accompanies it.

I am here primarily to present the financial reform recommendations of the bipartisan Pew Financial Task Force of which I have had the privilege to be a member.

It has now been more than a year since the near meltdown of the financial system. Since then, the Congress has worked hard to

develop a comprehensive legislative package to which you, Chair Maloney, just referred, aimed at preventing a repeat of these sorry events.

The need for reform could not be greater, and on this I agree with Brooksley. Fixing the financial system is critical to restoring faith in our financial institutions and markets, as well as to strengthening our lending institutions to the point where they can feel comfortable again lending to businesses and consumers.

You will find many common elements between our recommendations and the specifics in the bills that have come out of the House Financial Services Committee and that are now being considered in the Senate Banking Committee. Our task force members came into the process with very different views, much like the differences you see in Congress. We debated these views intensely, but calmly, and we listened to each other, and, frankly, we learned from each other. And at least from my part, there were a few mind changes, including my own, on some issues.

While we did not cover the waterfront, and while some members would have preferred different approaches with respect to specific recommendations, we came up with a package of principles and reforms that we believe will be a significant improvement over the status quo. My co-task force member, Bob Steel, will elaborate on some of our ideas. Here is my quick overview, five points.

Number one, we need systemic risk monitoring and regulation by an oversight council comprised of the relevant financial agencies. Specifically, this council, on its own initiative or upon recommendation of the Fed, should add to minimum standards for capital, liquidity, margins and leverage to prevent or slow the formation of future asset or credit bubbles.

Second, there are several ways to make sure that no financial institution is too big or too complex to fail. We can do this through capital and liquidity requirements that increase with an institution's size and complexity, and by mandating that large institutions file and gain regulatory approval of what are called wind-down plans.

Third, we recommend the consolidation of all current prudential Federal financial supervision and regulation into a single regulator. We believe that eliminating gaps and duplication in our current fragmented regulatory system will be a significant improvement, but at the same time, we also would retain the dual banking system under which banks will have the opportunity to choose between a State and a Federal charter.

Fourth, derivatives markets clearly should be strengthened by using capital requirements to drive more OTC derivatives to a central clearinghouse, and eventually exchanges. The compensation of senior financial executives and risk takers should be tied to long-term performance, best through very long-term restricted stock, much like the kind of things that the Fed has recently proposed. Other ideas for enhancing market discipline are spelled out in our report.

Finally, we support the creation of a new Consumer Financial Products Agency.

I look forward your questions.

[The prepared statement of Robert Litan appears in the Submissions for the Record on page 37.]

Chair Maloney. Thank you.

Mr. Carr.

STATEMENT OF JAMES CARR, CHIEF OPERATING OFFICER, NATIONAL COMMUNITY REINVESTMENT COALITION, WASHINGTON, DC

Mr. Carr. Good morning, Chair Maloney and other distinguished members of the committee. On behalf of the National Community Reinvestment Coalition, I am honored to speak with you today about the role that consumer financial protection has played in the current crisis.

I have been asked to discuss today whether the existence of a consumer financial protection agency modeled on any one of the proposals—either the administration, the House, or Senate—could or would have prevented the proliferation of reckless and irresponsible mortgage lending that triggered the foreclosure crisis that eventually led to the implosion of the housing and credit markets.

It is, of course, impossible to answer such a hypothetical question with certainty. I am convinced, however, that if a consumer financial protection agency had been in place and structured with the appropriate regulatory authority, funding and independence, that such an agency would have prevented the bulk of the most egregious predatory lending in the markets.

Climbing our way out of the current crisis will require that financial system regulation be reoriented to serving the needs of the American public, but given the damage that has occurred to both the credit markets and the economy in general, much more than improved consumer financial protections will be needed to accomplish a full recovery. Those additional actions would include better managing the foreclosure crisis and putting America back to work. In the limited time I have this morning for my opening remarks, I will focus specifically on consumer protection.

One of the most dispiriting aspects of the current crisis is that it was largely avoidable. For more than a decade, financial institutions increasingly engaged in practices intended to mislead, confuse, or otherwise limit a consumer's ability to judge the value of financial products offered in the marketplace. Nowhere was this more evident than in the subprime home mortgage market. Over the past decade, the subprime market increasingly specialized in pushing loans that were reckless and irresponsible, but that produced huge profits for mortgage brokers, mortgage finance institutions, and Wall Street investment banks. Excessive mortgage broker fees, irresponsible loan products, inadequate underwriting, bloated appraisals, abusive prepayment penalties and fraudulent servicing practices were all part of the problem. All of these issues were thoroughly documented, discussed and detailed in academic articles, news stories, policy papers, and more.

Federal regulatory agencies were fully aware of these policies and these practices, and they had the authority to act. They chose not to. And on the rare occasion when they did, it was to preempt State laws to prevent States from protecting the rights of their own citizens from abusive financial practices.

And while most of the costly financial services abuses occurred in the housing market, predatory financial services have come to permeate many aspects of the financial system, including abusive credit and debit card policies, exploitive overdraft protection practices, unreasonable check processing procedures, and more.

Repairing the economy requires that we reorient the financial system toward the mission of promoting economic well-being for the American public. This means removing the financial tricks and traps that create unnecessary financial instability for consumers, and ultimately for the system as a whole.

The Administration and both Houses of Congress have proposed or are considering the establishment of a consumer protection agency that would consolidate the highly fragmented system of consumer financial protection laws currently enforced by multiple agencies. Among the proposed agency's many positive attributes is the fact that it would eliminate the current practice of regulatory arbitrage whereby financial firms are allowed to select their regulator, in part based on how poorly they protect the public. A complementary attribute to the new agency would be its ability to ensure the same level of quality in financial products across institutional types.

Opponents of a consumer financial protection agency have argued that such an agency would undermine the safety and soundness of the financial system. Yet safety and soundness of the financial system begins and relies on the integrity and reliability of the products that are offered to consumers. The Administration's bill and draft Senate legislation require or authorize standardized products for financial firms. Arguments against this requirement or option are that standard products will stifle innovation. This argument is without merit. The 30-year fixed-rate mortgage has been, for example, the gold standard of mortgage products for decades. That product did not stifle development alternatives; its reliability and safety are the keys to its success. And the failure to offer low-cost, fixed-rate 30-year mortgages to those who qualify for it was a leading contributing factor in the spread of reckless subprime loans that were the core of the initial foreclosure crisis.

One of the major differences between the President and Senate's proposals relative to H.R. 3126 deals with the treatment of the Community Reinvestment Act. Unlike the President and Senate bill, H.R. 3126 leaves primary regulation of CRA with the Federal Reserve Board. This is a mistake. Many financial services providers historically and routinely offer or deny products at a community level rather than at an individual level. The excessive concentration of subprime loans in African American and Latino communities is only one example of this.

Other major keys to the potential effectiveness of the proposed agency include it having the breadth of coverage over financial institutions, independence of operations, product disclosures that can reasonably be understood by the typical consumer, and a funding stream that is not susceptible to the vagaries of shifting political winds or economic downturns. If structured and empowered properly, this agency can cultivate an environment of integrity into the financial system. Restoring trust and confidence in the financial system is essential both for the American public as well as inter-

national investors who have been harmed by America's failed experiment in poorly regulated financial institutions.

[The prepared statement of James Carr appears in the Submissions for the Record on page 44.]

Chair Maloney. Thank you.

Mr. Steel.

STATEMENT OF ROBERT K. STEEL, FORMER UNDER SECRETARY FOR DOMESTIC FINANCE OF THE UNITED STATES TREASURY, CHAIRMAN OF THE BOARD, ASPEN INSTITUTE, AND MEMBER OF THE PEW TASK FORCE ON FINANCIAL REFORM, WASHINGTON, DC

Mr. Steel. Chair Maloney, members of the committee, my name is Robert Steel, and I am pleased to be here today as a member of the bipartisan Financial Reform Task Force.

Along with my task force colleague Dr. Litan, I appreciate the opportunity to discuss our principles and the specific recommendations needed to achieve them, which we submitted along with our prepared testimony. We hope our principles and recommendations are helpful with regard to the financial reform process.

Our task force began work last summer and has covered a large amount of ground. We believe we have a solid and substantial framework, and look forward to further debate, hearing your reactions, and learning from this.

The task force recommendations reflect many of the topics now under consideration in the House Financial Services Committee and the Senate Banking Committee. Further, they share much in common with the recommendations advanced by Secretary Paulson and Treasury in June of 2007 in the Blueprint for a Modernized Financial Regulatory Structure, a report we worked on while I was at Treasury as Under Secretary for Domestic Finance.

Given the time constraints today, I would like to highlight a single crucial recommendation of our work. What has become known as the "too big to fail" problem is in many ways at the heart of the financial reform effort. There are different ways to approach this challenge. Congress could arbitrarily limit the size of financial institutions, they could limit the scope of their activities, or they could work to ensure that any failure is less likely to cause a financial crisis. We favor the latter strategy.

It is the strength of the American system that the opportunity to succeed carries with it the prospect of potential failure. To my mind, this system provides the best possible opportunity for shared prosperity. As a result, our task force recommends that all financial institutions should be free to fail, but free to fail in a manner that will not destabilize the financial system. The task force therefore recommends three specific things with regard to this issue.

First, a sliding capital scale so that the larger, more complex, more risky and more systemically important an institution, the higher the standards for capital, liquidity, and leverage to which it should be held.

Second, institutions above a certain size should submit for approval a living will or a funeral plan that will describe in detail how the firm, were it to fail, could be wound down with a reduced impact on the overall economy.

Third, a new solution should be adopted for failed or failing nondepository financial institutions. While the FDIC should continue to resolve failed or failing banks, we recommend that for nondepository financial institutions there be a strengthened bankruptcy process as the presumptive approach. In exceptional circumstances, only after strong safeguards have been met should there be an administrative resolution process as an option of last resort.

This proposed two-stage approach to winding down nonbank financial institutions brings together two quite desirable policy objectives: It maintains the market discipline of the bankruptcy process while at the same time providing the government with a new tool to protect the financial system in times of unusual stress. In all cases, moral hazard is reduced as shareholders, unsecured creditors, and senior management will bear the burden of the failure.

To create this two-step process, Congress should first amend the Bankruptcy Code as necessary to make bankruptcy the presumptive process for managing all failing nondepository financial institutions. In addition, Congress should create a new Federal financial institutions bankruptcy court and grant it sole jurisdiction in the United States for these cases.

In those exceptional circumstances when a bankruptcy would pose unacceptable systemic risk, a new administrative resolution process should be created for failing nondepository financial institutions. This process should be used only after strong safeguards have been satisfied. Congress should decide exactly how strong the safeguards are and what form they should take. For example, Congress could require consultation and formal agreement between Treasury and the concerned Federal financial regulatory agencies before the resolution mechanism was activated.

Congress also could instead opt for a stronger safeguard; this would empower Congress to make these decisions. There are several methods by which Congress could insert a higher hurdle. Let me outline one that our task force considered.

If a failing nondepository institution were judged to be a threat to the stability of the financial system, the administration could seek congressional appropriation. While the administration seeks the appropriation, the firm in question would enter the bankruptcy process in the proposed special purpose bankruptcy court. Congress would then have a limited and fixed number of days in which to make such an appropriation. A customary stay would apply, and the Fed could apply financing and collateral, permitting the firm to continue to operate while Congress deliberated. If Congress did appropriate, the estate of the firm would be transferred to the administrative procedure; if it did not, the bankruptcy would proceed, and the Fed would exercise its collateral once circumstances permitted.

In closing, we commend the hard work already done by Members in both Houses of Congress to move this crucial effort forward. The task force hopes that our efforts will complement the current work being done on these issues, as well as to provide additional momentum to the overall financial reform effort.

While there are unmistakable signs our economy has stabilized, it is imperative, we believe, that Congress act with urgency to enact comprehensive and effective reform.

Thank you very much.

[The prepared statement of Robert K. Steel appears in the Submissions for the Record on page 67.]

Chair Maloney. Thank you very much.

I want to thank all of the panelists. And because this is the first time that Ms. Born has testified before Congress since she left public service in the late 1990s, I would like to direct my first series of questions to her.

Ms. Born, when you were Chairperson of the CFTC, why were you so concerned about the over-the-counter derivatives market?

Ms. Born. I took office in 1996, and 3 years before that, the CFTC, my agency, had exempted customized swaps from the exchange trading requirement of our statute, but it had kept fraud and manipulation powers over the market.

When I got into office, I learned that the market was growing exponentially; it was, at that point, at about $30 trillion of notional value. We had no recordkeeping or reporting requirements, so there was no transparency. I could not effectively oversee that market for fraud and manipulation, even though we knew there had been major cases of fraud. Bankers Trust, an OTC derivatives dealer, had defrauded Proctor & Gamble and other customers. We knew there were major cases of manipulation. Sumitomo Corporation had used over-the-counter derivatives in copper to manipulate the world price in copper. We also knew that there was speculation on borrowed money in the market that was causing some major defaults.

Let me just mention Orange County, California, which had been speculating on over-the-counter interest rate derivatives with taxpayer money and was forced into bankruptcy because of its losses. I was extremely concerned because neither our agency nor any other Federal agency had a sufficient amount of information about the market to know the extent to which this enormous and quickly growing market was threatening the financial fabric of the country. In fact, while we were undertaking our inquiry into this market and I was appearing before a number of committees of Congress discussing whether or not over-the-counter derivatives should be subject to any Federal regulation, the Long-Term Capital Management crisis occurred.

Long-Term Capital Management was an enormous hedge fund which, unbeknownst to any Federal regulator, had managed to acquire a position of $1.25 trillion of over-the-counter derivatives even though it only had $4 billion in capital. Over a weekend, the Federal Reserve learned that it was about to collapse, and the Federal Reserve felt that if it collapsed with that kind of a position in over-the-counter derivatives, it would threaten the financial stability of the country. Fifteen of our largest banks and investment banks were its over-the-counter derivatives counterparties, and they were, at the request of the Fed, able to come up with hundreds of millions of dollars each to take over the position and prevent collapse. But that demonstrated very vividly to me the dangers of contagion; the way that these instruments spread risk

through the economy; and the danger that the failure of one institution, because of its trading, would bring down other institutions because of the connections through counterparty relationships.

Chair Maloney. I was a member of the Financial Services Committee at that time, and I remember there was a huge interest in moving forward with regulation, but then the economy improved and was booming, and the need for regulation was ignored, and we went forward with this problem. And look at the disaster that it caused with the financial crisis. So we should have acted then, and we are determined, with President Obama, to enact comprehensive regulatory reform. If we had acted back then, we would not have had the crisis that we are in.

My time has expired, and I am delighted to recognize Senator Brownback.

Senator Brownback. Thank you very much, Chairwoman Maloney. I am sorry for being late; I had another hearing I was at. This is a very important one, and I am delighted with the panel that is here and the topics being covered.

I want to go direct to dealing with large financial institutions and their failure, and how we handle that as an overall body, and how we handle that as a government. It seems like that, to me, is one of the key things that has come out of this crisis is our inability to handle something that is too big to fail; and consequently, if it is too big to fail, then we just have the taxpayer take the risk, and that has a lot of moral hazard in the marketplace. And if we don't fix it, it seems like, to me, it builds that moral hazard bigger in the next round that takes place so that people will say, well, last time they didn't fix it.

And it also strikes me that these bubbles build faster quicker. It is almost like financial storms build quicker, faster, bigger now than they used to. Whether it is the dot.com bubble and burst and the housing bubble and burst—and I am concerned we are in a government bubble and burst—that if we don't get ourselves in position now to be able to deal with these large institutions and tell them the marketplace will assume we are going to protect them, and then there will be more money going to places that it really shouldn't.

I would like to know, I think particularly Dr. Litan and Mr. Steel, if I could—and maybe others of you want to comment on this—I missed your testimony, I know that you have addressed some concerns on this. Tom Hoenig of the Kansas City Federal Reserve is a man I have worked with a fair amount on this. Do you generally support the model of what he is putting forward on this? Or perhaps this is your model and he is just adopting it, but I would like to get into some of the detail on this, if there is a kind of a collective thought coming together of how we structure ourselves to deal with this in the future.

Mr. Steel. Well, thank you, Senator. In my comments this morning, I highlighted my perspective that this too-big-to-fail issue is really at the crux or the crucible of all the issues that we are thinking about and really is a mission-critical part of what we are focused on.

With regard to President Hoenig's comments, we are familiar with the work. I think that the key construct, the philosophy of his

point of view is that resolution should be very painful, and that if we go through resolution, then whether it is bondholders, management, shareholders should suffer significant pain. We echo that same sentiment. He goes into much greater detail in the actual technicals of how he would organize his resolution process than we did in our work, but what he seems to look at is important.

We did offer a different step, though, and talked about a two-part process that we don't like identifying institutions that are too big to fail. We believe that there should be a sliding scale of capital required for important institutions that takes into account risk, asset size, complexity, et cetera. We also believe in the living will concept, that every firm should have a plan as to, if they do get into difficulties, how that can respond, and that should be filed and approved with a regulator. And if your plan is not filed and approved with a regulator, then you have to downsize.

But thirdly, what we have organized that is different than President Hoenig is that we feel that an enhanced bankruptcy process should precede resolution. So the first default position is bankruptcy. If bankruptcy can't work and it is too systemically important, then we would move to a resolution process consistent with his.

Senator Brownback. That seems to be a good mixture.

If I could, if we get in another financial crisis, and if the trajectory of the past is a projection of the future, it looks like we will, and it will be sooner rather than later, will the courage exist here to allow those triggers to be pulled, or are we just caught because these things will, in likelihood, exacerbate a financial crisis if you let one of these things go down like we saw with Lehman Brothers.

Mr. Litan. Okay, several comments. We know Dr. Hoenig's views very well in Kansas City. Part of my life is spent in Kansas City at the Kauffman Foundation, and Dr. Hoenig is actually a trustee of our foundation, so we are very familiar with his views. And I want to echo what Bob just said. We had the same directional suggestion that he talks about, which is to make sure the pain is spread.

And when we talk about too big to fail, I would like to clarify a couple of things. I think there is a lot of confusion in the public. We are really talking about protecting creditors in full, because the shareholders get wiped out, and—although actually in some cases the management did not get wiped out, but we certainly, on our task force, recommend that people who are responsible for failures should definitely lose their jobs. But the key thing to ending too big to fail is to make sure that unsecured creditors take some hit in some form. And so the bankruptcy process is clearly one approach to this. You can also accomplish that same haircut in an administrative process, but the key is that there be pain.

The second point, I will just elaborate on what Bob said. There is a huge debate now about whether or not we ought to preemptively break up institutions in advance. Should we arbitrarily set up some size and say above it we are just going to break you up? I am a former antitrust enforcer, and I can tell you that there are no antitrust principles to make that decision. We have market definition tests and so forth, but there is nothing in the antitrust laws that will tell you the magic size threshold above which you are too

big to fail. So you are going to have to look to some other principles. And our task force debated that extensively.

We came down where Bob said, which is we would not just across the board eliminate all too big institutions, because there are benefits of size, especially in the global market, but what we do say is that all large institutions ought to file this funeral plan or this wind-down plan with the regulators. And the regulators would have the ability, if they are unhappy with the wind-down plan and believe that it would not protect the financial system, they would have the authority to chop the institution up only in that circumstance. So we are against across-the-board size limits, but otherwise, I stand foursquare where Bob left his remarks.

Senator Brownback. Thank you.

Chair Maloney. Thank you.

Mr. Hinchey.

Representative Hinchey. First of all, I just want to thank you very much for what you have said in your testimonies, and the response that you have given to these questions. And the complexity of this situation is seen clearly in the context of the questions, but even more so in the context of the answers to the questions.

We are dealing with a very, very difficult and dangerous set of circumstances here economically for the future of this country. And one of the things that strikes me is the huge financial institutions, four of them, now hold half of the mortgages in America, issuing nearly two-thirds of our credit cards, and hold roughly 40 percent of all bank deposits. That strikes me as an absolutely fascinating set of circumstances, and why we allowed that to happen was a very big mistake. And we allowed it to happen intentionally. We allowed it to happen intentionally because there was a great interest on the part of some people to make as much money as possible and engage in this financial operation in ways that can be most beneficial to them. And if it had some benefits to others, well, you know, that might not be so bad. But the fact of the matter is that hasn't been precisely the case. Because of the size of these institutions, that is one of the main reasons why the economic collapse that we experienced came about.

One of the things that strikes me is this whole idea of too big to fail. If we have a situation where something is too big to fail, then we are just saying to ourselves, we are just turning everything over to them; they are going to do whatever they want, and all of the consequences of that are going to fall upon everybody else.

So nothing should be too big to fail. And the regulation of setting forth something that is not going to be too big is also very important. I think that there ought to be some analysis or some acceptance of the idea "too big to exist." We should not allow these institutions that are this size to actually come into play here and to engage in the circumstances that they have engaged in, particularly with regard to the way in which there has been this combined operation of commercial and investment banks and how that operation in and of itself played such a significant role in the impact of the economy that began to fall in the end of 2007.

So, what do you think that we should be doing about that? What is it that we should be engaged in here?

A number of the pieces of legislation that have come forward are constructive, they are moving in the right direction, but they are moving slowly in the right direction. I think that there are more things that need to be done. We see what happened back in the 1930s when there was basic legislation passed that said the combinations that we have seen and the adverse effects of those combinations and the manipulation of investment activities, all of that is now much clearer to us, and we need to stop that from happening in the future, and that was done. We have gradually weakened that process, and then we completely eliminated it just a decade ago. Now we have got to go back to something that is much more positive.

So maybe you can talk a little bit about that. What can be done now that is going to not bring about the financial collapse that so many of us apparently have in mind that is likely to occur if we continue to allow this set of circumstances to continue to exist and continue to override the entire financial circumstances that we have to deal with? What should we be doing?

Ms. Born, what do you think?

Ms. Born. Let me talk about the area that I know the best, over-the-counter derivatives, because one of the problems with these institutions is not only are they too big to fail, but they are too interconnected to fail; the failure of one will potentially bring down the others, or at least severely harm them.

One of the things we can do is bring over-the-counter derivatives trading out of the preserve of these big banks and onto exchanges and clearinghouses where we will not have enormous exposures building up in these banks that could bring down the banks.

In a clearinghouse situation, where derivatives are exchange-traded, the clearinghouse rather than an over-the-counter derivatives dealer—which all these institutions are—becomes the counterparty to each and every trade. It marks that trade to market twice a day, and at the end of every day at least, it calls for margin to be put up by all the traders who the market has moved against so we never get these enormous exposures like AIG had.

I think appropriate regulation of derivatives by bringing everything we possibly can onto regulated exchanges would certainly help. I do think that there are additional problems because these institutions not only will remain too big to fail, but I think they are too big to manage and too big to supervise.

Thank you.

Chair Maloney. The gentlewoman's time has expired. The gentleman's time has expired.

Mr. Burgess.

Representative Burgess. Thank you, Madam Chairwoman.

Ms. Born, I wonder if we could just continue on that line for a moment.

When you talk about the appropriate regulation of derivatives and the requiring a margin to be put up, is that not the case now? That mark-to-market twice a day and requiring a margin call to be made at least at some point on a daily basis, is that not the case now?

Ms. Born. That is not the case with any of the over $600 trillion in notional amount of over-the-counter derivatives. It is only the case on the regulated futures and option exchanges.

Representative Burgess. How difficult would it be to create that system? We have got an enormous financial regulatory system already in place, and we are being asked to create yet another new superstructure. Is there not the capability within the existing financial regulatory structure today to do just what you are describing.

Ms. Born. Yes. I think we have a wonderful prototype of what we need to do on the futures and option exchanges. Bringing as much of the standardized trading as possible onto exchange will take care of the problem for a lot of the market, because a great deal of the market is standardized contracts.

Now, I think the only legitimate, economically justifiable over-the-counter trades which justify the exposure the American public has to the harm from that market are hedging contracts, where large commercial entities are trying to hedge complex business risk. I think it is legitimate to continue that market, but I think there have to be capital requirements imposed on all the participants in that market; there have to be margin, collateral, and marking to market requirements in order to make that market safe. But you should realize we have no experience in successfully or effectively regulating an over-the-counter derivatives market. Our only experience with effectively regulating derivatives has been on exchange, and that has been effective since 1935.

Representative Burgess. Well, let me ask you a question that I posed to Walter Lukken 2 years ago when we got into all the difficulty with the futures speculation. And that is, what are the tools that I guess in this case the CFTC needs that it lacks in order to create the type of reality that you are describing here? Does the CFTC possess the tools today, or is there something legislatively that the CFTC needs or some other regulatory body needs in order to make what you described reality?

Ms. Born. In 2000, Congress forbid the CFTC or any other Federal regulator to oversee the over-the-counter derivatives market at all. So that has to be overturned. You have to give authority to the CFTC as the most experienced and expert federal regulatory body, and the SEC with respect to securities derivatives, to oversee these markets. And you need to require that standardized contracts go onto exchanges and clearinghouses.

Representative Burgess. Now, Mr. Lukken two summers ago said that the CFTC did still possess those capabilities but only in the case of an emergency. Now, in the summer of 2008, with four airlines declaring bankruptcy and the price of oil going up $16 in an hour, whatever it was, per barrel, I suggested to him that that was an emergency and that he ought to exercise those powers if he had them. But you are saying even in an emergency environment, those powers no longer exist?

Ms. Born. They do not. They have not existed since 2000 with respect to the over-the-counter market. There are powers that have not been exercised until recent days, during the last 10 years, by the CFTC with respect to exchange trading and regulated clearing that allow actions to be taken to reduce excessive speculation. And

it is my view that the CFTC really fell down on the job by failing its mandate to ensure against excessive speculation on the markets. I think that summer before last, there were tremendous bubbles in agricultural products and energy products, and it was because excessive speculation was being tolerated by the regulator and by the exchanges when it should not have been.

Representative Burgess. What are some of the potential pitfalls from creating this type of regulatory environment that you are envisioning?

Ms. Born. I think it exists right now for exchange-traded derivatives, or at least it certainly did when I was chair of the CFTC in the late 1990s. There were requirements that everybody trading on a regulated exchange declare whether—ahead of time, whether they were speculating or hedging, and speculators had special accounts that were designated as speculative accounts. They had special requirements like position limits imposed on them, by both the exchanges and the regulator. The CFTC had powers to step in and order a reduction of positions, order that a speculator who was abusing the system close out its positions entirely or pay extra margins, or any number of regulatory tools that were in the CFTC's toolbox.

Representative Burgess. Is there enough transparency in the market as it has evolved today with the unregulated over-the-counter exchanges to be able to provide that same type of oversight, or will it require creating a new financial regulatory system?

Ms. Born. I think it is very——

Chair Maloney. The gentleman's time has expired. You may answer the last question.

Ms. Born [continuing]. I think it is very important that as much of the over-the-counter trading as possible, all the standardized trades, go onto exchange so that they are transparent. I also think, if there are any continuing speculative trades in the over-the-counter market, which I don't think there is any justification for, that position limits should be imposed on those through a regulatory regime like is proposed in pending legislation.

Representative Burgess. Thank you.

Chair Maloney. Thank you very much.

This is an incredibly busy Congress, and I have just been called to the floor to manage a bill of mine that will bring transparency and accountability to the $700 billion in TARP funds, and that is an important bill and I have to go to the floor. But I would like to ask Dr. Litan and Mr. Steel to respond in writing, your ideas on too-big-to-fail and alternatives were very important. We have passed out a bill from the committee, which will be going to the floor, which allows government to basically dismantle too-big-to-fail.

And I would like to ask, how would this impact on the global economy if the too-big-to-fail large institutions become the norm in other countries. Would this put us at an economic disadvantage? And to comment on this proposal in writing. I think it is critically important and I would like to study it further.

I do want to say that, Brooksley Born, you are one of my heroines. I think you deserve the Nobel Prize for speaking out and

being courageous and pointing out what needed to be done. If we had listened to you, we would not have had this financial crisis.

I have a series of important questions that I would like to get on the record. Mr. Hinchey has agreed to help me get them on the record, or I think they are important in our review, as we move forward in financial comprehensive regulatory reform. I regret I have to leave.

[A letter from Representative Maloney to Robert Litan appears in the Submissions for the Record on page 71.]

[A letter from Representative Maloney to Robert Steel appears in the Submissions for the Record on page 72.]

Chair Maloney. I recognize Mr. Cummings for five 5 minutes. And Mr. Hinchey will assume the chair.

Representative Cummings. Thank you very much, Madam Chair.

Ms. Born, a moment ago you said something to the effect that not only were some institutions, large institutions, they fall into the too-big-to-fail category, but they are too big to control, something like that. And I found that all of our—on the Government Reform Committee when we dealt with AIG, a lot of times the left hand didn't have a clue as to what the right hand was doing, and it was just incredible to me. But listening to your testimony, I take it that you feel that the House bill certainly does not go far enough; is that right?

Ms. Born. I have just been focusing on the over-the-counter derivatives treatment. And in terms of the House bill on that, I do think that the end-user exemption for standardized contracts from exchange trading is unwise. I think that all standardized contracts should be required to be traded on exchange.

Representative Cummings. You know, Mr. Carr, the conduct of the credit-rating agencies during the financial crisis is extremely disturbing, and perhaps most disheartening is the destruction that has been done to the assets of public pension plans around the country. These public servants have lost their retirement security, threatened by the fact that the pension boards were required to hold assets that were later found to be inaccurately rated by these agencies.

The proposals in Congress have done a good job of addressing many of the conflicts and disclosure issues that have plagued the rating agencies. In your opinion, have the proposals gone far enough?

Mr. Carr. Thank you for the question. The National Community Reinvestment Coalition does not have a specific position on any one of the specific rating agency proposals, but we do believe that something like a public utility might be a very useful structure. We have documented quite extensively, as you know—which is probably why the question came our way—about the way in which the rating agencies were stamping investment grade on products that were obviously junk bonds for years.

So most of our work, Congressman, has really been focused on the front end of that question, which is documenting the abuses in the system, but not necessarily moving to the back end to structure the appropriate legal resolutions.

Representative Cummings. Do you have an opinion on that, Mr. Litan?

Mr. Litan. Yes. The issue of credit-rating agencies is incredibly complex. No one disagrees—at least none of the experts disagree—that they were at the heart of the crisis, among many other causes. And what they were doing that clearly contributed to the crisis is that they were rating instruments on the basis of very limited histories and then extrapolating that they would have AAA ratings, and we all know now that that was deeply mistaken. By the way, so too, similar mistakes were made by bond insurers.

So the question is what to do. Our task force at Pew debated this extensively. I can't tell you there is a silver bullet to fixing the rating agencies. What we end up recommending is to replace the letter grades that they now give with a suggestion, if not a requirement, that the rating agencies tell us what we really want to know; which is, what is their estimated probability of default of this bond? And then have an agency or at least private sector organizations track these predictions so that the investing public knows how good these forecasts are, and then the U.S. Government can have a choice. If it sees an agency that is consistently overestimating the likelihood that a bond is going to survive or, conversely, is underestimating the default probability, the government could either decertify the agency or it could impose penalties. But there ought to be some price to be paid for consistently going out to the public with over-optimistic ratings.

Now, my own personal view on the public utility model is—and I am not sure we extensively debated this within the task force—I am not wildly enthusiastic about it. You have got to remember that all of our bank regulators, all of them, had major failures. And so I don't have a lot of confidence that another government agency or utility commission is going to do any better in predicting these future events than our bank regulators did.

Representative Cummings. My time is running out. But when I listen to the testimony in Government Reform of the rating agencies, there is something that is very difficult to legislate, and that is integrity. And a lot of the things that were done, I know they may have been dealing with limited information, but we had testimony that showed that there were folks who were just not being honest. And maybe that is why you were having such a problem trying to come up with a solution.

Mr. Litan. Well, the core of the problem is that there is an inherent conflict, as you know, in the agencies. And because the way the market has developed, people can free-ride on the information. And so the only way they can stay in business up to now is by charging the people who issue the bonds, and that is right there a blatant conflict. And, frankly, given the state of the market, I am not sure we know how to fix it, except all we can do maybe is think of ways of penalizing these guys when they blow it.

Representative Hinchey [presiding]. Thank you, Mr. Cummings. Mr. Brady.

Representative Brady. Thank you, Mr. Chairman. A lot of good questions asked today, and a lot more to be asked on the liquidity resolution bankruptcy, just sort of a whole best approach on too-big-to-fail and how we move forward on all these issues.

I wanted to ask the panel, in no particular order, just your thoughts on credit default swaps. To a layman not in the financial services business, it seems like the fact that banks sold these credit default swaps to each other contributed to the contagion effects during the financial crisis. It seemed, in effect, banks were able to rent a higher credit rating for lower capital reserves during this process.

So one question is: Did the Basel II risk-based capital standards encourage banks to actually trade credit default swaps by allowing them to substitute the higher credit rating for lower—swap that for the lower credit rating of the borrower? And did the trading of credit default swaps among banks, in the end, have the unintended consequence of lowering, of reducing the capital in the banking system as a whole?

And then I am going to follow up on a thought on are credit default swaps a legitimate financial product? So let's open it up.

Ms. Born. Let me just start, since credit default swaps are a kind of over-the-counter derivative, and they certainly played a very important role in this latest financial crisis. They were used by banks and investment banks and other institutions to insure mortgage securitizations and other debt securitizations that perhaps otherwise would not have gotten a high rating. But, beyond that, they were used by many institutions, including the investment banks and banks, to speculate in the stability of other institutions, the stability of the mortgage market, the stability of the credit markets. And because of this highly speculative, highly leveraged trading that is essentially gambling on the creditworthiness of products, when there was a downturn there was an enormous crash, the most obvious entity being AIG that lost hundreds of billions of dollars and had to be bailed out.

Representative Brady. Just sort of drawing sort of a little narrower focus. Was the end result of all that, that in effect we reduced the capital in the banking system? By the use of credit default swaps, we created——

Ms. Born. I think the capital——

Representative Brady [continuing]. We really needed?

Ms. Born [continuing]. The capital requirements that we were using for the banking system were demonstrably inadequate in light of what happened.

Mr. Litan. I can address that issue specifically on the capital requirements. Before I do, though, I would say I would not ban credit default swaps. If subject to the appropriate institutional design regulation, they are the functional equivalent of insurance, and there is no reason we should ban insurance.

But your question raises the issue, were these CDS instruments used to effectively lower bank capital requirements? The answer is yes. Because under the Basel rules, the Basel committee outsourced the capital requirements, in effect, to the rating agencies. So that if you got a AAA on a security or other kind of instrument, you got a lower capital charge.

We did not debate this extensively in the task force, but my own personal view, and I have been writing about this for 10 years, is that this whole risk-rating system was nuts. I would have preferred a simple leverage ratio. And this idea that we can outsource

the capital requirements and bank risk assessments to the rating agencies who had this inherent conflict, in essence led to too little capital in the banking system. It was a big mistake. And so, going forward, I would get away from this risk rating.

Representative Brady. Mr. Steel.

Mr. Steel. Nothing to add.

Representative Brady. I will conclude with this. I think there is a legitimate role for this. One of the concerns I have is, as an insurance product, clearly when the market goes sour the claims hit in clusters. That is when the assets have the lowest market value. It seems like this is a product that it seems nearly impossible to—if you set aside adequate reserves, the price of the product itself would almost be of no longer use in the market.

The alternative of that is to have the Federal Government be the depositor or the—you know, insurer for all of that—which I don't think that is where Congress wants to go. Certainly, I don't.

Any thoughts on that that you can give? My time is up, Mr. Chairman. But, Mr. Steel, any thoughts?

Mr. Steel. Well, I thought that the gem of what you said was that if the—there is a moral to the story. If the appropriate capital requirement makes the product too expensive, then maybe we shouldn't have the product, I think is kind of the circle, the way that I would follow your logic. And so if we have these types of products, we have to make sure that they are reviewed and that supervisors and regulators understand them, so that we do have the right amount of capital.

Representative Brady. Great. I really do appreciate all of you being here today. Very helpful.

Representative Hinchey. Mr. Snyder.

Representative Snyder. Thank you, Mr. Chairman. And I appreciate you all being here. I missed most of your all's opening statements, but I don't think you covered this so far.

I think I will direct my question to you, Mr. Steel. I don't come out on the financial services industry and I am not on the Financial Services Committee. I am a family doctor. But the idea, the concept of having a living will for institutions that most Americans think have neither hearts nor souls intrigues me, and I wanted you to amplify on that a little bit, if you would.

I don't understand how that would work. They would file a document that I assume, in order for it to have any meaning, would have to have sufficient detail, but I would think would rapidly get out of date, or if it had any kind of detail in it, about how they would unwind. If it had lots of detail in it, I suspect competitors—I assume these would be public documents. Or would they be private documents?

Mr. Steel. Private.

Representative Snyder. Private documents. But I assume that there would be issues with them needing to come back and say, well, in the full disclosure we have changed—sold these assets already.

And also in your statement you say, "could be wound down with reduced impact on the overall economy." Institutions really don't have an obligation to watch out for the world or U.S. economy or a State's economy. They have an obligation to watch out for institu-

tions. So they are not going to file a document that says—I wouldn't think. I mean, I don't know what their fiduciary duty is. I assume it is to the people who own the business.

Would you amplify for me on what this document would look like, how long would it be? I just don't understand how it would have any real value.

Mr. Steel. Sure. I think that what we have found was that in this tumult the last period of time, that I believe that the two ingredients in short supply were capital and risk-management skills, in hindsight. And this is a personal perspective. And that we, in our report from our task force, talk about a series of things that can be done to address these issues. And key among them is this idea of an engagement with your regulator, where you have to have a tough conversation about, if you hit a turbulent or a period of stress, how would you deal with it, and that you have a plan. And I wouldn't—and I think that is the idea. And it should be an engagement with your regulator. And if you can't describe that and if you can't make your regulator comfortable that you have—you choose your analogy, an evacuation plan, a living will, that kind of idea. If you don't have a plan, then the regulator says: You are really not the person to be managing this institution of this complexity, this size and this risk level. And that is the type of engagement.

And while my own perspective, because I haven't used this analogy before—I think there were elements of this to the recent stress test—would be that type of engagement. I would invite my colleague, Mr. Litan, if he would like to add something.

Representative Snyder. I don't understand the kind of detail that we would have to have. It would be like at a time when things are going to go well, okay, what are you going to do when things go wrong? And if something goes wrong, then they will come back and say, we didn't know that was going to happen.

Mr. Steel. I think the idea of the analogy of the stress test is looking at your liquidity characteristics, understanding the correlation of assets, and having a plan that—if you had to move quickly, how would you respond, would be the essence of it.

Mr. Litan. And I will elaborate. It is not just to respond to stress, but how are you going to unwind yourself and dismember yourself in the event that you have to be liquidated or sold off? Who is going to lose money, which creditors, in what order and so forth. And I want to make this concrete for you. Do you know how many subsidiaries Citigroup has? Twenty-five hundred. All right? Now, they happen to be exceptional. But Deutsche Bank has roughly the same number, and a lot of the other banks, big banks, have lots of subsidiaries. My suspicion is, I am not sure the general counsel of Citigroup knows all 2,500 subsidiaries that bank has.

So, to be specific, if you are forced every year to write down to your regulator a plan that says how you are going to unwind this enormous elaborate mess, and you don't even understand it yourself, and, by the way, the board doesn't understand it, then the agency has got to have the authority to help you consolidate your complexity. And I think the sheer act of——

Representative Snyder. I wanted to ask—so let's take that as an example, the 2,500.

Mr. Litan [continuing]. Right.

Representative Snyder. So are you saying that—I am number 2,500, I am a little bank sitting someplace—that CitiBank has a piece of the action, and it is all going to be private, and then word will get around, you are the first to go? I don't understand how this operates.

Mr. Litan. No. First, these are living wills that are disclosed only to the regulator, and——

Representative Snyder. So they will have a document that says this is the order in which we are going to get rid of them. We never liked that one anyway. But it will be kept from those people and those shareholders?

Mr. Litan [continuing]. Well, in the case of Citigroup, I think most all of them are wholly owned subsidiaries. They are created in different jurisdictions. It is not clear who is responsible in the event of failure. There has to be a plan to say who is responsible for these different entities. And I will tell you, I mean, I will be blunt. I am not claiming this is going to be the magic answer. But, at a minimum, what the wind-down plans do is two things:

First, if the institution gets in trouble, they are the first draft of the resolution when the institution either ends up in bankruptcy court or ends up at the FDIC or its equivalent. Okay? That is the first thing.

And the second thing is that by having to prepare these plans every year and stare into the abyss, all right, just the sheer act of doing that is a mind-expanding exercise.

As a doctor, Congressman, you can analogize the preparation of the wind down plan to an annual physical exam. Back to the Citigroup example, the directors would then go to the general counsel and say, you mean you have got 2,500 companies and you don't even know all their names? How are we going to dismember these entities in case this organization goes under? And then you go back to the general counsel and you say, rationalize this for me, and then tell us exactly who is going to take the loss and so forth. That is a very instructive conversation to have.

Representative Snyder. Thank you.

Representative Hinchey. Thanks very much.

I just wanted to mention the over-the-counter derivatives markets and the role that they played in this economic crisis and see what you think about that. One of the most interesting aspects of it is the energy derivatives market, over the counter, and the way in which that was carried out and the way it is still carried out, without any oversight of the Commodity Futures Trading Commission. There is no oversight, no examination. And this is one of the reasons why we have seen the price of energy, gasoline, oil, go up so dramatically.

What do you think should be the proper steps that could be taken now to deal with this situation of these over-the-counter derivatives markets, so-called over-the-counter derivatives markets? It is interesting, the name is very interesting, over the counter. Mr. Carr, would you want to talk about that?

Mr. Carr. Congressman, I feel like I walked into the wrong hearing. I was asked to talk about the Consumer Financial Protection Agency, for which we have lots of views. We certainly do have

views on too-big-to-fail in the derivatives markets, but we don't have any formal positions on that. Our time is really being consumed with trying to figure out the consumer side of the puzzle.

Representative Hinchey. Okay. Ms. Born.

Ms. Born. I would be happy to respond to that. I think, first of all, that it is true that both on-exchange energy futures and options and the over-the-counter trades in energy have been used by speculators to manipulate the energy markets in the last few years, and that it is critically important to the economic well-being of this country to get that under control.

I would bring all the standardized contracts onto regulated exchanges where there are a lot of regulatory tools to limit speculation when it gets excessive. I would also require, with respect to any remaining over-the-counter derivatives trades, that they be reported to the regulator. I would not allow any over-the-counter speculative trades; but if you are going to allow them, there should be position limits that can be imposed by the regulators on both over-the-counter positions and exchange-traded positions.

Representative Hinchey. Dr. Litan.

Mr. Litan. Okay. I am now going outside the bounds of what our task force debate was, so I will just give you my own personal views. I am going to address the whole issue of just derivatives generally, not just energy.

I certainly agree that what we ought to do is have recording of all these trades on trade registries. Where there is collateral, the collateral ought to be held by third parties. This is something our task force was very strong about. If you go back to AIG, their collateral was not held in a third-party account.

When it comes to moving things to clearinghouses and exchanges, yes, we are for migrating it, but we would use capital requirements to induce that. So in effect what we would say is if you are a big bank and you have an OTC position that is not on a clearinghouse or an exchange, you have a much higher capital charge. So we would give very strong incentives for the geniuses on Wall Street to develop standardized instruments to go onto exchanges and to clearinghouses. But we wouldn't mandate it, instead using capital as a way of migrating these infringements. So we end up moving in the same direction that Brooksley talks about.

The reason why the clearinghouses are so important is that they eliminate the situation where as AIG is bilaterally responsible to its counterparties, and instead has obligations only to the clearinghouse. But then the clearinghouse needs to be regulated. You have to make sure that the clearinghouse has adequate capital and liquidity; otherwise, you have got a potential systemic problem. You can't make systematic risk go away, but you can certainly make it more visible and make it more controllable if you concentrate the risk.

Representative Hinchey. Mr. Steel, do you have anything else to say about that?

Mr. Steel. No. I think he described the perspective that we had in our committee. So that is fine.

Representative Hinchey. Ms. Born, do you think that that is enough? Don't you think that there is some additional regulation

to stop the manipulation of the prices of something that is essential to people across this country, like energy prices?

Ms. Born. Absolutely. I think that the tools that the CFTC has now with respect to exchange-traded oil futures are necessary for the entire market. And I think that as much as possible, oil derivatives should be on a regulated exchange so that there are the tools to limit excessive speculation.

Unfortunately, the summer before last the CFTC failed to do that even with respect to the exchanges, although they had power to do it. They could have required speculators on exchange to reduce their positions. They could have required them to eliminate their positions. They could have required them to pay extra margin, as is being suggested. And I think to the extent there is allowed any speculative trading over the counter, those should be the powers—there should be full oversight, full reporting, and powers to impose position limits.

Representative Hinchey. And to stop it.

Ms. Born. Absolutely. I think reporting should allow the CFTC to put together, aggregate, the positions an entity has on exchange and off exchange, and even in the physical market, so that the CFTC can assess whether the position is too big, and it can say reduce it or eliminate it. And if there is an emergency, it can tell all the speculators to reduce their position.

Representative Hinchey. Do you all have time to stay for a few more minutes? Dr. Snyder.

Representative Snyder. Thank you, Mr. Chairman. I wanted to give each of you a chance to predict the future for us as you look ahead and you follow this debate that is going on in Congress and amongst the American people with all the different players that are involved in this discussion of what kind of regulatory network we need.

When we finally have the President put ink on paper and sign into law major changes—and I think that will happen sometime next year—what is your greatest fear that we will leave out? What do you think the most likely mistake is, or mistakes, that we as a Congress and an administration will make?

Do you want to start, Ms. Born?

Ms. Born. Yes. And I will just talk about the over-the-counter derivatives area, which is what I know the best. The biggest concern I have is that some of the bills currently have exemptions for standardized contracts that can easily be traded on exchange but they are permitted to stay over the counter. I don't think there is any justification for that. I think that creates a loophole that can cripple this effort and really not result in effective regulation.

I would eliminate the end-user exemption for standardized contracts. I would eliminate the foreign currency exemptions some of the bills have on standardized contracts. I would eliminate the provision that suggests that contracts can be traded over the counter if one party is not an eligible member of a clearinghouse. Essentially, that seems particularly frivolous to me, because our clearinghouses have traditionally had clearing members acting as intermediaries for entities that aren't members. So that is not a relevant position. I am afraid that legislation could leave room for a

vast and underregulated over-the-counter market through these exemptions.

Representative Snyder. Mr. Litan.

Mr. Litan. So we have five principles that the Pew Commission has recommended, and I am not going to differentiate among all of them. We think all five should be in there. And if any of them aren't, I guess we would feel that Congress would be making a mistake.

Here's my personal view about what I would counsel the Congress, and even be so bold as to say to the President of the United States: Don't oversell this bill when it is passed. Don't use the word "never again." Because the fact is that capitalist systems are inherently susceptible to crises.

In fact, there is a new book out by Ken Rogoff, the former chief economist of the IMF, and a Maryland professor, Carmen Reinhart, that documents exhaustively the frequency of crises over hundreds of years in many countries.

I am old enough to remember 1991, the banking crisis, LTCM, savings and loan. That is sort of how I cut my teeth in academia and so forth. I have been through this. I have seen this movie before. This movie will happen again.

The best that we can hope for, and this is what I think we should tell the American people, is that this bill will reduce the frequency and the severity of future crises, and that is the best we can do. Because there will always be new instruments and new markets that will get out of control. And hopefully, if we have a systemic risk monitor, we will attenuate those bubbles, but we are never going to prevent them. And let's just don't overpromise.

Representative Snyder. Mr. Carr, the biggest mistake you think Congress will make.

Mr. Carr. Absolutely. I believe that the false positives in the condition of the banking industry as well as the economy may lead policymakers not to do the really bold and transformational systemic redesign that is needed.

The reason I say that is if you look at the current intervention—in fact, a lot has been said that we have been pulled from the edge of an abyss, we are no longer there, you know, the financial system is recovering.

Well, let's look at what we really did: We made too-big-to-fail bigger. At the same time, lending among those institutions is going down, even though their earnings appear to be going up. The FDIC's fund is depleted. If you look at the reality of unemployment, it is growing, with more than a third of the unemployed long-term unemployed. Food insecurity is growing. Poverty is growing. The fact of the matter is that, while the economy is technically out of recession, America is in deep depression, or at least millions of Americans are.

So I guess my bottom line is that we haven't come out of the woods yet. And we need to stay focused on the fact that the financial system is not working for the American public, it is not well regulated, it is not well supervised. And the fact that we are now away from the abyss does not mean that we can't make a U-turn and head back in that direction if we don't make the changes that are essential.

Representative Snyder. Mr. Steel, your personal opinion.

Mr. Steel. Yes. Well, my personal opinion is tied up in the Pew Report, but I will go past that. I think really what I am going to refer to is the methodology by which we developed our perspective. We took, a dozen or 15 of us, that had very, very different views, and we focused on what we thought were the five key issues: systemic risk, too-big-to-fail, prudential regulation, consumer protection, and strengthening the marketplace. And what we found was we all found ways we could compromise. And I think there is a dueling tension between wanting to encourage the way in which our economy can be so strong and resilient, but also yet wanting to have regulation. And getting that tension right and having long meetings to discuss this and listening to each other was the right way. And it is the tension between those two forces that I think is the right thing that you are going to have to measure. And getting it wrong would be to lean too much left or too much right on that point, but instead trying to basically not be too ideological, but trying to understand what can work would be my recommendation.

Representative Snyder. Thank you for your testimony. And, Dr. Litan, I want you to know that never again will I use the phrase "never again."

Representative Hinchey. Before we end, I just want to ask one last kind of general question, and that has to do with the history of the economic circumstances that this country has had to deal with.

We know that up until 1929, there were problems with the economy that would occur every 10, 15 years or so, but they were always managed, they were never deeply serious, but they were routine. But over time there was this sort of organization of the banking industry and the growing manipulation of investment circumstances, things of that nature. All of that brought about a big collapse in 1929.

Then, in 1933, we had the Glass-Steagall Act. The Glass-Steagall Act seemed to be something very, very effective. It stabilized the economy for a long period of time. We didn't have another collapse until 2007, I think, and the kind of experiences we are going through now, which are very, very tenuous and could be much more damaging over time. So the repeal of that Glass-Steagall Act is something that really bothered me a lot personally. I thought it was a big mistake at the time, and God knows it seems to have been.

What do you think about that? Do you think that we should be bringing back that form of regulation? Do you think that there should be this activity of oversight with regard to investment and consumer banking, and the manipulation of regulations that occurred so abundantly that really manipulated this economic condition that we are experiencing now?

Mr. Litan. All right. I don't know if I am going to make you feel any better, but I don't read history this way. I think the bulk of the economic historians identify the critical pieces of legislation which helped save the country during the depression as, A, deposit insurance; and B, all the SEC rules and so forth that we adopted. Glass-Steagall was incidental to all of this. One of the interesting historical facts is that the cosponsor of Glass-Steagall, Senator Car-

ter Glass, went to the floor of Congress 2 years later and said, "I want to repeal the act. It was a mistake." But by then it was too late.

Let's roll the clock forward today.

Representative Hinchey. It wasn't too late. It could have been repealed.

Mr. Litan. I know. But there was no momentum for it. It happened, and you know, you have been in Congress long enough to know that it is hard to reverse things.

Representative Hinchey. My opinion, that the momentum was that it was showing itself to be effective, that it was having good positive effects. But you disagree.

Mr. Litan. Yes, I disagree with that. And, by the way, it is not just my view. I think if you took a random sample of most economic historians, they would say the same thing.

But let's go forward. Let's look at this crisis. I would posit that even if we had separated commercial and investment banking, it wouldn't have made any difference if we hadn't fixed all this other stuff, you know, the stuff that Brooksley has talked about, that Jim talked about, and so forth. Because if we look at the institutions that got into trouble, it wasn't because of Glass-Steagall. Merrill Lynch, Goldman Sachs, Morgan Stanley, and other big institutions were not basically financial conglomerates, they were investment banks, and they underwrote a lot of the securities that helped get us into trouble.

Likewise, if you look at the big banks, it is true that Bank of America had an investment banking affiliate, but it was a minor thing. The only really true "financial conglomerate" in this entire system was Citigroup. But the rest of the big banks that got into trouble were not really mixing commercial and investment banking in any great degree.

So I don't view the Gramm-Leach-Bliley Act which eliminated the vestiges of Glass-Steagall, which by the way up until then had been largely removed anyhow through regulation by the Federal Reserve, I don't view that as really a precipitating cause of this crisis.

Now, it is a separate issue which you raised earlier: Did Gramm-Leach-Bliley allow some institutions to become larger, so big that they became too-big-to-fail? Well, if you look at these names that I just rattled off, they are all pretty big even as investment banks or as commercial banks.

So I conclude by looking at the recommendation of the Pew Task Force which says, let's look at an institution and see if its wind-down plan is not satisfactory, then selectively force the divorce that you are talking about. But I wouldn't actually mandate it by law.

And, by the way, as a practical matter, there really, as I said, aren't that many integrated financial institutions anyhow. That is sort of one of the ironies of Gramm-Leach-Bliley. We thought that there would be all these financial conglomerates, and it turns out there weren't many of them.

Representative Hinchey. Any other comment on that?

Ms. Born. Let me just mention that I do think it is a worthwhile exercise to look again at the activities we permit large financial institutions that have insured deposits to engage in. It wasn't

Gramm-Leach-Bliley that let our banks like JP Morgan act as over-the-counter derivatives dealers, but it was the banking regulators who did that years before Glass-Steagall was eliminated. But that added an enormous amount of risk to those institutions.

I think you could look at proprietary trading by large financial institutions that have insured deposits and ask yourselves, is that the kind of activity we want to be going on in an institution that the taxpayer is insuring?

So I do think there are issues. I agree with Bob that it wasn't only Glass-Steagall in the 1930s that protected the economy. It was the idea that there should be regulation of securities and securities exchanges, that there should be regulation of futures exchanges, that there should be deposit insurance, and several other things that, all together, had given us a long period of time of relative stability before this current crash. And a lot of that has been dismantled either through statutes like the Commodity Futures Modernization Act of 2000, or by the failure of regulators to actually exercise their powers and enforce the laws that they have been entrusted with.

Representative Hinchey. Anyone else?

Mr. Carr. I was just going to comment that I also would agree with much of what Bob said, and really just remind the committee that while the back end of the process, the derivatives, the investment banks, and on and on and on, played an important role. The point of the spear of the meltdown of the mortgage market happened at a more simple place, which was the interaction between the brokers and the lenders and the consumers. And had the products that they were offering not been literally designed not to be sustainable, we would not have had much of the process here. Our current laws, had they been enforced, could have eliminated much, if not the bulk of the unfair and deceptive lending practices that brought the housing and credit markets down.

Mr. Steel. Your original question, sir, was about the business model of large financial institutions. And I think my own instinct is while further study is always a good idea, is that in today's marketplace the distinction between lending, securities, and insurance is blurred to such a degree that you can make it whatever you want it. And trying to design business models that put people in one lane of those activities will not be successful; and, therefore, I wouldn't spend a lot of time doing it. And I would focus on having strong regulators who look at the business, understand it, apply capital standards, and move along that way, as opposed to trying to design the business model. Because someone will find a way around the business model that you try to prescribe. And I just think that is the likelihood and ultimate outcome.

Representative Hinchey. Well, I thank you all very, very much. Thanks for being here, and thanks for everything that you have said. We very much appreciate it.

[Whereupon, at 12:28 p.m., the committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF CAROLYN MALONEY, CHAIR, JOINT ECONOMIC COMMITTEE

Good morning. I want to welcome our distinguished panel of witnesses today as we discuss proposals to regulate the over-the-counter derivatives market and under-regulated credit markets.

The financial crisis and the ensuing recession were triggered by the collapse in the price of homes and the resulting defaults in the mortgages used to purchase them. Without interference from regulators, financial institutions aggressively purchased over-the-counter derivatives, such as mortgage-backed securities, with the expectation that they would generate high returns with minimal risk. To hedge against any risk, they also purchased unregulated credit default swaps that would pay them if the mortgages underlying the derivatives defaulted. This created a tangled web of counterparties.

This crisis didn't have to happen. One of our distinguished witnesses, Brooksley Born, had the foresight to recognize the dangers of unchecked growth, lack of transparency, and overleveraging in the over-the-counter derivatives market back in the late 1990s. As Chair of the CFTC, she advocated regulating this market, which at its peak was tied to over $680 trillion in assets—approximately 50 times the U.S GDP! However, she was ignored and silenced by a chorus of critics who hailed over-the-counter derivatives as the greatest financial innovation of the decade because they would spread risk efficiently among market participants.

With the economy booming, her fears seemed exaggerated. Siding with her critics, Congress passed the Commodity Futures Modernization Act of 2000, which prevented the CFTC from regulating the over-the-counter market. Ironically, the Act's stated purpose was "to reduce systemic risk in the markets for futures and over-the-counter derivatives."

During the current crisis, the lack of transparency and regulation in the over-the-counter market spread panic within the financial community when the housing bubble burst. Banks could not tell which banks were teetering on bankruptcy and which weren't because the positions they had taken in the over-the-counter market were unknown. A crisis of confidence erupted and a contagion of fear and uncertainty spread. Credit markets became crippled as banks held onto their assets and stopped lending.

The House Financial Services Committee and House Agriculture Committee are meeting this week to merge their versions of the bill that will finally regulate the over-the-counter market. The merged bill will promote transparency by requiring that these previously unregulated derivatives be traded on exchanges or clearinghouses. Capital and margin requirements will beestablished so that financial institutions can no longer make risky bets. And information about prices and trading volumes will be publicized so that market participants will no longer be uncertain of the value of their securities.

Although these bills exempt some derivatives from regulation, the exemptions are an attempt to balance concerns of some businesses that need customized derivatives and the potential risk to the financial system.

The House Financial Services Committee has also passed a bill establishing the Consumer Financial Protection Agency to shield consumers from deceptive financial practices. People will no longer have to deal with mortgage lenders who prey on those with poor credit histories by offering them subprime mortgages under unfair terms.

Although our economic recovery is far from complete, there is a growing understanding that the economy is moving back on track, helped along by the Recovery Act. Third quarter GDP grew 2.8 percent, after contracting for four consecutive quarters. Financial markets have recovered substantially and interbank lending is back to its pre-crisis level.

However, Congress cannot repeat its past mistake of turning a blind eye to the over-the-counter market. Even as our economy and financial markets stabilize, Congress cannot afford to once again embrace the misguided notion that this market can regulate itself. Now is the time to act.

I thank the witnesses for coming before the committee this morning and I look forward to hearing your testimonies.

PREPARED STATEMENT OF BROOKSLEY BORN, FORMER CHAIR, COMMODITY FUTURES TRADING COMMISSION

Madam Chair and Members of the Committee:

Thank you for inviting me to appear before you to discuss the over-the-counter derivatives market.

When I was Chairperson of the Commodity Futures Trading Commission more than a decade ago, I spoke out about the dangers posed by the rapidly growing and unregulated over-the-counter derivatives market and called for effective federal oversight. I was aware that powerful interests in the financial community were opposed to any examination of that market. Yet I spoke out because, as the head of the federal regulatory agency with the greatest experience and expertise in derivatives markets, I felt a duty to let the public, Congress and the other financial regulators know the potential threats to our financial stability. I strongly believed that the lack of transparency and the absence of government oversight of over-the-counter derivatives had to be remedied by the adoption of appropriate regulation.

My voice was not popular. The financial markets had been expanding, innovation was thriving, and the country was prosperous. The financial services industry argued that markets had proven themselves to be self-regulating and that the role of government in market oversight and regulation should be reduced or eliminated.

All of us have now paid a large price for that fallacious argument. We have experienced the most significant financial crisis since the Great Depression, and regulatory gaps, including the failure to regulate over-the-counter derivatives, have played an important role in the crisis. We have now spent hundreds of billions of taxpayer dollars to deal with the financial crisis, and the American people have experienced massive losses of jobs, homes, savings and businesses.

As a result of pressures from a number of the country's largest financial institutions, Congress passed a statute in 2000 that eliminated virtually all government regulation of the over-the-counter derivatives market, the Commodity Futures Modernization Act of 2000. Because of that statute, no federal or state regulator currently has oversight responsibilities or regulatory powers over this market.

The market is totally opaque and is often referred to as "the dark market." It is enormous. At its height a year and a half ago in June 2008 the reported size of the market exceeded $680 trillion in notional value or more than ten times the gross domestic product of all the countries in the world. As of June 2009 the market reportedly still exceeded $600 trillion in notional value.

While over-the-counter derivatives have been justified as vehicles to manage financial risk, they have in practice spread and multiplied risk throughout the economy and caused great financial harm. Lack of transparency and price discovery, excessive leverage, rampant speculation, lack of adequate capital and prudential controls, and a web of interconnections among counterparties have made the market extremely dangerous. Warren Buffet has appropriately dubbed over-the-counter derivatives "financial weapons of mass destruction." They include the credit default swaps disastrously sold by AIG and many of the toxic assets held by our biggest banks. They spurred the housing and credit bubbles and accelerated the contagion as the bubbles burst and the crisis spread. A number of the financial firms that failed or have required extraordinary government support during the recent crisis were among the world's major over-the-counter derivatives dealers, including AIG, Bear Steams, Lehman Bros., CitiGroup, Merrill Lynch, Bank of America, Morgan Stanley, Goldman Sachs, and J.P. Morgan.

This over-the-counter market continues to be unregulated and to pose grave dangers to the economy. It is critically important for Congress to act swiftly to impose the rules necessary to close this regulatory gap and to protect the public. As time passes and the economy appears to be stabilizing, there is a danger that the sense of urgency to adopt these important reforms may diminish. We now have a unique opportunity—a narrow window of time—to fashion and implement a comprehensive regulatory scheme for these instruments.

Existing U.S. laws governing the futures and options markets provide a worthy model for regulating the closely related instruments traded in the over-the-counter derivatives market. The Commodity Futures Trading Commission and the Securities and Exchange Commission should have primary regulatory responsibilities for derivatives trading, both on and off exchange. As with futures and options, all standardized and standardizable derivatives contracts should be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations. A regulatory regime based on the requirements established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts; ensure price discovery, openness and transparency; reduce leverage and speculation; and limit counterparty risk. While central clearing would mitigate counterparty risk, central clearing alone is not enough. Exchange trading is also essential in order to provide price discovery, transparency and meaningful regulatory oversight of trading and intermediaries.

In my view, there should be no statutory exceptions from the rule that all standardized and standardizable contracts should be traded on exchange rather than

over-the-counter. Some large corporations are arguing that they should be permitted to continue to trade standardized contracts over-the-counter because they wish to avoid paying the cash margins required for exchange-traded contracts. Such an exception is unwarranted. Large corporations will benefit from the price discovery, transparency and regulatory oversight of exchange trading, which generally should lead to lower prices for trades. Moreover, creditworthy corporations should be able to obtain lines of credit as needed to meet their margin requirements for exchange trading.

The over-the-counter market is necessarily much less transparent and much more difficult to regulate than an exchange market. If any trading in over-the-counter derivatives is permitted to continue, such trading should be limited to truly customized, non-fungible contracts between highly sophisticated parties at least one of which requires such a customized contract in order to hedge actual business risk. Such customized contracts by their nature cannot be traded on an exchange or cleared by a clearinghouse. While customized over-the-counter contracts may serve an economically useful purpose by allowing businesses to hedge complex business risks, there is no adequate justification for allowing purely speculative customized contracts to be traded in the more dangerous over-the-counter market. Therefore, at least one party to every over-the-counter contract should be required to certify and be able to demonstrate that it is using a customized contract to hedge a bona fide business risk. So limiting the over-the-counter market would reduce the potential risks created by that market.

Furthermore, any continuing over-the-counter market should be subject to a robust federal regulatory regime requiring transparency and protections against abuses and catastrophic defaults. There should be registration, recordkeeping and reporting requirements for all over-the-counter derivatives dealers, and they should be subject to business conduct standards, including requirements to disclose contract terms, pricing and risks to their customers. All over-the-counter trades should be subject to margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of over-the-counter derivatives should be publically reported on an aggregated and timely basis. The market should be subject to prohibitions against fraud, manipulation and other abusive practices.

These measures would go far toward bringing this enormous and dangerous market under control. They should be adopted and implemented if we hope to avoid future financial crises caused by this market. The country cannot afford to delay or weaken our response to the crisis. If we as a people do not learn from our experiences and respond appropriately, we will be doomed to repeat them.

Thank you very much.

Testimony of Robert E. Litan[1]

before the

Joint Economic Committee

December 2, 2009

Chairman Maloney and members of the committee: Thank you for inviting me to appear before you today.

My name is Robert Litan and I am here today primarily to discuss financial reform issues on behalf of the bipartisan Task Force on Financial Reform, of which I am a member. The Task Force is ideologically diverse and has as its members both academic economists and financial industry practitioners.[2] This group was first convened in June and given the task of producing bipartisan, consensus recommendations designed to meet one overriding goal: to create a financial system that allows the U.S. economy to grow without the kinds of risk we have recently witnessed and unfortunately experienced. I am pleased to discuss here today, together with Robert Steel, another Task Force member, the Task Force's five core principles for reform.[3]

We are meeting at critical time for the economy, underlined by the President's plans to hold a major jobs summit tomorrow. Hopefully, some creative ideas will come out of that meeting.

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[1] Robert E. Litan is Vice President of Research and Policy at the Ewing Marion Kauffman Foundation, a Senior Fellow in Economic Studies at the Brookings Institution, and a member of the Task Force on Financial Reform. The views expressed here are my own.

[2] In addition to myself, signatories of the Task Force Principles include: Martin Baily, Task Force Co-Chair, Senior Fellow, Economic Studies, Brookings Institution; Peter Wallison, Task Force Co-Chair, Senior Fellow at the American Enterprise Institute; Charles Calomiris, Professor of Finance at Columbia University; Morris Goldstein, Senior Fellow at the Peterson Institute for International Economics; Richard Herring, Professor of International Banking at the Wharton Business School; Paul G. Mahoney, Dean of the Law School at University of Virginia; Avinash Persaud, Chairman of Intelligence Capital Limited; Alice Rivlin, Senior Fellow at the Brookings Institution and Visiting Professor at Georgetown University; Robert Steel, Former CEO at Wachovia and; Benn Steil, Senior Fellow and Director of International Economics, Council on Foreign Relations .

[3] The recommendations are the views of the Task Force and do not necessarily represent the views of The Pew Charitable Trusts.

But there are already some ideas and subjects already on the table that need to be addressed if we are going to put our economy on a sustainable footing. One of those subjects is fixing the financial system. Until this happens, businesses of all sizes, large and small, cannot expect to gain the credit and financing they need as long as our financial institutions remain weak and at risk of future crises. Banks won't lend otherwise, or if they do and the incentive structures that helped lead to the recent financial crisis are not fixed, we will simply embark on yet another boom-bust cycle which none of us wants to repeat.

I understand that some feel that we should take time to better understand the causes of the financial crisis before we reform the system. While I have some sympathy with view, I also believe the danger from inaction is greater. Moreover, if we remember back to the Pecora Commission that investigated the causes of the Depression, that Commission only launched a debate that continues even today. Meanwhile, Congress did not hesitate then to act and, in my view, most of what it did to fix the financial system has stood the test of time remarkably well. Likewise, Congress should not wait this time to fix what clearly needs fixing.

I will spend little time on going through the extensive list of causes of the crisis, of which we and you know there are many: an extended period of low interest rates coupled with the continuous heavy inflow of savings from abroad; the widespread perception that U.S. housing prices would not fall; various government policies that encouraged excessive home mortgage lending; opaque mortgage backed securities (CDOs and their progeny) that were unwisely rated by the ratings agencies and insured by the monoline bond insurers; major failures in oversight of financial institutions; failures in risk management at many financial institutions; compensation structures that encouraged imprudent excessive risk-taking by mortgage originators and securitizers; unscrupulous mortgage lending practices; and so on. I know others have used this analogy, but it won't stop me from repeating it here: the culprits of this financial crisis are many, like all those on the train in the famous Agatha Christie story and movie, *Murder on the Orient Express.*

The members of the Task Force extensively debated these causes and what to do about them. We ultimately did not agree on every item of reform, or agree to take up every subject that has been connected to this crisis. But we did concentrate on some of the major issues in need of legislative attention. After much very useful and instructive back and forth discussion, we agreed

on some consensus recommendations, backed by what we hope is useful analysis that will help the Congress as it goes about the critical task of reforming our nation's financial laws to dramatically reduce both the likelihood and severity of future financial crises.

In this connection, all of the Task Force members commend the Congress – both the House and the Senate – for the hard work that has been on reform so far. You will find many common elements between our recommendations and the specifics in the bills that have come out of the House Financial Services Committee and that are now being considered in the Senate Banking Committee.

It is in that spirit that I now briefly outline our five key principles of reform and a brief summary of some key recommendations. My colleague on the Task Force Robert Steel will offer some additional details on some other key Task Force recommendations.

First, the U.S. must have an early warning system that prevents inappropriate and dangerous financial practices from harming the economy.

The financial crisis revealed both gaps in regulation and unanticipated interconnections among different types of financial institutions and markets. Yet no one was charged with understanding these interconnections, looking for gaps, detecting early signs of systemic threats and acting to mitigate them. The creation of a Financial Services Oversight Council (FSOC) charged with overseeing policy on systemic stability would rectify this oversight. The Fed would carry out systemic risk monitoring and make recommendations to the FSOC, while retaining observer status on examinations of specific institutions of its choosing.

The FSOC's systemic risk policy would outline the signals of systemic threats, such as the rapid growth of credit, housing and other asset classes. The policy also would specify how and under what circumstances the responsible federal agencies should respond with measures to encourage stabilizing behavior. Such measures could include varying additions to normal standards for capital, reserves, margins, and leverage (such as loan-to-value ratios for mortgages) across institutions and markets.

Second, no financial institution should be too big or complex to fail.

We have learned many things from this crisis, but clearly one of them is that the "well capitalized" positions of many of our financial institutions, especially the larger ones, were an illusion. Financial institutions took on too much risk, while moving a lot of it ostensibly "off balance sheet" only to find that once the crisis hit, they had to take these "structured investment vehicles" back home, for a combination of reputational and legal reasons.

Going forward, a new regulatory regime must address the too big to fail problem squarely. The Task Force believes this is best accomplished by having capital, liquidity and leverage requirements rise with the size and complexity of the institution. Larger institutions that are capable of accessing the capital markets should also be required to issue a minimum amount of subordinated debt (subject to haircuts in the event of failure) that converts to equity in times of stress. In effect, this progressively tighter regulatory regime would force larger, complex institutions to have greater buffers in the event of future financial turmoil and to internalize the potential systemic risks these institutions pose to the rest of the financial institution and economy.

The Task Force also strongly endorses the notion that large institutions above a certain size maintain a "wind-up plan" approved by a single prudential financial regulator. Large, complex institutions whose plans are persistently weak should be required to divest businesses until their failure would pose significantly less risk to the financial system.

Third, one strong and smart prudential regulator should replace the current alphabet soup of agencies.

The patchwork of federal financial regulatory agencies and their jurisdictions that long pre-dated the crisis allowed regulatory capture, charter shopping, inconsistent policies, gaps in coverage, inadequate resourcing and ineffective oversight. Future arrangements must allow for the evolution of the financial system while at the same time addressing all these weaknesses. Like institutions should be subject to like regulation. As an institution changes character, there should be no regulatory barriers to corresponding changes in the manner in which it is regulated.

The Task Force believes these objectives can be best met and the problems with the current system best cured by vesting responsibility for prudential supervision and regulation in a single National Financial Regulator (NFR). The Task Force urges that no institution be pre-designated

as systemically significant. The examination process must be strengthened, with more focus on risk-taking and outcomes and less on process. Better recruitment, selection, training and compensation of examiners are also needed.

Fourth, derivatives markets and market discipline broadly must be strengthened.

Derivatives markets would be more secure and transparent if all over-the-counter (OTC) derivatives were recorded with trade registries, and OTC transactions were encouraged to migrate to clearinghouses and exchanges. This is best done through the judicious use of capital required for OTC derivatives that are not centrally cleared to encourage the creation and demand for standardized OTC derivatives that are easily cleared centrally and eventually traded.

Senior executives and other risk-takers in financial institutions must be rewarded by compensation structures that provide incentives for constructive behavior, not imprudent risk-taking. Accordingly, a significant element of such compensation should consist of very longterm restricted stock (analogous to the compensation systems in traditional financial partnerships). Prudential regulation should penalize institutions that do not maintain compensation systems that are improperly aligned with risk – for example, through higher capital requirements.

Finally, consumers need better protection from financial abuses.

In recent years, unethical and deceptive practices in the sale of financial products and services became an issue in the run up to this crisis. Consumer protection was neglected even where it was mandated by statute: it was not given priority by agencies that were primarily concerned with protecting the safety and soundness of the financial institutions under their supervision.

Accordingly, the Task Force supports the creation of a new federal Consumer Protection Agency, which should have both rulemaking and enforcement powers with respect to all consumer financial products currently overseen by the various federal agencies (excluding products currently regulated by the SEC and CFTC and those offered by small service providers whose financial activities are only incidental to another business).

I am submitting the full report on the Task Force Principles along with my prepared testimony. Many of the specific Task Force recommendations in support of the Principles mirror

many of the recommendations made by the Administration, as well as those under debate in the House Financial Services Committee and the Senate Banking Committee. Yet, while the Task Force was not able to address all aspects of financial regulation and some members would have preferred somewhat different approaches with respect to certain individual recommendations, those who signed the report believe strongly that this entire package, if adopted, would represent a major improvement over the status quo.

Finally, I want to close with a comment about our overall economic predicament and ways to sustain economic growth in the months and years ahead, drawing on work that I and my colleagues at the Kauffman Foundation and the Brookings Institution have been doing in recent months.

As this committee is well aware, we have just come off the first quarter of positive GDP growth in a year and a half. But our economy remains very much at risk. Unemployment is now above 10% with little prospect of dipping much below this double digit level any time soon. The nearly 3% annual growth recorded in the third quarter was boosted by a series of temporary government initiatives that eventually will be phased down or come to an end: the "cash-for-clunkers" program, the housing tax credit, the stimulus money that was in the pipeline, and the continuing provision of liquidity by the Federal Reserve.

The central question we all face now is this: how and when is private sector activity – consumption, investment and exports -- going to kick in and not only sustain overall growth, but at a sufficiently high level to start bringing unemployment down continuously and significantly? Already many ideas for another fiscal stimulus have been floated to insure that this happens. I would be pleased to give you my thoughts on these ideas in the question period.

But I close with one modest suggestion for reducing unemployment that should have little or no impact on the federal budget. Why not authorize an "entrepreneurs' visa" – or more accurately a "job creators' visa" – for immigrants who come here, form businesses and hire American workers? Studies have shown that immigrants account disproportionately for the formation and growth of successful high-tech companies in particular. Moreover, Kauffman Foundation research documents the centrality of new firm formation to the growth of overall

employment.[4] We thus could use the energy and innovativeness of job-creating immigrant entrepreneurs now more than ever.

I look forward to any specific questions you may have about the matters I have discussed here. Thank you again for inviting me.

[4] See two studies on this topic: John Haltiwanger, Ron Jarmin and Javier Miranda, "Jobs Created From Business Startups in the United States," Kauffman Foundation, January 2009, at http://www.kauffman.org/uploadedFiles/BDS_Jobs_Created_011209b.pdf; and Dane Stangler and Robert E. Litan, "Where Will The Jobs Come From?", Kauffman Foundation, November 5, 2009, at http://www.kauffman.org/uploadedFiles/where_will_the_jobs_come_from.pdf.

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Testimony

Written Testimony of

James H. Carr
Chief Operating Officer
National Community Reinvestment Coalition

On the Subject of Unregulated Markets:
How Regulatory Reform will Shine a Light
In the Financial Sector

Submitted to the
United States Congress
Joint Economic Committee

G-01 Dirksen Senate Office Building
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Introduction

Good morning, Chair Maloney and distinguished members of the Committee. My name is James H. Carr and I am the Chief Operating Officer for the National Community Reinvestment Coalition. On behalf of our coalition, I am honored to speak with you today about the role of consumer financial protection in the economic crisis.

NCRC is an association of more than 600 community-based organizations that promotes access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families. NCRC is also pleased to be a member of a new coalition of more than 200 consumer, civic, labor, and civil rights organizations, Americans for Financial Reform, that is working to cultivate integrity and accountability within the US financial system. I serve on the executive committee of that coalition.

Members of the Committee, today we stand at a crucial junction in the road to recovery. After nearly two years of painful contraction, the economy has begun to grow again. Nevertheless, leading economists of all ideological stripes estimate that the recovery will be jobless, tepid, and prolonged. Millions of the 7.6 million Americans who lost jobs during the Great Recession remain out of work, including 4.1 million workers who have been unemployed for more than six months.[1]

While millions of American workers are suffering, profits on Wall Street are soaring. The largest investment firms on Wall Street have so far earned $23 billion in 2009.[2] Bonuses this year are likely to be the second highest on record, second only to those paid in 2007.[3] So, as the pains of recession continue for most American families, Wall Street is celebrating.

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[1] "New U.S. Jobless Claims Decline." *Associated Press*. November 12, 2009. Accessed online at: http://www.nytimes.com/2009/11/13/business/economy/13econ.html.
[2] Kouwe, Zachery. "Wall Street on Track for Record in Profits." *New York Times*. November 17, 2009. Accessed online at: http://www.nytimes.com/2009/11/18/business/18wall.html.
[3] Gralla, Joan. "Wall Street Profits Revive, Bank Bonuses May Jump." *Reuters*. November 17, 2009. Accessed online at: http://www.reuters.com/article/newsOne/idUSTRE5AG2UA20091117.

It is disquieting to contrast the headlines on profits and bonuses on Wall Street with the news that lending in the third quarter of 2009 declined 3 percent, the largest drop since the FDIC started tracking the data in 1984. Seventy-five percent of the decline is attributable to decreased lending at big firms, and the majority of the decline reflects restrictions on credit available to consumers and small businesses.[4] In short, the American people supported Wall Street in its time of need, but the banks have not responded to the American public in kind.

Worse yet, while many of the large institutions that have been most heavily subsidized are now reaping record profits and preparing to pay out near-record bonuses, the rest of the banking sector remains in a precarious state. The FDIC, for example, has entirely depleted its insurance fund.[5] More than 120 banks have failed so far this year, and the FDIC's list of at-risk banks now includes 552 institutions.[6]

Meanwhile, for the nearly 16 million Americans who are unemployed and looking for work,[7] the recession is far from over. Foreclosures continue at a staggering pace, with more than 300,000 new loans receiving a foreclosure filing each month since March.[8] As families exhaust their savings and unemployment benefits, they lose the ability to provide basic necessities. For example, 50 million people experienced food insecurity in 2008.[9] A record 36 million Americans now rely on food stamps: one in eight of the general population and fully one quarter of all children.[10] Despite these staggering statistics demonstrating the ongoing suffering on Main Street, Wall Street continues to operate under the banner of "business as usual."

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[4] Paletta, Damian. "Lending Declines as Bank Jitters Persist." *Wall Street Journal*. November 25, 2009. Accessed online at: http://online.wsj.com/article/SB125907631604662501.html?mod=rss_Today%27s_Most_Popular.
[5] Dash, Eric. "As Bank Failures Rise, FDIC Fund Falls into Red." *New York Times*. November 24, 2009. Accessed online at: http://www.nytimes.com/2009/11/25/business/economy/25fdic.html.
[6] Ibid.
[7] "Employment Situation Summary." Bureau of Labor Statistics, U.S. Department of Labor. November 6, 2009. Accessed online at: http://www.bls.gov/news.release/empsit.nr0.htm.
[8] Levy, Dan. "U.S. Foreclosure Filings Top 300,000 for Eighth Straight Month." *Bloomberg News*. November 12, 2009. Accessed online at: http://www.bloomberg.com/apps/news?pid=20601103&sid=aaXO2EVjAjb4.
[9] Goldstein, Amy. "America's Economic Pain Brings Hunger Pangs." *Washington Post*. November 17, 2009. Accessed online at: http://www.washingtonpost.com/wp-dyn/content/article/2009/11/16/AR2009111601598.html.
[10] DeParle, Jason and Robert Gebeloff. "Food Stamp Use Soars, and Stigma Fades." *New York Times*. November 29, 2009. Accessed online at: http://www.nytimes.com/2009/11/29/us/29foodstamps.html.

In the words of Nobel Prize-winning economist Joseph Stiglitz, business as usual meant that when the financial system discovered there was money at the bottom of the wealth pyramid, it did everything it could to ensure that it did not remain there. Stated otherwise, the business model for many financial institutions was to strip consumers of their wealth rather than build and improve their financial security.

Protecting consumers is one of the key elements of governmental reforms that aim to restructure the financial sector to be more accountable to the needs of the public. The new Consumer Financial Protection Agency (CFPA), first proposed by Harvard Law School Professor Elizabeth Warren, now the Chairwoman of the Congressional Oversight Panel on TARP, was formally proposed by President Obama in June 2009. The agency has the support of all the major consumer organizations and the approval of the American public, but is vigorously opposed by financial industry lobby groups.

With powerful and wealthy interests opposing CFPA, the difficult necessity of striking bipartisan compromise, and competing issues—such as health care, the war in Afghanistan, and climate change—demanding time on Congress's agenda, it would be easy to allow consumer protection, and financial regulatory reform in general, to languish. Delay or defeat, however, would have severe negative consequences for the American public.

Could CFPA have Prevented the Financial Crisis?

I have been asked today to discuss whether the Consumer Financial Protection Agency (modeled on any one of the proposals advanced by the President, the House of Representatives, or the Senate), had it existed, would have prevented the proliferation of predatory lending, which eventually led to the implosion of the housing and credit markets that, in turn, caused the sinking of the U.S. economy.

It is, of course, impossible to answer such a question with certainty. However, I am convinced that if a Consumer Financial Protection Agency had been enforcing consumer protection laws

and protecting consumers' interests throughout the past decade, much of the predatory lending that fueled the housing and credit crises would have been curtailed.

To evaluate this idea, I have considered the primary causes of the financial crisis and how the CFPA might reasonably have responded to them. In each case, it is likely that a federal agency, with the sole mission to protect consumers' interests within the financial sector, would have taken some action to stop illegal activities and encourage safe and sound lending that was beneficial to the public and lenders alike.

Predatory Mortgage Lending

In 1994, Congress passed the Homeownership and Equity Protection Act (HOEPA) in order to address predatory practices related to high-cost, subprime mortgages. The Federal Reserve was tasked with developing guidelines for financial institutions on how to implement HOEPA, but it declined to do so until 2008. The agency failed to act because it decided to put its core mission to ensure the safety and soundness above its responsibility to protect the public within the lending markets.[11]

In the interim, the subprime lending field grew exponentially. In 2003, for example, subprime mortgages accounted for only 8 percent of all mortgage originations, but by 2006, subprime accounted for 28 percent of all originations.[12] As early as 2006, lenders and policymakers knew that borrowers who received subprime loans were far more likely to default than borrowers with identical financial characteristics who received prime loans. In fact, according to the Center for Responsible Lending's research, as many as one in eight subprime loans made between 1998 and 2004 ended in foreclosure within just five years.[13]

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[11] For a detailed account of the Federal Reserve's actions regarding HOEPA, see the testimony of James H. Carr before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Domestic Monetary Policy and Technology presented at the hearing titled Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve. July 16, 2009. Accessible online at: http://www.house.gov/apps/list/hearing/financialsvcs_dem/carr_testimony.pdf.

[12] "A Snapshot of the Subprime Market." Center for Responsible Lending. November 28, 2007. Accessed online at: http://www.responsiblelending.org/mortgage-lending/tools-resources/snapshot-of-the-subprime-market.pdf.

[13] Schloemer, Ellen, Wei Li, Keith Ernst, and Kathleen Keest. "Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners." Center for Responsible Lending. December 2006. Accessed online at: http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf.

As far back as 1999, the State of North Carolina enacted a comprehensive, statewide anti-predatory lending law. Many states and localities followed in North Carolina's footsteps. But rather than support state actions to purge irresponsible lending from the markets, federal regulatory agencies, principally the OCC, aggressively set aside or preempted state laws to prevent states from protecting their own residents.

The danger to consumers was apparent and yet regulatory agencies, including the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), did not act. By now the regulatory race to the bottom – the competition between regulators to offer the least consumer protection oversight to the institutions they were responsible for supervising – has been well documented.[14] Prudential regulators, who treated consumer protection as a secondary or even tertiary responsibility, did not provide strict supervision. The consolidation of consumer protection responsibilities under the jurisdiction of a single Consumer Financial Protection Agency would have avoided this problem.

The CFPA, had it existed, would have had jurisdiction over the independent mortgage lending companies. These lenders accounted for as much as 70 percent of the market at the height of the housing boom and were virtually unsupervised.[15] Merely extending the regulatory framework that existed to cover this segment of the market would have helped rein in some of the most egregious lending practices, such as subprime, pay option adjustable rate mortgages (ARMs), and interest-only mortgages. Furthermore, the CFPA would have had more incentive than the prudential regulators to actively enforce laws already on the books, such as requirements related to the Community Reinvestment Act (CRA) and the Real Estate Settlement Procedures Act (RESPA).

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[14] Carr, James H. "Testimony on Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve." Presented to the U.S. House of Representatives Committee on Financial Services, Subcommittee on Domestic Monetary Policy and Technology. July 16, 2009. See also: Plunkett, Travis and Ed Mierzwinksi. "Testimony on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation." Presented to the U.S. House of Representatives Committee on Financial Services. June 24, 2009. Accessed online at: http://www.house.gov/apps/list/hearing/financialsvcs_dem/plunkett_-_submitted_with__mierzwinski.pdf.

[15] Trehan, Veena. "The Mortgage Market: What Happened?" *National Public Radio*. April 27, 2007. Accessed online at: http://www.npr.org/templates/story/story.php?storyId=9855669.

One of the major challenges that consumers face in applying for a mortgage is their lack of knowledge about financing home purchases relative to the expertise of industry professionals. To that end, numerous laws have attempted to provide consumers with the information they need to make informed decisions that are in their best interests (including RESPA, HOEPA, Truth in Lending Act, and others). Unfortunately, as anyone with a credit card knows, mandatory disclosures are written in language that is nearly impossible to understand. To address this challenge, consumer advocates recommend a "reasonableness standard" be implemented, requiring lenders to provide mandatory disclosures that communicate the terms and conditions of a loan in language that a person can be reasonably be expected to understand.

If the CFPA had been created ten years ago, it would likely have applied such a reasonableness standard to mortgage products to ensure that borrowers were fully aware of the presence and effects of features such as the expiration of low introductory rates and the due dates of balloon payments. Regulations such as a reasonableness standard are not intended to prevent consumers from exercising their own judgment about their interests or stopping consumers from making poor choices, but enabling them to successfully evaluate their options. In other words, a reasonableness standard would not prohibit a lender from offering option ARMs, but it might make some consumers less interested in choosing option ARMs if they qualified for less expensive loans.

The CFPA would also likely have issued guidelines related to "plain vanilla" products. Many consumer advocates support requiring lenders to offer a "plain vanilla," or standard, product alongside whatever exotic alternatives they preferred to pitch to borrowers. The CFPA might have implemented a requirement or provided lenders with boilerplate contract language on a 30 year fixed-rate mortgage and encouraged lenders to use it.

It is well documented that vast numbers of borrowers signed up for high cost loans even though they were qualified for a less expensive 30 year fixed-rate mortgage. In 2006, for example, more than 60 percent of subprime borrowers were qualified to receive a less expensive loan.[16] How

[16] "Snapshot of a Foreclosure Crisis: 15 Fast Facts." Center for Responsible Lending. August 2009. Accessed online at: http://www.responsiblelending.org/mortgage-lending/research-analysis/snapshot-of-foreclosure-crisis.pdf.

many of them knew that they were eligible to receive a less expensive loan? How many would have chosen subprime loans if they had been presented with a choice between subprime and a "plain vanilla" standard product?

The reasonableness standard and "plain vanilla" requirement seem to be matters of common sense, but they have met with fierce opposition from banking lobbyists. In fact, although the President's proposal included both, the House bill passed with an amendment that prohibits CFPA from promulgating any rules related to "plain vanilla" standard products and does not include the reasonableness standard. The manager's draft of the legislation that was introduced in the Senate does not include a reasonableness standard but has a similar provision. The Senate bill requires that mandatory disclosures associated with loan products be communicated clearly and concisely.

Predatory Consumer Credit and Small Business Lending

A major contributing factor to the proliferation of predatory lending over the past decade was the general trend of financial sector deregulation, beginning with the repeal of the New Deal-era Glass Steagall Act in 1999. As oversight and enforcement were relaxed throughout the 2000s, a number of practices emerged that undermined consumer wellbeing. Unfortunately, banking regulatory agencies did little to stop these abusive actions.

The CFPA, with a clear mandate to protect consumers within the financial markets, would likely have responded to issues such as the invention of "fee harvester" credit cards, deceptive interest rate practices, illegal payday lending schemes, kickbacks and markups in automobile lending, and disparate lending outcomes for minority homebuyers and minority-owned businesses.

Of course, it is impossible to know exactly what a CFPA would have done if it had existed during the past decade. However, it is likely that a consumer-focused regulatory agency would have had a significant impact on predatory lending. Indeed, as Travis Plunkett of the Consumer Federation of America put it in testimony before the House Financial Services Committee earlier

this year, "had regulators acted to rein in predatory and unsound mortgage lending when problems first began to emerge, the worst of the current crisis could likely have been avoided."[17]

The lesson that should be drawn from this counterfactual analysis of what a CFPA might have done is that existing regulators have held the mistaken belief that the same products that are harmful to consumers could nevertheless be safe and sound lending for the financial institution that offered them. In hindsight, the predatory and reckless lending that characterized the credit markets over the past decade was profitable and safe and sound only in the short term; their negative effects on consumers ultimately contributed to the vulnerability of the entire financial system. As financial regulatory reform proceeds it is essential to craft a regime that aligns prudential regulation, systemic risk, and consumer protections.

Enacting CFPA in 2009: What the New Agency Needs to be Effective

As interesting as it is to question what might have been different if a CFPA had been created a decade ago, the reality is that the crisis *did* happen and two years after the start of the Great Recession, there is still no Consumer Financial Protection Agency.

As Congress continues crafting the legislation to establish a CFPA, it should address several key issues of structure and jurisdiction in order to enact successfully an agency that will be able to protect adequately consumers' interests within the financial sector. The CFPA must be independent, have jurisdiction over all consumer protection laws, authority over all transactions that involve the extension of credit to consumers, and be invested with sufficient power to issue rules and guidelines, supervise, examine, and bring enforcement actions against banks and other financial firms.

Independent Leadership

[17] Plunkett, Travis. "Testimony on Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals." Presented to the U.S. House of Representatives, Committee on Financial Services. July 16, 2009. Accessed online at: http://www.house.gov/apps/list/hearing/financialsvcs_dem/travis_plunkett_fsc_testimony_july_16,_2009.pdf.

The Consumer Financial Protection Agency should be an independent federal agency with an appointed Director who sets the agency's agenda and policies, with the support and guidance of a subordinate advisory board. This will allow the agency to be flexible and decisive but also encourage a variety of perspectives on consumer affairs and finance to have a role in the agency's leadership.

At present, there are four different proposals for the CFPA's board. First, President Obama's white paper on financial regulatory reform put forward a chief executive who is appointed by the President with the advice and consent of the Senate. The director would be supported by a board of directors that included three additional experts in consumer affairs and consumer financial products, as well as the head of the new national bank regulator. Under the President's plan, the CFPA's chief executive would have the ultimate authority to set policy and priorities for the agency.

The House Financial Services Committee's version of the CFPA, as described in H.R. 3126, recommends a slightly different governance structure. The HSFC legislation proposes a strong chief executive, appointed by the President, who is assisted by an oversight board. The board is made up of the seven heads of the banking regulatory agencies, plus five appointed consumer advocates. The Director would have the sole authority to proscribe rules, and issue orders, as well as appoint officers such as an inspector general and general counsel. The oversight board would be limited to an advisory capacity, offering perspectives on how proposed regulations would interact with concerns regarding systemic risk and prudential regulation.

After passing the House Financial Services Committee vote, H.R. 3126 was considered by the Committee on Energy and Commerce, which made a third recommendation regarding the CFPA's governance structure. Representative Henry Waxman, the Chairman of Energy and Commerce, favored a commission-style governance structure similar to that of the Securities and Exchange Commission or the Federal Trade Commission. That would include five members, all of whom would be appointed by the President with the advice and consent of the Senate. None of the five commissioners would be required to be representatives of regulatory agencies or consumer finance experts.

Finally, Senator Chris Dodd, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, introduced CFPA legislation that included a five member Board of Directors that would operate by majority rule and wield strong authority. It would be headed by a Director, but this officer would be constrained in setting policy by the need to develop consensus within the board. The only automatic seat on the board would go to the head of the proposed Financial Institutions Regulatory Authority, with the four remaining seats appointed by the President, subject to Senate approval. The Director would have sole authority over personnel hiring, distribution of responsibility across administrative units of the agency, and the distribution and use of agency funds. All other decisions, including setting rules and regulations, would be made through majority vote of the Board of Directors.

Of these various proposed governance structures, the House Financial Services Committee's comes closest to the best possible outcome, with one important caveat. It is important that the board of directors be composed primarily of consumer representatives rather than regulators. Given that the agency's mission is exclusively focused on safeguarding consumers' interests, consumer advocates must be its primary leaders. Including too many prudential regulators on the Board of Directors will diminish the agency's ability to fairly and fully represent consumer interests.

Another strength of the HFSC's proposed governance structure is the powerful agency director. A chief executive will be better able to provide the responsive, flexible, and independent leadership that the CFPA will need in order to successfully react to emerging practices in the financial markets. On the other hand, given staggered appointment schedules and occasional vacancies, commission-style federal agencies all too often find themselves in deadlock, unable to reach internal consensus.

Robust, Independent Funding

It is imperative that the CFPA avoid regulatory capture by the firms it oversees. This requires that the agency have a funding stream that is not completely dependent upon fees from these firms.

Dependence on fees from firms has been a serious weakness for the Office of Thrift Supervision and the Office of the Comptroller of the Currency. At OCC, for instance, more than 95 percent of the office's budget comes from fees paid by the banks it supervises.[18] The threat that firms could "charter shop" to choose their regulator contributed to the regulatory race to the bottom by adding an additional factor to the environment favoring light oversight. The need for banking agencies to protect their funding encouraged the regulatory arbitrage that was ultimately detrimental to the health of the financial system as a whole.[19]

NCRC concurs with Consumer Federation of America's recommendation that the CFPA should have stable funding "that is sufficient to support robust enforcement and is not subject to political manipulation by regulated entities."[20] CFA advocates a funding stream supported by a variety of sources, whereby fees paid by regulated firms and priced services such as compliance exams comprise the CFPA's baseline budget and Congressional appropriations are used as supplemental funding; CFA also recommends ensuring stable funding in times when fees decline due to decreased economic activity.[21]

Although the Administration's financial regulatory reform proposal was not explicit on the matter of funding the CFPA, the legislation from both the House of Representatives and the Senate applies exactly the type of blended funding—mixing Congressional appropriations, fees

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[18] Wilmarth, Arthur. "Testimony on Credit Card Practices: Current Consumer and Regulatory Issues." Presented to the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit. April 26, 2009. Accessed online at: http://financialservices.house.gov/hearing110/htwilmarth042607.pdf.

[19] For a more detailed history of charter shopping and regulatory arbitrage, please see: Carr, James H. "Testimony on Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve." Presented to the U.S. House of Representatives Committee on Financial Services, Subcommittee on Domestic Monetary Policy and Technology. July 16, 2009.

[20] Plunkett, Travis and Ed Mierzwinksi. "Testimony on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation." Presented to the U.S. House of Representatives Committee on Financial Services. June 24, 2009.

[21] Ibid.

assessments, and diverting funds from the consumer protection operations at other regulatory agencies—that would provide stability.[22]

Jurisdiction

The CFPA's jurisdiction should include all of the nearly twenty consumer protection laws that are currently enforced by a patchwork of regulatory agencies. These include the Equal Credit Opportunity Act; the Fair Credit Reporting Act; Home Mortgage Disclosure Act; the Right to Financial Privacy Act; the Truth in Savings Act; the Truth in Lending Act; and the Community Reinvestment Act, among others.

The Community Reinvestment Act

The Community Reinvestment Act has been the subject of some debate, because it is the only consumer protection law that relates to communities rather than solely individuals. President Obama's proposal transferred CRA authority from multiple current agencies to the new CFPA, and Senator Dodd proposes to do the same. The House bill, however, does not include CRA in the laws transferred to the jurisdiction of the CFPA. This omission is a mistake.

The principal argument against transferring CRA enforcement to the proposed CFPA is that the new agency should address the targeting and sales of financial products to individuals only. It is argued that expansion of its mission to incorporate financial services at the community level would overwhelm the agency and undermine its effectiveness. This argument ignores the fact that financial services providers have historically and routinely offered products at a community level. Many firms use race as a proxy for financial vulnerability to concentrate their use of high-cost, deceptive and predatory financial products. The excessive concentration of subprime loans in African-American and Latino communities is one example of this phenomenon.

[22] Section 118 of H.R. 3126 and Section 115 of Senator Dodd's Discussion Draft on Comprehensive Financial Reform.

Moreover, geographically targeted predatory lending practices are not limited to the housing market. Payday lenders, check cashers, rent-to-own establishments, title lenders and other alternative financial services institutions also concentrate in communities of color. Until hyper-segregation of communities of color is no longer a common feature of the American residential landscape, lending discrimination by geography will continue. CRA is the single most powerful tool to purge predatory financial practices at a community level.

America has a long history of redlining, or the complete and deliberate failure to meet the legitimate financial services needs of all communities. The absence of competition for mainstream financial services creates the vacuum in which subprime mortgage, payday and other high cost lenders establish themselves. CRA is the most comprehensive law designed to ensure the extension of mainstream financial services in a safe and sound manner to all communities.

Stated otherwise, failure to include CRA enforcement in the CFPA might result in improvements in the design of consumer financial products, but that alone will not ensure that access to those products is provided by financial institutions. In that case, the agency's ability to ensure that communities of color have access to high quality, mainstream financial products and services would be greatly diminished.

Finally, similar to other consumer protection laws with similarly dismal track records for enforcement, CRA has suffered from a lack of commitment from its regulators. Leaving CRA under its current regulators will simply guarantee continued failure to protect the rights of consumers under CRA.

According to the Federal Reserve, nearly 10 million households have no relationship with a mainstream financial institution. Moreover, a recent report by the Center for Financial Services Innovation estimates that there are 40 million under-banked households in the United States.[23] In fact, an *Associated Press* analysis of Census Bureau data reveals that only about ten percent of all new full-service bank branches opened between 2003 and 2008 were located in the urban,

[23] Herrmann, Michael J. "CFSI Underbanked Consumer Study Fact Sheet." Center for Financial Services Innovation. Updated February 2009. Accessed online at: http://www.cfsinnovation.com/underbanked-study-detail.php?article_id=330525.

minority neighborhoods.[24] Yet people of color make up a disproportionate share of the unbanked and under-banked.

Despite the large numbers of under-banked households and the failure of depository institutions to address that lack of access, 97 percent of banks pass their CRA exams. Regulation of CRA under CFPA should improve the rating system for CRA so that assessments of the banking industry better reflect the reality of access to viable financial services by the American public.

Current regulations pertaining to CRA allow for loopholes, exceptions and opt-outs that enable CRA-covered banks to exempt the activities of their affiliate financial institutions on CRA exams. Loopholes and exceptions have allowed CRA-covered banks to exclude their subprime lending activities from CRA review. In a recent op-ed, Elizabeth Warren cited a Center for Public Integrity study that "found that 21 of the 25 largest subprime issuers leading up to the [foreclosure] crisis were financed by large banks."[25] Investment banks were also a major funder of irresponsible subprime loans. In addition to transferring CRA to the new CFPA, strengthening and expanding CRA is also essential. CRA should be expanded to cover non-depository institutions, particularly independent mortgage companies, non-depository lending affiliates of large banks, and investment banks, as well as traditional retail banks and credit unions.

Although the chambers of Congress currently differ on whether to transfer CRA authority to the CFPA, the conference committee process is an opportunity to ensure that the new regulatory regime is as supportive of the needs of residents of underserved communities as it is of the interests of individual consumers in general.

Office of Fair Lending

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[24] Frank and Linda Stuart Ball. "Banks Added 10,000 Branches During Boom but Left Inner Cities Behind." *Huffington Post*. August 17, 2009. Accessed on September 4, 2009 at http://www.huffingtonpost.com/2009/08/17/banks-added-10000-branche_n_261267.html.

[25] Warren, Elizabeth. "Real Change: Turning Up the Heat on Non-Bank Lenders." *Huffington Post*. September 4, 2009. Accessed online at http://www.huffingtonpost.com/elizabeth-warren/real-change-turning-up-th_b_276887.html.

In recognition of the lending disparities that persist in the mortgage market, consumer credit market, and other lending markets, the CFPA must not only have jurisdiction over CRA, but also have an Office of Fair Lending. This office would ensure that lenders do not behave in ways that perpetuate discrimination, and would liaise with the offices of fair lending and office of civil rights in other federal agencies, including the prudential regulators and the Department of Housing and Urban Development.

Both the House and Senate versions of the CFPA legislation include an Office of Fair Lending or a similarly titled entity with a specific focus on civil rights. The legislation is ambiguous, however, as to the exact responsibilities and activities of the office. Americans for Financial Reform has conducted a detailed analysis of the President's proposal on financial regulatory reform and described ways to bolster civil rights protection. Among its recommendations is that the other regulators should refer all potential fair lending violations directly to the CFPA's Office of Fair Lending, which should coordinate investigations with the Department of Justice and, as appropriate, HUD.[26]

Close Loopholes, Deny Exemptions

Another concern is the number of exemptions and loopholes that have already begun to make their way into the legislation to create the Consumer Financial Protection Agency. Despite the strong discussion draft introduced to the House Financial Services Committee, industry groups and lobbyists successfully convinced members of the Committee to introduce and support amendments during markup that would leave large swaths of the consumer credit landscape unsupervised by federal regulators. The Senate Committee on Banking, Housing, and Urban Affairs has yet to complete markup of Senator Dodd's draft, which means that it is still possible to enact strong legislation whose integrity is not undermined by unwise or otherwise unnecessary exemptions and concessions.

[26] "Civil Rights Policy Paper Comparison Matrix." Americans for Financial Reform. October 2009. Accessed online at: http://ourfinancialsecurity.org/wp-content/uploads/2009/10/civilrights-comparison.pdf.

The HSFC bill exempts from oversight and examination all banks with assets of less than $10 billion and credit unions with less than $2 billion—in other words, 8,000 of the nation's roughly 8,200 depository institutions (98%). By requiring regular examinations of only the largest financial institutions, the bill fails to ensure adequate protection for working families that bank with small and midsize financial firms.

It is understandable to want to spare small and regional banks from potentially costly routine examinations, as they were not as responsible for the bulk of the reckless lending that created the crisis. The fact that they were not the worst predatory lenders, however, does not mean that smaller banks do not participate in their fair share of abuse. In October 2009, for example, the Department of Justice settled a discrimination case that it had brought against First United Security Bank ($658 million in assets, 19 branches throughout Alabama).

The DOJ case was based on a 2005 referral from the FDIC, which determined that First United Security Bank was in violation of the Community Reinvestment Act, the Equal Credit Opportunity Act, and the Fair Housing Act. First United Security Bank's discretionary loan pricing policies charged African American borrowers more than white borrowers. The price difference was an average of 0.62%. First United Security Bank also practiced redlining by locating its branches only in majority-white neighborhoods and restricting lending for businesses and homes located in majority-minority communities.[27] This case was settled out of court but the full terms have not been made public.[28]

Small and regional banks also engage in predatory lending outside of the mortgage market. Consumer Federation of America documents the facts in a memo titled, "Abusive Lending Practices by Smaller Banks and Thrifts."[29] According to CFA, 75 percent of state-chartered banks automatically enroll customers in overdraft "courtesy loan" programs, and some banks do

[27] See text of DOJ complaint at http://www.usdoj.gov/crt/housing/documents/fusbcomp.pdf.
[28] "United Security Bancshares, Inc. Announces Settlement Agreement with Department of Justice." *Urban Mecca*. October 8, 2009. Accessed online at: http://urbanmecca.net/news/?p=9202.
[29] Consumer Federation of America. "Abusive Lending Practices by Smaller Banks and Thrifts." July 21, 2009. Accessed online at: http://consumerfed.org/elements/www.consumerfed.org/File/Small_Banks_Abusive_Lending_Practices_Fact_Sheet.pdf.

not allow customers to opt out. The median fee for an overdraft loan from these small banks was $27, which exceeds the average debit card transaction amount of $20.

Small banks also charge more than large banks for high-cost refund anticipation loans (RALs). RALs are marketed primarily in low-income and minority neighborhoods and provide cash advances on anticipated income tax refunds and Earned Income Tax Credit payments. The average APR for a $3,000 refund anticipation loan from a small bank in 2008 was 134%-187%.[30]

Moreover, small banks are the leading issuers of "fee harvester" credit cards. These are low limit credit cards marketed to consumers with poor credit. They come "loaded with high fees that use up most of the card's capacity, leaving consumers with minimal credit at an exorbitant price."[31] CFA documents the total fees on two such cards, including a $300 limit card issued by Continental Finance that started with a $99 initiation fee; $89 participation fee; $49 annual fee; and $10 monthly maintenance fee. The first day a consumer received this $300 limit credit card, she had only $53 in available credit.

Rather than exempting smaller banks from routine oversight and examination altogether, the better solution would be to institute a lighter oversight and examination burden for small banks that have proven to be consumer friendly, and reserve rigorous supervision for those whose actions necessitate greater regulatory involvement.

Another exemption with serious potential to undermine the CFPA's effectiveness has been carved out for automobile dealers. Shielding car dealers from oversight and examination by the new CFPA allow a lending market to remain unregulated despite evidence that this market is particularly discriminatory toward people of color, the elderly, and military personnel. According to Demos, a non-partisan research and advocacy organization, markups, kickbacks, and discriminatory discretionary pricing cost automobile buyers more than $20 billion per year.[32] Furthermore, dealer-originated financing accounts for almost 80% of all financing for car

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[30] Ibid.
[31] "Abusive Lending Practices by Smaller Banks and Thrifts."
[32] "Demos Calls Consumer Protection Loophole for Car Dealers "Bad Policy, Pure Politics."" Demos. November 25, 2009. Accessed online at: http://www.demos.org/press.cfm?currentarticleID=2C4C5F25-3FF4-6C82-541D966839786FC9.

purchases[33] and car dealers are the most frequently cited businesses against which complaints are filed with state and local consumer protection agencies.[34]

In fact, as recent federal discrimination cases show, auto dealers and small banks often collaborate to charge consumers more for car loans. Most dealerships that originate loans have arrangements with local and regional banks. The dealer originates the loan and then sells it to the bank on the secondary market; the difference between the interest rate charged by the dealer and the best rate customer could have received based on his credit is split between the dealership and the bank.

In 2006, the Federal Reserve Bank determined that Nara Bank ($2.1 billion in assets, 18 branches—14 in the Los Angeles area) was in violation of the Equal Credit Opportunity Act because it knowingly approved and purchased loans from two automobile dealership companies that charged Asian customers less than non-Asian customers.[35] While full terms of the settlement have not been made public, Nara Bank will make financial restitution to victims, pay fines, and change its policies.[36]

These cases and others like them illustrate several key points. First, the banks' discriminatory practices were detected through routine compliance examinations; under the House Financial Services Committee version, the new Consumer Financial Protection Agency would not have authority to conduct regular compliance exams at these banks, because they hold less than $10 billion in assets. Second, although the banks' current regulators (FDIC and Federal Reserve) have demonstrated that consumer protection is such a low priority for them that it takes years to

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[33] "Auto Race to the Bottom: Free Markets and Consumer Financial Protection in Auto Finance," Research note. Cambridge Winters Center for Financial Institutions Policy. November 16, 2009. Accessed online at: http://cambridgewinter.org/Cambridge_Winter/Welcome_files/auto%20finance%20111609.pdf.

[34] Annual Consumer Complaint Survey. Consumer Federation of America, in partnership with the National Association of Consumer Agency Administrators and the North American Consumer Protection Investors. Summary of 2009 survey accessible online at: http://consumerfed.org/elements/www.consumerfed.org/File/Consumer%20Complaint%20Survey%20Report%20PR%207-30-09.pdf.

[35] See text of DOJ complaint at http://www.usdoj.gov/crt/housing/documents/narabankcomp.pdf.

[36] "Nara Bancorp Settles Department of Justice Dispute." *Reuters*. October 1, 2009. Accessed online at: http://www.reuters.com/article/pressRelease/idUS207164+01-Oct-2009+BW20091001.

detect violations of the law and years to prepare a case, under the HFSC version of the CFPA, they would maintain the primary regulators for these banks.

Finally, automobile dealers involved in both of these cases, but the HFSC exempts auto dealers from consumer protection oversight. The exemption of 98% of banks, automobile dealers, and others from CFPA examinations and/or oversight will leave the new agency unable to fulfill its obligations to protect consumers from the unscrupulous and illegal practices that have devastated American households and the nation's economy.

Setting a Minimum Federal Standard

One of the greatest inhibiting factors to robust consumer protection throughout the past decade has been the federal policy of preempting state consumer laws that were tougher than federal standards. Starting in 1999, the OCC led the way in preempting virtually every state regulation that attempted to address predatory lending, payday lending, and consumer credit practices.

The Obama Administration's proposal and the manager's draft introduced in the Senate recognized the valuable role that state consumer protection laws can play and explicitly stated that preemption of state laws was no longer to be the automatic response of federal regulators. However, preemption is a favorite tool that powerful financial interest groups such as the American Securitization Forum and the Financial Services Roundtable have used to perpetuate predatory and abusive lending practices. These groups are fighting to maintain federal preemption of state laws as CFPA legislation moves through Congress.

According to the House version of the CFPA legislation, the OCC and the OTS will have the right to preempt state laws under certain circumstances. The Financial Services Committee passed an amendment offered by Congressmen Melvin Watt of North Carolina and Dennis Moore of Kansas that allows for preemption when a state law significantly interferes with the ability of nationally-charted banks or thrifts to engage in the business of banking. While case-by-case preemption is preferable to sweeping and automatic preemption of all state laws, OCC and OTS should not be the agencies with the authority to preempt state law. During the past fifteen

years, these agencies, particularly the OCC, engaged in large-scale preemption of state law, and did not carefully consider the ramifications of overriding state law protections against abusive lending.

The National Association of Attorneys General has documented the benefits that states bring to the consumer protection field, particularly in the areas of retail sales and insurance markets. NAAG describes the value of allowing interested states to "test drive" innovative consumer protection policies; when the federal government decides to craft new regulations, it can benefit from learning experiences at the state level and tailor its rules accordingly.[37]

In a letter sent to Senators Dodd and Shelby and Representatives Frank and Bachus, 40 of the nation's Attorneys General wrote that "states have the infrastructure and expertise to respond to and resolve consumer complaints." The signatories "[urged] members of Congress to provide states with concurrent authority to enforce federal law; and to allow states to enforce their own consumer protection laws… subject to minimum federal standards."[38]

Improved Data Collection

One bright spot to emerge from the legislative processes underway to create CFPA is that consensus has emerged that consumer protection efforts will be greatly enhanced by improved data collection. Under the President's proposal, the House's legislation, and the manager's draft introduced in the Senate, there are mandates to enhance data collection and disclosure related to deposit accounts, small business loans, and the Home Mortgage Disclosure Act (HMDA).

Banks and credit unions would be required to maintain and report data on their branches, ATMs, and other depository facilities, as well as maintain and report the census tract locations of their depository facilities. The number and dollar amount of deposit accounts for the residential and commercial customers for each deposit facility would also be collected. The place of

[37] "Attorneys General Support State Enforcement of Consumer Financial Protection Agency Rules." National Association of Attorneys General. November 4, 2009. Accessed online at: http://www.naag.org/attorneys-general-support-state-enforcement-of-consumer-financial-protection-agency-rules.php.
[38] Ibid.

residence/business of bank/credit union customers would be provided on a census tract basis, making it possible to analyze the income level and race/ethnicity characteristics of the census tracts of these customers.

Financial institutions would be required to collect and report data on the race and gender of its small business borrowers, similar to requirements under the Home Mortgage Disclosure Act (HMDA). In addition to collecting race and gender data, financial institutions would be required to collect the type and purpose of the loan for which the businesses apply, the actions taken with respect to the applications, the gross annual revenue of the small business applicants, the census tract location of the businesses, and any other information CFPA deems appropriate.

Financial institutions that would be required to collect and report these data include any partnership, company, corporation, and cooperative organization. This requirement extends beyond banks that have a current obligation to report small business loan data under CRA. CFPA does, however, reserve the right to exempt any class of financial institutions from this reporting requirement.

In addition to the demographic characteristics they already collect in HMDA data, financial institutions would be required to collect the age of the borrower. NCRC and others have documented that elderly borrowers experience lending disparities; this additional data will allow for a more systematic investigation of these disparities. Several loan terms and conditions would also be collected, including total points and fees, the difference between the annual percentage rate and a benchmark rate for all loans, prepayment penalties, the value of the real property pledged as collateral, whether the loan is a hybrid loan with a lower teaser rate, whether the loan is a negative amortization loan, whether the application was received by a broker or other retail channel, and the credit score of the borrower.

Conclusion

Instituting an effective CFPA is arguably the most important element of financial system reform, since treating consumers in a safe and sound manner will result in a more safe and sound

financial system. The three major proposals for regulatory reform now under discussion—President Obama's regulatory reform proposal, the House Financial Services Committee's legislation, and the Senate Committee on Banking, Housing and Urban Affair's bill—all recognize, to varying degrees, the necessity of such an agency. What remains to be done now is to work out the differences between the proposals and create a strong Consumer Financial Protection Agency.

If Congress takes action now to create an agency that has sufficient authority, funding, jurisdiction, and independence, it will facilitate the development of an environment that encourages innovations that benefit both firms *and* consumers.

Testimony of Robert K. Steel[1]

before the

Joint Economic Committee

Wednesday, December 2, 2009

Chair Maloney; Ranking member Brownback, members of the committee; my name is Robert Steel and I'm pleased to be here today as a member of the bipartisan Financial Reform Task Force.

The Task Force is ideologically diverse and has as its members both academic economists and financial industry practitioners.[2] This group first convened in June with the task of producing bipartisan, consensus recommendations designed to meet one overriding goal: to create a financial system that allows the U.S. economy to grow without the kinds of risk we have recently witnessed and unfortunately experienced. I am pleased to discuss here today, along with my Task Force colleague Robert Litan, our five core principles and the specific recommendations needed to achieve them.[3]

The Task Force developed consensus on most aspects of financial regulation, though some members would have preferred somewhat different approaches with respect to certain individual recommendations. Those who signed the report believe strongly that this entire package would, if adopted, represent a substantial step toward creating the fair, competitive and stable financial system that is a prerequisite for a return to robust economic growth.

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[1] Robert K. Steel is the former CEO of Wachovia, former Under Secretary for Domestic Finance of the United States Treasury and CEO of Grigg Street Capital.

[2] In addition to myself, Task Force signatories include: Martin Baily, Task Force Co-Chair, Senior Fellow, Economic Studies, Brookings Institution; Peter Wallison, Task Force Co-Chair, Senior Fellow at the American Enterprise Institute; Charles Calomiris, Professor of Finance at Columbia University; Morris Goldstein, Senior Fellow at the Peterson Institute for International Economics; Richard Herring, Professor of International Banking at the Wharton Business School; Robert E. Litan, Senior Fellow in Economic Studies, Brookings Institution and Vice President, Research and Policy, Kauffman Foundation; Paul G. Mahoney, Dean of the Law School at University of Virginia; Avinash Persaud, Chairman of Intelligence Capital Limited; Alice Rivlin, Senior Fellow at the Brookings Institution and Visiting Professor at Georgetown University, and; Benn Steil, Senior Fellow and Director of International Economics, Council on Foreign Relations.

[3] The Financial Reform Task Force received supported from The Pew Charitable Trusts. The Task Force recommendations reflect the views of the signatories. The Pew Charitable Trusts takes no position on any of these recommendations.

The Task Force recommendations reflect many of the changes under debate in the House Financial Services Committee and the Senate Banking Committee. Further, they share much in common with the recommendations advanced by Secretary Paulson in June 2007 in the *Blueprint for a Modernized Financial Regulatory Structure*; a report I am proud to have worked on while serving at the Treasury as Under Secretary for Domestic Finance.

The five Principles are:

1. The U.S. must have an early warning system that prevents inappropriate and dangerous financial practices from harming the economy.

2. No financial institution should be too big or complex to fail.

3. A single regulator that's strong and smart should replace the current alphabet soup of agencies.

4. Derivatives markets and market discipline broadly must be strengthened.

5. Consumers need better protection from financial abuses.

I would like to highlight a single, crucial recommendation. What has become known as the Too Big to Fail problem is in many ways at the heart of the financial reform effort. There are different ways to approach this problem. Congress could arbitrarily limit the size of financial institutions; they could limit the scope of their activities; or they could work to ensure that any failure is less likely to cause a financial crisis. We favor the latter. It is a strength of the American system that the opportunity to succeed carries with it the prospect of failure. To my mind, this system provides the best possible opportunity for shared prosperity.

As a result, our Task Force recommends that all financial institutions should be free to fail, but free to fail in manner that will not destabilize the financial system. The Task Force, therefore, recommends three specific things with regard to this issue:

1. A sliding capital scale, so that the larger, more complex, more risky and more systemically important an institution, the higher the standards for capital, liquidity and leverage to which it should be held;
2. Institutions above a certain size should submit for approval a "funeral plan" or "living will" that describes in detail how the firm, were it to fail, could be wound-down, with reduced impact on the overall economy;
3. A new solution should be adopted for failed or failing non-depository financial institutions. While the FDIC should continue to resolve failed or failing banks, we recommend that for non-depository financial institutions there be a strengthened bankruptcy process as the presumptive approach. In exceptional circumstances, only after strong safeguards have been met, there should be an administrative resolution process as an option of last resort.

This proposed two-stage approach to winding down non-bank financial institutions brings together two desirable policy objectives. It maintains the market discipline of the bankruptcy process while, at the same time, providing the government with a new tool to protect the financial system in times of unusual stress. In all cases, moral hazard is reduced, as shareholders, unsecured creditors and senior management will bear the burden of the failure.

To create this two-step process, Congress should first amend the bankruptcy code as necessary to make bankruptcy the presumptive process for managing all failing non-depository financial institutions. In addition, Congress should create a new Federal Financial Institutions Bankruptcy Court (FFIBC) and grant it sole jurisdiction in the United States for these cases.

In those exceptional circumstances when a bankruptcy would pose unacceptable systemic risks, a new administrative process should be created for failing non-depository financial institutions. This process should be used only after strong safeguards have been satisfied.

Congress should decide exactly how strong the safeguards are and what form they should take. For example, Congress could require consultation and formal agreement between Treasury and the concerned federal financial regulatory agencies before the resolution mechanism is activated. Congress could instead opt for a stronger safeguard. This is up to Congress.

There are several methods by which Congress could insert a higher hurdle. Let me outline one that our Task Force considered. If a failing non-depository institution were judged to be a threat to the stability of the financial system, the Administration could seek a Congressional appropriation. While the Administration seeks the appropriation, the firm in question would enter the bankruptcy process in the proposed special-purpose bankruptcy court. Congress would then have a limited and fixed number of days in which to make such an appropriation. A customary stay would apply, and the Fed could provide financing and collateral, permitting the firm to continue to operate while Congress deliberated. If Congress did appropriate, the estate of the firm could be transferred to the administrative procedure. If it did not, the bankruptcy would proceed and the Fed would exercise its collateral once circumstances permitted. As is known, despite being officially "well capitalized" by conventional measures, many large complex financial institutions in the United States were weak going into the crisis: risk management had become ineffective, complexity had become well nigh unmanageable, leverage had become excessive, and liquidity and high quality capital were in short and uncertain supply. When the crisis hit, the federal authorities were ill-equipped to deal with their serial collapse. Confusion over which institutions would be allowed to fail without intervention, and what the consequences of disorderly failure might be simultaneously heightened moral hazard, the scale of the market disruption and the costs to the taxpayer.

While the two stage resolution process is a novel solution I would like to reiterate that many of the other specific Task Force recommendations in support of the Principles mirror many of those under debate in the House Financial Services Committee and the Senate Banking Committee. We commend the hard work already done by the members in both houses of Congress to move this crucial effort forward. The Task Force hopes that our efforts will both complement the current work being done on these issues, as well as to provide additional momentum to the overall financial reform effort. While there are unmistakable signs our economy has stabilized, it is imperative that Congress act with urgency to enact comprehensive and effective reform.

We look forward to your questions about the Task Force and our Principles.

Thank You

December 10, 2009

Dr. Robert Litan
Member, Financial Regulatory Reform Task Force
Vice President of Research & Policy
Ewing Marion Kauffman Foundation
Senior Fellow, Economic Studies
Brookings Institution
Washington DC

Dear Dr. Litan:

At the December 2, 2009 hearing of the Joint Economic Committee entitled **"Unregulated Markets: How Regulatory Reform Will Shine a Light in the Financial Sector,"** I asked if you could respond in writing to a question regarding global competiveness and size of financial institutions. I am specifically interested in the impact on the global economy and the U.S. financial sector if too-big-to-fail institutions become the norm in other countries. Additionally, any evidence, either supporting or failing to support the notion that size is important for global competitiveness, would be of interest.

Please e-mail a copy of your written response to this question. The material you provide will be entered into the record in its entirety.

The Committee's contact is Gail Cohen, Acting Executive Director, who can be reached at gail_cohen@jec.senate.gov or (202) 228-0717. I look forward to your response.

Sincerely,

Carolyn B. Maloney

Carolyn B. Maloney
Chair

December 10, 2009

The Honorable Robert Steel
Former Undersecretary of the Treasury for Domestic Finance, 2006-2008
Chairman of the Board, The Aspen Institute
Member, Financial Regulatory Reform Task Force
Washington DC

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Sincerely,

Carolyn B. Maloney

Carolyn B. Maloney
Chair

AMY KLOBUCHAR
MINNESOTA

COMMITTEES:
AGRICULTURE, NUTRITION, AND FORESTRY
COMMERCE, SCIENCE, AND TRANSPORTATION
ENVIRONMENT AND PUBLIC WORKS
JOINT ECONOMIC COMMITTEE
JUDICIARY

Amy Klobuchar

United States Senate
WASHINGTON, DC 20510

Joint Economic Committee
"Unregulated Markets: How Regulatory Reform Will Shine a Light in the Financial Sector"
Questions for the Record
Senator Amy Klobuchar
December 2, 2009

Questions for The Honorable Brooksley Born, former chair of the Commodity Futures Trading Commission

1. In your testimony, you recommend that all standardized derivatives should be traded on an exchange and that "large corporations will benefit from the price discovery, transparency, and regulatory oversight of exchange trading, which generally should lead to lower prices for trades." Is there any way to estimate how much trade prices may drop?

2. You also note that "creditworthy corporations should be able to obtain lines of credit as needed to meet their margin requirements for exchange trading."

   a. How would this work in practice?

   b. How much more would this cost a corporation at the end of the day?

   c. How does obtaining a line of credit to meet margin requirements lead to greater systemic stability?

Questions for Dr. Robert Litan, Vice President of Research and Policy at the Ewing Marion Kauffman Foundation, a Senior Fellow in Economic Studies at the Brookings Institution, and a member of the Pew Task Force on Financial Reform.

1. In your testimony, you note that compensation should "provide incentives for constructive behavior, not imprudent risk taking" and that "very long term restricted stock" should be used. Could you describe in further detail what this long term restricted stock would look like and how this provides the proper incentives?

Questions for Mr. James A. Carr, Chief Operating Officer for the National Community Reinvestment Coalition.

1. In 1994, Congress passed the Homeownership and Equity Protection Act (HOEPA) in order to address predatory practices related to high-cost, subprime mortgages. Where did this legislation fail? In light of this and other lessons that should be learned, what should be done now to effectively address predatory lending?

Questions for Mr. Robert K. Steel, former Under Secretary for Domestic Finance at the U.S. Department of the Treasury.

1. It's now been one year since our nation's financial system came close to total collapse, with huge, long-established financial institutions toppling left and right, including Lehman Brothers, Merrill Lynch and Bear Stearns. I appreciate and agree with the need to implement comprehensive financial regulatory reform, and we are doing our best to move this comprehensive package through both chambers. However, if you had to pick just one or two aspects of financial regulatory reform to focus on, what should those be?

BROOKSLEY BORN

555 TWELFTH STREET, NW
WASHINGTON, DC 20004-1206

January 27, 2010

The Honorable Amy Klobuchar
Attn: Paul Zygmunt
Senator Amy Klobuchar's Office
302 Hart Senate Office Building
Washington, DC 20510

Dear Senator Klobuchar:

Attached are responses to questions you posed to me concerning the Joint Economic Committee's December 2, 2009 hearings.

Sincerely yours,

Brooksley Born

Brooksley Born

Enclosure

cc: The Honorable Carolyn Maloney
Chair, Joint Economic Committee
Attn: Andrew Wilson
G-01 Dirksen Senate Office Building
Washington, DC 20510

Joint Economic Committee
"Unregulated Markets: How Regulatory Reform Will Shine a Light in the Financial Sector"
Questions for the Record
Senator Amy Klobuchar
December 2, 2009

Questions for The Honorable Brooksley Born, former chair of the Commodity Futures Trading Commission

1. In your testimony, you recommend that all standardized derivatives should be traded on an exchange and that "large corporations will benefit from the price discovery, transparency, and regulatory oversight of exchange trading, which generally should lead to lower prices for trades." Is there any way to estimate how much trade prices may drop?

   Response:

   One way to estimate the drop would be to make a comparison between the fees charged for an exchange traded derivatives contract, such as, for example, a foreign currency futures contract or a natural gas futures contract, and the bid-and-offer spreads and fees obtained by the over-the-counter derivatives dealers for a similar standardized over-the-counter derivatives contract, such as a comparable foreign currency swap or a comparable natural gas swap. I do not have that data, but the data could be obtained from futures exchanges, futures commission merchants and over-the-counter derivatives dealers.

2. You also note that "creditworthy corporations should be able to obtain lines of credit as needed to meet their margin requirements for exchange trading."

   a. How would this work in practice?

   Response:

   A creditworthy corporation would enter into a line of credit with its bank and would draw down on that line of credit the amount needed whenever it received a margin call.

b. How much more would this cost a corporation at the end of the day?

Response:

Using a line of credit for margin calls on exchange traded contracts might very well cost the corporation less than the cost of comparable over-the-counter derivatives with embedded extensions of credit from the over-the-counter derivatives dealer.

c. How does obtaining a line of credit to meet margin requirements lead to greater systemic stability?

Response:

The systemic risk of over-the-counter derivatives trading would be greatly reduced by bringing the trading of standardized contracts onto a regulated exchange. The exchange trading and clearing operations would reduce systemic risk in the following ways. Exchange trading would result in accurate and efficient pricing of the contracts, market transparency, and effective government regulation of trading and intermediaries. The clearing house would mark the contracts to market at least daily and make a margin call if the price of the contracts had moved against the corporation. The corporation would be required to post that margin in cash or cash equivalents with the clearing house promptly and would draw down on its line of credit as needed to do so. If the price moved in favor of the corporation, the corporation would receive payments from the clearing house that it could use to reduce the amount owed on its line of credit. The corporation's bank would be responsible for assuring that the corporation was creditworthy and able to repay the loan. Making prudent loans, including lines of credit, to creditworthy customers is a significant part of a bank's business, and the banking supervisors oversee such lending to ensure the safety and soundness of the bank.

Ewing Marion
KAUFFMAN
Foundation

January 22, 2010

Senator Amy Klobuchar
United States Senate
Washington, D.C. 20510

Re: Response to Your Question on My JEC Testimony of December 2, 2009

Dear Senator Klobuchar:

Thank you for your question relating to my testimony before the Joint Economic Committee on December 2, 2009. Specifically, you asked if I would describe in further detail, my recommendation on the long-term restricted stock for financial executives, and how it would provide proper incentives for these individuals and their companies to avoid imprudent risk-taking.

On the design of restricted stock, I take no specific position, nor do I believe that the government should be heavily prescriptive here either. As you know, the Federal Reserve has announced that it will review the structure (not the amount) of compensation arrangements at the institutions it oversees to ensure that these arrangements do not encourage excessive risk-taking (for example, by rewarding only short-term performance, loan origination, etc.). However, I don't think the Fed is preparing to require a one-size-fits-all compensation structure. Rather, I think, appropriately, the Fed is going to review institutions on a case-by-case basis. If Congress ever were to legislate in this area, and require the Fed or other financial regulators (including a possible new combined regulator) to review compensation structures at financial institutions, I would suggest that such legislation leave discretion to the regulators to make these decisions case-by-case too.

The fundamental principle, however, is that a significant portion of the compensation of senior executives and others in the organization with the ability to take risks (such as traders, loan originators) be tied to the longer-term performance of their own activities, as well as to the performance of the entire company. Restricted stock – stock that cannot be sold for some significant period, such as five years or more (unless the individual leaves the company) – is one good way of accomplishing the latter objective (tying compensation to company-wide performance).

The rationale for this is straightforward. One lesson from the financial crisis is that too many individuals in financial institutions – not necessarily the CEO and

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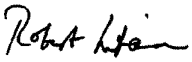
leading executives – but loan originators and those involved in loan securitizations in particular, were rewarded on volume, irrespective of how those mortgages or securities turned out. If pay were more aligned with the longer-term performance of such instruments, there would be much less incentive to take such imprudent risks in the future.

I hope these answers are helpful. Please feel free to contact me at 816-932-1179 or by email at rlitan@kauffman.org if you would like to discuss further.

Sincerely,



Robert E., Litan
Vice President, Research & Policy

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