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EXAMINATION OF THE FEDERAL FINANCIAL REGULATORY SYSTEM AND OPPORTUNITIES FOR REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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EXAMINATION OF THE FEDERAL FINANCIAL REGULATORY SYSTEM AND OPPORTUNITIES FOR REFORM

Thursday, April 6, 2017

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:15 a.m., in room 2128, Rayburn House Office Building, Hon. Blaine Luetkemeyer [chairman of the subcommittee] presiding.

Members present: Representatives Luetkemeyer, Rothfus, Royce, Lucas, Posey, Pittenger, Barr, Tipton, Williams, Trott, Loudermilk, Kustoff, Tenney; Clay, Maloney, Scott, and Green.

Chairman LUETKEMEYER. The Subcommittee on Financial Institutions and Consumer Credit will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "Examination of the Federal Financial Regulatory System and Opportunities for Reform."

Before we begin, I would like to thank the witnesses for appearing today. We appreciate your participation and look forward to a robust conversation.

We do apologize that we have votes scheduled this morning sometime between 10 and 10:30, so we will recess for a period of time. If the witnesses want to step out and get some refreshments, grab breakfast, whatever, we will be back probably shortly thereafter, but we will have to stop for a little while and go vote.

With that, I recognize myself for 5 minutes for an opening statement.

Financial companies are standing on regulatory quicksand, having to constantly shift in an effort to stay afloat. There are unending attempts to decipher a regulator's wants and needs, allowing little to no foundation on which to run a business. Ultimately, this world of ambiguous guidance, contradictory rules, and aggressive enforcement has led to confusion for financial companies seeking to comply with the Dodd-Frank Act and other Obama-era rules. But the greatest impact is on the customers of those financial companies, who in many cases have been left clamoring for access to financial services and paying more for the ones they are able to retain.

Take a look at the boxes sitting on the dais over here. These boxes represent the 20,000 to 30,000 pieces of paper that the average bank submits to the Federal Reserve for the annual CCAR review process. And, in fact, I was talking to one of the larger banks last night and I found out that tt can go up to 100,000 pages. That is 20,000 to 30,000 pages per bank per year just for CCAR.

Despite the amount of information contained in these boxes, feedback from the Federal Reserve is limited, leaving some institutions to wonder who, if anyone, actually reads the material before issuing what has been described as an arbitrary qualitative decision.

To have a picture of what overregulation looks like, allow me to provide you with a real-life example. The Mid America Bank & Trust was originally founded in 1920 and serves communities in my area of the world in central Missouri. For nearly 5 years, the Federal Reserve has blocked acquisition of the bank. Despite years of document production, there has been little communication between the Board of Governors and bank leadership, and there is no indication of when a decision might be made as to whether or not an acquisition will be approved.

Mid America Bank & Trust has already lost several interested buyers, not because of questions surrounding the business, but, instead, because of the delays from the Fed. So for 5 years, the Federal Reserve has left this bank, its customers, and the communities it serves sitting in purgatory. This is all in spite of the fact that, as I understand it, the FDIC has given the institution and its products a clean bill of health.

The Consumer Financial Protection Bureau (CFPB) hasn't exactly been a poster child for reasonable rulemaking and enforcement either. Just yesterday, members of this committee heard from Director Cordray directly. The Director continues to state that the Bureau has never and would never regulate through enforcement. But, as I pointed out to the Director several years ago, failure to issue guidance while simultaneously subjecting institutions to enforcement actions is, in fact, regulation through enforcement. Now, because of the Bureau, people need a crystal ball to run their businesses.

The CFPB rules and policies are a perfect example of, "Washington knows best." The Federal Government knows what types of financial products should be offered and to whom. Rules and enforcement actions leave little to no room for innovation, despite the fact that American consumers and small businesses continue to struggle to get the financial services they need to pursue growth and economic freedom. Once again, the consumer suffers. Eventually, one must wonder what the Federal financial agencies really want: a stable economy; or just more control.

Today's hearing will serve to examine the state of the Federal financial regulatory system and to determine what can be done to increase transparency and build a strong, steady, financial system and U.S. economy. It is long past time to take the power out of Washington and return it to the American people. It is past time to demand a reasonable regulatory structure that fosters innovation and economic opportunity while simultaneously allowing for robust consumer protection.

We have a distinguished panel with us today. We look forward to your testimony and your ideas for reform.

The Chair now recognizes the distinguished gentleman from Georgia, Mr. Scott, who is sitting in today for Ranking Member Clay. Mr. Scott is recognized for 5 minutes for an opening statement.

Mr. SCOTT. Thank you very much, Mr. Chairman. I really appreciate this.

First, I want to thank Chairman Luetkemeyer for convening this very, very important hearing. Nothing could be more important right now than making sure we have a healthy financial system, and not just to have the financial system, but the most healthy financial system in the world. And I look forward to our distinguished witnesses and their testimony.

But I don't think it would be difficult to say that any member on our committee, Democrat or Republican, would disagree that our striking the right balance between consumer protection and regulatory burden is an important priority for this committee. We should certainly and constantly reexamine whether we are achieving this goal, and hopefully we can come to some conclusions today on that in hearing from our distinguished panel.

But without any reexamination, we must always start looking at the lay of the land before us, the data we have in front of us. So why don't we take a moment to do just that.

First, we are, indeed, experiencing record month-over-month job growth. For the past 77 consecutive months, we have seen positive gains in employment, but I hasten to add, not enough gain, and in some ways we are backtracking when it comes to many of our urban centers. This is something we need to devote more attention to.

Second, small business lending is trending upward. And since the financial crisis, we have seen nearly a 75 percent jump in business lending.

And lastly, we are seeing our housing debt, an enormous part of our financial crisis, finally dipping back below the previous peak we saw in 2008. So things seem great, but we can make them better. But even with all these positive signs, we also are seeing some areas in the financial services world that still need improvement. For example, I previously expressed concerns that some regulations might hamstring the unbanked and the underbanked famililes' ability to gain access to important financial services.

Many of your committee, you have followed our progress with indirect auto lending. That is a prime example where some regulations certainly hamstring the unbanked family. We have 70 million unbanked and underbanked Americans in our financial system.

But I really want to challenge both sides of the aisle, Democrats and Republicans, and our panelists, to begin this conversation by reexamining the whole regulatory system, not just Dodd-Frank. Dodd-Frank is an important part, but we have to look at and examine all sides of our regulatory system.

I would welcome a constructive bipartisan conversation about Dodd-Frank, but let's not forget all the ways that Dodd-Frank has improved the banking system and health of our economy, and how

it helped us to come out of the worst financial depression we have had since the 1930s.

So throwing it out completely, as our distinguished Financial Services Committee Chairman, Mr. Hensarling, is proposing in his CHOICE Act, ignores these positive developments and is, therefore, a nonstarter for Democrats. But we Democrats equally look forward to working with our Republican colleagues to both strengthen our financial regulatory system while simultaneously also looking and making sure our regulations do not hamper our financial system.

So, again, I want to thank Chairman Luetkemeyer for calling this hearing, and I am looking forward to hearing what the witnesses have to say. Thank you, Mr. Chairman.

Chairman LUETKEMEYER. Thank you, Mr. Scott.

Today, we welcome the testimony of Mr. Greg Baer, president, The Clearing House Association; Mr. Norbert J. Michel, senior research fellow for financial regulations at The Heritage Foundation; Mr. Amias Moore Gerety, former Acting Assistant Secretary for Financial Institutions at the U.S. Department of the Treasury; and Mr. Bill Himpler, executive vice president of the American Financial Services Association.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

And without objection, each of your written statements will be made a part of the record.

Just a quick tutorial on the lighting system: green means go; yellow means you have 1 minute to wrap up; and red means it is time to pass on the baton.

So with that, Mr. Baer, you are recognized for 5 minutes.

STATEMENT OF GREG BAER, PRESIDENT, THE CLEARING HOUSE ASSOCIATION

Mr. BAER. Thank you, Chairman Luetkemeyer, Ranking Member Scott, and members of the subcommittee.

I am pleased to appear before the subcommittee today to discuss regulatory process. Public input and a transparent process tend to produce better regulation, but the current trend is clearly away from both. My testimony will highlight areas where the administrative process has broken down, harming the quality of regulation and the ability of banks to serve their customers.

The first area is the Federal Reserve CCAR stress test. To be clear, The Clearing House believes that stress testing is the smartest way to evaluate the resiliency of a bank, but the CCAR process contains significant procedural and substantive deficiencies.

Under CCAR, banks use models to forecast losses and revenues under a severely adverse stress. These models are reviewed and approved by the Federal Reserve and are regularly back-tested to ensure accuracy. Nonetheless, in determining the bank's stress law and, therefore, its effective capital requirement, the Federal Reserve discards these results and, instead, runs a variety of its own models. Neither the formulas for those models nor their combined results have ever been subject to notice and public comment or any type of peer review. This matters, because banks tend to shift lend-

ing away from sectors with higher implicit capital requirements under CCAR.

For example, our research shows that the Federal Reserve's model has imposed dramatically higher capital requirements on small business loans and residential mortgages. Given the stakes involved, it is remarkable how little we know not only about the contents of these models, but also about their performance. This too is a black box.

We urge that the Federal Reserve continue to engage in modeling as part of CCAR, but only as a check on the bank's own projections. If a given bank's models are deemed insufficient, the Federal Reserve's models can be offered as evidence in issuing a capital directive or an order to improve them.

Although highly unlikely, if the Federal Reserve's models ever prove more accurate over time for a given bank, they could be adopted instead. Notably, this approach would alleviate any concerns that making the Federal Reserve's models public would cause banks to cluster into assets that those models favor, causing an unhealthy concentration of risk. Once generally nonbinding, the Federal Reserve's models could benefit from peer review by the academic community in a way that bank models, which are necessarily proprietary, cannot.

A secondary is the CAMELS rating system, which was adopted in 1979 when there was no capital regulation, no liquidity regulation, and no stress testing. In other words, at a time when bank regulation was necessarily subjective. Remarkably, it has not been materially updated since. Over that time, CAMELS ratings have become progressively more arbitrary and compliance-focused, likely because capital and liquidity regulation have supplanted them as the best indicators of financial condition.

All of this is significant, because a low CAMELS rating, as I believe as the chairman alluded to, is now generally treated by regulators as a bar on bank growth. A wholesale review of the CAMELS system is required. In the interim, its ratings should be made more objective and modernized. For example, the bank that is well-capitalized under the 35-plus capital standards currently applicable to large banks should be presumed to be rated a one for capital.

Next, living wills. Title I of Dodd-Frank requires large banks to construct a prepackaged bankruptcy plan and requires regulators to review the credibility of that plan. This requirement is important and altogether appropriate. The required review, however, has been translated into a shadow regulatory regime with real economic consequences. For example, the most recent living will process has effectively ring-fenced some major bank holding company subsidiaries through capital and liquidity prepositioning. The costs of doing so are significant, but have never been debated.

Another area where process appears to have broken down is supervision of bank corporate governance. Examiner oversight is increasingly subjective and arbitrary, more akin to conservatorship than traditional examination, and in almost all cases without basis in law or regulation. In some cases, examiners attend Board of Directors or Board committee meetings, which both chills candid discussion and inevitably shifts the agenda away from corporate strategy and real economic risk and towards regulatory topics.

Even when examiners do not attend meetings, they insist on detailed minutes so as to judge the participants' performance. Examiners are dictating reporting lines within management and to the Boards of Directors as well as the proper jurisdiction of committees and their agendas.

Consequently, we now frequently hear from bank management that more than half of Board of Directors' time is devoted to regulation and compliance as opposed to innovation, strategy risk, and other crucial topics. We actually did a catalog for our members of all the requirements by regulation or guidance that are imposed on bank Boards of Directors. It runs to 144 pages.

In all these areas, more transparency and the ability of the public to evaluate the wisdom of these policies would, we believe, produce better outcomes. And I hope today's hearing marks the beginning of a change in that direction.

Thank you again for this opportunity to testify.

[The prepared statement of Mr. Baer can be found on page 44 of the appendix.]

Chairman LUETKEMEYER. We thank Mr. Baer for his testimony. Mr. Michel, you are recognized for 5 minutes.

STATEMENT OF NORBERT J. MICHEL, SENIOR RESEARCH FELLOW, FINANCIAL REGULATIONS, THE HERITAGE FOUNDATION

Mr. MICHEL. Chairman Luetkemeyer, Congressman Scott, and members of the subcommittee, thank you for the opportunity to testify today. The views that I express in this testimony are my own and they should not be construed as any official position of The Heritage Foundation.

My testimony argues that there are countless opportunities to reform the Federal financial regulatory system. It is full of counterproductive overlapping authorities and duplicative efforts. There are three main issues that I would like to address in my oral testimony.

First, the U.S. has too many financial regulators. Banks, just for instance, could be forced to comply with regulations from any combination of the following: the FDIC; the OCC; the Federal Reserve; the CFPB; the SEC; the CFTC; the FHA; and the FHFA; all on top of State regulators, just to name a few.

While there is good reason to limit consolidation so that the U.S. does not have a single super financial regulator, the system is so cumbersome that some consolidation clearly makes sense, and the trick would be to consolidate while guarding against efforts to apply bank-like regulation outside of the banking industry. A reasonable approach would be to reorganize so that the U.S. has only one banking regulator and one capital markets regulator; and the obvious place to start would be merging the CFTC and the SEC.

These agencies regulate markets that have increasingly blurred into one another over the years and that are closely tied through common participants and common purposes.

Indeed, the U.S. is unusual for having separate regulators for these markets. On the banking side, Congress could shift the Federal Reserve's regulatory and supervisory powers to either the OCC or the FDIC, and then merge those two agencies. The most impor-

tant part of that type of reorganization, I think, is to get the Fed out of the regulation business. The Fed should be conducting monetary policy, nothing else.

Regrettably, Dodd-Frank took us in the opposite direction and expanded the Fed's regulatory role, even though this move is counter to the trend found in most developed nations. More than a dozen developed countries, among them the U.K. and Sweden, have already removed regulatory functions from their own central banks.

My second point would be that the U.S. did not need and does not need the Consumer Financial Protection Bureau. The CFPB is unaccountable to the public in any meaningful way and raises serious due process and separation-of-powers concerns. But most importantly, there was no shortage of consumer protection from fraudulent companies prior to the Dodd-Frank Act.

Title X of Dodd-Frank created the CFPB, in part, by transferring enforcement authority for 22 specific consumer financial protection statutes to the new agency. These Federal statutes were administered by seven different Federal agencies and layered on top of State laws and local ordinances. So it is reasonable to say that some consolidation may have been warranted.

Regardless, for decades this framework outlawed deceptive and unfair practices in financial products and services. And, in fact, if Congress eliminated the CFPB right now, Americans would be just as protected against unfair and deceptive fraudulent practices as they are with the CFPB. Financial firms do not need another Federal supervisor, and Americans do not need protection from themselves through the ill-defined protection regime against abusive practices.

My final point is that given the political difficulty in making these types of changes, Congress should take a careful look at using the reorganization authority under 5 U.S. Code Section 901. Granting the President this authority, which has been used by Presidents in the past of both parties, is a flexible way to enable the Executive Branch to propose viable Government reorganization plans.

These plans could be narrowly targeted to improve the efficiency and effectiveness of specific areas of financial market regulation, and they can be enacted by Congress more easily than if the Legislative Branch had to develop these plans from scratch. This route seems like a particularly good idea now, because the Trump Administration has started its formal review of financial regulation, and specifically expressed a desire to improve its effectiveness and efficiency.

Thank you for your consideration, and I am happy to answer any questions that you may have.

[The prepared statement of Mr. Michel can be found on page 91 of the appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Michel, for your testimony.

Mr. Gerety, you are now recognized for 5 minutes.

STATEMENT OF AMIAS MOORE GERETY, FORMER ACTING ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS, U.S. DEPARTMENT OF THE TREASURY

Mr. GERETY. Thank you, Chairman Luetkemeyer, Ranking Member Scott, and members of the subcommittee, for the opportunity to be here today and to offer my perspective on the ongoing need for effective regulation and supervision of the financial system.

It is important to start in the fall of 2008. A financial crisis of tremendous scale and severity left millions of Americans unemployed and resulted in trillions of dollars in lost wealth. Our financial system had evolved dramatically over decades and the regulatory approach had moved in the wrong direction. For instance, derivatives were statutorily protected from oversight, and subprime lending and securitizations grew with little to no oversight.

When the crisis exposed these massive inadequacies, we were faced with the unpalatable choice of either intervening to prevent certain institutions from failing, or letting them fail, at the risk of imperiling the entire financial system and plunging the country into a second Great Depression. Americans nonetheless paid a high price and lost wealth, jobs, homes, delayed retirements, and college educations.

We all learned that in the end, our financial system only works, and our market is only free, when there are clear rules and basic safeguards that prevent abuse, check excesses, and ensure that it is more profitable to play by the rules than to game the system.

Dodd-Frank enacted a number of provisions that curb excessive risk-taking and hold financial firms accountable. However, the policymakers that drafted Dodd-Frank recognized that our financial system is dynamic and risks cannot be adequately addressed by a one-size-fits-all approach.

Today, I would like to share with the committee two key points. First, the post-crisis Wall Street reforms have strengthened our financial system and supported our economic recovery. As financial reform was being implemented, the private sector added 15 million net new jobs, and household wealth grew by $30 trillion. At the same time, real GDP growth continued steadily since Dodd-Frank passed and remained positive, even as Europe weathered a sovereign debt crisis and the U.K. suffered a double-dip recession.

Within the banking sector, recovery has been strong and widespread. The banking system is currently delivering on its promise to provide credit to the economy. In the past 2 years, community bank lending and earnings growth has outpaced the industry as a whole, with more than 10 percent income growth in 2016 and lending up nearly 9 percent year over year, both vaster than the industry.

Second, Dodd-Frank provides a clear and coherent framework to deliver regulation that is appropriate to the risk of individual institutions and the system as a whole. Dodd-Frank uses clear exemptions, statutory requirements for tailoring, and market-based rules to help ensure that regulators are focused on a tiered and tailored approach. Regulators have responded to the statutory direction and used their discretion to consistently respond to legitimate concerns about regulatory burden and to create a tiered and tailored regime.

Let us start with a simple but central point. A $200 billion bank is not the same as a $2 trillion bank, nor is it the same as a $20 billion bank, a $2 billion bank, or a $200 million bank. The U.S. banking system is far less concentrated than our peer developed nations, and this diversity is a strength.

In order to deliver a regulatory system that is appropriate to the risk, we must be clear-eyed about the risks we face. This means acknowledging that tough standards must apply to the largest, most complex institutions, and that we must have the tools to handle their failure. It is only by having a clear plan and clear legal authority that we can avoid the awful choices that we faced in the fall of 2008 between the panic-inducing failure of Lehman Brothers and the bailout of AIG. Removing the authority to liquidate large, complex financial institutions the way we have done for banks of all sizes would be a return to the policy of too-big-to-fail.

In closing, it is important to note that the goal of bank regulators must not be to satisfy the banking industry, but, rather, to satisfy the public interest. For that reason, the best test of how regulators are progressing through their work is whether financial markets are stable, loans are extended on clear and fair terms, and agencies demonstrate consistent openness to new approaches and an ability to flexibly apply their rules over time.

Thank you, members of the subcommittee, and I look forward to observing my perspective in today's hearing.

[The prepared statement of Mr. Gerety can be found on page 66 of the appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Gerety, for your testimony.

Mr. Himpler, you have a very high bar to—every one of the previous folks who have testified have come in under 5 minutes. So we will test you here.

Mr. HIMPLER. Mr. Chairman, I noted that as well, and I fully expect to use all 5 minutes.

Chairman LUETKEMEYER. You are recognized for your time plus theirs, I guess, huh?

STATEMENT OF BILL HIMPLER, EXECUTIVE VICE PRESIDENT, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. HIMPLER. I like the sound of that.

Good morning, Mr. Chairman, Ranking Member Scott, and members of the subcommittee. I am the executive vice president of the American Financial Services Association (AFSA).

AFSA was founded in 1916 as the only national trade association solely focused on consumer credit issues. As such, let me state at the outset that we stand shoulder to shoulder with members of this subcommittee on both sides of the aisle as well as with the CFPB in wanting to see bad actors eliminated from the marketplace. However, it is equally important to ensure access to affordable credit for all Americans.

As the Federal Reserve notes, consumer credit balances, exclusive of mortgage, stand at roughly $2.5 trillion. Banks account for about 60 percent of this credit, but finance companies account for almost one-third. Yet, banks and finance companies represent very different business models.

Federal regulators have a long history of effectively supervising banks. Finance companies, though, are creatures of State law and have been supervised and examined at the State level for close to 100 years. Trying to supervise banks and finance companies as if they are the same could be disastrous for consumers and the economy as a whole.

To that point, then-Representative Barney Frank, one of the authors of the Dodd-Frank Act, wrote to the CFPB in 2011, stating that: "I urge staff to pay close attention to the differences in products offered by nonbank institutions and to be mindful of Congress's intent in financial reform that State consumer protection laws be preserved to the extent possible."

He went on: "For example, there are key differences in product characteristics between payday, car title, and other high-cost secured loans and more traditional closed-end unsecured lending and related products, and the products are often regulated differently in various States."

He concluded: "To the extent that State regulation has worked to protect consumers with regard to financial products offered by nonbank institutions, I encourage the Bureau to coordinate and work with States to preserve these protections."

AFSA believes in the CFPB's mission to help consumer finance markets work effectively by putting in place clear rules that are consistently enforced. But all too often, it feels as if the CFPB is following a "gotcha" mentality that is more interested in grabbing flashy headlines and punishing the industry. Furthermore, despite the CFPB's vast authority, it often manages to exceed the limits placed on it by Congress.

Here are a few examples of what I mean. The CFPB issued a short bulletin that attempts to hold indirect lenders liable for discrimination resulting from dealer compensation policies. This is contrary to Dodd-Frank, which prohibits the CFPB from regulating dealers. It is also an example of guidance designed to function as rulemaking without due process of law.

In this instance, the CFPB has pursued disparate impact cases against financial services companies without a valid legal basis, employing a proxy methodology it knows to be flawed, refused to consider nondiscriminatory factors that could explain alleged pricing disparities, and employed a remuneration process that was designed to achieve a political end. As a solution, Congress should work quickly to preclude the CFPB explicitly from using disparate impact theory under ECOA.

The second example of the CFPB's overreach can be found in its attempt to impose interest rate caps, which Dodd-Frank, again, prohibits the CFPB from doing. But that is exactly what the Bureau is attempting to do with its small dollar loan rule. The proposed small dollar rule imposes substantial and burdensome underwriting requirements on loans with a total cost of credit that exceeds 36 percent. Because these additional requirements are so costly, many lenders will choose not to make such loans to needy consumers. Keep in mind, these are institutions that had played no part in the financial crisis in 2008.

This proposed rule imposes a de facto usury limit by making it uneconomical for many lenders to comply with these new require-

ments. In fact, in a hearing last year before this committee, the members of the committee pressed Acting Deputy Director David Silberman to specify what deficiencies in State law the CFPB was trying to address; and the acting Deputy Director could not answer the Members of this body. We ask Congress to encourage the CFPB to go back to the drawing Board on this rule.

My third example is the CFPB's use of regulation by enforcement. Despite the CFPB's authority to write rules, the CFPB chooses to govern industry by enforcement orders. But these orders are not consistent. For example, in the area of dealer compensation that I mentioned earlier, does the CFPB expect vehicle finance companies to comply with the enforcement order against American Honda Finance Company or the enforcement order against Ally? These are two very different orders, and it is unclear.

The CFPB also tries to utilize the unfair prong in UDAAP regulation. For example, debt collection practices employed by EZCORP were consistent with both Federal and State law, and the CFPB did not like them so they labeled them as unfair. The CFPB's UDAAP authority should be removed and returned to the Federal Trade Commission.

I see I have exceeded my time. I look forward to the questions of the members of this subcommittee.

[The prepared statement of Mr. Himpler can be found on page 76 of the appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Himpler, for your testimony.

With that, the Chair recognizes himself for 5 minutes for questions.

And, Mr. Baer, I want to begin with you. We brought a visual this morning with regards to the CCAR process that represents 20,000 to 30,000 pages. That is the norm for midsize regional banks to comply with stress tests. I was discussing last night with one of the larger banks, it can go up to 100,000 pages for some of those folks. And they get back a three- or four-page letter saying that you don't comply and you didn't hit the model that we had intended for you to do, without any guidance as to how to hit that model.

Would you like to elaborate a little bit on this? I know you talked a little bit about it in your testimony, about how—and quite frankly, it would appear to me, from having an examiner background, that examiners are in these banks on a full-time basis, the larger banks, and they see this information every day, and yet for the banks to have to compile this in these voluminous reports seems superfluous to me. Would you like to comment?

Mr. BAER. Sure. Mr. Chairman, yes, if you think about CCAR, there are actually really two components: one is the quantitative assessment that I referenced in my oral remarks; and the other is the qualitative, which has uniquely, of all the types of regulations supervised by the regulators, become an annual binary public, life-or-death decision that you pass or you fail and has not had a lot of standards around it such that banks can know whether they are going to pass or fail.

To the Federal Reserve's credit, I think they have eliminated that or proposed to eliminate that for almost all banks. We obvi-

ously urge them to go ahead do that for all of them. There is no reason that capital planning cannot be evaluated through the traditional examination process that you are aware of, just as any other credit underwriting or cybersecurity. So we think that should be subject to the same process.

With respect to the quantitative test, yes, clearly, there is an extraordinary amount of data that is submitted. The number of people at the banks working on this ranges from the dozens to the hundreds, full-time year round. I think there are clearly ways that process could be streamlined and the burdens of that reduced.

That said, I do think that one of the great frustrations of the banks is that they go to all this trouble. They do all this work. They produce projections of losses and revenue under the stress, but then those results are discarded and the Federal Reserve runs its own models, which they do not see, and actually, I think, they don't have confidence that those models are better than their own with respect to a particular bank.

So I think the burdens of this process would be more tolerable and more sensible to the extent the results actually mattered and weren't discarded.

Chairman LUETKEMEYER. Thank you.

During your testimony, you also made the comment that a lot of examiners attend regular meetings, and sitting there has a chilling effect. And I assume they don't participate in the meeting unless called upon, but it would seem to me that would be an example of them trying to micromanage the bank, which they are not supposed to be in the middle of this as a regulator. They are supposed to be on the outside trying to enforce the law.

If the bank wants to make decisions based on a business model, they should be allowed to do that and not have an examiner sitting there to try and have a chilling effect on their ability to actually perform what they need to do in order to be able to fulfill their mission.

Mr. Himpler, given the number of comments here with regard to the CFPB, the rulemaking process, some of it they do without due process when they enforce things and regulation by enforcement, would you like to elaborate on the regulation by enforcement a little bit? I know, to me, this is really problematic from the standpoint that this is an agency that promulgates a rule, and then they go out and enforce the rule through fines and what have you, and basically, there is no—to me, that is a law. And there is only one group around here that can make law and that is us, and yet that is what they are doing.

Would you like to elaborate on that?

Mr. HIMPLER. I would. First, I would like to see things return to regular order, where Congress is making law, as opposed to unelected folks in agencies such as the CFPB. I think it does go back to the founding author of the CFPB, Senator Warren, who expressed at the outset in creating this that rules are like fence posts on the prairie; they are useless. Lawyers try and get around them. So there is a new sheriff in town, and we have to crack a few heads.

That mentality has continued to reverberate through the Bureau. We have had civil investigative demands (CIDs) that have been

hanging out over companies for years without any feedback from the Bureau as to whether or not somebody has been cleared.

We have had different orders with respect to the vehicle finance industry, in terms of which order a company should follow. And I guess most importantly, the Bureau put out a blog last year saying that they had backed off from pursuing this type of activity, but that activity still continues in examinations.

Companies come forward with plans to actually try and work with the CFPB and get very little credit for it. Discover was one of the first enforcement actions that the CFPB took. They self-reported and got no credit for it. You would have thought the CFPB had identified that and rooted out a bad actor.

Chairman LUETKEMEYER. Thank you. My time has expired.

With that, we recognize the ranking member, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

Let me continue that line of questioning, if I may, with you, Mr. Himpler. I listened very intently to your comments about the CFPB, but here's the rub: We need to protect our consumers from the bad actors out there.

And I think that my situation is somewhat similar to yours, because, as you recall, during the auto indirect lending fight, I more or less tried to lead the way in examining. In my own estimation, there were errors made, but they were errors made basically in the methodology that was applied to determine who was being discriminated against, not the function of the CFPB going after and trying to do its major function of protecting the consumer.

And, as I mentioned in my testimony yesterday, ours is a very complex, complicated financial system. Again, we have 70 million unbanked/underbanked citizens out there, the most vulnerable being many who are low-income African Americans and others.

So the question I want to ask you is—I am not sure you agree—don't we need to make sure that all of our consumers, especially the most vulnerable, deserve financial protection?

Mr. HIMPLER. Thank you, Mr. Scott. I couldn't agree with you more. Everyone needs to be protected. But in the area of vehicle finance in particular, it is a very fragmented market. You have thousands of players who are competing for market share. But the lion's share of the folks who are being regulated are finance companies, that are creatures of State law, that are putting their own capital at risk. It is a different business model than banks, that are putting deposits on the line for lending activity.

I think that what we are looking for, and Mr. Gerety got to it a little bit in terms of the bank sizes that he mentioned, but where he stopped was a $200 million bank. What I am talking about is institutions that are below $200 million, in terms of activity. They are providing a meaningful service and just want clear rules for the road. It is kind of like a sheriff pulling over somebody where there is no speed limit posted.

Mr. SCOTT. All right. Mr. Himpler, thank you very much for that.

I want to go to you, Mr. Michel, because you outline somewhat thorough your recommendations, which were basically mergers, and you recommend merging, for example, the CFTC and the SEC. Do you not feel that kind of merger with two distinct entities would

bring more confusion and less order to our financial system, given the fact of their jurisdictions? The CFTC strictly deals with this area, the commodities futures trading, and more or less handles this growing derivatives market, swaps, all of that business, cross-border, and dealing with a very growing and complex $800 trillion piece of the world's economy. So I don't see how that fits together.

Mr. MICHEL. I don't think there would be any more confusion than there is confusion between what is a swap and a securities-based swap. I think that an artificial distinction was made in Dodd-Frank Title VII. And those markets are—although commodities are not the same as securities or derivatives necessarily, they are essentially all financial instruments that are I would call cousins. And the distinction that we have been making legally over time has grown to the point where it is almost pointless.

Whether you are trading futures, whether you are trading derivatives, whether you are trading indexes, whether you are trading stocks, you are trading some sort of financial asset in the market and these things are very similar.

Mr. SCOTT. The other point you mentioned, which I have some experience with, was the overlap and the confusion that takes place with our Federal regulators and our State regulators. And I spent 28 years in the Georgia Legislature, 14 now in Congress, and I can speak to that.

One case in mind was we had to deal with Fleet Finance and their predatory lending. They were allowed to come into the State and use our usury laws for paying down second mortgages. But the point is that it was because we were able to get a better working relationship between what the Feds were doing and what the State was doing, and this was a new frontier we had to create.

But I see my time is up. Thank you, sir.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we go to the vice chairman of the subcommittee, the gentleman from Pennsylvania, Mr. Rothfus, who is recognized for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Mr. Baer, I would like to ask you a couple of questions. I have concerns about whether the current regulatory framework properly recognizes the various business models and risk profiles of banking organizations. Custody banks, for example, are very different from investment banks. The one-size-fits-all regulations are pushing banks to a one-size-fits-all business model and balance sheet. This homogeneity cannot be good for the financial system or financial stability.

Do you have any opinion as to whether more tailoring is needed to preserve this diversity in business models?

Mr. BAER. Thank you, Congressman. I think custody banks are a terrific example of that, in the sense that, clearly, their primary purpose is to safe-keep assets, but that also involves holding very large amounts of deposits. If you think about how the regulations affect a custody bank, the liquidity rules assume that those deposits, counterfactually, will all run in a crisis.

Now, certainly, deposits are at risk of a run in a crisis, but I think we saw in the last crisis that custody banks did not see large runs. But even if you assume that that is a fair assumption and

that lots of those deposits will run and, therefore, that you need to hold a Treasury security against that deposit to be able to fund that run, you then for a custody bank also have the leverage ratio, which requires you to hold the same amount of capital against that Treasury security as you would against a junk bond or an illiquid loan.

So they are put in a very difficult position, even though they are in an extremely low-risk business, of having to hold very large amounts of liquidity and capital on the liquidity. The same liquidity that is being held for a safety and soundness purpose, they are holding 6 percent capital against that, and that really doesn't make a lot of sense.

Mr. ROTHFUS. I plan on introducing legislation shortly that would exclude custody bank funds held at a central bank from supplementary leverage ratio calculations. How would this measure impact the viability of custody banks?

Mr. BAER. I think it would assist not only custody banks, but to potentially applying that to dealers, it would assist them in meeting liquidity requirements. It is interesting—actually, I just came back from Europe—that the Bank of England recently took just that step and deducted deposits on reserve at the central bank from the leverage ratio in the United Kingdom. So clearly, it is something they have thought about and makes a lot of sense.

One of the ideas behind the leverage ratio is that in a crisis you don't really know what any asset is going to be worth, and you go to that sort of ratio because you may have the risk weights wrong. But in no crisis has anybody ever gotten the value of cash wrong, or specifically cash on reserve at the Federal Reserve.

Mr. ROTHFUS. Dr. Michel, in your testimony, you wrote, "Leading up to 2008, financial firms funded too much unsustainable activity, largely because of the rules and regulations they faced, including the widespread expectation that Federal rules had guaranteed safety and soundness and that the Federal Government would provide assistance to mitigate losses." I find this interesting, because one of the main narratives that we hear from the left is that the financial crisis was caused by banks that got out of control because of deregulation.

Can you elaborate a bit more on which rules and regulations had the greatest impact in the lead-up to the crisis?

Mr. MICHEL. Sure. And first of all, I will reiterate that I think it is absolutely insane for people to say that there was deregulation and that there was no oversight of this activity. All of this activity took place under the direct supervision of the Federal Reserve, the FDIC, and the OCC, at the very least.

I think if I were to sort of prioritize the rules that were screwed up and that contributed to this, I would start with capital requirements and then bankruptcy preferences. On the capital requirement side, you had a risk weight system that incentivized banks to load up on mortgage-backed securities, to not hold mortgages, and to lower their capital charge for just doing the mortgage-backed securities, which were guaranteed, everybody knew, by the Federal Government, for the most part.

On the other side of that, with the bankruptcy laws, a lot of the funding for these vehicles, through swaps and repos, were given ex-

emptions from the bankruptcy safe harbors. So all the counterparties in those markets had very little reason to care how much of it they were writing and who they were writing it with, because they knew that they would be in the front of the line and be the first ones out the door with their money.

Those would be my two main categories of those rules.

Mr. ROTHFUS. Are there similar rules, regulations, and practices today that are setting the stage for financial instability down the road?

Mr. MICHEL. Well, we have changed the risk-weighting a little bit, but we haven't really fixed it, in the sense that we are still depending on this crazy idea that the Federal regulators or any group of any particular persons can get together and know exactly what those risks are going to be, what those financial assets are going to be worth going forward.

And that is just not true. We have proven that already. And we have not fixed that part. And we are going through all the CCAR exercises as if we know exactly how a bank is going to operate in a crisis and exactly what is going to happen in a crisis and exactly how much money is going to be there to protect it. History shows that that is not a good idea. That is what we have been doing, though.

Mr. ROTHFUS. Thank you. I yield back.

Chairman LUETKEMEYER. The gentleman's time has expired.

I now recognize the ranking member of the subcommittee, Mr. Clay from Missouri, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

And I would like to ask unanimous consent to place in the record a letter I have here from Public Citizen on the importance of Dodd-Frank and financial regulation.

Chairman LUETKEMEYER. Without objection, it is so ordered.

Mr. CLAY. Thank you.

Thank you, Mr. Chairman.

Earlier this year, the President issued an executive order directing the Treasury to consult with all members of the Financial Stability Oversight Council and produce a report on whether the current financial regulatory system meets several high-level noncontroversial principles. If the Administration produces a report that resembles Chairman Hensarling's radical rollback of Dodd-Frank, known as the wrong CHOICE Act, it would be very controversial and poorly received.

Mr. Gerety, as a former Treasury official, what would your advice to the Treasury be as it conducts its review? Should they be focused on trying to dismantle the CFPB, repeal the Orderly Liquidation Authority of the Dodd-Frank rollbacks?

Mr. GERETY. Thank you, Ranking Member Clay.

I am glad to offer my perspective. I will note, just as a factual matter, the consistent review and regular engagement with agencies on how rules are working is a standard practice of the Treasury Department. We conducted such an engagement in the spring of 2009, and we regularly engaged, at the behest of the President and the Treasury Secretary, over the years in lots of discussions.

So I think that the fact of doing a review, as the Chair of this subcommittee said earlier, is a natural part of the responsibility of

any Federal regulator or policymaker in Congress or in the administrative branch.

In terms of the recommendations, I think the central question is how we articulate the regulations, the statutes, and the guidance in ways that are appropriate to the risk, and how do we build on the progress we have made, to make our financial system stronger, to make our financial system more fair, and also make it more effective.

In particular, I would highlight areas like small business lending, where we have spent a lot of effort to try and promote small business lending among community banks. We did investments in community banks to help them support small business lending. And I think also along the theme of simplification, especially for the smallest banks in our system.

Mr. CLAY. Thank you for that response.

Mr. Gerety, it seems that despite evidence to the contrary, Republicans and industry lobbyists think that the financial protection for consumers and community banks in Dodd-Frank are harming them and the broader economy. However, I know that Democrats work with representatives of trade associations, such as the Independent Community Bankers of America, to craft wholesale exemptions for small financial institutions.

For example, community banks and credit unions under $10 billion are not supervised nor subject to enforcement actions brought by the CFPB. And while they are subject to consumer protection rules, they were subject to these rules even before Dodd-Frank was passed.

Indeed, all of CFPB's $12 billion worth of enforcement actions, providing relief for 29 million consumers, have been against large banks and nonbanks, direct competition to the community banks and credit unions.

Mr. Gerety, would you please comment on how the Dodd-Frank Act promoted community banking and shifted the regulatory focus to more risky large banks and nonbanks that can compete with small banks and credit unions?

Mr. GERETY. Thank you. I think this is a really important point about the structure of Dodd-Frank. It is not just that there are affirmative exemptions, such as the one that you mentioned with the CFPB supervision; but also, there is an affirmative targeting of making sure that the toughest rules apply to the largest and most complex institutions.

This happens in specific directions. For instance, under Title I of Dodd-Frank, there are specific enhanced prudential standards that only apply to the largest banks in the system. And those standards are further tailored by statutory mandate. So that the so-called G-SIBs, the globally systemic, the money center banks with trillions of dollars on their balance sheet, are subject to different rules. It is also true that with issues like derivatives or securitization, which community banks and smaller regional banks simply do not participate in, the weight of those rules do not fall there.

So, in terms of both its affirmative exemptions and its direction in terms of creating tough standards, Dodd-Frank explicitly and implicitly carves out community banks. I think there is still work to do to make sure that the rules—already, the banking agencies

have talked about simplifying the Basel III rules, making sure that those issues are easier for community banks to comply with. And I think that is a very fruitful direction and should be taken further.

Mr. CLAY. Thank you for your response.

My time is up.

Chairman LUETKEMEYER. The gentleman's time has expired.

The gentleman from Florida, Mr. Posey, is recognized for 5 minutes.

Just a minute, Mr. Posey—votes have been called, so we are going to try and get in hopefully two more people, two more questioners here.

So go ahead, Mr. Posey. Thank you.

Mr. POSEY. Thank you, Mr. Chairman.

Mr. Himpler, yesterday, Director Cordray appeared before the committee. And, as you know, the Consumer Financial Protection Bureau has a mission, and let me just state it precisely here: "To make consumer financial markets work for consumers, arm people with information, steps, and tools they need to make smart financial decisions."

I am interested to hear your opinion about whether or not you believe the CFPB is, in fact, adhering to their mission?

Mr. HIMPLER. Thank you, Mr. Posey.

And I guess my first response would be to kind of follow on the discussion that Mr. Gerety and Mr. Clay had just a second ago about independent community banks.

That exemption is afforded to the community banks because of the high burden of having a Federal regulator adding to the regulations that you are already facing at the State level. Representing finance companies that are providing both small dollar credit as well as vehicle finance, we would love to work with Mr. Clay and the members of this subcommittee and of the full Financial Services Committee to get that exemption so that there is a level playing field for all financial institutions.

We are willing to play by the same rules as everybody else, but what we are talking about is a difference between profitability, sustainability, and the ability to provide affordable credit or being out of business and having to shutter your doors.

One example of where I think the CFPB has missed its mission is in the area of its consumer complaint database. I don't think it really provides any information to consumers. Information that is gathered in that database, namely through a narrative field that customers are able to utilize, is not verified; and, most importantly, consumer information is not safeguarded.

So, from my perspective, that is something that really needs to be addressed, in terms of meeting its mission, in terms of providing helpful information and protecting the consumer.

Mr. POSEY. Again, offhand, can you think of any other steps you think should be taken to get back on course with the mission?

Mr. HIMPLER. I would say also, in the area of enforcement, our concern is that the Bureau is regulating by enforcement. It is not providing clear guidelines in the vehicle finance space, in terms of utilizing not so much its abusive authority under unfair, deceptive, and abusive practices, but the unfair prong. That has really never

been used by regulators before. The reason it hasn't been used is it is very hard to create any sort of objective standard.

Like I said at the outset in answering your question, our members are willing to play by the same rules as everybody else, and we do. What we don't think is in the best interests of the consumer is creating a "gotcha" environment where you don't know what the rules of the road are.

Mr. POSEY. Yes. I think that the CFPB indicated at one time they might be required or requested to issue something like 50,000 opinions on interpretations of their rules. And they kind of committed to doing at least one to three a year, and to date they haven't done any. Do you see that as problematic?

Mr. HIMPLER. Again, in the vehicle finance space, they issued a four-page bulletin to provide guidance to lenders in the vehicle finance space. They have at least three public enforcements. They have other private enforcements. None of them look like each other. And the Director has said it is regulatory malpractice for financial services players not to follow these orders. Which one do we follow?

Mr. POSEY. We get statistics that we are now losing something like a community bank a day or something. It is just unbelievable. Do you think this is a root cause of that?

Mr. HIMPLER. I do think that is a root cause. We don't represent the community banks, but they are great players. Everybody has a part to play in this. But another proposed rule by the CFPB is its arbitration rule. The Director's own economics team said that arbitration is better than litigation for the consumer, in terms of time, convenience, and monetary awards. And yet, his own statement when he rolled out this rule totally contradicted that.

I will stand here and tell you today that a significant number of financial players that are small and community-based, if that rule goes into effect, those businesses will go out of business, because they can't afford the risk associated with a class action lawsuit.

Mr. POSEY. Thank you, sir.

Thank you, Mr. Chairman.

Mr. HIMPLER. Thank you.

Chairman LUETKEMEYER. The gentleman's time has expired.

We are going to get one more questioner in here before we recess.

The gentleman from North Carolina, Mr. Pittenger, is recognized for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

Mr. Himpler, I would like to ask you, do you think that there has been an uptick in the enforcement actions by the Bureau since the November elections? Is that your sense?

Mr. HIMPLER. I do think that it has been sustained. But a lot of the enforcements are now through the supervisory process. And so what we have happening, as opposed to the more public orders that we have seen, is a lot of the enforcement orders are in the supervisory process, and they are not a matter of public disclosure. So it is very hard for our members to actually articulate what is happening to them.

But I will tell you that, again, in the vehicle finance space, the CFPB said last December that they were moving on from this. I

can tell you clearly they have not moved on from this and they have, in fact, probably doubled down on this.

Mr. PITTENGER. Do you feel like, in a sense, the CFPB has moved the goalpost?

Mr. HIMPLER. I'm sorry, I missed your—

Mr. PITTENGER. Do you feel that, in a sense, the CFPB has moved the goalpost? Do you have any examples of that?

Mr. HIMPLER. I do think that it is interesting with respect to the bulletin that they put out. They put out a clear standard that was not achievable by industry. The vehicle finance industry is very fragmented, and nobody was willing to step forward. It said that all compensation to dealers had to be flat. Nobody was willing to go there.

The first public settlement that they came out with dealt with monitoring. Two subsequent ones dealt with capping the compensation. And I can tell you another one actually came forward and offered to cap compensation and were still penalized for doing so.

Mr. PITTENGER. Thank you.

Mr. Michel, how was consumer protection handled before the creation of the CFPB?

Mr. MICHEL. It was fragmented. It was spread around several different agencies. If you go through Title X, I believe subtitle (h), of Dodd-Frank, you can see part of what was done, which is it literally shifted enforcement authority for 22 Federal statutes into the Bureau. So, unfair and deceptive practices, primarily enforced by the Federal Trade Commission (FTC), are all under all of those authorities. And banking regulators also had the authority, although not the explicit statute requirement, the authority to enforce laws under those rules as well on top of State regulatory agencies, all policing fraud. So the fact that there is deceptive and unfair practices, fraud—you cannot, as a business, lie about what you have sold me; you cannot mislead me; you cannot trick me—all of this was done prior to Dodd-Frank.

As Congressman Clay alluded to a moment ago himself, smaller banks were subject to consumer protection laws prior to Dodd-Frank. That is the body of that framework that you see there in Dodd-Frank.

Mr. PITTENGER. Do you think that process provided more protection to consumers or do you think the CFPB provides more protection?

Mr. MICHEL. The CFPB, the only argument you can possibly make is that we have consolidated that authority in one agency, and that is fine. But it didn't have to be the CFPB. It could have been the FTC. In fact, I think it made a lot more sense to be the FTC. They have a Bureau of Consumer Protection. That is their mission.

Mr. PITTENGER. Was there any benefit in consolidation?

Mr. MICHEL. I would say, yes, there would be benefit in consolidating, and it was quite fragmented. So, yes, but not with the CFPB because the CFPB goes much further than that, and it is not really designed primarily to enforce those statutes. It is not an enforcement agency per se, like the FTC. And what you have—the agency is primarily designed to go much further than that, particu-

larly with abuse of authority, which is ill-defined and will not be defined under the Bureau and is not defined under the statutes.

And it is really designed, if you look at the intellectual architects Gill and Warren, the idea is that you have to protect consumers against themselves or from themselves. That is a very different concept than what was in consumer protection law prior to Dodd-Frank.

Mr. PITTENGER. Many members of the Financial Services Committee have spoken to Fed Chair Yellen about the need to tailor regulations to specific institutions. Do you think the prudential regulators do enough to tailor these regulations to an institution or to smaller groups of institutions?

Mr. Baer?

Mr. BAER. Sure. I would agree, Congressman. Certainly, more can be done. I think we already talked about the custody bank example. There are certainly other examples, for example, the living will process, which is a large resource drain on firms that are actually quite easy to resolve and don't need that level of planning.

I will also just say—and there has been a lot of talk about the CFPB in terms of tailoring. I think, as Mr. Michel notes, at least in theory, the statute transferred consumer enforcement authority away from the banking agencies and to the CFPB. I think what has happened, though, in reality is that the banking agencies have re-christened every consumer compliance violation as a safety-and-soundness issue using the amorphous concept of reputational risk, meaning, "If you do something I don't like, somebody else might not like it; that will hurt your reputation, and, therefore, you have a safety-and-soundness problem."

So that is another example. Maybe it is a different kind of tailoring, but that jurisdiction wasn't really transferred. It was more duplicated.

Mr. PITTENGER. Thank you.

My time has expired.

Mr. LUETKEMEYER. The gentleman's time has expired.

And, with that, we apologize to the witnesses. We do have to go vote. Votes have been called. We will take a recess here and probably reconvene around 10:45 roughly.

[recess]

Mr. LUETKEMEYER. Let's reconvene the hearing. I again apologize for the interruption, but we do have to go do our job from time to time.

So, with that, we want to again thank the witnesses for their indulgence, and we will continue the questioning.

Mr. Williams, the gentleman from Texas, is recognized for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Mr. Himpler, as you know, yesterday our committee had the opportunity to hear testimony from CFPB Director Cordray. From his testimony, you would have thought that community financial institutions, which facilitate a significant amount of lending in my district in Texas, are doing great. But perhaps the Director hasn't been to rural Texas, where many credit unions and community banks have simply closed.

So, last year, 329 Members of Congress and many of the members of this subcommittee sent a letter to Director Cordray calling on him to invoke his authority to exempt community financial institutions from CFPB regulations. Yet, instead, he went ahead and released a 1,300-page rule on small-dollar lending, which applies to community banks and credit unions. I am not quite sure he got the message, but in your opinion, why does a small bank or a credit union need a 1,300-page rule to tell them how to make a $500 loan to their local customer or member?

Mr. HIMPLER. Thank you, Mr. Williams. It is good to see you this morning.

I don't know why any community financial institution needs a 1,300-page regulation. Most of the small-dollar products are fairly clear on their face. We do not represent payday, but it is a very clear disclosure. Most small-dollar extensions of credit are only a couple of pages in length, if that. There are clear disclosures of APRs. And the rule that the Bureau has come forward with will cripple access to credit, particularly in the communities that you are talking about.

The whole rule, I must admit, I find personally offensive. No one would dare ask members who have premium or gold credit cards to have a cooling-off period after they paid off their monthly statement for March or April, but that is exactly what we are doing to working- class and lower-income folks. And to me, that is unfair.

Mr. WILLIAMS. And staying with that line of questioning, Mr. Himpler, I want to talk about an issue that, unfortunately, I did not have time to discuss at yesterday's hearing. In March 2013, the CFPB issued a bulletin that allegedly provided guidance for indirect auto finance companies. We now know this was the Bureau's way to get around Section 1029 of the Dodd-Frank Act, which explicitly excluded them from the CFPB oversight and rightfully left the duty to the FTC.

As the story goes, the CFPB used a now debunked study citing disparate impact to hold the indirect auto finance companies liable for discrimination resulting from dealer compensation or markup. So why is the Bureau continuing to utilize this methodology in enforcement actions against banks and indirect auto finance companies?

Mr. HIMPLER. That is probably a question best suited to the Bureau. I can tell you that, having worked with the CFPB and represented indirect auto for 13 years now, the staff has this kind of stuck in their craw that dealers are exempt under Dodd-Frank, and the only way to address that shortcoming that they see is to do it through vehicle finance companies, like the ones that I represent. And despite the fact that they have issued a bulletin—or actually a blog—last December calling a truce, that may be the case for public enforcement orders, but it is not the case in supervision and enforcement that stems from that. That continues to go forward. And even in instances where finance companies are trying to do the right thing and meet the Bureau halfway, I am afraid that all too often the Bureau is still looking for the flashy headline.

Mr. WILLIAMS. I agree with you. In their semiannual report, the Bureau has dropped ECOA auto lending enforcement from its fair lending priorities just this past year. The Director himself has said

that the CFPB has abandoned work in this space. You have touched on that. Yet, in my opinion, the damage has already been done. So, by my count, the CFPB has already extorted hundreds of millions of dollars from these auto lending companies. In your opinion, why do you think the Bureau has abandoned work in this space?

Mr. HIMPLER. I think the curtain has been pulled back on their flawed methodology, the fact that they were unwilling to account for nondiscriminatory factors that we presented to them to explain any disparities that they found, and the fact that you had bipartisan pressure trying to get the Bureau to come forward with some sort of regular order. Even in just trying to figure out how they did the methodology, in terms of trying to duplicate their efforts, it took industry a year-and-a-half for them to even turn over the computer code. That is just silly, Congressman, and uncalled for.

Mr. WILLIAMS. Thank you for your testimony.

I yield back.

Mr. LUETKEMEYER. The gentleman yields back his time.

The gentleman from Georgia, Mr. Loudermilk, is recognized for 5 minutes.

Mr. LOUDERMILK. Thank you, Mr. Chairman.

And, Mr. Himpler, welcome, and thank you for being here today.

Mr. HIMPLER. Thank you for having me.

Mr. LOUDERMILK. Yes, well, maybe we will have a little more productive meeting today than what may have happened yesterday when it comes to actually getting some questions answered.

To follow on kind of the direction that Mr. Williams was heading in, some of the questions I asked yesterday were not adequately answered. There were a lot of things said but I don't think Director Cordray actually addressed the question at hand. A lot of it has to do with the CFPB and their database.

And let me kind of just pose a question I did to Mr. Cordray yesterday and see if you can help me get to some of the answers, at least what you believe the truth would be there.

In their annual report, which came out Monday, their numbers showed that in 2016, the CFPB handled 291,000 consumer complaints, and about 17,000 of them were resolved with monetary relief for the customer. Now that equates to only 6 percent of the complaints being resolved with monetary relief, and 94 percent had no monetary relief.

So my question was, does this low number show that the vast majority of their claims really have no merit? Or is it just incompetence in the agency? Or is it a priority issue in your opinion? From your knowledge, could you help me with that?

Mr. HIMPLER. I would actually like to give the Bureau a little bit of credit here. I think the fact that you have such a low numerical value associated with monetary rewards means that the lion's share of complaints that come into the Bureau may not warrant a monetary award. We have had complaints come in regarding one of the captive auto finance companies under a particular brand, and they didn't actually finance the car; it was financed by one of their competitors. And it took them a while to sort it out and make sure the complaint got to the right consumer, and it was resolved.

That is just one instance. But I do have other problems with the database.

This is reputational risk at its finest. No one in our industry can afford to take on their Federal regulators, let alone a Federal regulator that has "consumer protection" in the title. What is the upside to that? Okay? Then you have numerous mistakes. They have now put in place a narrative field that allows consumers to put something online that is totally unverified. Well, how do you correct that? Once the damage is done to a company, it is hard to get your reputation back.

Mr. LOUDERMILK. I agree.

Mr. HIMPLER. And probably most importantly is the fact that they don't protect the consumer's private information on this database. If the whole goal of the CFPB is to protect the consumer, protecting their private information should be at the forefront.

Mr. LOUDERMILK. I appreciate you going in that direction because that is really where I was going. Without the 96 percent, there has to be a large number that are—let me use the term "frivolous." In his testimony yesterday, Director Cordray said that, once the company has an opportunity to respond—this is when a customer posts something on their website, a complaint—that they confirm that there was a commercial relationship with the customer. That is the extent of any confirmation. Why will they not go and at least try to validate the complaint? Because, as you say, once that reputation has been damaged by a consumer protection agency, it is irreparable; it is very difficult.

Mr. HIMPLER. That is correct. I think, at the end of the day, although it is listed as a consumer complaint database, there is no real interest in terms of looking at both sides of the equation. As I said at the outset of my statement, we share the CFPB's mission to protect consumers, but that has to be balanced with ensuring the availability of credit. And all too often, I am concerned that the Bureau does not have that balance in mind.

Mr. LOUDERMILK. So is the purpose of the database just to name and shame companies, or should they have a disclaimer on there that says it is a fact-free zone, or "This is fake news?" It is really what I see is happening.

Mr. HIMPLER. As entertaining as that is, yes, something needs to be done, particularly in this space in terms of protecting reputational risk because that comes at a cost. It will drive companies out of business.

Mr. LOUDERMILK. Thank you.

I yield back.

Mr. LUETKEMEYER. The gentleman's time has expired.

The gentleman from Tennessee, Mr. Kustoff, is recognized for 5 minutes.

Mr. KUSTOFF. Thank you, Mr. Chairman.

Mr. Baer, good morning to you. I recently had the privilege of talking with a good community banker in my district in Fayette County in west Tennessee who talked about the Community Reinvestment Act. He said, while the intent of the CRA was to create fair lending practices, current test criteria are often so stringent, so tough, that it makes it impossible for smaller institutions to pro-

vide credit to those who want to reinvest in the communities that they live in.

We know that the CRA was designed to ensure that financial institutions were providing capital and meeting the financial needs of the communities in which they operate. Regulators have ensured that these institutions meet the requirements of the Act through tests that look at the bank's lending, investments, and services. Until recently, these tests provided a clear benchmark for a bank to meet its CRA responsibilities. However, lately, regulators have been increasingly including in their CRA examination criteria, unrelated to the CRA, including compliance with other financial laws or consumer regulations that have their own standards and penalties for violations. I bring all this up because, in your testimony, of course, you mentioned that one institution was graded by the OCC as "outstanding" but yet then was later downgraded to—I think you said—"needs to improve"—because of issues related to the bank's account management. Does that seem like a reasonable process to you?

Mr. BAER. No, Congressman. I think the important point is that that process or that kind of behavior actually undercuts the value of the Community Reinvestment Act. As you note, the legislative history and clear statutory purpose of the Community Reinvestment Act was to ensure that banks were meeting the credit needs of all the people in the communities they operate in. And the grade is outstanding; it is outstanding for meeting credit needs. That is the focus of the statute. And it is a good example of how the examination regime around this has actually worked pretty well in the sense that the standards, the three tests you mentioned, are applied rather objectively. Banks know what they need to do to get a satisfactory rating, what they need to do to get an outstanding rating, and they can benchmark that and know where they are. That is all somewhat ancient history now but certainly not true now.

What has happened is that any consumer compliance violation now can result and likely does result in a downgrade of the CRA rating. There are plenty of other consumer laws to punish that kind of behavior, whether it is informal supervisory or formal enforcement action or State action or Justice Department action. So it is not like this sort of behavior would go unpunished but for the CRA. But the unfortunate consequence of adding the CRA to the list of punishments for that kind of behavior is it diminishes the transparency of how it is applied to banks, and it really gives them less of incentive to stretch to make the extra loans to become either satisfactory or outstanding.

Firms used to actually like, even aside from the compliance aspect, sort of the marketing of being an outstanding CRA institution. But if you tell them going into the exam, "Well, you have an unrelated consumer compliance violation; you are going to have a 'needs to improve' no matter what you do," that really undercuts for everybody—the banks and then also the communities who want the lending—the value of the CRA.

Mr. KUSTOFF. Thank you very much, Mr. Baer.

Mr. Michel, if I could, your testimony about the CFPB, I heard that; I think we all heard that in your testimony and your opening statements.

Yesterday, when Director Cordray appeared, I had a line of questioning involving the unfair, deceptive, or abusive acts or practices, the UDAAP authority that was granted to the CFPB. As we look at the statute as written, it appears that there is little guidance as to what actually constitutes an abusive act or practice. Without clear and consistent guidance to make sure what that determination is, the Bureau now apparently has the discretion to make unilateral decisions that ultimately result in the elimination of a useful practice and service for the consumer.

If I could ask you, in your opinion, has the CFPB adequately defined what constitutes an "abusive practice?" And is more clear, concise guidance needed for the CFPB to demonstrate further transparency in the process?

Mr. MICHEL. They haven't clearly defined it, and Mr. Cordray has said that they don't want to define it and shouldn't define it. And that is not the rule of law. That is, "We are going to figure out what you did wrong after you did it, and we will tell you." It is absolutely 100 percent counter to the rule of law and the type of governmental system that we have in the United States.

And then the next part of your question, as to whether they should clarify that, the only thing that we know is that it is not unfair or deceptive. So it has to be something else. Well, the question should be, what is wrong with unfair and deceptive? In other words, if unfair and deceptive is not okay, is not enough protection, then let's talk about something else. But that debate was never really had. So I don't think that we should waste any time trying to force them to come up with a better guidance for abusive. I think that should be thrown out. It is, in my opinion, superfluous.

Mr. KUSTOFF. My time has expired. I yield back.

Mr. LUETKEMEYER. The gentleman's time has expired.

The gentlelady from New York, Mrs. Maloney, is recognized for 5 minutes.

Mrs. MALONEY. Thank you so much, Mr. Chairman, for calling this hearing. And it is very good to see Mr. Baer and some other constituents here and all the panelists for being here today.

We have a busy day on the Floor. We have one important Financial Services bill that came out of this committee that we were debating and it just passed unanimously. That doesn't happen often in this Congress—unanimous support.

So, Mr. Gerety, I would like to ask you a question about the orderly liquidation authority. One of the main changes, as you know, that we made in Dodd-Frank was to give the regulators the authority to wind down large nonbank financial institutions when they fail. The FDIC has long had the authority to wind down commercial banks, but they did not have the authority to wind down large noncommercial banks like Lehman Brothers and AIG.

And I distinctly remember one weekend, the beginning of the weekend with 11 investment banks in my district; at the end of it, every single one of them had failed. Yet, I give strong support to the FDIC. They very, very expertly worked with the private sector to save the commercial banks, to wind them down, to merge them,

to keep them moving. So we were really forced with two decisions: we could either bail it out, like we did with AIG; or we could let it fail, which we did with Lehman. Neither was a good option, as we all know, and, if anything, contributed to more confusion and pain in the financial crisis.

Dodd-Frank gave the regulators a third option: an orderly wind down that prevents a government bailout but does not harm the broader markets so that they would have another tool, God forbid, that we have another financial crisis, but that we could better manage it.

So, Mr. Gerety, I would like to ask you to talk about the structural change and why it is important and what would happen if—some of my Republican colleagues are very intent on repealing the orderly liquidation authority, although it says expressly in the statute that no taxpayer money should ever be used or can be used. So it is really prevention of using taxpayer money and gives them another tool to really react to the crisis as the FDIC was able to do with the powers that were given to them.

So your thoughts on that, and any other panelist who would like to add or comment on it, we would like to hear what you have to say.

Mr. Gerety?

Mr. GERETY. Thank you, Congresswoman Maloney. I think this is such an important issue, and you have laid out the facts, as we saw them in 2008, so eloquently.

I think there are a couple of principles at stake that are really important to highlight any debate about how we handle the failure of a large complex financial institution. The first principle, which you have outlined, is the fact that this authority did not exist in 2008. The choices were limited and the fact that those choices were limited was a massive problem for the American people.

The second is that market discipline works when firms have the ability to fail. Market discipline does not work if firms are—if the market does not believe that the firms have the ability to suffer from their own mistakes. And so I think we have seen already—in the implementation, the development of the capital rules to go along with orderly liquidation, the strategies of the single point of entry that give that credibility—we have seen the markets react positively. And when I say "positively," what that means is they have taken away the assumption that the government will step in. The ratings agencies have noticed this as well. So I think moving in the opposite direction would be a move away from market discipline and move toward too-big-to-fail.

I think the second thing is that there is often a discussion about bankruptcy versus orderly liquidation. I think it is important to not see those as substitutes. Certainly, this House has worked on a bankruptcy bill focused on Financial Services. That should be seen as a compliment. It cannot be a substitute for the approaches that we know have worked and the approaches that we know need to be differentiated for financial services companies because of their extreme size and their different structure than regular corporations in America.

Mrs. MALONEY. I would like to ask Mr. Greg Baer if he would like to comment.

Mr. BAER. Sure, thank you, Congresswoman.

I think it is important to note, as I think Amias did, that under the statute, and quite sensibly, the first option is bankruptcy. That is why banks are submitting living wills and either all now have or probably soon will have credible living wills under the Bankruptcy Code. So, at that point, it is really a cost-benefit analysis: What is the cost of retaining Title II? What is the benefit?

Given—you can argue the benefit is low in the sense that banks are now extremely resilient at extremely high capital liquidity levels. There is a credible bankruptcy process using the single-point-of-entry strategy that Amias mentioned. And there is even liquidity available because their prepositioning liquidity or the trigger for bankruptcy is now sufficiently high that there will be liquidity available through the living wills.

On the other hand, there doesn't really seem to be much of a cost at this point of retaining Title II as a backup plan in the sense that, as noted, markets are pricing the debt as if there will be no government support. So there is not a moral hazard being created or an unfair subsidy. That has been validated by the GAO, by two other recent studies, and by the rating agencies now as well as.

So it is a backup plan. I think it is an unlikely-to-be-used backup plan, but it appears to be a backup plan for which there aren't a lot of costs to retaining.

Mrs. MALONEY. And it would have been a backup plan that would have been helpful in the 2008 crisis, and we don't know what the next financial crisis is going to be. As you said, banks are very well-capitalized now. So it won't be like the last one; it will be something different. So having tools to respond might be helpful.

Thank you all for your testimony.

Thank you, Mr. Chairman.

Mr. LUETKEMEYER. The gentlelady's time has expired.

With that, the gentleman from Michigan, Mr. Trott, is recognized for 5 minutes.

Mr. TROTT. I thank you, Mr. Chairman, for calling this hearing. And I want to thank the panel for spending time with us this morning. And as has been mentioned, we spent about 5 hours yesterday with Mr. Cordray. And I am not sure how productive of a discussion it was. But I want to share with you a couple of the statements he made and get your thoughts.

Mr. Michel, at one point, Mr. Cordray said, "Certainly no one can claim that their voices are not heard at the CFPB." And when I had occasion to ask him a few questions, I told him I was astonished at that statement because I go home every weekend, and I talk to REALTORS® and title agencies, and mortgage brokers, and debt collectors, and attorneys, and small-business owners, and they are all terrified of the CFPB. In fact, one constituent recently said that the CFPB is like the Mafia. They show up, and they say: "This is a nice business you have here; I hope nothing happens to it."

So I want to get your thoughts on whether you feel there is an adequate framework for people to bring questions, honest business people to bring questions to the CFPB; if not, maybe give me a few examples of their failure in that regard; and then, finally, what the consequences for our economy are of an operation that runs itself providing guidance through enforcement.

Mr. MICHEL. I have heard firsthand—and Bill probably has a thousand times more firsthand accounts than I do—of people who say that this is not true, that the CFPB does not listen to them, in the mortgage industry and outside of the mortgage industry. So I don't think—no, I don't believe that that is accurate. I don't believe they do listen. That is not why they are there.

We had Dennis Shaul, who is an ex-Barney Frank staffer, talk to us about how different the Bureau became versus what it was pitched as it was going to be. So, no, I don't agree with him at all.

Mr. TROTT. Great.

Mr. Himpler, let's go to another statement he made. I questioned him on his press releases, particularly a press release that was issued August 26, 2016, regarding First National Bank of Omaha. The press release made it sound like the First National Bank of Omaha had basically admitted guilty to egregious transgressions and where they were just a terrible organization. But then, when you look at the settlement agreement, section 2, there is no admission of guilt of any kind.

So you mentioned a few minutes ago they are prone to flashy headlines, and I am just wondering if you think some of the press releases issued by the CFPB in connection with their settlements of enforcement actions are accurate and largely whether you believe there is really a due process issue when you consider the fact that fighting the government really is a tough row to hoe for many companies given the reputational risk and, again, what the consequences of that method of operation is.

Mr. HIMPLER. Thank you, Mr. Trott.

And if you will indulge me, I would like to comment on your question that you asked Mr. Norbert just to start off.

Don't take our word for it. The Small Business Administration, under the previous Administration, actually opined on this because a lot of the rules that the CFPB have put forward have to go through a small business review panel to anticipate the impact on small businesses if they were to go forward. The SBA said that the CFPB was not listening to folks. That is—and Norbert is correct: I do have plenty of other examples. I would love to talk to you about them offline.

A lot of the discussion, even Mrs. Maloney's previously, was about big institutions, too-big-to-fail. We are talking about institutions that are too-small-to-succeed. If you guys don't get it right, with all due respect, you can have serious consequences and take a lot of folks that have institutions and access to credit in rural areas right out of the equation.

With respect to the press releases, more often than not we see press releases that don't reflect the orders that the Bureau puts forward. More importantly, sometimes the parties that are subject to those orders don't even see the order until it has actually been issued by the Bureau. That is being convicted before you even see the indictment, sir, and there is nothing more unfair than that.

Mr. TROTT. When I asked the Director about his press releases, his response was, "I know the facts." And it sounded—and I don't know that he particularly appreciated this analogy—like the line from, "A Few Good Men," when Jack Nicholson was on the stand and he said, "You can't handle the truth," and he is acting as judge

and jury. So how would he feel if I drafted a press release saying, "Director Cordray admitted responsibility for sex and racial discrimination at the CFPB and retaliatory actions against his employees, apologized, said it would never happen again, but no one there is going to be fired as a result of their bad behavior." I know the facts. I read the National Review articles. How can you dispute that?

Mr. HIMPLER. Sir, as far as I know, all of the public orders in the vehicle finance space, none of the companies admitted to guilt. That was part of an agreed-to consent order, and the press releases all, from top to bottom, say that they are guilty and then, in the fine print, say, "Nothing in here accurately reflects the order."

Mr. TROTT. Thank you for your time.

I yield back.

Mr. LUETKEMEYER. The gentleman's time has expired.

The gentleman from Kentucky, Mr. Barr, is recognized for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

And I appreciate the testimony from our witnesses.

Dr. Michel, I was particularly interested in your proposal to remove the supervisory responsibilities from the Fed and transfer them to other regulators, and proposals to consolidate regulatory activities. As chairman of the Monetary Policy Subcommittee, I have raised that proposal with Fed Governors and regional bank presidents. And as you might imagine, I got a little push back on that idea.

What they have said to me is that their supervision informs their monetary policy. Can you speak to that argument?

Mr. MICHEL. I am not surprised. And I think that is scary. That is not the way this is supposed to work. Monetary policy in a fiat money system—the central bank is supposed to provide liquidity to the system. It is not supposed to be making bank determinations or bank safety-and-soundness determinations and picking and choosing who to lend to. That is the problem, literally.

So the way to stop that is to let the Federal regulators do the regulating on the safety and soundness and let the central bank provide liquidity to the system. It can do that in a very open and transparent process without emergency lending authority, without regulatory authority. It is all it has to do.

Mr. BARR. To the extent that the CHOICE Act, or other reform efforts here in Congress, maintains this concept of a stability oversight council, even if Congress were to remove its designation authorities, should the Fed participate in an FSOC?

Mr. MICHEL. In the unfortunate event that you retain the FSOC, no.

Mr. BARR. To your point about overlap, duplication, and inconsistency in the excessive number of these regulators, could you address the argument that multiple regulators can in fact lead to greater accountability and talk about that in the context of this argument of the race to the bottom?

Mr. MICHEL. The research on this is pretty muddled. There are arguments for regulatory competition and that you get better outcomes that way. There is very little support for the race-to-the-bottom hypothesis, and there is also some support for the idea that

regulatory competition turns out to largely end up being a myth. If you look at bank failure rates—and this just one example, admittedly muddled research—but one example is that bank failure rates across the different Federal regulators were pretty much the same. So it is pretty hard to say that there was sort of like a charter shopping thing going on and that some regulators were being tougher or easier on others. That is—

Mr. BARR. One final quick question, if I could, and then I want to move on to Mr. Baer. Talk about your proposal of regulatory consolidation in the context of the dual banking system, and specifically, what do you propose with respect to State-chartered Fed members? Who would be regulating them besides the State financial institutions regulator?

Mr. MICHEL. I think you would just have to go to the FDIC. That would be my preference.

Mr. BARR. Mr. Baer, I was interested in your testimony, particularly about the CCAR qualitative assessments over bank capital planning processes. Talk about the arbitrariness of that and why you think we should get rid of that qualitative assessment.

Mr. BAER. I think the place to start is the regulators and the examiners, including the Federal Reserve, routinely assess the quality of bank's processes and their compliance with law across a whole wide range of activities, whether it is credit underwriting, cybersecurity, trading, anything.

In none of those cases do they feel the need to announce publicly at the end of the year, pass or fail. They work diligently with the institution throughout the course of the year. Their findings are reflected in an examination rating, and that system works.

Especially in an area like capital planning, you already have the quantitative assessment, which is—and I think will continue to be—public. But the real question is, what is the value added by having that final assessment be public and binary? There has also been, I think, a real sense—and I think some public reports—around this function has been transferred largely from the exam teams to Washington. I think the standards are not particularly clear. There isn't a lot of very good feedback such that we routinely hear that firms simply do not know going into that week whether they are going to pass or fail, which is not the way the exam system—

Mr. BARR. Sorry to cut you off.

But in my remaining time, Mr. Himpler, can you address the unique challenges associated with the regulation of finance companies as opposed to banks, credit unions, and other lenders?

Mr. HIMPLER. Sure. This is not a problem with the CFPB. It is a problem in D.C. Washington, D.C., is a bank-regulated town. Finance companies and a lot of community banks are creatures of State law. They have been effectively regulated at the State level for close to 100 years. And trying to put community institutions through the same pace as some of the bigger institutions and the tens to hundreds of billions just doesn't work.

Mr. BARR. Thank you.

I yield back.

Mr. LUETKEMEYER. The gentleman's time has expired.

With that, we recognize the gentlelady from New York, Ms. Tenney.

Ms. TENNEY. Thank you, Mr. Chairman.

Thank you to the panel for being here.

I like what I am hearing from Mr. Himpler, as a Member from rural suburban central New York, where we have a number of small businesses and some of the largest out-migration of people, businesses in the Nation and—I just found out today—in my district some of the highest property tax rates based on per 1,000.

I want to focus a little bit on Operation Choke Point and just the nature of Operation Choke Point and how it focuses on small-dollar lenders, payment processors, and companies that are believed to be reputational or moral risks. And I am concerned about what could happen in my district, particularly because we do have a number of small businesses that would probably fit that definition, one being Remington Arms, the oldest continuously running manufacturing firm, which happens to be large. But there are other smaller offshoots, such Oriskany Arms, that could be targeted by an Operation Choke Point—a small startup that is making firearms right now for hunting and personal protection. But Remington also provides for our military. But other smaller businesses, whether it is payday lenders, check cashers, coin dealers, some people who provide some kind of services for people who are largely unbanked because of the massive regulation of so many of the big banks.

As we regulate the big banks, we end up hurting the small banks even more. And as a small-business owner, it is sort of a parallel; we know we have a hard time complying with New York's regulatory burden as a small business, but we can't afford to hire compliance agents just like in a smaller bank.

And I was just struck by your comment about too-small-to-succeed. I would like to say they are too small to be cared about by a lot of politicians and bureaucrats. Small businesses, small lenders, and people who are in these persona non grata categories.

I am just concerned that some of these tactics that the DOJ and the FDIC are using are almost like threats to increase the scrutiny on these types of lenders. I know we have written a number of letters, and I know I am getting—we have written a number of letters to the FDIC and the OCC about Operation Choke Point and how it is affecting our industry.

I just want to know—and I guess I would single out Mr. Himpler, since you have the great quote of the day with "too small to succeed"—can you wager a guess—and I think you could probably give me a more educated answer—as to why the government agencies believe that these licensed legal businesses that I have described should not have access to the banking system and why we put them into the underground? And maybe you could answer why they are so targeted, it appears, from the regulators.

Mr. HIMPLER. Thank you, Ms. Tenney. In full disclosure, I wish I had come up with that quote, but I heard it from someone else.

I think your point is dead on. And whether we are talking about Choke Point or whether we are talking about using the unfair prong of UDAAP, you have folks in the regulatory community, be it at the CFPB, the FDIC, or others, who feel a need to stand in judgment of hardworking Americans and how they utilize the cred-

it system. And whether we like it or not, the FDIC can say that they are no longer deploying Choke Point. That message has not gotten down to the rank and file. Our members are still being subjected to the questions that call into question whether or not they are a moral provider of credit.

Our association is 100 years old. We were formed with consumer groups in order to provide access to credit for hardworking Americans at the turn of the last century, folks in steel mills, folks in factories and the like, that banks couldn't provide credit to. And we take great pride in the fact that we are able to work directly with the consumers that we serve, but the CFPB and the FDIC and others have made it increasingly difficult by not following a rule of law, not providing clear guidelines and coming up with squishy standards, such as unfair because somebody doesn't think it is appropriate. All we are looking for is to be treated fairly.

Ms. TENNEY. Do you think that some of these are targeted or calculated attempts to eliminate an industry that might not be or someone that is involved in a banking institution or financial institution of this nature that is just not desirable in their world?

Mr. HIMPLER. I do think that is the case, and I don't want to cast aspersions, but I think what we are dealing with, especially at the Bureau, is a lot of very young examiners right out of college, very idealistic, who think that they know better than the folks that they serve.

Ms. TENNEY. Thank you very much.

Thank you, Mr. Chairman.

Mr. LUETKEMEYER. The gentleman from California, Mr. Royce, the chairman of the House Foreign Affairs Committee, is recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Baer, I appreciate your expertise on the issue of combatting money laundering and the financing of terrorism. We had a hearing last week, and I shared my concern at that time that we are misaligning our resources and hindering legitimate consumers and businesses from accessing capital. And I specifically referenced the Clearing House's research on the subject, which concluded that the billions in bank resources spent on AML/CFT compliance have limited law enforcement or national security benefit. Now that was the conclusion.

Now, to be clear on this, I know you agree that banks should be spending ample resources on AML/CFT compliance, as do I. But we have missed the mark on creating a framework that emphasizes identifying and catching the bad actors. So examiners seem, at this point, to be more concerned with quantitative metrics. So the metrics are, you know, how many compliance officers have been hired or suspicious activity reports have been filed? But I am looking here for your direction in terms of what legislative steps would you have this committee take to better align our regulations with the goal of protecting the financial system from illicit financing, which was the original intent.

Mr. BAER. Thank you, Congressman. And thank you very much for your leadership on this issue, which has been continuing and important.

I think what we see—and it wasn't just the Clearing House. We worked on this report with experts in law enforcement, national security, global development, diplomacy, and everyone really came to pretty much the same conclusions, both about the problems with the system and the ways to fix them. The fundamental problem is not a resource problem; it is a management and leadership problem.

The analogy I use is you have one person teaching the course and another person drafting the exam and grading the test. And law enforcement and national security and development folks and others are not engaged in the enterprise of telling banks how to spend that money. They don't give them direction, goals, priorities.

Instead, as you note, they are graded by bank examiners who do what bank examiners do, which is look for policies and procedures and rigid adherence to those policies. So what law enforcement and national security want are financial intelligence units that think very cleverly about how to find a human trafficker or terrorist financier. And what the examiners have to in practice do—because they are actually excluded from that process. They really don't know what happens after these CCARs are filed. Law enforcement doesn't talk to them. National security doesn't talk to them. They check boxes. And that is not a really very smart system.

A lot of this could actually be reformed by Treasury, TFI, and FinCEN working with the regulators. Congress can certainly help in certain areas, I think, expanding information-sharing under 314(b) of the PATRIOT Act. And then, really importantly, and I know this Congress, this committee has in front of it legislation from Representative King and Representative Maloney on so-called beneficial ownership or eliminating the use of anonymous companies to cloak who owns—

Mr. ROYCE. Right, right. That probably would be a huge step if we could do that.

I have to turn to Mr. Michel. We have already seen the failure of a model that separates consumer protection regulation from safety-and-soundness regulation with respect to the GSEs. As the former Fed Chair Alan Greenspan noted after the financial crisis, "Fannie and Freddie paid whatever price was necessary to reach the affordable housing goals put in place by Congress in 1992." Now the result of that was that the GSEs purchased more than $1 trillion in junk loans. When we rang the alarm bell, when we tried to pass legislation—I had a measure on the House Floor to rein in the GSEs—our efforts were blocked as a tax on affordable housing. We had two agencies tasked with entirely different, often conflicting, objectives at the time.

So my question is, are you concerned that we have gone down this road with the CFPB? For example, I look at the plan to overhaul overdraft rules. If the CFPB gives borrowers 21 days to repay an overdraft rather than requiring it to come out of the next deposit, does it not morph into a line of credit that the bank will need to hold capital against? In other words, where do safety-and-soundness concerns come into play here? Where does the prudential regulator have that responsibility to take a look at that issue, if you can respond? Do you have that same concern?

Mr. HIMPLER. I'm sorry. I didn't hear the last part.

Mr. ROYCE. Do you have that same concern?

Mr. MICHEL. Oh, well, yes. And I don't think adding another regulator on top of the process does anything to fix this. And I think the whole premise is wrong in that the idea that finance companies, community banks, or big banks don't want to succeed and want to lend to people that cannot pay them back—the whole thing is twisted. So you have to start by uprooting that. That is my opinion.

Mr. ROYCE. Thank you very much.

Mr. Chairman, thanks.

Mr. LUETKEMEYER. The gentleman's time has expired.

I would like to go to a second round. I have a couple of follow-up questions myself, and Mr. Barr has a couple.

So, with that, we will recognize the gentleman from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman, for giving us a second round here.

And as you all know, Mr. Michel and Mr. Himpler, Director Cordray was in front of our committee yesterday, and I raised a concern with him about the Bureau's regulation on international remittances, and I shared with him a concern that was raised with me from a constituent about the Fort Knox Federal Credit Union. And as you can imagine, the Fort Knox Federal Credit Union serves many servicemembers who are deployed overseas, and they simply want to be able to send some of their paycheck back home to their spouses while they are deployed.

And because of the Bureau's overly burdensome regulations and the implementation of those rules, the credit union had to basically get out of the business, and that obviously was a huge inconvenience for those servicemembers and their families.

Director Cordray's excuse was that Congress made him do it and that it was our fault that this was happening. And, while, Mr. Himpler, you don't represent credit unions per se, but you all are observers of the Bureau. I just took a look at the statute, the Dodd-Frank law, Section 1022, which actually requires the Bureau to look at cost-benefit analysis and to mitigate costs such as this.

Does the Bureau have the discretion? Does Director Cordray have the discretion to ease the regulatory burden on regulated parties so that these kinds of consequences do not occur? And by the way, I asked him—the credit union in question called him thinking that this was an unintended consequence, and they reported to me that Director Cordray himself told them, no, this was an intended consequence. Can you comment on that?

Mr. MICHEL. Sure. He absolutely has the discretion to go the other way. It is one of the bizarre things, from my point of view. I understand what was going on in that environment when they passed Dodd-Frank. But from my perspective, you don't want—either side of the aisle—you don't want to create an agency like this because you might find yourself in a situation where you are on the opposite end of what you just created. Even if the Trump Administration doesn't fire Director Cordray, there will be a new Director. If that is somebody like, just say, I don't know, Todd Zywicki from George Mason, he will have the discretion to reverse a lot of this

stuff, just outright authority to do it, and then not do anything else that he doesn't want to do.

Mr. BARR. Mr. Himpler, can you comment on Director Cordray's pointing the finger at Congress instead of looking at what the Bureau can do itself to ease the burden on regulated entities like this Fort Knox Credit Union that no longer can serve its deployed servicemembers?

Mr. HIMPLER. Thank you, Congressman. Yes, I can.

I think one of the basic problems here when it comes to, not only remittance, but also other consumer products is that very few people—especially at the CFPB, but I would say just as equally at some of the other Federal regulators—have no experience in extending credit to consumers, have no experience in some of these products, be they remittance products, be they an installment loan, be they a subprime vehicle finance loan because you are trying to extend credit to a college grad that needs to finance his car to get to his first job.

Mr. BARR. I would just note that the Bureau seems to be able to have the discretion to ban financial services and products. I don't know why it doesn't have the discretion to help servicemembers deployed overseas send some of their paycheck back to their spouses back home. I think that is absurd.

Mr. Baer, one final question. This idea of gold plating of U.S. standards, we believe, as the financial CHOICE Act reflects, we believe that large systemically important institutions should be required to maintain or at least be incentivized to maintain healthy levels of capital. But can you speak to the apparent need for the government to impose requirements that go well beyond anything that we impose on banks around the world and the effect that this gold-plating idea may have on the competitiveness of American banks as they compete in a global economy?

Mr. BAER. Sure. Yes, gold plating is generally referred to as where U.S. regulators go off to the Basel Committee or the FSB and negotiate an international standard and then come back and dramatically increase the stringency of that requirement for U.S. banks and U.S. banks alone.

The competitiveness aspect is difficult to tease out, certainly at a time when European banks particularly are in difficulties and U.S. banks are doing well. We may see that over time. I can't tell you I have seen research to demonstrate that right now.

I think the bigger concern is simply the effect on economic growth and, in particular, certain types of lending as a result of higher standards than at least an international body thought was necessary. And that is true not only with respect to the ones that have been officially gold-plated, like the leverage ratio or the LCR, but if you think about the Federal Reserve CCAR stress test, there is a European stress test which bears no relation to it. So that is actually a whole construct that has no international parallel in any meaningful way except perhaps in the United Kingdom.

So there are certainly benefits to U.S. banks that have accrued from being the best capitalized and the most rapidly recapitalized postcrisis, and I don't think anyone would dispute that. And it has helped them competitively in a lot of ways.

But there are certainly areas where you see overlaps between these gold-plated rules. We talked about one earlier with respect to custody banks. And you also see with the way that they have imposed ring-fencing on foreign banks operating in the United States.

They are having, if not competitive effects, real effects on the ability of those firms to serve U.S. customers, whether they be corporate or individual.

Mr. BARR. Thank you.

I yield back.

Chairman LUETKEMEYER. The gentleman yields back.

I have just a few follow-ups to kind of clarify a few points very quickly here.

Mr. Baer, you talked at length about the Community Reinvestment Act. And one of the things that I have seen—you did a good job of explaining the Act and some of the concerns, probably some reforms that need to be done.

One of the things that I have seen is that the examiners now use this as sort of a punitive way to sort of—a carrot-and-stick approach where we will hold the exam open until you do something, or we will keep you from being able to merge a bank until you put a facility over here.

Is this something that you see yourself other places, how they are misusing some of these laws and leveraging against for other activities, trying to micromanage the bank?

Mr. BAER. Absolutely, Mr. Chairman. It is not just the Community Reinvestment Act. It is why I focused so much of my testimony around the CAMELS requirements and those standards, and a whole host of unwritten rules now that say, for example, if you have a consent order pending for any reason, even something unrelated to the kind of expansion you want to do, that effectively puts you in what the regulators now call the penalty box.

And if you look at why there hasn't been more growth, be it branching, mergers, acquisition, among, for example, midsize banks that everyone expected would be growing, it is because many of them have been in the penalty box for years. Because there is another unwritten rule that if you get a consent order, you can't get out of it for generally at least 2 years and often more; and during that whole time, you are in the penalty box, whether you are making good progress or not.

So, again, Congress never enacted any of these obstacles to expansion. In fact, if you look at the Bank Merger Act, or the National Bank Act or the Bank Holding Company Act, there are explicit standards for when you should be allowed to expand. And yet, there are new invented rules that have come along over the past few years that have really stopped this in their tracks.

Chairman LUETKEMEYER. And the arbitrariness of their actions really is breathtaking sometimes. The bank that I referenced in my opening testimony is someone from my area, and they have a very unique product at the bank. It is not illegal, they had it approved by the banking regulators, but it is a unique product. And as a result of that uniqueness, now that they want to sell the bank, the regulators are trying to get them to divest themselves of this product. Well, that is one of the reasons that the other banks want to

purchase them is because it is a money-generating activity that can help pay for the purchase of the bank.

And yet, they have been holding this open now for 5 years to try and keep them from doing this. This is the kind of nonsense that is going on, and that is why this hearing is here today, to see how these rules are being used and abused. So thank you for your comment.

With regards to the CAMELS rating, I would like for you to just explain a little bit more what your concerns are with that and your suggestions for reworking it, because I think this is very important.

Mr. BAER. Sure. The CAMELS rating, again, this was started in 1979 by the FFIEC, which is sort of the umbrella group for the regulators when they examine, and it rates you according to capital asset, asset quality management, earnings, liquidity, and then the S for sensitivity to interest rate, particularly market risk, was added probably a decade or so later.

The oddity is that when they adopted it, they had a series of subjective standards that examiners should look at in deciding whether you have good capital. Now, almost 40 years later, we have dozens of capital requirements that banks have to meet, and including the stress test for the larger institutions. And to the extent that you meet all of those, there really doesn't seem to be a very good argument that your rating should be anything other than one.

The same with liquidity, if you comply with the liquidity coverage ratio, which the regulators have explicitly designed to be a comprehensive look at the quality of your liquidity position. And, in fact, examiners—and they frequently do not give you a one or even a two for those things—they don't engage in a robust discussion or analysis of why, notwithstanding the fact that you have met all the requirements that their agencies themselves have created, you can't get a good rating.

And there is also another unofficial unwritten rule that if you have a three for management, you can't have better than a 3 for composite. And, of course, there are legal consequences in terms of your ability to expand if you have a three for either.

We look at what has happened over time as the CAMELS rating has sort of been divorced from financial condition, because that is being taken care of by capital and liquidity requirements. It has really become a compliance rating system. And that is what drives your management rating, that is what drives your overall composite rating, and that is what really, if you think about what has made the examination process so much more draconian, subjective, and really in a lot of areas arbitrary, it has been that move away from CAMELS as a wholesale look at your financial condition to really a focus on your willingness to engage in compliance activities that the examiners want you to engage in.

Chairman LUETKEMEYER. Thank you, Mr. Baer.

Mr. Michel, you talked a lot about the reorganization of these financial regulators. And one of the things in my discussions with a couple of the Fed presidents has been that they would like to see all of the Fed presidents be on the Fed Board instead of a rotating situation.

For instance, if a Fed president is not on the Board, that area of the country is not represented, per se, as other areas are on and

off, when the New York Fed has their permanent position there. To me, there is a fairness issue there. Would you like to comment on that?

Mr. MICHEL. Sure. And the way that it is set up is definitely a relic of the founding of the Fed in early 1900s, and there are a lot of issues like that. But this is one where it really doesn't make any sense anymore not to have everybody rotate on and to give the New York Fed a special sort of place there for various reasons.

I think you could even make the argument that the West Coast district is overly large now, based on obviously the way the population was when we started it.

The Federal Open Market Committee conducts open market operations through a system that was created for the technology at that time, and we have outstripped that. So these are all issues that could easily be addressed. I think the New York Fed one seems to be, although the New York Fed won't like it, a slam dunk, in that it really doesn't make any sense anymore not to have everybody rotate on.

Chairman LUETKEMEYER. Thank you.

With that, we want to conclude the hearing here.

The title of the hearing today was, "Examination of the Federal Financial Regulatory System and Opportunities for Reform." I have a whole list of the different bills or laws and actions that you all have discussed today, and we are going to use this hearing as a predicate to go out and have some more hearings and do some bills and some things, and we certainly appreciate your testimony along that line.

As a followup here, we didn't get a lot of testimony from the other side over here today and some of our members had to leave early.

So I would like to allow a minute or so—no 5-minute testimony now. I have a plane to catch, too. But if each of you would like to take just a minute to either summarize something that you thought was important that you didn't get a chance to discuss or respond to somebody else or present a new idea that we didn't have here, I would certainly entertain that opportunity. I will give you that opportunity.

So, Mr. Baer, if you would like to start first, why, we would certainly—

Mr. BAER. Mr. Chairman, I think the hearing has actually been quite good in doing a good survey of the procedural issues that we are now facing in banking. I think your anecdotes and some others were quite powerful in demonstrating how a breakdown in process actually makes a real difference to the way that banks are able to serve the community.

And I also think it is an area that is really ripe for Congressional oversight, because, again, we are talking about unwritten rules that have no basis in law and have no basis in regulation. Sometimes, they have basis in guidance, but often they don't even have basis in guidance.

And so I think it is—I guess maybe that is the one thing that we haven't focused a lot on, though—and I think someone alluded to it—is that we really now have regulation by guidance, regulation by enforcement.

And I think all of that is why Congress needs to keep an eye on this and make sure that the regulators actually are running a transparent process, not just because it is fun to run a transparent process and it is fair, but because that actually makes for better regulation.

Chairman LUETKEMEYER. Very good. Thank you.

Mr. Michel?

Mr. MICHEL. I would just sort of dovetail on that. I think we focus a lot on the CFPB and their discretion to do these things, and in some sense you see that in other banking regulators. Not just in some sense, but you often see that. Everybody knows that the bank examiners come in and say something about too many loans in one area or another, and you have to stop doing it. And so this is a discretionary sort of process that has evolved that I think you have a really good case to make for simplifying and fixing that problem by doing something like what you had in the CHOICE Act. It is an election. You can choose to go into a simpler regime. I think there is a lot of room to expand that. I know we didn't get to talk about that here, but I like where that is going.

Chairman LUETKEMEYER. Very good. Thank you, Mr. Michel.

Mr. Gerety?

Mr. GERETY. Thank you, Mr. Chairman, and thank you again for the opportunity to be here today.

I think the most important theme that I would pick up in the testimony today is just the great diversity of our banking system. We talked earlier today about rural banks. I was looking at data yesterday. The average rural bank with $50 million to $100 million in deposits earns about $1 million a year. At $10 billion, the average bank earns more like $100 million, $120 million a year. So even within the community bank space, there is just tremendous diversity.

And I think one of the major themes that needs to be focused on in any conversation about how to improve our financial regulatory system is about how do you simplify the burdens for the smallest banks in the system and not use those as a reason to roll back really important reforms for the largest and most complex institutions.

Chairman LUETKEMEYER. Great observation. Thank you, Mr. Gerety.

Mr. Himpler?

Mr. HIMPLER. Thank you, Mr. Chairman. I also want to thank you for holding this important hearing today.

I think I would reiterate what some of my colleagues have already said, in terms of the rural bank at $50 billion in deposits making a million dollars. We have small finance companies that are struggling with the same compliance burden as JPMorgan Chase. We are talking about the difference between keeping the doors open and affordable access to credit and closing those doors, because you just can't live under the burden as a small business.

For example, in its supervisory process in the auto space, the CFPB issued a larger participant rule. They captured in their net 90 percent of the overall market. That goes well beyond the largest of the large, even the large. Anybody that qualifies as large, they captured those folks. And what it means is that some of the small

finance companies are not going to be able to extend access to credit to that single mom who needs a car to get to work.

Chairman LUETKEMEYER. Thank you, Mr. Himpler.

And, again, thank all of you for being here today.

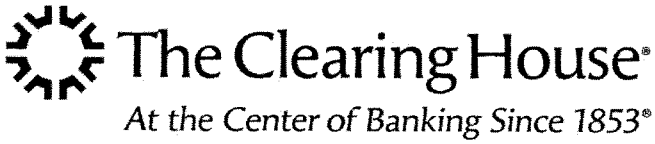
The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And, with that, this hearing is adjourned.

[Whereupon, at 11:43 a.m., the hearing was adjourned.]

A P P E N D I X

April 6, 2017



Testimony of Greg Baer
President
The Clearing House Association

Before the U.S. House Financial Services Subcommittee on Financial Institutions and Consumer Credit

At the Hearing *Examination of the Federal Financial Regulatory System and Opportunities for Reform*

April 6, 2017

I am pleased to appear before the Committee today to discuss the subject of excessive regulatory discretion. It is one in great need of attention. The due process clause and the Administrative Procedure Act are crucial to the proper administration of government, not only because they guarantee us fundamental regulatory fairness but also because public input and a transparent process tend to produce better regulation. Thus, while the purpose of this hearing is not to identify the post-crisis policies whose costs most exceed their benefits, it could well be, as there is a very strong correlation between policies that are procedurally flawed and those that turn out to be substantively flawed. Certainly, there are post-crisis regulations that, while procedurally unobjectionable, raise clear concerns – the Durbin Amendment and the regulation implementing the Collins Amendment, for example – but my focus today will be areas where reform of process could make a meaningful difference in substance, and yield clear economic benefits.

I should also note that there are certainly many post-crisis regulations that are both procedurally and substantively sound, and have helped to make the U.S. banking system significantly more resilient, and its largest banks resolvable (in other words, not too big or complex to fail). In other testimony and publications, The Clearing House has detailed both the benefits and costs of the post-crisis regime, but my focus today, as noted, is necessarily more on the latter.[1]

My testimony will highlight five areas where administrative procedure in banking regulation and supervision has broken down, with adverse consequences for the quality of rules being administered and the ability of our banking system to support economic growth.

1. CCAR

Bank capital levels clearly have risen dramatically and are significantly higher than they were before the financial crisis. The aggregate common equity tier 1 ratio of TCH's 25 owner banks rose from 4.6 percent at the end of 2008 to 12.2 percent at the end of last year. In dollar terms, tier 1 common equity for those banks nearly tripled from about $331 billion to $1.013 trillion over the past eight years. We now have a resilient banking system, and capital regulation has played a valuable role in constructing it.

That said, it is important to consider capital standards carefully because they have important ramifications for economic growth. While large banks are currently subject to over 35 different capital requirements, I will focus today on the Federal Reserve's "Comprehensive Capital Analysis and Review" or CCAR, stress test. To be clear, The Clearing House believes that stress testing is the smartest way to evaluate the resiliency of a bank. More static measures are necessarily backward looking and therefore assume,

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1 *See* https://www.banking.senate.gov/public/_cache/files/53257b19-de9a-4734-8fde-beead88a2de6/440F70F96DF111ADCEF153AFE8650672.062316-baer-testimony.pdf; http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-jnewell-20160712.pdf; and https://www.theclearinghouse.org/-/media/action%20line/documents/volume%20vii/20161201_state-of-american-banking-report_tch.pdf.

for example, that if subprime mortgages have repaid consistently over a period of years, they will continue to do so. Importantly, stress testing also recognizes implicitly the benefits of firm diversification: a given stress might cause losses to certain divisions of a diversified firm but bring gains to others. But there are growing concerns about the Federal Reserve's CCAR exercise – in particular about both procedural and substantive deficiencies in how it is constructed in theory and applied in practice. Because CCAR is becoming a binding constraint for most large banks, and they are changing their portfolios consistent with its implicit mandates, it therefore has considerable economic impact.

Background

The Federal Reserve's stress testing framework attempts to measure the ability of banks to withstand a very severe economic downturn. The quantitative stress test has two components: (i) the Dodd-Frank Act stress tests (DFAST) and (ii) CCAR. Under DFAST, both participating banks and the Federal Reserve each run their own stress test using backward looking assumptions about future capital actions – so-called "company run" and "supervisory" DFAST stress tests. In the company-run DFAST exercise, participating banks use their own models to run separate simulations to determine the effects of various supervisory scenarios, as well their own scenarios, on the bank's capital adequacy – that is, the estimated net losses and resulting reduction in capital of the consolidated BHC under those scenarios. Banks' own DFAST models are subject to an intensive review and approval process, both by compliance and audit teams at the bank and by the Federal Reserve staff. In the supervisory DFAST exercise, the Federal Reserve uses its own models to perform the same exercise.

CCAR builds upon this DFAST framework to calculate post-stress minimum regulatory capital ratios that banks are required to meet. Here, the Federal Reserve uses own proprietary models (i.e., those it also employs under the DFAST supervisory stress test), but runs the test based on the bank's actual proposed capital actions rather than standardized assumptions. After this stress, a large bank must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio. And it must do so assuming that it does nothing to shrink its balance sheets, reduce its dividend, or postpone planned share repurchases under severely adverse economic conditions– almost certainly deeply counterintuitive and extraordinary assumptions. Thus, a large bank that passes the CCAR exercise not only has sufficient capital to avoid failure under historically unprecedented adverse conditions – it has enough capital to emerge from such an event doing business as usual, and without taking actions that would be normal (or even compelled) under the circumstances.

For the 2017 exercise, banks must demonstrate how they would perform under a sudden and severe recession and coincident market crisis that features the following:

- A sudden jump in the unemployment rate of 4.2 percentage points (from 4.7 percent to 8.9 percent) during the first 4 quarters of the scenario;

- A sudden decrease in GDP of more than 6 percentage points;
- An abrupt rise in the BBB corporate bond spread;
- A 50 percent drop in the equity market over four quarters – roughly a 10,000-point loss on the Dow; and
- For banks with substantial trading and processing operations, the abrupt failure of their largest counterparty.

Collectively, this stress is far more sudden and stressful than the one imposed by the financial crisis of 2007-09, and apparently inconsistent with the Federal Reserve's own self-imposed standard for the severely adverse stress of being consistent with "post-war U.S. recessions."[2] As we have documented in our own research, the severely adverse scenario assumes a recession that includes an increase in the unemployment rate that is more severe than prior years' scenarios, and considerably more severe than the 2007-2009 financial crisis.[3] It is also considerably more stressful than its European stress testing counterpart.[4]

The Federal Reserve does not provide notice and the opportunity for public comment on these stress scenarios. However, since the CCAR process is a year-long cycle and the specifics of the supervisory scenarios change from year-to-year, with banks operating under short deadlines, it is difficult to understand why a full-year CCAR process could not accommodate a 30-day comment period, with 30 days for the Federal Reserve to incorporate and respond to comments.

Qualitative Assessment

The Federal Reserve's CCAR process also annually subjects banks to a "qualitative" assessment of their capital planning processes, and prohibits them from distributing capital to shareholders if the Federal Reserve fails them. This process is highly subjective, with the Federal Reserve routinely imposing standards and criteria that it has never communicated, let alone published for notice and comment. Furthermore, the results are effectively unappealable and have major consequences for bank equity prices – meaning that the qualitative assessment gives the Federal Reserve extraordinary power over the banks over which it renders a verdict. Recently, the Federal Reserve has rightly ended the opaque annual qualitative test in favor of the traditional examination process for all but the largest banks subject to CCAR. There is no reason to retain it for anyone.

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2 *See* 12 CFR part 252.

3 *See* The Clearing House, 2016 Federal Reserve Stress Testing Scenarios (March 2016), *available at* www.theclearinghouse.org/~/media/action%20line/documents/volume%20vii/20160316%20tch%20research%20note%20ccar.pdf.

4 *See* The Clearing House, *Comparison Between United States and European Union Stress Tests* (May 2016), *available at* www.theclearinghouse.org/-/media/files/research%20notes/20160518-tch-research-note-ccar-vs-eba-stresstests.pdf.

Objection to Bank Capital Plans under CCAR

Under CCAR, the Federal Reserve may object to a bank's capital plan on the basis of either the quantitative or qualitative assessment. In either case, the supervisory objection, effectively operates as both (i) a cease-and-desist order directing the bank to refrain from engaging in paying dividends or other distributing capital to shareholders, and (ii) a capital directive that requires the bank to increase its capital ratios, even if it is operating above regulatory minimums, and regardless of how far above regulatory minimums it is currently operating. This result effectively divests a bank's board of directors from its traditional (and fiduciary) authority to pay dividends and share repurchases.

CCAR's Impact on Credit Allocation in the Economy

As CCAR is the binding capital requirement, banks will tend to shift lending away from sectors with higher implicit capital requirements under CCAR – that is, sectors that are disfavored by the severe macroeconomic scenarios in the tests – and toward sectors with lower implicit capital requirements. In other words, the CCAR exercise has substantial asset allocation power, and the Federal Reserve's choices with resepect to CCAR can and do have a strong effect on the availability of credit.

A recent research note issued by the TCH Research Department shows just how powerful these credit allocation effects of CCAR can be.[5] The results of that research show that the Federal Reserve's CCAR stress test is imposing dramatically higher capital requirements on certain asset classes – most notably, small business loans and residential mortgages – than bank internal (approved by the Federal Reserve) models and Basel standardized models. For some asset classes – for example, commercial real estate – the Federal Reserve's CCAR stress test produces results similar to the results of the banks' modeled results, and lower capital requirements relative to the relevant standardized model.

By imposing higher capital requirements on loans to small businesses and mortgage loans, stress tests are likely curtailing credit availability to the types of borrowers that lack alternative sources of finance. Both small businesses and the housing sector perform a very important role in the U.S. economy. For instance, small businesses account for more than 40 percent of private nonfarm gross domestic product and the formation of new businesses contribute substantially for the creation of new jobs; large banks originate about half of those loans by dollar amount and substantially more than half by number.[6] Thus, by curtailing credit to these two key sectors of the U.S. economy, stress tests may be having an adverse impact on economic growth and contributing to the widening of income inequality among households. Conversely, our results also suggest

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5 *See* The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Tests* (January 2017), *available at* https://www.theclearinghouse.org/~/media/TCH/Documents/TCH%20WEEKLY/2017/20170130_WP_Implicit_Risk_Weights_in_CCAR.pdf.

6 *See* https://www.theclearinghouse.org/eighteen53-blog/2017/march/24-small-business-lending.

that stress tests impose lower capital requirements for commercial real estate and consumer loans than other capital standards; however, this outcome may reflect large banks' concentration in the lower-risk end of the commercial real estate lending spectrum and still tight consumer lending standards.

Opacity

Given the substantial economic importance and impact of the CCAR regime, one would expect that its key elements would have been subject to a robust and transparent public debate pursuant to the Administrative Procedure Act. But this is not at all the case: the most important drivers of CCAR results are decided by the Federal Reserve without public input and indeed, in some cases, without public access to the decision itself. First, as noted, although the Federal Reserve does at least publish its annual stress scenarios, it does so only in final form, without soliciting public feedback on those scenarios. Second, the Federal Reserve uses its own internal models to estimate stressed credit losses and net revenues but provides virtually no detail regarding the statistical specifications of these models. Nor does it disclose any data on the actual performance of the models it uses in stress testing.[7]

As a matter of basic administrative procedure, the lack of transparency around CCAR's most important aspects is deeply problematic. Imagine, for example, if the IRS were to repeal the tax code and tell you instead that it would determine your tax liability by taking your income information and running it through a secret internal model. Most would find such an idea unfathomable, and yet this process is how the binding capital requirement for our largest banks is actually set.

It is also worth noting that although stress-testing is now a standard supervisory practice globally, the U.S. CCAR exercise is unique in its opacity. Most notably, under both the Bank of England and the European Banking Authority stress testing regimes, models used by participating banks play a key role. In particular, in these jurisdictions banks can take into account their own past loss experience and incorporate differences in business models, which likely results in more accurate bank-specific projections of post-stress capital ratios.

The Bottom Line: Concerns about Accuracy

Given the significant impact that the Federal Reserve's CCAR models have on economic output, it is remarkable how little we know not only about their contents, as noted above, but about their *performance*. Even if one were to grant that the Federal Reserve had reason to keep its models secret (which we do not), nothing stopped it from using those models to perform baseline predictions of losses or revenue, and compare those results with bank results. Thus, we simply have no idea if the Federal Reserve's models – whatever their formulas may be in theory – actually work in practice. It is worth noting that while the GAO conducted a critical review of the Federal Reserve's

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[7] *See* https://www.aei.org/wp-content/uploads/2017/03/Kupiec_Stress-Test_032017.pdf

CCAR process – taking over two years to do so – that review did not include an analysis of the quality of the models (which it was not permitted to see) or the performance of those models (as either the Federal Reserve has no such data or would not share it).

There is little reason to believe that the Federal Reserve's models are more accurate predictors of stress losses and revenue than banks' own (Federal Reserve-approved) models. For the large majority of projections, Federal Reserve's models are based on an industrywide, portfolio-specific, and instrument-specific approach and generally do not incorporate bank-specific effects. For example, the loss given default on a particular type of loan is assumed to be the same for all banks, and does not take into account an individual bank's own resources and experience in recovering defaulted loans. This will likely generate sizable differences between loan loss estimates from banks' own models and the projections made by the Federal Reserve. Similarly, in order to model revenue successfully, banks use models tailored to their individual business models.[8] The Federal Reserve's ccar models do not do so; instead, the Federal Reserve tries to ameliorate this problem by including time-varying bank risk characteristics as explanatory variables in their revenue models; however, this approach likely harms the predictive accuracy of Federal Reserve's models.[9]

At least in part because of the simplifying assumptions on Federal Reserve's models, we observe sizable differences in the projections of stress losses and revenues made by Federal Reserve and banks' own models each year. For example, the Federal Reserve's estimates for loan losses (provisions) were $382B in CCAR 2015 and $439B in CCAR 2016, while banks' own estimates were $324B and $345B, respectively, or, approximately 18 percent lower than the Federal Reserve's projections.

Recommendations

To address these and other existing problems with CCAR, we recommend that the Federal Reserve undertake the following changes:

- Subject the annual stress test scenarios to a 30-day notice and comment period under the Administrative Procedure Act;
- Correct counterfactual and incorrect assumptions about how banks would behave in a crisis (e.g., continued dividends and repurchases under severe stress);
- Permanently suspend any action to increase effective post-stress minimum requirements under CCAR (e.g., through incorporation of the GSIB capital surcharge);
- Use banks' own DFAST results to estimate stress losses for purposes of the CCAR quantitative assessment; restrict use of the Federal Reserve's own models to a supervisory assessment; and disclose those models to the public to

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8 *See* Michael Duane, Til Shuermann and Peter Reynolds, *Stress Testing Bank Profitability*, J.OF RISK MANAGEMENT IN FINANCIAL INSTITUTIONS (2014), Vol. 7(1) at 72-84.

9 *See* Paul Kupiec, *Inside the Black Box: The Accuracy of Alternative Stress Test Models* (2017).

benefit from peer review; and

- Eliminate the qualitative assessment from CCAR for all banks, returning to the traditional examination process.

We note that pursuant to these reforms, the Federal Reserve would continue to engage in modeling as part of CCAR. Such modeling would inform its oversight of the banks' own models. If a bank's own models were deemed insufficient, the Federal Reserve's model would be offered as evidence in issuing a capital directive or other enforcement action.

Significantly, under this approach, because there would be no concern that all banks would allocate credit according to the Federal Reserve's models (a/k/a "gaming"), there would be no reason for the Federal Reserve's models to remain secret. They could then benefit from peer review by the academic community in a way that bank models (which are proprietary) cannot.

2. **CAMELS Ratings**

The CAMELS rating system was adopted in 1979, at a time when there was no capital regulation, no liquidity regulation, and no stress testing regulation – in other words, at a time when bank supervision was necessarily highly subjective. That system is now hopelessly out of date. Detailed capital, liquidity and other rules have been expressly designed and carefully calibrated to evaluate the key components of the CAMELS ratings: obviously, capital and liquidity, and less obviously, earnings and asset quality, which are evaluated through stress testing for certain banks. The CAMELS regime thus is now clearly outmoded in design, and has also become punitive and arbitrary in practice.

Outmoded Design

The CAMELS system evaluates a bank across six categories – capital, asset quality, management, earnings, liquidity, and sensitivity to market risk, especially interest rate risk – and assigns a composite rating, all on a scale of 1 (best) to 5. Except for the addition of the "S" component, the CAMELS standards have not been materially updated in the almost 40 years since their adoption – not since adoption of the Basel Accord on capital in 1988, the Comprehensive Liquidity Analysis and Review in 2012, or the Liquidity Coverage Ratio in 2014 .

Thus, for example, the standards that examiners apply in deciding the Capital component of the rating do not include consideration of any post-1978 regulatory capital standards – or any market indicators, which also have grown in sophistication over the past few decades. Rather, they speak vaguely of "the ability of management to address emerging needs for additional capital" and "balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities." Similarly, for the Liquidity component, compliance with the Federal Reserve's self-titled "*Comprehensive* Liquidity Analysis and

Review" is not mentioned in the standards; instead, there are vague conditions such as "access to money markets and other sources of funding" and "the trend and stability of deposits."

In a speech in 2013, the Federal Reserve Board noted approvingly this state of affairs:

> If you look at the criteria for rating capital adequacy under the banking agencies' CAMELS rating system for banks, and under the Federal Reserve's RFI rating system for bank holding companies, you will actually see very few references to minimum regulatory capital. Instead, the focus is on maintaining capital that is commensurate with the overall risk profile of the bank, not just credit risk. This requires both management and the supervisor to have an effective understanding of the banking organization's risk profile, which is central to our supervisory program.[10]

This statement is difficult to fathom. The stated purpose of CCAR, DFAST, Basel III, and even the standardized approaches to capital adequacy is *exactly* to ensure that capital is "commensurate with the overall risk profile of the bank."[11] The Federal Reserve has, on numerous occasions, touted CCAR – which, as indicated by its very title, is intended to be a "comprehensive" assessment as a program through which "the Federal Reserve assesses the overall capital adequacy of the firms, including evaluations of whether each firm's capital provides an adequate buffer for the losses that would be incurred during the stress scenarios, whether its risk management and capital planning processes are appropriately well-developed and governed, and how its plans to distribute capital through dividends or share repurchases could affect its ability to remain a viable financial intermediary in the hypothesized scenarios."[12] Thus, in no sense whatsoever are those capital standards limited to "just credit risk." While there is a standardized approach to capital solely devoted to credit risk, there are also frameworks for market risk and operational risk for banks for which they are relevant. If there is a part of the

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10 *See* Sarah Bloom Raskin, Let's Move Forward: The Case for Timely Implementation of Revised Capital Rules (June 6, 2013), available at www.federalreserve.gov/newsevents/speech/raskin20130606a.pdf.

11 Indeed, the Basel Committee has explained that one of the primary purposes and functions of the Basel III capital reforms was to respond to "the need to strengthen the risk coverage of the capital framework" and ensure that all types of risks were reflected and addressed in the bank capital framework. *See* Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (rev. June 2011) at 3.

12 Governor Daniel K. Tarullo, Next Steps in the Evolution of Stress Testing (September 26, 2016), *available at* https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm, *See also* Tim P. Clark and Lisa H. Ryu, CCAR and Stress Testing as Complementary Supervisory Tools, *available at* www.federalreserve.gov/bankinforeg/ccar-and-stress-testing-as-complementary-supervisory-tools.htm (noting that "[t]ogether [supervisory stress tests and CCAR] allow supervisors to move beyond more traditional static analysis of capital ratios and to conduct a forward-looking evaluation of capital adequacy that incorporates both quantitative analysis and qualitative reviews of large BHCs' capital planning and positions").

"banking organization's risk profile" that these risk-based capital measures are missing, no regulator has ever identified them.[13]

Indeed, one further weakness of the CAMELS system is that it treats each factor as independent, when in fact they are intensely interrelated. Consider the Federal Reserve's CCAR stress test, which is effectively a measure of capital adequacy. Both the asset quality and earnings of the firm drive that capital requirement. So, a firm with more risky loans and more capital can perform as well as a firm with less risky loans and less capital. The "A" in CAMELS, taken singularly and literally, suggests that a bank that takes more risk would receive a lower score than one that takes less risk. But, as modern capital measures and stress testing recognize, the reality is far more complex, and demand an assessment that is holistic, not compartmentalized.

Arbitrary Practices

The CAMELS rating system was adopted to evaluate an institution's "financial condition and operations" – in other words, its safety and soundness. Over time, however, CAMELS ratings have become progressively more arbitrary, subjective and compliance focused. Perhaps because capital, liquidity and other factors are now regulated directly and specifically, the CAMELS rating has come to focus myopically on the one highly subjective factor: Management. Various "unwritten rules" reportedly have been adopted:

- Any compliance problem resulting in enforcement action, regardless of its materiality, results in a downgrade of Management;.
- In terms of ratings, "2" is the new "1," and "3" is the new "2." Thus any downgrade in management rating will be from a "2" to a "3."
- An institution with a "3" for Management cannot have better than a "3" Composite rating.

This is not to say that there cannot be cases where a bank that is deemed well-capitalized under 35-plus different capital tests could not in theory still require more capital. It is to say, though, that an examiner making a judgment that those 35-plus tests have proven insufficient with respect to the bank under supervision should face a high bar and, more importantly, have to produce an actual, reasoned, and easily appealable analysis as to why. Nothing can be further from the truth today.

Major Consequences

The stakes for a CAMELS rating were raised significantly in 1999, when the Gramm-Leach-Bliley Act conditioned the ability to continue as a financial holding company on maintaining a CAMELS 1 or 2 rating. (Financial holding companies are those that may exercise certain non-bank financial activities.) Prior to 1999, a supervisor

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[13] It is worth noting that if the sole capital requirement were a leverage ratio, which treats all assets as having the same risk, then a subjective supervisory assessment of capital would be necessary. But that is manifestly not the case currently.

with genuine safety and soundness concerns was required to use the options laid out for it by Congress in statute: namely, the issuance of an order to correct an unsafe and unsound condition or practice – an enforcement action under 12 U.S.C. § 1818 of the FDI Act—or the issuance of a capital directive under 12 U.S.C. § 3909(d)), promulgated under the International Lending Supervision Act of 1983. Both types of orders came with a meaningful ability for the institution to appeal, including a notice of charges and an opportunity for a hearing before an Administrative Law Judge. With enactment of the Gramm-Leach-Bliley Act, both those processes became dead letters with respect to financial holding companies. Regulators had no need to draft a formal notice of charges, or put their allegations to the test in front of a neutral arbiter, when all they had to do was threaten a CAMELS downgrade, or actually execute a CAMELS downgrade.

While only larger banks tend to be part of a financial holding company, mid-sized and small banks are effectively subject to the same restrictions. Regulators call this the "penalty box," whereby all expansion is halted until compliance violations – generally minor and relevant to only a small part of the organization – stop all expansion for years at a time.

Thus, the CAMELS system has changed from an overall evaluation of the safety and soundness of an institution to an evaluation of routine compliance matters and the readiness with which management accedes to examiner criticism – all as the consequences of a low rating have risen dramatically. That is not to say that compliance matters are not important; it is to say that they should not pollute a system designed for an altogether different, very important safety and soundness purpose, and should not be exempt from legally required procedural requirements. *Nothing better explains the current imbalance in the supervision and regulation process than these changes to the CAMELS regime.*

Relatedly, other supervisory "unwritten rules" have grown up alongside the CAMELS process. For example, expansion is prohibited so long as any consent order is pending. Consent orders cannot be lifted for at least two years, and generally significantly longer. Consent orders and more informal enforcement action often require a bank to hire independent consultants to perform the work of the bank (and the examiner), which further lengthens the remediation process.

The results of this new supervisory regime are significant:

- Banks of all sizes, but particularly mid-sized banks, have been blocked from branching or merging to meet their customers' needs.
- Bank technology budgets often are devoted primarily, not to innovation, but rather to redressing frequently immaterial compliance concerns.
- Board and management time is diverted from strategy or real risk management and instead spent remediating frequently immaterial compliance concerns, and engaging in frequent meetings with examiners, to ensure that they are fully satisfied.

The unfortunate truth is that examiners have three powerful reasons to ignore market data and regulatory capital ratios in assigning CAMELS ratings. The first reason is to remain relevant. Second, to gain leverage over the firms they examine. Third, to avoid an accusation – either now or in the future – that they were either inattentive or captive. Those are powerful motivations, and perfectly understandable ones. Of course, it is exactly why the CAMELS regime must be upgraded to include clear, objective standards for evaluation.

Lack of Process

Given the potential impact of a CAMELS rating, one might expect banks to appeal adverse ratings frequently. That does not happen, however, for two reasons. First, every banker and bank counsel is taught that "examiners have long memories," so retaliation is expected as the norm.[14] Second, appeals are made to the same agency that assigned the rating. For example, at the Federal Reserve, the ultimate arbiter in an appeal is a designated Federal Reserve Board Governor, while at the FDIC, appeals are ultimately decided by the agency's Supervision Appeals Review Committee, which consists of three voting members: one inside FDIC Board member, and one deputy or special assistant to each of the inside FDIC Board members who are not designated as the SARC Chairperson. In addition, the FDIC's General Counsel serves as a non-voting member of the Committee.

Law Professor Julie Andersen Hill published an article in 2014 in which she analyzed the appeals process at each of the three federal banking agencies"[15] Professor Hill explains that the processes and standards governing appeals are far from transparent and that the standards for reviewing appeals differ across the agencies (and with respect to the Federal Reserve, among individual Federal Reserve Banks themselves), leading her to conclude that the appeals process at each agency is "a dysfunctional and seldom used system."[16] Further, for those few banks that attempt to appeal a supervisory decision, Professor Hill concluded, based on the data that she was able to obtain, that banks seldom win their appeals.[17] Thus, the appeals system is rife with disincentives for financial institutions to pursue remedies against supervisory actions with which they disagree, and it is not surprising how few appeals there are. Indeed, there are so few that the agencies do not even keep good records of them. For example, when Professor Hill attempted to obtain the records of banks' appeals from the Federal Reserve under FOIA, the agency advised that there were no records available for any appeals between 1995 and 2000.[18]

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[14] Indeed, in recognition of this tendency to retaliate, the agencies have adopted internal policies criticizing examiner retaliation against institutions for pursuing supervisory appeals.

[15] "When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations," by Julie Andersen Hill, Associate Professor of Law, University of Alabama School of Law (2014) at 14, *available at* www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION2_AndersonHill.pdf

[16] *Id.* at 4.

[17] *Id.* at 4.

[18] *Id.* at 4, 64.

Interestingly, the CAMELS rating system has no reference in statute. It was issued by the FFIEC – the umbrella group through which the banking agencies issue call reports and other common forms – pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, which provides only that the FFIEC "shall establish uniform principles and standards and report forms for the examination of financial institutions which shall be applied by the Federal financial institutions regulatory agencies." It seems difficult to read "uniform principles and standards" to convey a numerical grading system.

Recommendations

We strongly recommend that Congress repeal the CAMELS requirement for financial holding company status under the Gramm-Leach-Bliley Act and replace it with a requirement allowing the regulators to disqualify a bank from financial holding company status on managerial grounds – after notice and the right to a hearing. We also recommend that the banking agencies replace the current CAMELS system with an entirely different construct, after a notice and comment process under the Administrative Procedure Act. One potential model is the system that the Federal Reserve uses to evaluate bank holding companies.[19]

In the interim, existing guidance should be amended to modernize the CAMELS rating system, as follows:

- A bank that is well capitalized under all relevant capital requirements, including its parent holding company's passage of its most recent CCAR/DFAST stress test if applicable, should be presumed to be "1" rated for purposes of its Capital rating.

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[19] Under this "RFI/C(D)" rating system, BHCs generally are assigned individual component ratings for risk management (R), financial condition (F), and impact (I) of nondepository entities on subsidiary depository institutions. The risk management component is supported by individual subcomponent ratings for board and senior management oversight; policies, procedures, and limits; risk monitoring and management and information systems; and internal controls. The financial condition rating is supported by individual subcomponent ratings for capital adequacy, asset quality, earnings, and liquidity. An additional component rating is assigned to generally reflect the condition of any depository institution subsidiaries (D), as determined by the primary supervisor(s) of those subsidiaries. An overall composite rating (C) is assigned based on an overall evaluation of a BHC's managerial and financial condition and an assessment of potential future risk to its subsidiary depository institution(s). A simplified version of the RFI rating system that includes only the risk management component and a composite rating is applied to noncomplex BHCs with assets of $1 billion or less. Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 numeric rating indicates the highest rating, strongest performance and practices, and least degree of supervisory concern, whereas a 5 numeric rating indicates the lowest rating, weakest performance, and the highest degree of supervisory concern. *See* Federal Reserve Supervisory Letter SR 04-18, "Bank Holding Company Rating System," (December 6, 2004), *available at* www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm

- A bank whose parent holding company has passed its most recent CCAR/DFAST stress test should be presumed to be "1" rated for purposes of its Asset Quality rating.
- A bank's Management rating shall reflect primarily the risk management practices of the bank, focused on those practices that have a *material* effect on its *safety and soundness*.
- A bank whose parent holding company has passed its most recent CCAR/DFAST stress test should be presumed to be "1" rated for purposes of its Earnings rating.
- A bank that is in compliance with the Liquidity Coverage Ratio, if applicable, should be presumed to be "1" rated with respect to Liquidity.
- A bank's composite rating should be an average of each of its component ratings, weighted equally.
- Compliance with laws that do not directly affect safety and soundness – including the Bank Secrecy Act and consumer laws – should be dealt with under separate and existing enforcement authority or the Compliance rating.

Consistent with these changes, the banking agencies should also adhere to the statutory standard prescribed by Congress in evaluating acquisitions under the Bank Holding Company Act, mergers under the Bank Merger Act, and branching applications under the International Banking Act, and not pursuant to additional hurdles created by supervisory fiat. The statutory standards here are clear.[20] Applications should be

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[20] The Bank Holding Company Act prohibits the Board from approving any acquisitions that would result in a monopoly or substantially lessen competition and requires the Board to consider, among other things, the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, the effectiveness of the relevant company or companies in combating money laundering, and whether the transaction would result in greater or more concentrated risks to the stability of the United States banking or financial system. *See* 12 U.S.C. § 1842(c). Similarly, the Bank Merger Act provides that the responsible agency shall not approve any proposed merger transaction that would result in a monopoly or substantially lessen competition and requires such agency to take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, the effectiveness of the relevant institutions in combating money laundering, and the risk to the stability of the United States banking or financial system. *See* 12. U.S.C. § 1828(c). Finally, in considering an application by a foreign bank to establish a federal branch or agency in any state outside its home state, as set forth in 12 U.S.C. § 3103(a)(3), the Comptroller of the Currency must determine that the foreign bank's financial resources, including the capital level of the bank, are equivalent to those required for a domestic bank to be approved for branching under 12 U.S.C. § 36 and 12 U.S.C. § 1831u, which sets forth the criteria that must be considered in evaluating interstate bank mergers. In addition, the OCC must consider the factors that must be considered in evaluating interstate bank merger applications under 12 U.S.C. § 1831u, including consideration of the most recent CRA evaluation of any bank which would be an affiliate of the resulting bank and the record of compliance of any applicant bank with applicable State community reinvestment laws. In addition, each bank involved in the transaction must be adequately capitalized, and the resulting bank must be well capitalized and well managed upon the consummation of the transaction. The Comptroller also must consider the same factors that the Board must consider in evaluating an application for the establishment of a foreign bank office in the United States under the financial and managerial resources of the foreign bank, including the bank's experience and capacity to engage in international banking. *See* 12 U.S.C. 3105(d).

processed promptly according to those criteria, and arbitrary CAMELS requirements and other supervisory creations should not be imposed.

We also strongly recommend that the Federal Reserve publish for notice and public comment, and submit any final rule to the Congress pursuant to the Congressional Review Act, the contents of its Supervisory Letter 14-2. That guidance, which the Federal Reserve has clearly treated as a regulation, includes a wide range of supervisory limits and conditions on bank expansion that have no basis in law.

3. Living Wills

Title I of Dodd-Frank requires large banks to construct a pre-packaged bankruptcy plan under the Bankruptcy Code, and requires regulators to review the credibility of that plan. This requirement is an important and altogether appropriate one. The required review, however, has been translated into a shadow regulatory regime, almost entirely opaque, and with real economic consequences. While any regulatory review of a bankruptcy plan will necessarily have subjective elements, and require some element of confidentiality, many requirements imposed under the living will process are unnecessary and even counterproductive under the resolution regime accepted by those same regulators.

Most U.S. G-SIBs have based their living will on the single-point-of-entry (SPOE) resolution strategy.[21] Under the SPOE strategy, all the losses across a U.S. G-SIB would be absorbed by shareholders and creditors of its parent holding company, which would fail and be put into a Chapter 11 bankruptcy or an FDIC receivership under Title II of Dodd-Frank. The two principal benefits of this strategy are (i) making it legally and operationally feasible to impose losses on holding company debt holders, thereby vastly expanding the loss absorbency of the relevant banks, and (ii) allowing the material operating subsidiaries to remain open and operating, thereby minimizing the systemic consequences of a large banking organization failure.

The Federal Reserve has made SPOE a viable option through its Total Loss Absorbing Capacity Rule, which requires U.S G-SIBs to hold massive amounts of capital or long-term debt at the top-tier holding company level.[22] Under the rule, each U.S. G-SIB is required to maintain minimum total loss absorbing capacity equal to 21.5 percent

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[21] All but one of the U.S. G-SIBs have now publicly adopted the SPOE bail-in strategy as their preferred resolution strategy under the U.S. Bankruptcy Code and are otherwise expected to be resolved with an SPOE strategy under Title II of the Dodd-Frank Act. These U.S. G-SIBs have adopted the SPOE strategy in their living will plans: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup Inc.; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; and State Street Corporation.

[22] The Federal Reserve's TLAC rule also requires the U.S. IHCs of non-U.S. G-SIBs to maintain substantial amounts of internal TLAC that can be utilized to recapitalize the U.S. IHCs should they become troubled. See Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8266 (Jan. 24, 2017).

to 23 percent of its total risk-weighted assets, and 9.5 percent of its total assets. *The eight U.S. G-SIBs alone are expected to maintain, on an aggregate basis, more than $1.5 trillion in total loss absorbing capacity.* The scale of this reform has not been widely appreciated. Furthermore, a protocol entered into among the major dealer G-SIBs, the ISDA 2015 Universal Resolution Stay Protocol, prevents close-out of derivatives at the subsidiary level based on a holding company bankruptcy, thereby eliminating the largest possible source of systemic instability (witness, Lehman Brothers) from a holding company bankruptcy.[23] In order to extend this systemic protection beyond dealer bank transactions, the Federal Reserve, FDIC and OCC have proposed a rule that would generally require G-SIBs to include resolution stays in financial contracts with all of their counterparties, and we urge them to finalize that rule promptly.[24]

Despite the fact that these banks have credible living wills based on an SPOE strategy, the FDIC and Federal Reserve are imposing massive costs on some firms – and their customers – by effectively requiring them to structure themselves almost as if the SPOE strategy did not exist. In other words, the regulators seem to be requiring substantial liquidity and capital to be pre-positioned – and therefore, trapped – at material subsidiaries on the assumption that each such subsidiary will be resolved independently. This is the antithesis of the SPOE strategy outlined in the approved plans.

By way of example, the most recent living will guidance issued in April 2016 requires each of the largest U.S. banking organizations to determine its Resolution Liquidity Adequacy and Positioning, or RLAP, as well as its Resolution Liquidity Execution Need, or RLEN.[25] RLAP requires the firm to estimate standalone liquidity needs of each material subsidiary for 30 days of stress, and ensure liquidity is either pre-positioned in the subsidiary or otherwise available at the parent as HQLA to meet deficits. RLEN requires the firm to further account for the estimated liquidity needed post-bankruptcy filing to support the surviving or wind-down subsidiaries. The guidance states that firms must assume that a net liquidity surplus in one material subsidiary cannot be moved to meet liquidity deficits at another material subsidiary. The guidance imposes similar requirements with respect to pre-positioning of loss absorbing capital resources at material subsidiaries. Not only are these overly prescriptive liquidity and capital pre-

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23 International Swaps and Derivatives Association ("ISDA"), Adhering Parties: ISDA 2015 Universal Resolution Stay Protocol (last updated June. 17, 2016), available at https://www2.isda.org/functional-areas/protocol-management/protocol/22

24 Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (proposed May 11, 2016) (the Federal Reserve's proposal); Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 81 Fed. Reg. 55,381 (proposed Aug. 19, 2016) (the OCC's proposal); and Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 74,326 (proposed Oct. 26, 2016) (the FDIC's proposal).

25 Similar guidance was issued just last week to the largest foreign banks operating in the United States.

positioning requirements antithetical to the underlying premise of the SPOE strategy, they also interfere with, and indeed may even supersede, other existing liquidity regulations, at high cost to the efficiency with which firms operate, and the efficiency with which they can serve their clients. The appropriate remedy here is clear: any firm using the single-point-of-entry resolution strategy and in compliance with the TLAC requirement for holding company loss absorbency, the living will process should not include any incremental liquidity or capital requirement at the operating subsidiary level.

Finally, the agencies take an extraordinarily broad, counterfactual view of what constitutes a "material entity" at which both capital and liquidity must be prepositioned for resolution purposes. The agencies generally define a material entity to include any subsidiary that is significant to the activities of a critical operation or core business line of the firm. But this definition is far too broad. At a minimum, a material entity for this purpose should include only entities whose failure would impose systemic consequences or result in a material loss to the organization's insured bank affiliate.

Most remarkably, none of these requirements have been put out for public comment (or submitted to the Congress under the Congressional Review Act), although they meet every criterion for a rule. RLEN and RLAP are creations of the supervisory process, and have no grounding in law or regulation. Moreover, the details of the requirements are designated as "confidential supervisory information," and thus any public complaint about their contents is, in the view of the agencies, a federal crime.

If notice and public comment were permitted, we would argue that the extraordinary costs of entity-level requirements are unwarranted given the absence of any benefit. Furthermore, we believe that such requirements are actually counterproductive to resolution: trapped liquidity cannot be used by the holding company in recovery or the resolver in resolution to be sent to the entity actually experiencing trouble in the way that holding company liquidity can.

4. Supervisory Involvement in Bank Corporate Governance

Another area that has become subject to increasing and alarming levels of supervisory intrusion, opacity and subjectivity is bank corporate governance. There is little public appreciation for the extent to which regulators and supervisors now seek to influence, or even dictate, aspects of the governance of banks' boards of directors and management. These actions, which can be more akin to conservatorship than traditional examination, can take various forms:

- In some cases, examiners attend board of directors or board committee meetings, which both chills candid discussion and inevitably shifts the agenda from corporate strategy and economic risk to regulatory topics.
- Even where examiners do not attend meetings, they insist on detailed minutes for all board and many management committee meetings.

- These minutes are used by examiners to grade how well the participants are performing, in the entirely subjective opinion of an examiner. The result can be junior examiners quizzing Fortune 500 CEOs and other seasoned directors on whether they are asking enough questions at board of director meetings.
- Examiners insist on votes at management committees that operate by consensus.
- Examiners have decided views on the appropriate jurisdiction of board committees – often insisting, for example, that the Risk Committee assume the most authority – and management committees.
- Examiners often assert that the positions of chairman of the board and chief executive office should not be held by the same person. Boards make this judgment as a fundamental exercise of their fiduciary duties to shareholders. Shareholders are frequently asked through the proxy shareholder proposal process whether such a structure should be adopted. Nevertheless, regulators have forced this structure in some institutions and have raised the possibility of imposing such a requirement generally.
- Examiners have decided views on reporting lines within management and to board of directors.
- Examiners require banks to expend extraordinary resources conducting due diligence on vendors, many of whom pose little or no safety and soundness risk.
- Examiners generally view it as necessary for the board of directors to review in depth the remediation of any compliance violation, regardless of materiality.

These regulatory positions invariably have two things in common: (i) they are not based on any study or analysis – e.g., which structures performed best in the financial crisis, or over some longer period of time; and (ii) they are generally not subject to public notice and comment. Also, in many cases, these views vary by examination team. So, for example, while it may well be true that banks perform better when the head of compliance reports to the chief risk officer rather than the chief legal officer – and that is decidedly the current regulatory view – we are aware of no analysis or study demonstrating as much. The question of splitting the CEO and chairman position is obviously one debated across all industries, many of them heavily regulated, but it is only bank regulators who have chosen to substitute their views for those of the board and shareholders.[26]

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[26] For example, the OCC has noted that "some national banks have split the roles of Board Chairman and Chief Executive Officer," and so "[w]e should consider whether this structural change by some national banks makes sense for all federally supervised banks, or at least the largest most complex ones." Comptroller of the Currency Thomas J. Curry, *Remarks Before The Clearing House Annual Conference* ((Nov. 30, 2016) at 6, available at www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-149.pdf. This notion is hard to reconcile with the National Bank Act, which states that, as a default matter, "[t]he president of the [national] bank shall be a member of the board and shall be the chairman thereof." 12 U.S.C. § 76.

Of course, one could observe that bank management and boards simply should say no to such mandates. Here, the relationship to CAMELS and other "unwritten rules," and the absence of any meaningful appeals process, is highly relevant. A bank resisting examiner mandates risks a "3" management rating, a refusal to lift a consent order that is blocking any expansion, or some other version of regulatory penalty box.

Consequently, we hear frequently from bank management that more than half of board of director time – and in some cases, significantly more – is devoted to regulation and compliance, as opposed to innovation, strategy, risk and other crucial topics. Examiner pressure has bank boards and management frequently driving with a rear view mirror, focused on ensuring remediation with past problems, frequently immaterial, rather than anticipating future risks. It also inappropriately blurs the distinct roles of board and management on which U.S. corporate governance is based. These regulatory mandates often impose on directors a range of responsibilities and duties that are effectively management, rather than oversight. Last year, The Clearing House published a report on the proper role of the board that included an annex that summarized all the matters that regulation or guidance requires a bank board or committees to review; this annex was 144 pages long.[27]

For example, bank boards of directors are required or generally expected to:

- Approve and periodically review the liquidity risk-management strategies, policies, and *procedures* established by senior management (12 CFR 252.34(a)(2));
- Approve written *policies and procedures* for insurance and annuity *sales programs* (BHC Supervision Manual, Section 3950.0.4.1);
- Approve a *list of appraisers* as part of the loan or appraisal policy (SR 97-25; SR 95-51);
- Approve the *choice of* and *networking agreements with* third parties providing retail nondeposit investment products (Comptroller's Handbook, Retail Nondeposit Investment Products);
- *Establish* dual controls and separation of duties for funds transfer systems (FFIEC Information Technology Handbook, Wholesale Payment Systems Booklet); and
- *Ensure* that vendors to which collective investment fund management functions are outsourced perform in a safe and sound manner in compliance with applicable laws and policy guidance (OCC Bulletin 2011-11 (March 29, 2011)).

If a goal is for banks to refocus on lending and economic growth, a good start would be for the banking regulators to undertake a wholesale review of all the formal or informal corporate governance guidance they have issued (generally, without notice and

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[27] https://www.theclearinghouse.org/sitecore/content/tch/home/issues/articles/2016/05/20160505-tch-publishes-the-role-of-the-board-of-directors-report

comment) to determine what level of examiner intervention in the governance and management of banks is appropriate. We would strongly urge that such a review be undertaken pursuant to the Administrative Procedure Act, so that public comment could inform that process.

5. Community Reinvestment Act

The Community Reinvestment Act was enacted by Congress in 1977 to encourage financial institutions to help meet the credit needs of their local communities.[28] Congress enacted the CRA in response to concerns that federally insured banking institutions were not making sufficient credit available in the local areas in which they were chartered and acquiring deposits.[29] Consequently, the CRA was enacted to reaffirm the obligation of financial institutions "to help meet the credit needs of the local communities in which they are chartered, consistent with the safe and sound operation of such institutions."[30] The CRA requires federal banking regulators to conduct examinations to regularly assess the records of banks in terms of meeting local credit needs and requires those records to be taken into account when institutions apply for charters, branches, mergers, acquisitions, and other applications that require regulatory approval.[31]

The legislative history of the CRA demonstrates that it was motivated by Congressional concern with "redlining" – the practice by "banks and savings and loans [in which they take] their deposits from a community and instead of reinvesting them in that community . . . actually or figuratively draw a red line on a map around the areas of their city, sometimes in the inner city, sometimes in the older neighborhoods, sometimes ethnic and sometimes black, but often encompassing a great area of their neighborhood."[32] The purpose of the Act was thus to require "private financial institutions [to] play the 'leading role' in providing the capital required for 'local' housing and economic development needs."[33] Indeed, "the overwhelming focus of the legislative history of the CRA was on the need to preserve local communities through recognition of the fact that depository institutions could invest in their local communities and still make a profit."[34]

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28 P.L. 95-128, 12 U.S.C. §§ 2901-2908.

29 Congressional Research Service, "The Effectiveness of the Community Reinvestment Act," Darryl E. Getter, Specialist in Financial Economics (January 7, 2015).

30 12 U.S.C. § 2901.

31 *See* 12 U.S.C. §§ 2901, 2903.

32 *See* "The Community Re-Investment Act of 1977: Its Legislative History And Its Impact On Applications For Changes In Structure Made By Depository Institutions To The Four Federal Financial Supervisory Agencies," Warren L. Dennis, *citing* Statement of Senator Proxmire, Congressional Record, daily ed., June 6, 1977, at S.8958, available at: http://faculty.msb.edu/prog/CRC/pdf/WP24.pdf

33 *See id. citing* Statement of Senator Proxmire, Hearings on S.406, at 1.

34 Joseph Moore, *Community Reinvestment Act and Its Impact on Bank Mergers*, 1 N.C. Banking Inst. 412, 415 (1997), *citing 123 CONG. REC. 17,631 (1977) (statement of Sen. Proxmire); See*

Thus, under the CRA, the ratings are defined as to an "outstanding [or satisfactory, or needs to improve] record of meeting *community credit needs*."[35] The statute directs the agencies to "assess the institution's record of meeting *the credit needs* of its entire community, including low- and moderate-income neighborhoods...."[36]

While the CRA has proven controversial over the years, until relatively recently, it could fairly be said that the agencies had implemented it in a way that gave banks clear incentives to lend to underserved communities, and clear benchmarks for determining whether they were doing a satisfactory or outstanding job of doing so.[37] More recently, however, regulators have increasingly included in their assessments other criteria, and in particular, consumer compliance or other violations outside the scope of the CRA. The result of this departure from the letter of the law undermines the larger objectives of the CRA itself.[38] A company doomed to a "needs to improve" rating by virtue of an unrelated compliance issue has no regulatory incentive to engage in additional lending to raise its rating to satisfactory or outstanding. Thus, John Taylor, the head of the National Community Reinvestment Coalition and a staunch proponent of the CRA, recently criticized the regulators' expansion beyond the original purpose of the CRA to encourage lending in underserved communities. Mr. Taylor stated, "I don't want the message to the banks to be, 'It doesn't matter how good you do on the lending, if you do something wrong in another area, you could fail.' . . . I think it's a better idea to ding them, downgrade them, but don't totally ignore the positive performance. You want to support that."[39]

Community Credit Needs: Hearings on S. 406 Before the Senate Comm. On Banking, Housing, and Urban Affairs, 95th Cong. 133 (1977 at 17,633 (statement of Sen. Sarbanes), *available at* http://scholarship.law.unc.edu/ncbi/vol1/iss1/23.

35 12 U.S.C. § 2906(b)(2) (emphasis added).

36 12 U.S.C. § 2903 (emphasis added).

37 To assess compliance with the CRA, the federal banking regulators today apply three tests, known as the *lending*, *investment*, and *service* tests. *See* 12 CFR parts 25, 195, 228, and 345. The *lending* test evaluates the number, amount, and distribution across income and geographic classifications of mortgage, small business, small farm, and consumer loans; the *investment* test grades community development investments in the assessment area; and the *service* test examines retail service delivery, such as the availability of branches and low-cost checking in the assessment area. *Id.* at 3. Small banks are evaluated only under the lending test; intermediate small banks are subject to both the lending and investment tests, while large banks are subject to all three tests.

38 This problem is exacerbated by the fact that CRA ratings are inherently backward-looking, such that the negative consequences of any past issues may persist long after they are successful remediated and addressed.

39 *See* Politico Morning Money (March 30, 2017), *available at* www.politico.com/tipsheets/morning-money/2017/03/brexit-has-broken-219500.

Finally, it seems clear that when a bank commits a sales practice or other consumer law violation, there is no shortage of enforcement agencies and legal regimes available to seek redress and punishment. Adding the CRA to that long list thus has little marginal benefit, and risks undermining its core purpose. Realigning the CRA with its actual language and intent, and eliminating the regulators' subjective and inappropriate extension of the CRA into other areas at their own discretion, would render the CRA both procedurally sounder and substantively more effective.

Conclusion

Thank you again for the opportunity to testify before you today on these important matters. As I mentioned at the start of my testimony, we believe that transparency and public input make for better rulemaking. I would add that your oversight also contributes to better enforcement of the rules. In the case of CCAR, better rulemaking will help achieve better economic outcomes, while in areas like the CRA transparency will help achieve the purposes of the original statute. We believe these goals are achievable without abandoning the many improvements that have been made in supervision and regulation since the financial crisis.

I look forward to answering your questions and continuing to work with you on these and other matters.

Flexibility and Responsiveness in Financial Regulation:
The Design and Implementation of the Dodd-Frank Act

Amias Moore Gerety
Former Acting Assistant Secretary for Financial Institutions
U.S. Department of the Treasury

Testimony before the House Financial Services Committee

Thank you Chairman Luetkemeyer and Ranking Member Clay, Committee Chairman Hensarling, Ranking Member Waters, and members of the Committee for the opportunity to be here today and to offer my perspective on the ongoing need for effective regulation and supervision of the banking system.

In the fall of 2008, a financial crisis of tremendous scale and severity left millions of Americans unemployed and resulted in trillions in lost wealth. Our broken financial regulatory system was a principal cause of that crisis. It was fragmented, antiquated, and allowed large parts of the financial system to operate with little or no oversight. The financial system had dramatically evolved over decades, with business models often intentionally designed to take advantage of regulatory gaps or unequal treatment of similar markets and institutions. For example, trillions of dollars in swaps were traded without transparency or oversight. Many bank-like institutions operated outside the regulatory view of bank agencies. This allowed some lenders to make irresponsible loans and then shed all the associated risks, often through securitization vehicles that both obscured and interconnected these risks, and use hidden fees and fine print to take advantage of consumers. When the crisis exposed these massive inadequacies, another became apparent -- regulators did not have the tools to safely wind down many of the system's largest, most complex institutions. Instead they were faced with the unpalatable choice of either intervening to prevent certain institutions from failing, or letting them fail at the risk of imperiling the entire financial system and plunging the country into a Second Great Depression.

Americans paid a high price in lost wealth, jobs and homes, delayed retirements and college educations. We all learned that in the end, our financial system only works -- our market is only free -- when there are clear rules and basic safeguards that prevent abuse, check excesses, and ensure that it is more profitable to play by the rules than to game the system. Dodd-Frank was passed to make sure that Americans could again put their trust in financial markets and institutions.

Dodd-Frank enacts a number of provisions that curb excessive risk taking and hold financial firms accountable. Our regulators also worked with international counterparts to refine capital and liquidity standards to ensure that U.S. firms face an even playing field at home and abroad. However, the policymakers that drafted Dodd-Frank recognized that our financial system is dynamic and risks cannot be adequately addressed by a one-size-fits all approach. The law therefore provides that regulatory requirements be tailored and commensurate with the risks they seek to regulate – including exempting smaller banks from most of its new requirements – and providing regulators with flexibility to address new risks as they arise.

I've organized my testimony today in two parts. First, I will begin with a brief discussion of the how the post-crisis Wall Street Reforms have strengthened our financial system and supported our economic recovery and offer a number of considerations that should be part of any evaluation of changes to financial regulation.

In the second section, I will discuss how the ability to deliver regulation that is appropriate to the risk is the central question for policy makers designing financial regulation-- both of individual institutions and for the constantly evolving financial system as a whole. In this section , I will discuss how the interplay between statute, regulation, guidance, and supervision can work together to provide appropriate regulation for the country's wide diversity of banks and nonbanks. I will then discuss how the statutory architecture of Dodd-Frank is designed to help achieve that goal. In particular, Dodd-Frank uses clear exemptions, statutory requirements for tailoring, and market-based rules to help assure that regulators are focused on this central question. Finally, I will discuss how regulators have responded to statutory direction and used the statutory discretion that they have been given to be consistently responsive to legitimate concerns about regulatory burden and to create a tiered and tailored regime.

Before continuing, it is important to note that the goal of bank regulators must not be to satisfy the banking industry, but rather to satisfy the public interest. For that reason, the best test of how regulators are progressing through their work is whether financial markets are stable, loans are extended on clear and fair terms, and agencies demonstrate consistent openness to new approaches and an ability to flexibly apply their rules over time. And I will discuss how I believe our current economic backdrop provides evidence of that.

SECTION I: ECONOMIC STRENGTH AND EVALUATING CHANGES TO FINANCIAL REGULATION

ECONOMIC RECOVERY AND FINANCIAL SYSTEM HEALTH

The continued economic recovery since the financial crisis, particularly when viewed in comparison to other countries that were hard hit, demonstrates that the increased stability and resilience of our financial system have not come at the expense of economic growth. As financial reform was being implemented, the private sector added 15 million net new jobs and household wealth grew by $30 trillion. At the same time real GDP growth continued steadily since Dodd-Frank passed and remained positive, even as Europe weathered a sovereign debt crisis and the UK suffered a double dip recession.

Within the banking sector, recovery has been strong and widespread. Business lending has grown steadily since Dodd-Frank was passed, and corporate bond issuance in public markets has reached record highs. The banking system is currently delivering on its promise to provide credit to the economy. In the past two years, community bank lending and earnings growth has outpaced the industry as a whole -- with more than 10% income growth in 2016, and lending up nearly 9% -- both faster than the industry as a whole.[1] Examining these trends for segments of

1 FDIC, "Quarterly Banking Profile: Q4 2016," February 28, 2017.

banks by size, bank performance data show that the annual growth rate of lending by community banks has been consistently positive across large and small community banks and recently has been in line with rates seen even in the pre-crisis period. In fact, the four years from 2011 to 2015 each set new, all-time records for aggregate earnings in the banking sector.[2]

The improvements within the fundamentals of the banking sector are coupled with improvements in capital markets -- asset managers and investors benefit from increased transparency and resiliency -- whether delivered by improvements to derivatives markets or clearer understanding of bank risk through stress testing. Market discipline is supported by clear rules and by additional transparency.

Of course, this aggregate strength masks local weakness in some markets, particularly in rural or underserved communities; and nationally for small businesses that do not have strong track records of profitability or assets to use as collateral. To address these issues, Treasury oversaw an expansion of the Community Development Financial Institutions fund -- and in particular worked closely with community development bankers to help them better serve their communities. Implementing the Small Business Jobs Act of 2010, Treasury created the Small Business Lending Fund, which invested $4 billion dollars in more than 300 community banks to spur small business lending, and partnered with states and cities to support local small business lending programs in the State Small Business Credit Initiative. The Small Business Lending Fund supported more than $18 billion in new small business lending. The State Small Business Credit Initiative has created an innovative network of partnerships between state and local governments and industry, and is on track to leverage the federal support for small business lending ten-fold. This network is working today and should be renewed, and I know that members of this Committee, including Ranking Member Waters have supported that legislation.

EVALUATING CHANGES IN FINANCIAL REGULATION

Briefly, I'd also like to point out a few considerations by which to evaluate the course and progress of our financial regulations.

As you know, while many non-controversial rules are finalized within a year, the process of a promulgating a major, new regulation from statutory direction to implementation can be 4-5 years. The time it takes a regulator to develop a final rule will depend a variety of factors, and is driven primarily by three interlocking forces: the analytical complexity of the rule and the number of agencies required to collaborate; the obligations to follow the Administrative Procedures Act, to follow agency authorizing statutes, and to make rules consistent with the specific statutory direction; and the need to consider the perspectives of all affected constituencies, including entities that will be directly regulated or indirectly affected, oversight bodies such as this committee, consumers and public interest groups, and industry groups. Importantly, the same care and attention that makes these rulemaking processes slow to complete, also make these rules slow to revise. One common criticism of the rulemaking process is the length of the number of pages of text in the final release. Yet in most cases, the length of releases is driven by the desire to explain the rule and in particular to explain how the

2 FDIC, Historical Statistics on Banking, 2016.

final rule responded to each and every comment that was submitted during the process. The rule text itself is often less than 10% of the final release.

It also is critical to appreciate the difference between transition costs and long-run costs. Even for the most beneficial change in regulation there will be transition costs that any regulated entity will have to incur in order to move their systems and processes into line with the new approach. For example, the CFPB's move to an integrated disclosure form for TILA/RESPA compliance has shortened and simplified the forms needed for a mortgage closing, even though firms do face burdens in order to update their systems and processes for the simpler forms.[3] I would encourage any member of this committee to spend time looking at the new and the old forms. The clarity and simplicity of the new forms is striking. To take another example, asking firms to create living wills was something that no bank had ever been asked to do prior to Dodd-Frank. Developing those plans required significant new thinking and for many large firms, required them to make changes to their legal structure. However, these changes are largely transition costs of simplifying banks and of building systems necessary to keep their plans up to date. These transition costs can be managed through tiered transition timelines, guidance, and trainings from regulators; but they should not undermine the effort to change our financial system so that it can work better in the long run.

Comparisons of economic or financial statistics between the current day and the pre-crisis peak are both a misleading and dangerous way to evaluate the effects of a regulation. The period immediately preceding the global financial crisis, seemed at the time to be an era of positive economic growth and dynamism. Yet the outcomes of the crisis demonstrated that those years were actually driven by significant imbalances, unstable financial engineering, and systematically underappreciated risk. Therefore, any analysis of the current economic and financial environment must look very carefully to make sure that it does not compare current prices or levels of activity with the immense excess that led to the global financial crisis.

SECTION 2: REGULATION APPROPRIATE TO RISK

Financial stability benefits banks, insurance companies, and asset managers, as well as small businesses, tech startups, and families looking to refinance a home mortgage or save for retirement. Economists who have studied the banking system and financial markets have shown how market distortions and disruptions undermine financial stability. If those problems are left unaddressed, the consequences can be dire for everyone, as we saw in 2008. We must prevent the future instability by maintaining robust safeguards, which is what the Dodd Frank Act set out to do.

Let us start with the simple but central point: a $200 billion bank is not the same as a $2 trillion bank; nor is it the same as a $20 billion bank, a $2 billion bank, or a $200 million dollar bank. The U.S. banking system is far less concentrated than our peer developed nations, and this diversity is a strength. Moreover, the diversity in size among the 6,000 banks in the U.S. actually

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3 The TILA/RESPA forms before revision and after are available at https://www.consumerfinance.gov/know-before-you-owe/compare/

understates their differences, given the diversity in business models. From a community bank that focuses on serving one rural community, to a bank that focuses on banking medium-sized businesses across a region, to money center institution with enormous capital market operations stretching across the globe -- banks come in all stripes. Even among the very large banks, there are significant regional and business model differences, with different degrees of exposure to capital markets and to macroeconomic trends. Because of this diversity our regulatory approach needs laws, regulation, guidance, and supervision that are able to deliver appropriate oversight based on risk to financial stability.

Doing so is not simply a matter of having tiered regulation- moving numerical thresholds up and down to govern different kinds of regulation- it is a matter of both assessing risk and tailoring regulation to that risk. Therefore, Dodd-Frank takes both a tiered and tailored approach.

In order to deliver a regulatory system that is appropriate to the risk, we must be clear-eyed about the risks we face. This means acknowledging that tough standards must apply to the largest, most complex institutions; and that we must have the tools to handle their failure.

For the largest and most complex institutions, Dodd-Frank matched an increase in simple requirements, like the leverage ratio, with new quantitative standards on liquidity, and new tools to monitor and mitigate risk across the network of financial institutions. Dodd-Frank also recognizes that the financial system is changing all the time and that new nonbank firms can grow to be central to our financial system. That is why the Financial Stability Oversight Council is accountable for monitoring changes to the financial system and for making sure that any firm whose failure could disrupt financial stability is subject to strong oversight. From the perspective of being better prepared to handle a crisis, we now have a clear statutory framework for letting any financial firm fail without taxpayer support. It is only by having a clear plan and clear legal authority that we can avoid the awful choices that we faced in the fall of 2008, between the panic-inducing failure of Lehman Brothers and the bailout of AIG. Removing the authority to liquidate large, complex financial institutions the way that we have done for banks of all sizes would be a return to the policy of too big to fail.

DODD-FRANK PROVIDES A COHERENT FRAMEWORK TO CREATE RISK-APPROPRIATE REGULATIONS

The tiered and tailored approach uses a combination of different tools to fit carefully the risk posed by both types of activities and types of entities. In many cases, Dodd-Frank creates simple demarcations for where rules and standards do or do not apply, and even within these demarcations, Dodd-Frank uses clear and strong statutory language to require specific tailoring based on risk. In other cases, Dodd-Frank bases its statutory requirements on participation in particular markets and activities. Since the activities subject to these provisions, like comprehensive derivatives reform and disclosure and risk-retention requirements, are largely capital markets oriented, these markets and activity-based frameworks create natural tailoring and tiering to only the large, complex firms that engage in these activities. And importantly, Dodd-Frank distinguishes between the largest firms and the significantly different and simpler standards needed for community banks. It is important to note, however, that the principles of tiered and tailored regulation are also balanced with the needs and demands of citizens who

expect to have consistent and ethical treatment in their financial transactions. Therefore, the statutory framework governing the CFPB creates a supervisory and enforcement focus on the large participants, while also applying consumer rules broadly in the marketplace.

Title I of Dodd-Frank, lays out a statutory framework for applying the toughest regulations, so-called enhanced prudential standards, to the financial institutions that pose the most risk. These standards begin with a simple demarcation, they only apply to bank holding companies with more than $50B in assets and to nonbank financial firms designated by the FSOC. In addition, the Federal Reserve has a clear statutory mandate to adjust these regulations based on the risk and the business models of these firms.

I will make two observations relevant to the ongoing debate about changing this level. First, this threshold acts as a statutory requirement for where the Federal Reserve must begin to engage in enhanced oversight and monitoring of these firms -- it does not, either by statute or by regulation, imply that firms at this threshold are "systemically important." Second, any movement of this threshold does not absolve policy makers from answering the central question -- given a bank of $50 billion or $75 billion or $100 billion, what are the capital and liquidity standards that should be applied based on the risk of that bank? Moreover, the Federal Reserve has already made significant modifications of their rules -- both to make the standards and their application significantly stricter for the largest, most complex banks, and to create lower standards with simpler application for smaller banks.

Another tailored aspect of the regime is the comprehensive reforms of the derivatives markets, which only apply to entities significantly engaged in derivatives markets. These new rules are a key pillar of Dodd-Frank's efforts to protect the U.S. economy from the potential of another devastating financial crisis. In the crisis, derivatives were both a central accelerant of the market panic and implicated in many of the worst practices that characterized the sub-prime mortgage bubble. For example, Bear Stearns, Lehman Brothers and AIG had trillions of dollars in derivatives contracts that tied them tightly to other large, complex financial institutions around the globe. As these institutions neared failure in 2008, their derivatives exposures were unknown by general market participants, counterparties, and government officials. The question of who was bearing the risk dominated discussions in markets and accelerated the contagion to other financial firms. The overwhelming importance of derivatives in the midst of the crisis was not incidental. These same instruments played a key role in the original construction of sub-prime mortgage backed securities, as well as, the construction of collateralized debt obligations (CDOs). Of course, synthetic CDOs were constructed entirely of bundles of derivatives contracts.

From the perspective of Dodd-Frank implementation, community banks and small institutions can avoid any burden associated with regulating these enormous markets simply by continuing to avoid significant engagement in derivatives markets. Even among entities that engage routinely in derivatives markets, the statute directs the rules to apply more stringently to swap dealers and major speculative players in derivatives markets. It also sets out specific rules appropriate for clearing houses and trading venues, entities that have always been under the oversight of the SEC and CFTC -- and for whom, heightened scrutiny is needed given the importance and risk in

derivatives markets. Moreover, the statute provides exemptions for entities that use derivatives purely as end-users; and makes clear that banks with less than $10 billion in assets can be end users.

The application of the disclosure and risk retention requirements for securitizations follow a similar statutory framework. A securitization is a pool of financial assets grouped together into a security that can be sold off in pieces. This structure was central to the contagious panic that pervaded in the depths of the crisis. By pooling assets without clear and consistent disclosure -- investors could know the type of assets and the overall characteristics but not the way in which these assets would be affected by fast-developing market movements. Moreover, it was well known that the financial entities who created these securitizations did not have to hold on to the risk. When the assets started to underperform, these skewed incentives caused a significant rupture in the market and in the flow of credit to the economy. In particular, Dodd-Frank requires for the first time asset-level disclosure in all securitizations. Just as importantly, Dodd-Frank requires that entities that create securitizations retain a portion of the risk of the securitization -- a simple requirement that chefs must eat their own cooking.

While Congress was developing these statutory provisions, there were many advocates who believed that the incentives should be structured to require that the rules apply to anyone who originated an asset that would be included in a securitization. In Dodd-Frank, however, Congress did not apply these rules to originators of assets. Congress recognized that many smaller institutions and even non-financial institutions could be considered originators of assets that might be later securitized. Therefore, Dodd-Frank applies these rules to the entity that engages in the financial action to create a securitization -- this language means that the rules apply to the major financial players who are at the center of this market, not peripheral actors.

In the creation of the CFPB, Dodd-Frank uses both clear demarcations and statutory guidance to drive a tiered and tailored approach. Most importantly, Dodd-Frank maintains a single supervisor for all community banks with less than $10 billion in assets -- more than 90% of all banking institutions have no supervision from the CFPB.[4] This means that an FDIC supervised bank before Dodd-Frank remains supervised by the FDIC, and only the FDIC, for both consumer compliance and safety and soundness. For nonbanks, Dodd-Frank requires the CFPB to follow a similar principle. Before the CFPB can supervise a nonbank financial company, it must go through a notice and comment rulemaking to define the large participants in a consumer financial market -- and supervision only applies to those large participants. Importantly, the purpose of these large participant rules is that they provide the CFPB the ability to supervise nonbanks in the same way that community banks have been supervised by the bank regulators for decades.

Moreover, the CFPB's statutory purpose is tailored to making consumer financial markets "fair, transparent, and competitive." And the Bureau must consider the benefits and costs of its rulemaking, and has a specific requirement to consult with small businesses that could be affected by its rules.

Of course, the long standing consumer lending laws, such as the Truth in Lending Act are

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4* FDIC Community Banking Study. https://www.fdic.gov/regulations/resources/cbi/study.html

generally applicable to any entity that extends credit to a consumer. This breadth of application carries over into the CFPB's work, which now has authority to implement these consumer lending laws. It reflects Congressional judgment, dating back nearly 50 years, that consumers should not be subject to widely divergent statutory protections, based on whether they engage with a bank, nonbank, or other entity.

Finally, the work of Congress and the last Administration since the passage of Dodd-Frank reflected a commitment to the principles that changes should be broadly bipartisan, practical, and focused on the needs of smaller community banks. This is why statutory changes such as doubling the threshold for small bank holding companies, or increasing the exam cycle for well-managed and well-capitalized community banks from 12 to 18 months, passed both the House and Senate and were signed by President Obama without controversy.

REGULATORY FOLLOW THROUGH ON DODD-FRANK'S TIERED AND TAILORED APPROACH

Following the clear and coherent statutory framework in Dodd-Frank to apply a tiered and tailored approach, regulators have demonstrated commitment to design regulations that differentiate firms based on their risk as well as a consistent willingness to be responsive to legitimate concerns about overbearing regulatory standards both through regulation and guidance.

In the final text of the Volcker Rule, the agencies eliminated compliance burdens for any banking entity that does not engage in activities covered by the rule. The only requirement is that if any bank begins to engage in capital markets activities, only at that time must they develop compliance policies. With this approach, the rule-writing agencies sought to create an effective protection for community banks from the Volcker Rule's provisions which did not apply. However, when the rule was finalized -- certain capital instruments that were commonly held by community banks, known as Trust Preferred Securities or TruPS were caught up in the definition of private equity and hedge funds. When community banks and members of Congress brought this issue to the attention of regulators, they were able to issue guidance to resolve the issue within 5 weeks of promulgating the final rule.

In another example, as the CFPB was finalizing its mortgage rules, it recognized that rural lenders would likely require more latitude to comply with the requirements and would need to be exempt from key provisions. In the initial final rule, the CFPB adopted a definition of rural area used by the U.S. Department of Agriculture (USDA). However, many community banks determined that the USDA definition would not capture many small rural communities that were within geographical proximity of metropolitan areas. For example, the initial rule would have excluded some rural portions of Maryland's Eastern Shore from the definition of rural because of their distance to Baltimore. Because this definition was too significant to clarify with guidance, the CFPB worked quickly to re-propose and finalize a different and more expansive definition of rural area.

The Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") requires the federal banking agencies to conduct a review of their regulations every ten years. The purpose is

to identify outdated or otherwise unnecessary regulatory requirements imposed on banks. On March 21, the banking agencies sent the latest report required under EGRPRA to Congress.[5] Governor Daniel Tarullo's accompanying letter to Congress restated his view that it is appropriate to tier regulatory requirements based on size, including with respect to capital, enhanced prudential standards, incentive compensation, and the Volcker Rule. Specifically, Governor Tarullo said that, "precisely because community banks were not at the source of the problems that led to the financial crisis, it has been easier to identify areas in which the burden associated with certain regulations seems incommensurate with any incremental gains to safety and soundness."[6]

The Report that the FFIEC agencies produced at the end of the EGRPRA process highlights several ways in which banking regulators have sought to simplify regulations and better tailor them to institutions. In thinking about differences of size, the bank regulators have introduced a new version of the Call Report for banks with less than $1 billion in assets, which will reduce the length from 85 pages to 61 pages. There are also other Call Report simplifications for larger banks that have just gone into effect. In addition, qualifying banks with less than $1 billion in total assets are now eligible for an 18-month (rather than a 12-month) examination cycle; subject to qualifications, this could cover 83% of insured depository institutions in the U.S. The regulators also recognize geographic differences; commentators raised the fact that in rural areas it is often difficult for banks to satisfy the appraisal requirements necessary for certain real estate transactions. In response, the regulators raised the threshold that triggers appraisal requirements and created a process for issuing waivers and allowing temporary practice permits. And the regulators have also shown a willingness to be responsive to general concerns raised by the industry. Specifically, the FFIEC announced that they will issue for notice and comment new, simplified capital rules for certain assets in direct response to comments received under EGRPRA on issues like high volatility commercial real estate, mortgage servicing assets and deferred tax assets.

CONCLUSION

A broad, diverse, and dynamic financial system is a benefit to the U.S. economy and to our citizens. But this strength can only be realized on the foundation of clear rules, appropriate oversight, and independent expertise. Here in Washington, the pain of the financial crisis may be receding from memory, but throughout the country the cost of lost jobs, lost homes, and the immeasurable cost of lost opportunities persist. This cost, above all,to the United States, our citizens and taxpayers, must be the central consideration when evaluating changes to our regulatory system.

In writing the Dodd-Frank Act, Congress sought to make our financial regulations both more protective and more responsive to changes in our economy and in finance. Since the passage of Dodd-Frank, the regulatory agencies and their staff have demonstrated immense capacity to

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5 EGRPRA Report Release and materials can be found at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170321a.htm.

6 https://www.federalreserve.gov/foia/files/crapo-brown-hensarling-waters-letter-20170321.pdf

listen to the concerns of industry, advocates, and citizens -- both to design and revise regulations and guidance that increase the stability and the fairness of our economy.

The result is that our financial firms, our financial system, and most importantly our economy is far stronger and more resilient today than it was preceding the crisis. Investors and counterparties have more faith in their financial transactions and investments, and the U.S. has continued to distinguish itself as the safest and most dynamic place to invest capital in the world. Our task is to build on that growth and stability to deliver benefits to more communities and more small businesses, not to roll back this progress and increase our risk of another crisis by bringing back the policies that led to panic and bailouts.

United States House of Representatives

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

* * *

Hearing On:

Examination of the Federal Financial Regulatory System
and Opportunities for Reform

* * *

Thursday, April 6, 2017

* * *

Statement for the Record

By The

American Financial Services Association

The American Financial Services Association (AFSA) is pleased to submit this testimony to the Subcommittee on Financial Institutions and Consumer Credit on the occasion of its hearing on the Examination of the Federal Financial Regulatory System and Opportunities for Reform. Founded in 1916, AFSA is the only national association that is solely focused on consumer credit issues.

Over a hundred years ago, hardworking Americans had difficulty getting small personal loans. Commercial banks generally limited personal loans to the more affluent and to their bank depositors. State usury laws often set limits that made it unprofitable for other legitimate lenders to make small cash loans. With few borrowing options available, many consumers resorted to loan sharks. A group of lenders decided to change this situation. They formed the American Association of Small Loan Brokers, now known as AFSA. The association worked with the Russell Sage Foundation to draft the Uniform Small Loan Law, a version of which was adopted by many states to ensure that consumers had access to affordable credit at a rate that provided a sustainable profit for lenders. Today, AFSA members provide consumers with many kinds of credit.

As the Federal Reserve notes, consumer credit balances, exclusive of mortgage, stand at roughly 2.5 trillion dollars.[1] Banks account for originating roughly 60 percent of this credit, but finance companies account for almost one third. It is imperative that the subcommittee understands that banks and finance companies represent very different business models. Federal regulators have a long history of effectively supervising banks. Finance companies, though, are creatures of state law and have been supervised and examined at the state level for close to 100 years. Trying to supervise banks and finance companies as if they are the same could prove disastrous for the consumers they serve and for the health of the economy.

To that point, while he was still a member of Congress, Rep. Barney Frank, one of the authors of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), wrote to Raj Date, the then-acting director of the Consumer Financial Protection Bureau (CFPB or Bureau) in 2011, "I urge the staff to pay close attention to the difference among products offered by nonbank institutions, and to be mindful of Congress' intent in financial reform that state consumer protection laws be preserved to the extent possible."[2] Rep. Frank went on to state, "For example, there are key differences in product characteristics between payday, car title, and other high-cost secured loans, and more traditional closed-end, unsecured lending and related products, and the products are often regulated differently by the states."[3] Rep. Frank concluded, "To the extent that state regulation has worked to protect consumers with regard to financial products offered by nonbank institutions, I encourage the Bureau to coordinate and work with the states to preserve such protections."[4]

AFSA strongly believes that credit should be available to everyone who can manage it. Credit should not be limited to the wealthy or those with perfect credit scores. Credit should be made available to the single mom who needs a loan to purchase a car seat and crib for her new baby – regardless if she has a few dings on her credit, so long as she can still afford the monthly payments

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[1] *See Appendix I.*
[2] *See Appendix II.*
[3] *Ibid.*
[4] *Ibid.*

of an installment loan. Credit should be made available to the recent college grad who may not have a good credit record yet, but needs financing to purchase a car to get to his first job.

It is not apparent that the Consumer Financial Protection Bureau (CFPB or Bureau) shares this philosophy. The CFPB seems to believe that credit should only be extended to those borrowers who do not present any risk, such as holders of the Amex Black Card who make more than enough money to pay back a loan.

The CFPB's ostensible mission is to help consumer finance markets work by making rules more effective, by consistently and fairly enforcing those rules, and by empowering consumers to take more control over their economic lives. AFSA supports that goal one hundred percent. When the CFPB takes actions that follow that mission statement, AFSA generally supports those actions. However, not all of the CFPB's actions seem to support that mission.

The Dodd-Frank Act granted the CFPB broad authority and gave it an expansive jurisdiction. Still, as CFPB Director Cordray has emphasized many times, the Dodd-Frank Act places limits on what the CFPB can do. Incredulously, the CFPB manages to exceed its vast authority. There are several examples of this overreach: (1) the CFPB's use of disparate impact theory in the vehicle finance market; (2) regulation by enforcement; (3) a flawed supervision process; (4) the CFPB's attempt to impose rate caps; (5) the CFPB's proposal to ban pre-dispute arbitration agreements, despite the CFPB's findings that they benefit consumers; (6) the CFPB's expansive definition of "larger participant" in rulemaking; and (7) the CFPB's insistence on relying on a flawed complaint database.

I. The CFPB's Use of Disparate Impact Theory in the Vehicle Finance Market

The Equal Credit Opportunity Act (ECOA) makes it unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. AFSA and its members fully support the ECOA.

However, the CFPB's view of the ECOA is overly expansive and not supported by logic or the law, notably in the vehicle finance space. In March 2013, the CFPB issued a bulletin that allegedly provided guidance about compliance with the fair lending requirements of the ECOA. The bulletin is four and a half pages. Far from providing guidance, the CFPB was actually issuing new rules using a questionable legal theory, without going through any notice and comment period. The CFPB blatantly ignored the lack of congressional intent to provide for disparate impact theory under the ECOA.

The CFPB's March 2013 bulletin attempted to hold indirect auto lenders liable for discrimination resulting from dealer compensation policies. Not only is this contrary to the Dodd-Frank Act which prohibits the CFPB from regulating dealers, but it demonstrates the CFPB's fundamental misunderstanding of the vehicle finance market – a retail interest rate offered by a dealer and voluntarily accepted by a car buyer is different from a wholesale rate offered by a finance company or bank to a dealer.

Furthermore, the methods employed by the CFPB to proxy for the demographics of borrowers is deeply flawed and the CFPB has known this for years. As revealed in the report prepared by the Republican staff of the House Financial Services Committee, *Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending,*[5] CFPB employees were aware that the Bureau's proxy methodology was deeply flawed. Despite these problems, the CFPB brought several enforcement actions against banks and indirect auto finance companies.

For example, in December 2013, the CFPB stated that at least 235,000 consumers were alleged to have been discriminated against by Ally Financial and Ally Bank, even though at the time, the CFPB did not know the race of a single borrower in any vehicle finance contract purchased by Ally. In fact, the CFPB knew that factors other than discrimination were causing the disparities they observed, but refused to control for such factors in their statistical analysis. Moreover, internal documents reviewed by the Republican staff of the House Financial Services Committee showed that CFPB officials knew that in order to generate a sufficient number of check recipients, they would have to remove a number of safeguards from the claims process, including confirming the race of claimants alleged to have been discriminated against.

The third installment of the report, *Unsafe at Any Bureaucracy,* states, "Bureau employees conceded, however, that 'damages will go to many non-Hispanic White borrowers ...' In other words, the Bureau considered remunerating borrowers in proportion to their statistical probability of being a minority, rather than simply asking borrowers to verify their race, which demonstrates the Bureau's extraordinary aversion to testing the accuracy of BISG's[6] assignments by comparing them to borrowers' actual races."[7] Consumers returning the participation form they were sent as part of the settlement were not required to supply any kind of oath or affirmation. Moreover, the form contained no warnings about perjury or penalties for misrepresenting one's race. In fact, and perhaps incredulously, the form did not even require borrowers to indicate the protected minority race/ethnicity to which they belong.

One reason for this decision was that if remunerated borrowers were limited to actual minorities, it could turn out that the CFPB inflated the harm caused by the alleged disparate impact. Bureau employees said that if borrowers had to opt-in to get remuneration, only 36,000 – 143,000 consumers would receive settlement checks. However, Director Cordray had claimed publicly that Ally had harmed 235,000 minority borrowers.[8]

While the CFPB was bringing these actions, and despite numerous requests, the CFPB did not publish the methodology it used for determining if disparate impact existed for over a year and a half. This is equivalent to a cop pulling over a driver for speeding without posting the speed limit.

In short, the CFPB pursued a disparate impact case without a valid legal basis, issued "guidance" designed to function as rulemaking without due process of law, employed a statistical proxy

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[5] Staff of H. Comm. on Fin. Serv., 115th Cong., *Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending*, Jan. 18, 2017. Available at http://financialservices.house.gov/uploadedfiles/1-18-17_cfpb_indirect_auto_staff_report_iii.pdf.

[6] Bayesian Improved Surname Geocoding or BISG, is the flawed disparate impact methodology used by the CFPB.

[7] *Ibid.* p. 10

[8] *Ibid.* p. 14-15

methodology it knew was flawed, refused to consider non-discriminatory factors that could explain alleged pricing disparities, tried to force finance companies to regulate dealers because the CFPB is prevented by Dodd-Frank from doing so, and employed a remuneration process that was designed to achieve political ends.

SOLUTION: Congress should preclude the CFPB explicitly from using disparate impact liability theory under the ECOA.

II. Regulation by Enforcement

The CFPB has the authority to write rules governing the consumer finance industry. Despite this authority, the CFPB chooses to govern the industry by issuing enforcement orders and then telling the financial services industry it has to figure out how to comply with those orders. Director Cordray recently said, "Indeed, it would be 'compliance malpractice' for executives not to take careful bearings from the contents of these orders about how to comply with the law and treat consumers fairly."[9]

But it is often difficult for financial services companies to comply with the orders, especially when they are not consistent. For example, does the CFPB expect vehicle finance companies to comply with: (1) the enforcement order against American Honda Finance Corporation, in which Honda agreed to reduce dealer discretion to mark-up the interest rate to only 1.25 percent above the buy rate for auto loans with terms of 5 years or less, and 1 percent for auto loans with longer terms; or (2) the enforcement order against Ally, in which Ally agreed to implement a compliance monitoring program?

In other enforcement orders, the CFPB claims that practices that are permitted under both federal and state law are "unfair." For example, the debt collection practices employed by EZCORP were consistent with federal and state law, but the CFPB did not like them, so it took an action against EZCORP and labeled the practices as "unfair."

The CFPB is so anxious to issue enforcement orders, it does so even when there is no consumer harm. The First Investors' consent order does not show any resulting consumer harm – neither does the press release or prepared remarks. The CFPB claimed only that First Investors *potentially* harmed customers.

SOLUTION: The CFPB should be limited to enforcing federal consumer financial laws and regulations. The Bureau's unfair, deceptive, or abusive acts or practices (UDAAP) authority should be removed. The Federal Trade Commission will retain its unfair or deceptive acts or practices authority.

III. Flawed Supervision Process

[9] Consumer Financial Protection Bureau, Prepared Remarks of CFPB Director Richard Cordray at the Consumer Bankers Association. March 9, 2016. Available at https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-consumer-bankers-association/.

The CFPB's supervision process is flawed. First, the CFPB makes liberal use of the UDAAP doctrine to find violations during examinations. Second, the CFPB does not always understand the markets of the companies that it is supervising. Third, supervision examinations often start as a fishing expedition.

The standards the CFPB is using to examine its regulated entities for their level of compliance are far-reaching and not well-grounded in comparison to common state audit examinations. In particular, the CFPB makes liberal use of the UDAAP doctrine to find violations. While UDAAP commonly refers to types of laws that are intended to prevent businesses from engaging in deceptive practices, the CFPB emphasizes the first prong of UDAAP, i.e. the "unfair" prong, which is not commonly used. The CFPB examiners use the "unfair" prong of UDAAP to claim that companies that, while in full compliance with all applicable laws in an examined area, are still in violation of the CFPB requirements because the practice or conduct is subjectively deemed by the examiners to be "unfair" to consumers. The examined company's compliance is thus subject to being judged by the particular whim of the examiner, rather than based upon express, objective statutory law. Therefore, the CFPB's examination practices make it impossible for a company to style its compliance model with an assurance that it will pass muster in the examination.

Not only are the CFPB's examination practices inconsistent with state law, but it is clear that some examiners do not even understand the businesses of the companies they are examining. Time and again, examiners have demonstrated their confusion over the difference between "loans" and "retail installment sales contracts." Indirect auto finance companies do not make "loans." They are not selling money. They purchase retail installment sales contracts from dealers. Dealers are not agents of the finance company; they are completely separate entities. While it is understandable that those not in the finance industry do not understand the complexities of the market, the examiners undoubtedly should.

The fact that the Bureau misunderstands the business is evident on page 1 of the exam manual in the examination objectives which state, "To identify acts or practices that materially increase the risk of violations of Federal consumer financial law, and associated harm to consumers, in connection with an entity's automobile loan or lease origination business or automobile servicing business."[10] There is no mention of indirect auto finance. The exam procedures do go on to explain indirect lending, but it is clear that the market is still misunderstood. For example, the examination manual lists the Fair Debt Collection Practices Act as an applicable law, but that law is only applicable to debt collectors, not creditors. In another example, the word "loan" which is not relevant to indirect auto financing occurs 57 times, but the phrase, "retail installment sales contract," can only be found twice.

Because of these misunderstandings, examiners have initially given failing marks to indirect auto finance companies, even when they do not find a specific violation. The examiners just do not like certain practices. For example, examiners have held that a violation occurs when a finance company does not provide a refund on an ancillary product, such as credit insurance, when there is an early pay-off. State law is very clear that it is almost always the dealer which must provide

[10] Consumer Financial Protection Bureau, *Automobile Finance Examination Procedures*. June 2015. Available at http://files.consumerfinance.gov/f/201506_cfpb_automobile-finance-examination-procedures.pdf

the refund, not the finance company. But examiners fail to understand that the dealer is not an agent of the finance company.

Examiners are so anxious to find violations that many, if not most, exams begin with a fishing expedition. An examiner shows up at a financial institution with a thumb drive and asks to copy all the company's files. The examiners then dig through the files until they find some violation. (A similar procedure is also used in civil investigative demands.)

SOLUTION: Congress should remove the CFPB's supervisory authority and return it to the prudential regulators or the states. The state examiners have had decades of experience examining finance companies and understand the industry. They are also closer to the situation and understand better what financial products and services their constituencies need and want. Because they know the market and the consumers, they can better strike a balance between appropriate access to financial products and services and the need to protect consumers from harmful products and services.

Contrary to many news reports, the recent problems at Wells Fargo provide a good example of how states are ahead of the CFPB. Los Angeles City Attorney Mike Feuer submitted testimony stating that he first learned of the fake accounts at Wells Fargo when he read the *Los Angeles Times*' lengthy Dec. 22, 2013, investigative article. Within days, his office had started an investigation that resulted in his office's May 2015 lawsuit. He, in turn, notified the OCC and the CFPB after the suit was filed. The three agencies then worked together on the settlement package, announced Sept. 8, 2016.[11] The CFPB had been examining Wells since 2011. Director Cordray claimed that he knew of the problem from a whistleblower in 2013, but that just begs the question, why did he wait two years to do anything?

IV. The CFPB's Attempt to Impose Rate Caps

The CFPB is statutorily prohibited from imposing rate caps. Yet, that is just what it is trying to do in its small-dollar rulemaking. The proposed small-dollar rule imposes substantial and burdensome underwriting requirements on loans with a total cost of credit that exceeds 36 percent. Because these additional underwriting requirements are so costly, many lenders will not make such loans and charge such interest rates. It is irrelevant that the proposed rule does not categorically prohibit covered loans with a total cost of credit in excess of 36 percent. The Proposed Rule imposes a de facto usury limit by making it uneconomical for many lenders to comply with the new underwriting requirements.

SOLUTION: The CFPB should not finalize the proposed small-dollar rule.

V. The CFPB's Proposal to Ban Pre-Dispute Arbitration Agreements

The Dodd-Frank Act authorizes the CFPB to "prohibit or impose conditions or limitations on the use of a pre-dispute arbitration agreement between covered persons and consumers, only if the CFPB finds that doing so is in the public interest and for the protection of consumers." It has not

[11] James Rufus Koren, "Wells Fargo to pay $185 million settlement for 'outrageous' sales culture," *Los Angeles Times* (Sept. 8, 2017), http://www.latimes.com/business/la-fi-wells-fargo-regulators-20160.

been determined that the CFPB's proposed arbitration rule is in the public interest, or that it will protect consumers. In fact, there is abundant information that arbitration serves these goals better and more effectively than other options, such as class actions. And to ignore this information would conflict with the CFPB's statutory duties. Until additional factors are considered, the CFPB does not have the authority to prohibit or impose conditions or limitations on the use of pre-dispute arbitration agreements.

In March 2015, the CFPB published a study of arbitration clauses in connection with the offering or providing of consumer financial products or services. Contrary to what the CFPB has claimed, a careful reading of the 728-page study shows that arbitration benefits consumers.

- Arbitration is quicker and more cost effective for consumers than litigation. Unlike in civil litigation where a consumer faces uncertain attorney fees, arbitration fees are modest and disclosed. Consumers paid an average of $206 in fees in arbitration cases reviewed by the CFPB. In some of those cases, consumers' final fees were modified by the arbitrator's decision. In addition, needy consumers may seek a waiver of fees.

- Arbitration is a convenient option for consumers. Most arbitration clauses reviewed by the CFPB required hearings to take place close to the consumer's residence. The study estimated that consumers traveled an average of 15 miles to attend in-person hearings.

- Arbitration provides consumers with fairly quick resolutions to their disputes. According to the CFPB study, telephone arbitrations were resolved in a median five months, and in-person hearings were resolved in a median seven months. By contrast, class action settlements received final court approval after an average of 690 days, or close to two years.

- Arbitration leads to higher monetary relief for consumers than lawsuits. The CFPB found that the average consumer relief in an arbitration was $5,389. Many consumers in class actions will not receive any benefit. For those that do receive something, the CFPB found that the average settlement a class member receives is $32.

- Class action settlements yield high awards for attorneys. While class members who are entitled to awards frequently fail to obtain them, the CFPB showed that class action attorneys are the real winners, raking in $424,495,451 in fees awarded in settlements during the period studied.

As noted by the U.S. Supreme Court in a 1995 decision upholding arbitration: "The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices."[12]

SOLUTION: The CFPB should not finalize the arbitration rule.

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[12] ***Allied-Bruce Terminix Cos. v. Dobson***, 513 U.S. 265 (1995).

VI. Expansive Definition of "Larger Participant" in Rulemaking

Under Dodd-Frank, the CFPB has authority to define larger participants of certain consumer financial product and service markets and then supervise those larger participants. By any common sense description, "larger participants" would mean those participants in a market who are at least large in size. But that is not the case. There are auto finance companies who meet the Small Business Administration's definition of a small business, but yet still qualify as "larger participants" according to the CFPB.

The CFPB is not including just the large players, but in a vast overreach, the overwhelming majority of the players in each market. For example, in the debt collection market, the larger participant rule covers 63 percent of the market. In the consumer reporting agency rule, 94 percent of the market is covered. The larger participant rule for auto finance covers approximately 90 percent of the market.

SOLUTION: The CFPB's authority should be limited to rule writing and enforcement. The authority to supervise financial institutions should be left to the prudential regulators and the states.

VII. Complaint Database

There are a number of significant problems with the CFPB's Complaint Database, including the fact that it does not provide any meaningful information to the public. The CFPB does not verify the validity of the complaints posted and does not have robust security systems in place to safeguard consumers' personal identifiable information and financial data.

SOLUTION: The CFPB should halt the use of the complaint database.

* * *

The CFPB is tasked with helping consumer finance markets work by making rules more effective, by consistently and fairly enforcing those rules, and by empowering consumers to take more control over their economic lives.

Unfortunately, that's not what the CFPB does. The CFPB has greatly expanded its mission, and needs to be reined in. Congress should: expressly prohibit the CFPB from using disparate impact theory in the vehicle finance market, limit the CFPB's enforcement authority, remove the CFPB's supervision authority, prohibit the CFPB from finalizing the small-dollar and arbitration rules, and halt the use of the CFPB's complaint database.

APPENDIX I

FEDERAL RESERVE statistical release

G.19

Consumer Credit
January 2017

For release at **3 p.m.** (Eastern Time)
March 7, 2017

In January, consumer credit increased at a seasonally adjusted annual rate of 2-3/4 percent. Revolving credit decreased at an annual rate of 4-1/2 percent, while nonrevolving credit increased at an annual rate of 5-1/2 percent.

Consumer Credit Outstanding[1]
Seasonally adjusted. Billions of dollars except as noted.

						2015	2016						2017
	2012	2013	2014	2015	2016[r]	Q4	Q1	Q2	Q3	Q4[r]	Nov[r]	Dec[r]	Jan[p]
Total percent change (annual rate)[2]	5.9	6.0	7.2	7.0	6.5	6.2	5.6	6.4	7.2	6.2	8.3	4.7	2.8
Revolving	0.5	1.4	3.9	5.2	6.5	5.9	4.8	7.2	5.3	8.1	15.8	4.3	-4.6
Nonrevolving[3]	8.3	7.9	8.4	7.7	6.5	6.3	5.9	6.1	7.9	5.5	5.7	4.9	5.5
Total flow (annual rate)[2,4]	164.1	175.8	221.8	232.7	229.0	216.3	196.7	228.9	261.4	228.8	310.1	177.1	105.5
Revolving	4.2	12.0	33.8	46.4	61.0	54.6	44.7	68.7	51.0	79.7	154.9	43.0	-45.5
Nonrevolving[3]	159.9	163.9	188.0	186.4	167.9	161.8	152.0	160.2	210.4	149.0	155.2	134.1	151.0
Total outstanding	2,920.4	3,096.2	3,318.0	3,535.7	3,764.7	3,535.7	3,584.9	3,642.1	3,707.5	3,764.7	3,749.9	3,764.7	3,773.5
Revolving	845.7	857.7	891.5	937.9	998.9	937.9	949.1	966.2	979.0	998.9	995.3	998.9	995.1
Nonrevolving[3]	2,074.6	2,238.5	2,426.5	2,597.9	2,765.8	2,597.9	2,635.9	2,675.9	2,728.5	2,765.8	2,754.6	2,765.8	2,778.4

Terms of Credit
Not seasonally adjusted. Percent except as noted.

Commercial bank interest rates[5]													
New car loans													
48-month	4.91	4.43	4.24	4.19	4.30	4.00	4.17	4.33	4.25	4.45	4.45	n.a.	n.a.
60-month	4.82	4.46	4.25	4.20	4.14	4.05	4.11	4.15	4.25	4.05	4.05	n.a.	n.a.
Credit card plans													
All accounts	12.06	11.91	11.87	12.09	12.35	12.22	12.31	12.16	12.51	12.41	12.41	n.a.	n.a.
Accounts assessed interest	12.96	12.95	13.19	13.66	13.56	13.70	13.51	13.35	13.76	13.61	13.61	n.a.	n.a.
Personal loans													
24-month	10.71	10.20	10.22	9.75	9.69	9.66	10.03	9.65	9.64	9.45	9.45	n.a.	n.a.
Finance companies (new car loans)[6]													
Interest rates	4.6	4.7	4.9	5.1	5.0	5.0	5.2	5.0	5.0	4.9	n.a.	4.9	n.a.
Maturity (months)	62	63	64	65	66	65	66	66	66	67	n.a.	67	n.a.
Amount financed (dollars)	25,341	25,586	26,288	27,472	28,601	27,986	28,140	28,127	28,667	29,469	n.a.	29,469	n.a.

This release is generally issued on the fifth business day of each month. See the Statistical Release Schedule for more information.
Footnotes appear on the second and third pages.

Consumer Credit Outstanding (Levels)
(Billions of dollars)
Not seasonally adjusted

	2012	2013	2014	2015	2016[r]	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4[r]	2016 Nov[r]	2016 Dec[r]	2017 Jan[p]
Total	2,920.4	3,096.2	3,318.0	3,535.7	3,764.7	3,535.7	3,538.8	3,604.3	3,692.2	3,764.7	3,732.1	3,764.7	3,770.8
Major holders													
Depository institutions	1,218.6	1,271.6	1,343.1	1,428.3	1,532.1	1,428.3	1,405.8	1,446.6	1,475.7	1,532.1	1,505.6	1,532.1	1,510.0
Finance companies	679.8	679.1	684.1	681.7	667.2	681.7	669.3	666.8	673.4	667.2	669.5	667.2	666.8
Credit unions	243.6	265.6	302.8	342.3	382.0	342.3	345.1	357.8	373.5	382.0	380.3	382.0	386.2
Federal government[7]	622.2	735.5	846.2	949.7	1,050.1	949.7	989.7	1,001.1	1,036.7	1,050.1	1,044.7	1,050.1	1,077.4
Nonprofit and educational institutions[8]	58.0	51.8	47.6	44.2	38.7	44.2	42.8	41.4	39.9	38.7	39.2	38.7	38.3
Nonfinancial business	48.0	43.4	44.4	43.6	42.8	43.6	41.7	41.9	42.2	42.8	42.2	42.8	42.5
Pools of securitized assets[9,10]	50.0	49.1	49.8	46.0	51.8	46.0	44.4	48.7	50.8	51.8	50.5	51.8	49.7
Major types of credit, by holder													
Revolving	845.7	857.7	891.5	937.9	998.9	937.9	902.7	930.5	946.1	998.9	971.9	998.9	974.3
Depository institutions	676.5	693.5	731.6	786.8	845.1	786.8	756.2	782.2	796.7	845.1	821.3	845.1	821.7
Finance companies	71.4	67.1	60.3	54.9	53.3	54.9	53.2	53.6	53.4	53.3	53.3	53.3	55.3
Credit unions	38.9	43.4	46.8	49.4	53.1	49.4	48.7	49.7	50.9	53.1	52.0	53.1	52.5
Federal government[7]	...	...	...	...	...	...	...	...	...	...	...	...	...
Nonprofit and educational institutions[8]	...	...	...	...	...	...	...	...	...	...	...	...	...
Nonfinancial business	27.8	23.2	24.0	23.2	22.4	23.2	21.3	21.5	21.6	22.4	21.8	22.4	21.9
Pools of securitized assets[9,10]	31.2	30.5	28.9	23.5	25.0	23.5	23.3	23.5	23.5	25.0	23.5	25.0	23.0
Nonrevolving	2,074.6	2,238.5	2,426.5	2,597.9	2,765.8	2,597.9	2,636.1	2,673.9	2,746.1	2,765.8	2,760.2	2,765.8	2,796.5
Depository institutions	542.1	578.1	611.6	641.5	686.9	641.5	649.6	664.4	679.0	686.9	684.3	686.9	688.3
Finance companies	608.4	612.1	623.8	626.7	613.9	626.7	616.1	613.2	620.0	613.9	616.1	613.9	611.5
Credit unions	204.8	222.2	256.0	292.9	328.9	292.9	296.4	308.1	322.7	328.9	328.4	328.9	333.7
Federal government[7]	622.2	735.5	846.2	949.7	1,050.1	949.7	989.7	1,001.1	1,036.7	1,050.1	1,044.7	1,050.1	1,077.4
Nonprofit and educational institutions[8]	58.0	51.8	47.6	44.2	38.7	44.2	42.8	41.4	39.9	38.7	39.2	38.7	38.3
Nonfinancial business	20.2	20.2	20.4	20.4	20.4	20.4	20.4	20.4	20.6	20.4	20.5	20.4	20.6
Pools of securitized assets[9,10]	18.8	18.6	20.9	22.5	26.8	22.5	21.1	25.3	27.3	26.8	27.0	26.8	26.7
Memo													
Student Loans[11]	1,055.2	1,146.5	1,236.3	1,320.4	1,406.9	1,320.4	1,357.8	1,364.5	1,397.3	1,406.9	n.a.	1,406.9	n.a.
Motor Vehicle Loans[12]	809.2	878.8	957.9	1,038.8	1,110.5	1,038.8	1,046.4	1,070.4	1,100.1	1,110.5	n.a.	1,110.5	n.a.

Footnotes

1. Covers most credit extended to individuals, excluding loans secured by real estate.
2. The series for consumer credit outstanding and its components may contain breaks that result from discontinuities in source data. Percent changes are adjusted to exclude the effect of such breaks. In addition, percent changes are at a simple annual rate and are calculated from unrounded data.
3. Includes motor vehicle loans and all other loans not included in revolving credit, such as loans for mobile homes, education, boats, trailers, or vacations. These loans may be secured or unsecured.
4. Flow data represent changes in the level of credit due to economic and financial activity, and exclude breaks in the data series due to changes in methodology, source data, and other technical aspects of the estimation that could affect the level of credit.
5. Interest rates are annual percentage rates (APR) as specified by the Federal Reserve's Regulation Z. Interest rates for new-car loans and personal loans at commercial banks are simple unweighted averages of each bank's most common rate charged during the first calendar week of the middle month of each quarter. For credit card accounts, the rate for all accounts is the stated APR averaged across all credit card accounts at all reporting banks. The rate for accounts assessed interest is the annualized ratio of total finance charges at all reporting banks to the total average daily balances against which the finance charges were assessed (excludes accounts for which no finance charges were assessed).

Consumer Credit Outstanding (Flows)
(Billions of dollars, annual rate)
Not seasonally adjusted

	2012	2013	2014	2015	2016[r]	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4[r]	2016 Nov[r]	2016 Dec[r]	2017 Jan[p]
Total	164.1	175.8	221.8	232.7	229.0	277.5	12.2	262.2	351.5	289.9	352.0	390.5	73.9
Major holders													
Depository institutions	28.1	52.9	71.5	100.2	103.7	238.9	-90.2	163.2	116.5	225.4	286.5	317.3	-265.1
Finance companies	-7.8	-0.6	5.0	-2.4	-14.5	-30.3	-49.6	-10.0	26.5	-24.9	-19.5	-27.8	-4.9
Credit unions	20.6	21.9	37.2	39.5	39.7	35.7	11.0	51.0	62.9	33.8	18.9	19.6	50.6
Federal government[7]	127.5	113.3	110.7	103.4	100.4	52.5	160.3	45.6	142.1	53.8	71.4	64.4	327.7
Nonprofit and educational institutions[8]	-9.1	-6.2	-4.2	-3.4	-5.4	-5.3	-5.6	-5.6	-5.7	-4.8	-4.3	-5.6	-5.3
Nonfinancial business	1.0	-4.6	0.9	-0.8	-0.8	-5.9	-7.5	0.9	1.0	2.6	1.4	6.9	-3.9
Pools of securitized assets[9,10]	3.8	-0.8	0.6	-3.8	5.8	-8.1	-6.3	17.2	8.2	4.0	-2.4	15.7	-25.2
Major types of credit, by holder													
Revolving	4.2	12.0	33.8	46.4	61.0	186.2	-140.9	111.3	62.4	211.4	274.9	324.0	-295.3
Depository institutions	12.6	17.0	38.1	55.3	58.3	199.3	-122.4	103.8	58.3	193.5	263.4	285.4	-281.3
Finance companies	-11.6	-4.3	-6.8	-5.4	-1.6	-10.7	-7.1	1.6	-0.7	-0.3	-0.4	-0.4	23.5
Credit unions	0.9	4.5	3.4	2.6	3.6	7.6	-3.1	4.2	4.6	8.9	9.9	13.5	-6.6
Federal government[7]	...	...	...	...	...	...	...	...	...	...	...	...	...
Nonprofit and educational institutions[8]	...	...	...	...	...	...	...	...	...	...	...	...	...
Nonfinancial business	0.9	-4.6	0.7	-0.8	-0.8	-5.2	-7.5	1.0	0.3	3.2	2.1	7.5	-6.4
Pools of securitized assets[9,10]	1.4	-0.7	-1.6	-5.4	1.5	-4.7	-0.7	0.6	0.0	6.0	0.0	18.1	-24.4
Nonrevolving	159.9	163.9	188.0	186.4	167.9	91.3	153.1	151.0	289.0	78.6	77.1	66.5	369.2
Depository institutions	15.5	35.9	33.5	44.9	45.4	39.6	32.2	59.4	58.2	31.9	23.2	31.9	16.3
Finance companies	3.8	3.6	11.7	2.9	-12.9	-19.6	-42.5	-11.6	27.2	-24.6	-19.0	-27.5	-28.4
Credit unions	19.7	17.4	33.8	36.9	36.0	28.1	14.1	46.8	58.3	24.9	9.0	6.1	57.2
Federal government[7]	127.5	113.3	110.7	103.4	100.4	52.5	160.3	45.6	142.1	53.8	71.4	64.4	327.7
Nonprofit and educational institutions[8]	-9.1	-6.2	-4.2	-3.4	-5.4	-5.3	-5.6	-5.6	-5.7	-4.8	-4.3	-5.6	-5.3
Nonfinancial business	0.1	0.0	0.2	0.0	0.0	-0.6	0.1	-0.2	0.7	-0.6	-0.7	-0.6	2.5
Pools of securitized assets[9,10]	2.4	-0.2	2.2	1.6	4.3	-3.4	-5.6	16.7	8.2	-2.1	-2.4	-2.4	-0.8
Memo													
Student Loans[11]	94.2	91.3	89.8	84.1	86.5	32.6	149.8	26.6	131.1	38.4	n.a.	38.4	n.a.
Motor Vehicle Loans[12]	60.0	69.5	79.1	80.9	71.8	34.5	30.4	96.1	119.0	41.6	n.a.	41.6	n.a.

6. Covers most of the captive and non-captive finance companies. The series of finance company new car loan terms included in previous releases are discontinued. They remain available from the Data Download Program.
7. Includes student loans originated by the Department of Education under the Federal Direct Loan Program and the Perkins Loan Program, as well as Federal Family Education Program loans that the government purchased under the Ensuring Continued Access to Student Loans Act.
8. Includes student loans originated under the Federal Family Education Loan Program and held by educational institutions and nonprofit organizations.
9. Outstanding balances of pools upon which securities have been issued; these balances are no longer carried on the balance sheets of the loan originators.
10. The shift of consumer credit from pools of securitized assets to other categories is largely due to financial institutions' implementation of the FAS 166/167 accounting rules.
11. Includes student loans originated under the Federal Family Education Loan Program and the Direct Loan Program; Perkins loans; and private student loans without government guarantees. This memo item includes loan balances that are not included in the nonrevolving credit balances. For additional information, see public documentation. Data for this memo item are released for each quarter-end month.
12. Includes motor vehicle loans owned and securitized by depository institutions, finance companies, credit unions, and nonfinancial business. Includes loans for passenger cars and other vehicles such as minivans, vans, sport-utility vehicles, pickup trucks, and similar light trucks for personal use. Loans for boats, motorcycles and recreational vehicles are not included. Data for this memo item are released for each quarter-end month.

r=revised. p=preliminary. n.a.=not available. ...=not applicable.

APPENDIX II

SPENCER BACHUS, AL, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

BARNEY FRANK, MA, RANKING MEMBER

October 26, 2011

Mr. Raj Date
Acting Director
Consumer Financial Protection Bureau
Washington, DC

Dear Acting Director Date:

I remain frustrated by Senate Republicans' continuing abuse of the Constitution's advice and consent provisions regarding the nomination of Richard Cordray to be the Bureau's first Director. This delay means that the Bureau is for now unable to exercise authority regarding non-bank financial firms. This authority is crucial in two ways: it not only will provide a uniform level of protection for consumers, it also will allow bank and nonbank providers to compete on equal regulatory footing in the marketplace – no longer will some entities be subject to lighter consumer regulation.

As you know, I support the Bureau's vigorous use of all of its powers. As the Bureau prepares for the day that it is able to exercise authority over nonbank financial firms, I urge that the staff pay close attention to the differences among products offered by nonbank institutions, and to be mindful of Congress' intent in financial reform that state consumer protection laws be preserved to the extent possible. For example, there are key differences in product characteristics between payday, car title, and other high-cost secured loans, and more traditional closed-end, unsecured lending and related products, and the products are often regulated differently by the states. To the extent that state regulation has worked to protect consumers with regard to financial products offered by nonbank institutions, I encourage the Bureau to coordinate and work with the states to preserve such protections.

I look forward to working with the Bureau as it continues to develop a nonbank regulatory structure.

BARNEY FRANK
Ranking Member

CONGRESSIONAL TESTIMONY

Opportunities to Reform the Federal Financial Regulatory System

Testimony before the Financial Institutions and Consumer Credit Subcommittee, Committee on Financial Services, United States House of Representatives

April 6, 2017

Norbert J. Michel, PhD
Senior Research Fellow in Financial Regulations
The Heritage Foundation

Chairman Luetkemeyer, Ranking Member Clay, and Members of the Committee, thank you for the opportunity to testify at today's hearing. My name is Norbert Michel and I am a Senior Research Fellow in Financial Regulations at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

In my testimony I will argue that the U.S. financial regulatory framework is in dire need of an overhaul. The 2008 financial crisis is an obvious example of a poorly functioning financial sector, but not because it was deregulated. The opposite is true—it was, and still is, overregulated. Leading up to 2008, financial firms funded too much unsustainable activity largely because of the rules and regulations they faced, including the widespread expectation that federal rules had guaranteed safety and soundness and that the federal government would provide assistance to mitigate losses.

Yet, the dominant narrative that supported passage of Dodd–Frank in 2010 was that deregulation in financial markets, beginning in the 1990s, caused the crash. This story is wrong. There was no substantial reduction in the scale or scope of financial regulations in the U.S. Rather, the sheer number of financial regulations steadily *increased.* From the supposed deregulation in 1999, up until the Lehman Brothers failure in 2008, financial regulators issued 7,100 pages of regulations for more than 800 separate rules.[1]

Financial firms—not just banks—have long dealt with capital rules, liquidity rules, disclosure rules, leverage rules, special exemptions for rules, and the constant threat that regulators would make up new rules or enforce old rules differently. There is no doubt that, for decades, the U.S. regulatory framework has increasingly made it more difficult to create and maintain jobs and businesses that benefit Americans. One of the main reasons the regulatory regime has been counterproductive for so long is because it allows regulators to micromanage firms' financial risk, a process that substitutes regulators' judgments for those of private investors.

This approach provides a false sense of security because the government confers an aura of safety on all firms that play by the rules, and it is bound to fail for at least three reasons: (1) people take on more risk than they would in the absence of such rules; (2) people have lower incentives to monitor financial risks than they would otherwise; and (3) compared to other actors in the market, regulators do not have superior knowledge of future risks. In addition to these shortcomings, the U.S. regulatory framework, for at least a century, has repeatedly protected incumbent firms from new competition—the very market forces that drive innovation, lower prices, and prevent excessive risk-taking.

The result is that entrepreneurs have suffered from fewer opportunities, and consumers have suffered from fewer choices, higher prices, and less knowledge regarding financial risks. When the system crashes, as it has done on several occasions, people naturally tend to blame the excesses in the private sector while giving the government more power to stabilize the economy. In the end, this process is a perverse self-reinforcing cycle that fails to make the economy any safer as it chips away at economic freedom and the prosperity it fosters.

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[1]Norbert J. Michel and Tamara Skinner, "The Popular Narrative About Financial Deregulation Is Wrong," The Daily Signal, July 29, 2016, http://dailysignal.com/2016/07/29/the-popular-narrative-about-financial-deregulation-is-wrong/ (accessed April 3, 2017).

Government rules that profess to guarantee financial market safety create a false sense of security, lower private incentives to monitor risk, increase institutions' financial risk, and protect incumbent firms from new competitors. It is important to reverse these trends because competition in markets drives innovation, lowers prices, prevents excessive risk-taking, and allows people to invest their savings in the best investment opportunities. There are many policy solutions to begin restoring the competitive process and strengthening financial markets, such as consolidating and reorganizing federal financial regulators.

Consolidation Versus Competition

After the 2008 crisis, Congress considered creating a single consolidated financial regulator.[2] The ultimate product of that debate—the Dodd–Frank Wall Street Reform and Consumer Protection Act[3]—did not create such a super regulator. Still, Dodd–Frank has moved the financial system toward uniform regulation. It has increased the scope of the Federal Reserve's authority to include new powers, such as an explicit systemic-risk mandate, and supervisory authority over new entities, such as savings-and-loan holding companies, securities holding companies, and systemically important financial institutions (SIFIs).[4]

As of May 2016, the Federal Reserve had supervisory authority over approximately 25 percent (based on total assets) of the insurance industry.[5] The Federal Reserve is also active in international regulatory efforts to identify and establish regulatory standards for SIFIs,[6] and it has been actively advocating changes outside its normal regulatory sphere.[7] If these trends continue, the system may well end up under the

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[2]Restoring American Financial Stability Act of 2009, discussion draft, http://thf_media.s3.amazonaws.com/2016/DoddSenateBankingMarkup.pdf (accessed November 22, 2016). The discussion draft included statutory language to create a single financial regulator called the Financial Institutions Regulatory Administration (FIRA).

[3]Public Law 111–203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 7, 12, 15, 22, 26, 28, 31, and 42 U.S. Code).

[4]For a discussion of this expansion, see Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd–Frank," Mercatus Center at George Mason University, November 13, 2013, http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank (accessed October 8, 2016).

[5]Daniel K. Tarullo, speech at the National Association of Insurance Commissioners' International Insurance Forum, Washington, DC, May 20, 2016, https://www.federalreserve.gov/newsevents/speech/tarullo20160520a.htm (accessed October 8, 2016).

[6]See, for example, Financial Stability Board, "About the FSB," http://www.fsb.org/about/ (accessed October 8, 2016). ("The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.") The Federal Reserve, along with the Federal Insurance Office at the Treasury and state insurance regulators, represents the United States in the International Association of Insurance Supervisors, which is working on identifying and establishing regulatory approaches for globally systemically important insurers. International Association of Insurance Supervisors, "Financial Stability and Macroprudential Policy & Surveillance," http://www.iaisweb.org/page/supervisory-material/financial-stability-and-macroprudential-policy-and-surveillance (accessed October 8, 2016).

[7]See, for example, Daniel K. Tarullo, speech at the Brookings Institution, Washington, DC, November 17, 2015, https://www.federalreserve.gov/newsevents/speech/tarullo20151117a.htm (accessed October 8, 2016). Federal Reserve Governor Tarullo calls for "market regulation," which he illustrates by citing the

de facto control of a super regulator: the Board of Governors of the Federal Reserve. Though the U.S. financial regulatory structure needs reform, a single "super" regulator with a banking mindset and a ready safety net would not improve economic outcomes. Any structural reorganization should guard against the current tendency of bank regulation to seep into capital markets regulation.

There are many arguments for and against regulatory consolidation. Critics of consolidation believe that a structure based on multiple regulatory agencies is good because it allows regulators to specialize in particular types of institutions,[8] it allows regulatory experimentation and competition,[9] and it helps highlight one regulator's mistakes. Also, if a regulator does make an error, only the subset of entities it regulates will be directly affected. Finally, maintaining distinct capital markets and banking regulators provides speed bumps to banking regulators' efforts to apply bank-like regulation more broadly.[10]

One argument for consolidating regulators is to avoid "charter-shopping" or a "race to the bottom" among regulators.[11] This argument, however, assumes a degree of competition between financial regulators that is at odds with the existing regulatory system. During the recent financial crisis, contrary to the charter-shopping argument, banks failed at roughly similar rates across the various bank regulators.[12] Furthermore, as professors Henry Butler and Jonathan Macey have so aptly observed, competition among banking regulators is largely a myth.[13]

In surveying the literature of state corporate governance and banking laws, one recent article found that such competition did not generally lead to a "race to the bottom"

Federal Reserve's plans to "establish minimum haircuts for securities financing transactions (SFTs) on a market-wide basis, rather than just for specific classes of market participants." See also Stanley Fischer, Vice Chairman, Board of Governors of the Federal Reserve System, speech at the Debt and Financial Stability—Regulatory Challenges Conference at the Bundesbank and the German Ministry of Finance, Frankfurt, Germany, March 27, 2015, https://www.federalreserve.gov/newsevents/speech/fischer20150327a.htm (accessed October 8, 2016). Fischer calls for additional reforms in the non-bank financial sector.

[8]Lawrence A. Cunningham and David Zaring, "The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response," *George Washington University Law Review*, Vol. 78 (2009), pp. 1–56, http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=1551&context=faculty_publications (accessed October 8, 2016).

[9]Ibid., p. 50.

[10]Former SEC Commissioner Daniel Gallagher has frequently discussed the importance of preventing bank regulators from taking over capital markets regulation. See, for example, Daniel M. Gallagher, "Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers," speech at the 2015 Virginia Law and Business Review Symposium, April 10, 2015, https://www.sec.gov/news/speech/041015-spch-cdmg.html (accessed November 22, 2016).

[11]Jessica Silver-Greenberg, "Small Banks Shift Charters to Avoid US as Regulator," *The New York Times*, April 2, 2012, http://www.nytimes.com/2012/04/03/business/small-banks-shift-charters-to-avoid-us-as-regulator.html (accessed November 22, 2016), and Sumit Agarwal et al., "Inconsistent Regulators: Evidence from Banking," *The Quarterly Journal of Economics*, Vol. 129, No. 2 (2014), pp. 889–938.

[12]U.S. Government Accountability Office, "Causes and Consequences of Recent Bank Failures," *Report to Congressional Committees*, GAO–13–71, 2013, http://www.gao.gov/assets/660/651154.pdf (accessed November 22, 2016).

[13]Henry Butler and Jonathan Macey, "The Myth of Competition in the Dual Banking System," *Cornell Law Review*, Vol. 73 (1988).

but rather a sorting into alternative regulatory systems.[14] Although full regulatory consolidation could harm financial markets, some streamlining is important because the current framework embodies inefficiencies and redundancies. The U.S. banking regulatory structure, for example, is complex, with responsibilities fragmented among the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Federal Reserve.[15] The following list summarizes these agencies' overlapping authorities.

- The FDIC, in charge of maintaining the Federal Deposit Insurance Fund, has backup supervisory authorities over all banks and thrifts that are federally insured; this responsibility creates overlap between the FDIC's authorities and those of the Federal Reserve and OCC as the primary prudential regulators of insured depository institutions.
- The NCUA supervises only federally chartered credit unions, but it is the deposit insurer for both federal credit unions and most state-chartered credit unions; its role as deposit insurer creates overlap with state credit union regulators.
- The Federal Reserve has consolidated supervision authority over most holding companies that own or control a bank or thrift and their subsidiaries; this authority creates overlap because the Fed's role is in addition to the oversight provided by the banks' primary federal regulator.
- State banking regulators share oversight of the safety and soundness of state-chartered banks with the FDIC and the Federal Reserve.

This fragmentation and overlap has a long history of creating inefficiencies in regulatory processes, as well as inconsistencies in how regulators oversee similar types of institutions. Even when these overlapping authorities do not lead to inconsistencies, coordination among agencies requires considerable effort that could be directed toward other activities. Inconsistencies create an uncertain operating environment for regulated entities, as well as an uncertain environment for regulators when their decisions are contradicted by those of other regulators. The following points summarize some of the best known historical examples of these inefficiencies and inconsistencies.[16]

- Differences in examination scope, frequency, documentation, guidance, and rules among the FDIC, OCC, and the Fed.

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[14]Bruce G. Carruthers and Naomi R. Lamoreaux, "Regulatory Races: The Effects of Jurisdictional Competition on Regulatory Standards," *Journal of Economic Literature*, Vol. 54, No. 1 (2016), pp. 52–97.

[15]States also have their own banking regulatory agencies, and banks are subject to various rules and regulations promulgated by the Consumer Financial Protection Bureau (CFPB), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Federal Housing Administration (FHA), the Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD).

[16]U.S. Government Accountability Office, "Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness," GAO–16–175, February 2016, http://www.gao.gov/assets/680/675400.pdf (accessed April 4, 2017).

- Inconsistent methods for assessing loan loss reserves.
- Inconsistent guidance and terminology for Bank Secrecy Act examinations *and* compliance.
- Inconsistencies with oversight and compliance of federal consumer financial protection laws (such as fair lending laws).
- The Fed and other primary regulators have not, though they have tried, successfully coordinated their supervision and examination responsibilities.
    - Duplication in the examinations of financial holding companies, despite the OCC's and the Fed's efforts to coordinate.
- Conflicting guidance from the Fed and the OCC.
- Prudential regulators requiring regulated entities to report the same data in different formats.

It makes sense to fix these problems by having one federal banking regulator, but that banking regulator should not be the Federal Reserve.

Remove the Federal Reserve's Regulatory and Supervisory Powers

As the United States central bank, the Federal Reserve's primary role is, and should remain, monetary policy. The Federal Reserve Act directs the central bank to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."[17] The Federal Reserve has struggled to fulfill these macroeconomic responsibilities, and its supplementary regulatory and supervisory responsibilities—particularly as they have expanded since the financial crisis[18]—are simply unnecessary for conducting monetary policy.

Dodd–Frank, in conjunction with increasing the responsibilities it placed on the Federal Reserve, established a new, Senate-confirmed position—Vice Chairman for Supervision.[19] This as-yet-unfilled position is to be filled by one of the Federal Reserve Governors, whose ability to focus on monetary policy would therefore be attenuated. Perhaps worse, allowing the same entity to exercise regulatory and monetary functions gives rise to unnecessary and potentially dangerous conflicts of interest. A central bank that is also a regulator and supervisor could be tempted to use monetary policy to compensate for mistakes on the regulatory side, and financial stability concerns could lead to regulatory forbearance.

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[17]Federal Reserve Act § 2A, 12 U.S. Code 225a.

[18]Peirce and Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd–Frank." Also see Patrick McLaughlin, Chad Reese, and Oliver Sherouse, "Dodd–Frank and the Federal Reserve's Regulations," Mercatus Center at George Mason University, February 4, 2016, http://mercatus.org/publication/dodd-frank-and-federal-reserve-s-regulations (accessed October 8, 2016).

[19]Dodd–Frank § 1108(a).

The current system is far from ideal, and the Fed's responsibilities overlap with those of other financial regulators.[20] The overlap results in inconsistencies and duplicative efforts by both regulators and regulated entities.[21] Efforts at inducing coordination, including the Federal Financial Institutions Examination Council (FFIEC)[22] and the Financial Stability Oversight Council's (FSOC's) mandate to encourage cooperation among regulators, have not addressed this problem adequately. Removing the Federal Reserve's regulatory and supervisory powers would allow it to focus on monetary policy, and shifting the Fed's regulatory and supervisory responsibilities to either the OCC or the FDIC would reduce duplicative regulations.

Merging the SEC and the CFTC

Similar to the consolidation of federal banking regulators, it makes sense to have one federal capital markets regulator. And, in fact, Congress has, on several occasions, contemplated merging the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) into one capital markets regulator.[23] The SEC and CFTC regulate markets that have increasingly blurred into one another over the years, and yet the two agencies have approached their regulatory responsibilities in different and sometimes conflicting ways.[24] There is a theoretical case for allowing the two regulators, which historically have taken very different regulatory approaches,[25] to exist side by side. If one regulator's approach is flawed, for instance, regulated entities may be able to migrate to the markets in the other

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[20]See, for example, U.S. Government Accountability Office, "Financial Regulation," p. 28, which explains that "[a]ll forms of consolidated supervision by the Federal Reserve create overlap with authority of the primary regulators of the holding company's regulated subsidiaries."

[21]See, for example, U.S. Government Accountability Office, "Financial Regulation," p. 36, which noted that "the Federal Reserve's data requests can be very similar to the OCC's requests and that often the two requests will ask for the same data but in different formats." See also Office of the Inspector General to the Board of Governors of the Federal Reserve System, "2015 List of Major Management Challenges for the Board," *Memorandum*, September 30, 2015, https://oig.federalreserve.gov/reports/board-management-challenges-sep2015.pdf (accessed October 8, 2016). Among the items in the list was "maintaining effective relationships with other regulators." The Inspector General noted: "While the Board has taken steps to improve interagency collaboration and cooperation…continued coordination with other federal supervisory agencies, such as the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, is crucial to implementing the financial stability regulatory and supervisory framework." Ibid., p. 6.

[22]The FFIEC is "a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the" Board of Governors, FDIC, National Credit Union Administration, OCC, and CFPB.

[23]House Financial Services Chairman Barney Frank (D–MA) proposed legislation to merge the SEC and CFTC. See Sarah N. Lynch, "Retiring US Lawmaker Barney Frank Seeks SEC–CFTC Merger," Reuters, November 29, 2012, http://www.reuters.com/article/sec-cftc-merger-idUSL1E8MTGFA20121129 (accessed November 24, 2016).

[24]See, for instance, U.S. Government Accountability Office, "Financial Regulation," p. 41, which observes: "Over time, separate regulation of the securities and futures markets has created confusion about which agency has jurisdiction and has raised concerns about duplicative or inconsistent regulation of entities that engage in similar activities."

[25]Historically, the CFTC applied a principles-based approach to regulation, whereas the SEC's approach was more rule-based. The two agencies' approach is now very similar, particularly since Congress passed the 2010 Dodd–Frank Act.

regulator's purview. In practice, however, the bifurcated responsibility has resulted in tense regulatory battles and duplicative effort by regulators and market participants.

Periodic attempts to address the problem have helped calm some of the interagency fighting, but the agencies' closely related mandates promise continued discord.[26] For example, the Shad–Johnson Jurisdictional Accord of the early 1980s brought a measure of peace, but jurisdictional disputes continued. Dodd–Frank, which awkwardly split regulatory responsibility for the over-the-counter derivatives market between the two agencies, only compounded the problem with overlapping authorities.[27] The CFTC, although built on the hedging of agricultural commodities, now is primarily a financial markets regulator. The markets it regulates are closely tied—through common participants and common purposes—with SEC-regulated markets. The U.S. is unusual in having separate regulators for these markets.

A merged SEC and CFTC might be better able to take a holistic view of the capital and risk-transfer markets. A single regulator could conserve resources in overseeing entities that are currently subject to oversight by both the SEC and CFTC. In addition, a unified regulator would eliminate discrepancies in the regulatory approaches that can frustrate good-faith attempts by firms to comply with the law. Consolidating regulatory authority in one federal banking regulator and one federal capital markets regulator, respectively, would help improve the U.S. regulatory framework. However, there are still many other ways to improve the U.S. financial regulatory system.

The CFPB: Unnecessary for Protecting Consumers

The Consumer Financial Protection Bureau (CFPB) was designed specifically to determine which financial products people may choose rather than allow consumers to make their own choices. This design is primarily to protect consumers from themselves by standardizing financial products.[28] As a result, the CFPB constrains access to credit and erodes Americans' financial independence. Furthermore, the CFPB is unaccountable to the public in any meaningful way, and raises serious due process and separation of powers concerns. A three-judge panel of the Circuit Court of Appeals for the District of Columbia recently ruled that the Bureau's single-director model is unconstitutional. The court ruled that the unilateral power wielded by the CFPB Director "represents a gross departure from settled historical practice" and "poses a far greater risk of arbitrary decision making and abuse of power, and a far greater threat to individual liberty, than does a multi-member independent agency."[29]

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[26]For a discussion of cooperative efforts over the years, see U.S. Government Accountability Office, "Financial Regulation," pp. 43 and 44.

[27]See, for instance, Annette L. Nazareth and Gabriel D. Rosenberg, "The New Regulation of Swaps: A Lost Opportunity," *Comparative Economic Studies*, Vol. 55, No. 3 (September 2013), pp. 535–548.

[28]In the words of Oren Bar-Gill and Elizabeth Warren, the academic architects of the CFPB, borrowers suffer "cognitive limitations" and borrowers' "learning is imperfect." Oren Bar-Gill and Elizabeth Warren, "Making Credit Safer," *University of Pennsylvania Law Review*, Vol. 157, No. 1 (November 2008), https://www.law.upenn.edu/live/files/112-bargillwarren157upalrev12008pdf (accessed December 21, 2016).

[29]*PHH Corporation, et al., Petitioners v. Consumer Financial Protection Bureau, Respondent*, U.S. Court of Appeals, District of Columbia Circuit, October 11, 2016, https://assets.documentcloud.org/documents/3131047/Cfpb-Dccircuit-20161011.pdf (accessed March 31, 2017).

CFPB advocates claim that the agency is vital for protecting consumers in financial markets, but there simply was no shortage of consumer protection against fraudulent companies prior to the Dodd–Frank Act. In fact, if Congress eliminated the CFPB, Americans would be just as protected against unfair and deceptive fraudulent practices as they are today. The main reason is that Title X of Dodd–Frank created the CFPB by transferring enforcement authority for 22 specific consumer financial protection statutes to the new agency.

These federal statutes were administered by seven federal agencies, and layered on top of state laws and local ordinances too numerous to count. For decades, this framework governed the offering of consumer credit and outlawed deceptive and unfair practices in financial products and services. Congress can improve the efficiency of financial regulation by consolidating enforcement authority for these traditional consumer protection statutes with the Federal Trade Commission (FTC), the one agency with decades of experience in promoting the welfare of consumers *and* market competition.

Dodd–Frank also codified a new, ill-defined, type of consumer protection. Under the traditional framework, it was illegal for businesses to engage in *deceptive* or *unfair* practices when marketing their offerings to consumers.[30] Title X of Dodd–Frank empowers the CFPB "to exercise its authorities under Federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services, consumers are protected from unfair, deceptive, *or abusive* acts and practices."[31] The statute does not define the term abusive, and the agency has issued neither guidance nor rules to define abusive practices. Furthermore, officials have not shown much willingness to provide clarity. During a 2012 hearing of the House Financial Services Committee, for example, when asked by lawmakers to define "abusive," CFPB Director Richard Cordray said that

> the term abusive in the statute is…a little bit of a puzzle because it is a new term…. We have been looking at it, trying to understand it, and we have determined that that is going to have to be a fact and circumstances issue; it is not something we are likely to be able to define in the abstract. Probably not useful to

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[30]Historically, the FTC was the primary federal consumer protection agency outside of banking, while banking regulators were primarily responsible for consumer protection in depository institutions. The Federal Trade Commission Act (15 U.S. Code 41 et seq.) was amended in 1938 to prohibit "unfair or deceptive acts or practices." See, generally, Federal Trade Commission, "Bureau of Consumer Protection," https://www.ftc.gov/about-ftc/bureaus-offices/bureau-consumer-protection (accessed November 4, 2016). Federal banking regulators, including the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, the Comptroller of the Currency, and the National Credit Union Administration, had authority to enforce unfair or deceptive acts or practices in or affecting commerce under their statutes in a manner consistent with carefully crafted FTC limiting principles applicable to unfairness and deception. See 15 U.S. Code § 45(n) (defining "unfairness"); Federal Trade Commission, FTC Policy Statement on Unfairness, 104 F.T.C. 949, 1070 (1984), https://www.ftc.gov/public-statements/1980/12/ftc-policy-statement-unfairness (accessed March 31, 2017); and Federal Trade Commission, FTC Policy Statement on Deception, 103 F.T.C. 110, 174 (1984), https://www.ftc.gov/public-statements/1983/10/ftc-policy-statement-deception (accessed March 31, 2017). See also, e.g., FDIC Compliance Manual, Chapter 7 (Federal Trade Commission Act, Section 5 Unfair or Deceptive Acts or Practices), https://www.fdic.gov/regulations/compliance/manual/7/VII-1.1.pdf (accessed March 31, 2017).

[31]Dodd–Frank, Section 1021, 12 U.S. Code § 5511. (Emphasis added.)

> try to define a term like that in the abstract; we are going to have to see what kind of situations may arise.[32]

Under this framework, financial firms must operate under a vague legal standard to which they might never be able to adhere. Aside from the near impossibility of complying with such a fleeting standard for abusive acts or practices, there is no objective way to measure a consumer's ability to understand terms and conditions of financial products and services.[33] Regardless, forcing financial firms into such a role, where they are effectively required to verify consumers' understanding of terms rather than merely disclosing relevant information, goes well beyond the long-established consumer protection framework.

Perhaps worse, this change, based on a hostile view of free enterprise, comes dangerously close to absolving one party in a financial contract from any real responsibility. The U.S. did not need a new type of consumer financial protection, and it certainly did not need another federal regulator (especially one with supervisory authority) to add to the already overly burdensome regulatory system. Congress should eliminate the CFPB (along with the new abusive practices concept of consumer protection), and transfer enforcement authority for the statutes enumerated in Title X of Dodd–Frank to the FTC.

Presidential Reorganization Authority

Many of the changes discussed here will be contentious and difficult for Congress to implement. One approach that might help facilitate these changes is to revive the reorganization authority codified at 5 U.S. Code §§ 901 et seq. that has been used by past Presidents of both parties. Granting this authority is a flexible way to enable the Executive branch to propose government reorganization plans that improve the efficiency and effectiveness of government regulators in financial markets. Given that the Trump Administration has issued an executive order calling for "efficient, effective" financial regulations, Congress could grant the President the authority to reorganize all—or some—of the federal financial regulatory agencies.[34]

Granting this authority, consistent with prudent protections, would require the Trump Administration to submit reorganization plans for consideration by Congress. Reorganization authority under 5 U.S. Code §§ 901 et seq. has been granted many times

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[32]"How Will the CFPB Function Under Richard Cordray," transcript of hearing before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, U.S. House of Representatives, January 24, 2012, http://oversight.house.gov/wp-content/uploads/2012/06/01-24-12-Subcommittee-on-TARP-Financial-Services-and-Bailouts-of-Public-and-Private-Programs-Hearing-Transcript.pdf (accessed March 31, 2017).

[33]See Katz, "Title X and the Consumer Financial Protection Bureau: Limiting Americans' Credit Choices"; Todd Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?"; and Diane Katz, "The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect," Heritage Foundation *Backgrounder* No. 2760, January 22, 2103, http://www.heritage.org/housing/report/the-cfpb-action-consumer-bureau-harms-those-it-claims-protect#_ftn11.

[34]The White House, Presidential Executive Order on Core Principles for Regulating the United States Financial System, February 3, 2017, https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states (accessed March 27, 2017).

between 1932 and 1984, with some plans being enacted and others rejected.[35] Congress can easily grant this authority now to target specific agencies within a specific time frame under any rules it deems necessary.[36] For example, under the first reauthorization of the 1949 reorganization act, which finally expired in 1973, 52 reorganization plans were submitted to Congress, eight of which were rejected.[37] The following is a list of organizations that were established under the act:[38]

- The Department of Health, Education and Welfare;[39]
- The Environmental Protection Agency;[40]
- The National Oceanic and Atmospheric Administration in the Department of Commerce;[41] and
- The Drug Enforcement Administration in the Department of Justice.[42]

Another example is President Jimmy Carter, who asked Congress for a four-year renewal of the Reorganization Act of 1949, with certain modifications. Congress ultimately decided to enact an entirely new statute, the Reorganization Act of 1977, based largely on the 1949 statute.[43] The new law made several procedural changes to the manner in which plans could be submitted or amended, and "a prohibition against establishing, abolishing, transferring, or consolidating departments was expanded to prohibit also the abolition or consolidation of independent agencies."[44] There are many ways that reorganization authority could be used to improve the efficiency and effectiveness of the financial regulatory framework.

For instance, the SEC currently operates under Reorganization Plan No. 10 of 1950.[45] That plan transferred from the Commission (composed of five Commissioners) to the Chairman of the Commission power over "(1) the appointment and supervision of personnel employed under the Commission, (2) the distribution of business among such personnel and among administrative units of the Commission, and (3) the use and expenditure of funds."[46] However, the plan reorganized the Commission so that "the

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[35]Ronald C. Moe, "The President's Reorganization Authority: Review and Analysis," Congressional Research Service, March 8, 2001.
[36]Also see David Walker, U.S. General Accounting Office, "Executive Reorganization Authority: Balancing Executive and Congressional Roles in Shaping the Federal Government's Structure," testimony before the Committee on Government Reform, U.S. House of Representatives, April 3, 2003, and Henry B. Hogue, "Presidential Reorganization Authority: History, Recent Initiatives, and Options for Congress," Congressional Research Service, December 11, 2012.
[37]Hogue, "Presidential Reorganization Authority," p. 25.
[38]Ibid., pp. 25–26.
[39]Reorganization Plan No. 1 of 1953 (67 Stat. 631).
[40]Reorganization Plan No. 3 of 1970 (84 Stat. 2086).
[41]Reorganization Plan No. 4 of 1970 (84 Stat. 2090).
[42]Reorganization Plan No. 2 of 1973 (87 Stat. 1091).
[43]The Reorganization Act of 1977, as amended, is not presently operative for execution because it expired on December 31, 1984. Moe, "The President's Reorganization Authority."
[44]Hogue, "Presidential Reorganization Authority," p. 28.
[45]Title 5, U.S. Code, Appendix, Reorganization Plans, 15 U.S. Code 78d-2, http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title5a-node84-leaf114&num=0&edition=prelim (accessed April 4, 2017).
[46]Ibid., section 1(a).

appointment by the Chairman of the heads of major administrative units under the Commission shall be subject to the approval of the Commission."[47]

In practice, this change means that the Chairman of the Commission has almost unrestricted power over how the Commission is run and its agenda. The four other commissioners have little influence over its agenda or its operation. One of the reasons to have a bipartisan, multi-member commission is to allow various perspectives to have weight in the agency's operation and agenda. Granting the President reorganization authority could be used, narrowly, to restore balance to the Commission. The plan could, for example, ensure that any two members would have the ability to place an item on the agenda and, if it relates to a rule-making, receive adequate staff support to develop an idea to the point where the Commission can vote on whether to instruct the staff to develop a proposed rule.

Congress could easily tailor reorganization authority to solicit several broader plans from the Trump Administration.[48] For instance, these plans could:

- Establish a single capital markets regulator by merging the SEC and the CFTC;
- Establish a single bank and credit union supervisor and regulator by merging the OCC, the FDIC, the NCUA, and the Federal Reserve's bank supervisory and regulatory functions; and
- Revise the structure, mission, and functions of the CFPB.

Conclusion

The U.S. financial regulatory framework is in dire need of an overhaul. Prior to 2008, U.S. financial markets were overregulated, not deregulated. Leading into the 2008 crisis financial firms funded too much unsustainable activity largely because of the rules and regulations they faced, including the widespread expectation that federal rules had guaranteed safety and soundness and that the federal government would provide assistance to mitigate losses. For decades, the U.S. regulatory framework has increasingly made it more difficult to create and maintain jobs and businesses that benefit Americans, and these trends must be reversed.

One of the main reasons the regulatory regime has been counterproductive for so long is because it allows regulators to micromanage firms' financial risk, a process that substitutes regulators' judgments for those of private investors. There are many policy solutions to begin restoring the competitive process and strengthening financial markets, such as consolidating and reorganizing federal financial regulators. There is no good reason, for example, to have seven federal financial regulators (the Federal Reserve, the FDIC, the OCC, the NCUA, the SEC, the CFTC, and the CFPB) and individual state

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[47]Ibid., section 1(b)(2).

[48]It is likely that a major difference for any reauthorized versions of this authority is that any plan would now have to be ratified by Congress, rather than automatically going into effect but for exercise of a Congressional veto. In response to *INS v. Chadha*, 642 U.S. 919, the U.S. Supreme Court (*Process Gas Consumers Group v. Consumer Energy Council*, 463 U.S. 1216) summarily affirmed the DC Circuit's decision in *Consumer Energy v. FERC*, 673 F.2d 425, which provided that "a rule issued pursuant to a one-house veto scheme cannot have a different legal status from a rule issued pursuant to a two-house veto scheme." Even if a two-house veto satisfies the bicameralism requirement, it fails the presentment requirement and is presumptively unconstitutional.

regulatory agencies. Congress should work with the Trump Administration to improve the effectiveness and efficiency of the U.S. financial regulatory system.

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CONFERENCE OF STATE BANK SUPERVISORS

April 5, 2017

The Honorable Blaine Luetkemeyer
Chairman, Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
Washington D.C. 20515

The Honorable William Lacy Clay
Ranking Member, Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
Washington D.C. 20515

Dear Chairman Luetkemeyer and Ranking Member Clay:

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to submit this letter in advance of your Subcommittee's hearing entitled "Examination of the Federal Financial Regulatory System and Opportunities for Reform."

CSBS is the national organization of bank regulators from all 50 states, District of Columbia, and U.S. territories. State regulators supervise over 75% of all banks in the United States. In addition, state regulators license and supervise a variety of non-depository financial services. CSBS, on behalf of state regulators, also operates the Nationwide Multistate Licensing System to license and register those engaged in mortgage, money transmission, consumer finance, and other non-depository financial services industries.

The dual banking system is founded on the recognition that state governments and the federal government have a shared interest in a banking system that is both stable and diverse to meet the varied needs of communities and customers throughout the country. This system requires a balance between state and federal authority that creates both national and local accountability. On numerous occasions, Congress has recognized the value of state regulators' perspectives and the value of integrating state regulators into federal regulatory structures and processes -- for example, in creating a voting role for state regulators on the Federal Financial Institutions Examination Council; in requiring that one member of the Federal Deposit Insurance Corporation have state bank supervisory experience; and in requiring that state banking regulators have a role in the Financial Stability Oversight Council.

State regulators, in addition to ensuring that their regulated institutions operate in a safe and sound manner and treat consumers and customers fairly and responsible, are responsible for promoting economic development in their states. Despite accounting for only 13 percent of total industry assets, community banks provide more than 40 percent of the total loans to small

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www.csbs.org • 202-296-2840 • FAX 202-296-1928

businesses made by the industry. We are particularly concerned with the significant decline in the number of community banks and the lack of new entrants in recent years. The current federal regulatory system has become far too prescriptive for many community banks to thrive. The future regulatory system needs to balance the safety and soundness of the system with economic growth and consumer empowerment.

As policy makers have shaped, reviewed, and revised the federal regulation of financial services, state regulators have sought to preserve and enhance this local accountability by ensuring that federal regulatory requirements and processes properly integrate the role of state regulators as chartering and supervisory authorities. For example, state regulators have proposed providing state regulators with greater visibility and involvement in bank stress-tests, resolution planning, and horizontal reviews. Additionally, state regulators, recognizing that banks of all sizes are relying more and more on third party service providers (TSPs) for a variety of critical services, have been seeking ways to improve supervision of these bank service providers by seeking to modernize the Bank Service Company Act to support state-federal coordination and information-sharing regarding bank TSP exams.

State regulators share supervisory responsibility over state-chartered banks with the federal banking agencies. This is a relationship that state regulators value, but it is also one that provides a view into two trends that warrant policymakers' attention:

- The federal agencies' increased centralization of decision making in Washington D.C., which eliminates the opportunity for examiner judgment and creates delays and uncertainty; and

- In the area of compliance issues (as opposed to safety and soundness), a "zero tolerance" approach by the federal agencies to violations that leaves examiners and institutions with no opportunity for correction and follow-up.

More broadly, as Congress and other stakeholders consider longer-term approaches to regulation, policy makers should consider a framework which provides more responsibility and deference to the chartering authority, fosters state level innovation in the banking system, and focuses the federal insurer on systemic risk and troubled banks.

We look forward to working with you and other Members of the Committee to serve the interests of the financial services ecosystems that we supervise in the 50 states and territories.

Sincerely,

John W. Ryan
President and CEO

1129 20th Street, N.W. • Ninth Floor • Washington, DC • 20036
www.csbs.org • 202-296-2840 • FAX 202-296-1928

Consumer Mortgage Coalition

Testimony Submitted for the Hearing Record

U.S. House of Representatives House Financial Services

Subcommittee on Financial Institutions and Consumer Credit:

Examination of the Federal Financial Regulatory System and Opportunities for Reform

April 6, 2017

The Consumer Mortgage Coalition appreciates this opportunity to submit testimony for this hearing on the impact of federal agency rules and processes on financial companies and their customers. This is a timely hearing for the mortgage industry because this industry has been unable to fully recover because of regulatory excess.

Our submission today is focused on the Consumer Financial Protection Bureau ("CFPB") because that agency is the primary federal regulator for the consumer mortgage industry.

The Dodd-Frank Act required the CFPB to write a large number of consumer mortgage regulations. The result has been an inundation of regulations that, together, have prevented private capital from returning to the mortgage market and have driven up consumer costs exponentially.

The CFPB has written a number mortgage regulations that are broader and more complex than is reasonable for their goals. CFPB mortgage rules are quite prescriptive and yet unclear. The CFPB rules have also created unnecessary conflicts of law. The rules are so poorly written that lenders and servicers are often forced to guess what is required or prohibited. It is not realistic to believe mortgage participants can comply with all the rules because of the conflicts of law and the vagueness of CFPB rules.

The CFPB has released a small amount of guidance. At the same time, the CFPB has made clear, and continues to reiterate, that its guidance is not binding. The CFPB has attempted to penalize a mortgage lender, PHH, for relying on written agency guidance, waiting until years after that written guidance was given to take the retroactive position that the written agency guidance is "not binding" on the CFPB. As a result, companies subject to the CFPB's authority cannot rely on even formal, written CFPB guidance.

Violations, and even alleged violations, of these unclear rules carry substantial litigation and liability risk, even for minor errors and for guessing incorrectly about what the rules require, even when there is no consumer harm. The cost and litigation risks of complying with the unknowable has driven up the costs borne by consumers very substantially. These cost increases are a strong impediment to homeownership in this country.

The risks of litigation and liability under the CFPB's mortgage rules is also working to keep housing finance constrained, not only by driving up the cost by also by keeping private capital out of the mortgage markets. The rules have very substantially reduced the availability of housing credit, even for creditworthy for American families.

We describe several of the worst problems and suggest an ability to cure that could provide relief while protecting consumers. This ability to cure would help draw private capital back to the mortgage markets. We also suggest areas where consumer privacy is

at risk, where the False Claims Act is interfering with the Federal Housing Administration ("FHA") program to provide housing finance, particularly to lower-income and first-time homebuyers, and where one antiquated statute should not apply to consumer mortgage loans because it has been entirely surpassed by CFPB rules and other laws.

TRID Rules Are Unmanageably Unclear

The TILA / RESPA integrated disclosures ("TRID") rulemaking was intended to integrate mortgage origination disclosures required by two statutes. In the process of integrating the forms, the TRID rule caused a number of unintended problems.

First, it made the forms longer. Consumers receive more pieces of paper now than they did before TRID, even though the information they receive is substantively the same, although the information is now less clear. The CFPB missed an opportunity to streamline the forms.

Second, the TRID rule requires repeated re-disclosures of the forms throughout the loan underwriting process, with most of the information in the re-disclosures unchanged. When one item changes, rather than just disclosing the change, lenders are required to send the entire form again with the same information but for the changed item, and consumers are supposed to find the change. This is a needle-in-the-haystack approach to consumer disclosures. It also inundates consumers with a blizzard of forms, and expects consumers to be able to tell which form is which even though they all look almost the same.

More importantly to most consumers is that the new forms have caused closing costs to increase dramatically. One cause of increased closing costs is that implementing the new TRID forms required wholesale reprogramming of loan origination systems, a very costly undertaking. Implementation has also been made costlier than necessary because the TRID rule is so unclear in significant ways. At the same time, liability for errors is severe, and applies to assignees. Investors have rejected loans due to disclosures that contain even potential errors that have absolutely no consumer impact. This has caused unnecessary disruptions in the mortgage markets.

The ATR-QM Rule Is Also Unclear

The ability-to-repay rule ("ATR") rule, also known as the qualified mortgage ("QM") rule, has greatly constrained consumer mortgage credit, potentially much more than the CFPB intended. The rule requires lenders to document loan applicants' ability to repay a mortgage loan, but it does much more.

It requires lenders to guess what documentation is sufficient because the rule sets underwriting standards that are very vague. At the same time, the rule creates enormous liability, throughout the life of the loan, for even minor errors that have no consumer impact. Lenders and investors are "driving blind" because they are liable for not meeting an invisible target. They have pulled back because of the litigation risk under this rule. Borrowers with the strongest credit profiles can still obtain housing finance. Too many other consumers cannot, even though they could readily make the loan payments. The reason credit remains so constrained is that the litigation risk on mortgage loans outweighs potential lending profits. Capital has turned to other markets where investors have a fair chance at making a profit.

The ATR rule established a safe harbor from liability for QM loans, and there are two forms the safe harbor can take. One is a true safe harbor from liability, while the other is a "rebuttable presumption" that a borrower has the requisite ability to repay the loan. Non-QM loans have neither of these protections from liability.

A loan can meet the true safe harbor if it is a government-backed loans, or if the loan has a debt-to-income ("DTI") ratio of 43 percent or less and the loan is underwritten according to Federal Housing Administration ("FHA") standards. These standards are vague, and incorporating them into the QM rule increases QM litigation risk. This litigation risk strengthens the incentive to restrict mortgage lending to government-backed loans.

Not only is there almost no non-QM lending, even QM lending is limited. The rebuttable presumption offers only minimal protection from liability. Litigation is necessary to determine whether the lender met the requisite ability-to-repay standard for rebuttable-presumption QM loans. However, the purpose of a safe harbor is to prevent litigation in the first place, so a litigation-based rebuttable presumption is not really a safe harbor from litigation risk. Additionally, the litigation risk of rebuttable-presumption QM loans is exacerbated because the presumption depends on a consumer's "residual income" after making loan payments, but the CFPB has never defined or set a "residual income" standard. This is unfortunate because the Veterans Administration has a residual income standard that has worked quite well, and the CFPB could simply adopt it.

We are unable to understand why the CFPB was willing to incorporate the FHA underwriting standards into its ATR rule but declines to adopt VA residual income standard into the same rule.

The liability for violations of the ATR rule can be severe. As with liability for TRID violations, it can exceed the profit on a loan. But ATR liability, unlike TRID liability,

lasts for the life of the loan. The liability for mortgage lending is now so severe that private capital has left the mortgage market and has stayed away. Government-backed loans meet the definition of QM loans, so those loans are most of the market now.

If there is to be private capital behind mortgage loans in this country, Congress or the CFPB will need to address the open-ended litigation risk for even minor and harmless error, and for failure to fully comply with vague lending standards.

The CFPB's Successors in Interest Rule Creates Unnecessary Hurdles

The CFPB released a final regulation on successors in interest in 2016. Unfortunately, this rulemaking was based on a misdiagnosis of the problem the CFPB wanted to address. As a result, this rule "solved" a problem that did not exist, while creating a new problem.

The stated purpose of the rule was to enable successors in interest to mortgage borrowers to obtain loss mitigation according to the loss mitigation procedures in Regulation X, and to avail themselves of other protections of CFPB servicing rules. Successors in interest can and do obtain loss mitigation even in the absence of this rule, and all the protections of all the CFPB's servicing rules apply to a loan as long as the loan exists regardless of whether there is a successor in interest.

The problem the CFPB wanted to address was a practice the agency noticed after a borrower died. Servicers sometimes request probate documents from the borrower's survivors before providing loan account information, even if the family does not plan to probate the borrower's estate. During the course of the successor in interest rulemaking, we discovered that the CFPB staff was apparently unaware that two federal privacy laws prohibit servicers from providing loan account information to successors in interest of deceased borrowers, absent the borrower's consent, in many cases. There are exceptions that permit servicers to provide account information to a borrower's executor, but if a borrower dies intestate, there is no executor absent probate. The privacy rules have no exceptions, other than borrower consent, that permit servicers to provide account information to non-borrowers generally after a borrower's death. Absent borrower consent, then, probate is sometimes necessary to appoint an executor solely so the family can obtain basic loan information from a servicer, even if the family has no other reason to probate an estate.

In its successor in interest rulemaking, the CFPB proposed no amendments to the privacy laws that cause the problem the CFPB wanted to address. It apparently did not realize at the time that the privacy laws restrict the communications that the CFPB wanted to increase.

The final rule addresses the privacy rules only indirectly, and in the process creates a new and substantial hurdle to communication. The final rule will permit servicers to disclose account information to a successor in interest, without borrower consent, only after the successor in interest has demonstrated ownership of the mortgaged property. This will require the person to elect to acquire title to the property before learning even basic loan information such as the loan balance. Acquiring title involves costs, such as legal fees to document the title transfer, recording fees, perhaps owners' title insurance, and sometimes very high transfer taxes. This new hurdle will actually *prohibit* the servicer from indicating whether the mortgage loan balance exceeds the property value until *after* the successor in interest has incurred the costs of acquiring title to the property. This is not a consumer protection; it creates consumer harm.

A practical effect of the final rule will be to prevent exercise of due-on-sale clauses even in cases in which a federal statute has made their exercise entirely proper. The CFPB's rule provides successor in interest with a private right of action against servicers based on failure to provide the CFPB's loss mitigation procedures. However, the successor in interest regulation defines "successor in interest" so vaguely (for example, it includes a borrower's "relative," whatever that means) that servicers cannot know whether the loss mitigation procedures are required. Any person claiming to be a successor in interest (a "claimant") can claim a need for loss mitigation. In this case, even before the claimant establishes ownership of the property, the servicer will not be able to exercise a due-on-sale clause until the loss mitigation process is complete. This is despite the fact that multiple federal statutes protect default remedies in mortgage contracts, including due-on-sale clauses.[1] Under this rule, servicers will face new litigation risk for ordinary and permissible exercise due-on-sale clauses that Congress expressly protected, even when

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[1] The Garn-St. Germain Act, a 45-year old statute for which the CFPB has no rule-writing authority, explicitly protects all contractual mortgage rights other than exercise of a due-on-sale clause in some circumstances:

> "Except as otherwise provided in subsection (d) *[transfers exempted from due-on-sale exercise]*, the exercise by the lender of its option pursuant to such a [*due-on-sale*] clause shall be exclusively governed by the terms of the loan contract, **and all rights and remedies** of the lender and the borrower **shall be fixed and governed by the contract**."

Garn-St. Germain Act § 317(b)(2), 12 U.S.C. § 1701j-3(b)(2) (emphasis added). The CFPB's successor in interest rule will substantially interfere with this statute. Additionally, RESPA, a statute the CFPB relies on for its successor in interest rulemaking, also protects mortgage contracts:

> "**Nothing in this Act** [*RESPA*] **shall affect the validity or enforceability of any** sale or contract for the sale of real property or any **loan, loan agreement, mortgage, or lien** made or arising in connection with a federally related mortgage loan."

RESPA § 17, 12 U.S.C. § 2615 (emphasis added). To the extent the CFPB's regulation will interfere with a servicer's ability to exercise a due-on-sale clause according to the Garn-St. Germain Act and a mortgage contract, it is impermissible.

the claimant appears unrelated to the borrower. Mortgage investors will need to price for this new interference with their statutory and contractual rights.

This rulemaking is unfortunate because successors in interest can and do obtain loss mitigation today, even though the new rule is not yet effective. This rule is based on a misdiagnosis, adds complexity for servicers, creates a new source of litigation risk, is unclear, conflicts with statutes and with contracts, and is harmful to consumers.

The CFPB's Loan Originator Compensation Rule is Overbroad and Vague

The Dodd-Frank Act required the CFPB to prohibit yield-spread premiums, compensation paid to a loan originator that varies based on the loan terms. The CFPB did so, but went much farther than was necessary or reasonable. The result is a regulation with far-reaching yet vague requirements. The rule covers many more people than just loan originators, discourages supervisors and managers from stepping in to resolve questions that arise during loan origination, and discourages or prohibits reducing a loan originator's compensation in reaction for failure to comply with lending standards. Once again, there is litigation risk for noncompliance with a vague rule even in the absence of consumer harm.

Reliable CFPB Guidance Is Not Forthcoming

It is unfortunate that the CFPB has not provided the industry with regulatory certainty. Many of its regulations are unclear, and the litigation risk for failure to comply with the unknown is severe. The CFPB has released informal guidance. Director Cordray stated on March 31 that, "Addressing ambiguities and conflicts is another important task that we take seriously," a statement that is quite puzzling to the industry, as explained below.

The CFPB has posted some staff discussion of the many questions the industry has asked, but all the guidance the CFPB has put out is not binding. The CFPB has been very clear that its guidance is not binding. In the CFPB's case against mortgage lender PHH, PHH relied on written agency guidance. The CFPB decided this was "not binding" and faulted PHH for relying on it. That case is presently on appeal in the D.C. Circuit Court, and in a filing in that litigation on March 31, 2017, the CFPB reiterated that in enforcement actions, the CFPB might not follow earlier-issued guidance. The CFPB stated:

> "Indeed, there is another good reason why this Court should not permit PHH to use the letter as a shield. Agencies need flexibility when responding to requests for compliance advice. . . . So the agency may permit its staff to respond, but may want to make sure that staff advice does not bind the agency prospectively."

The CFPB's has made its position extremely clear to the industry – *i.e.*, even explicit, written guidance is not binding in the CFPB's eyes, and may be revoked retroactively. The industry can only rely on CFPB final regulations, not on its guidance.

This is why our suggested ability to cure is important. Even if the CFPB were to come out with guidance addressing all its areas of regulatory uncertainty, the industry could not rely on the guidance.

An Ability to Cure Could Draw Private Capital

We expect the CFPB to revisit its mortgage rules to improve their focus and to clarify what they require and prohibit. A series of rulemakings will take time if they are to have sound results. Absent an earlier fix, we see no reason to believe that consumer mortgage markets will draw in private capital, or will become less unattractive to lenders or servicers. This is unfortunate because the dearth of capital limits the supply of housing finance. Even now, when interest rates are relatively low by historical standards, many families are deprived of housing finance because of the litigation risk of overbroad and unclear mortgage rules.

We suggest a legislative remedy that would remove some of the largest risks to mortgage lending without waiting years for multiple rulemakings. This would be legislation creating a process by which consumers would seek remedial relief under TILA or RESPA directly from a lender or servicer without litigation. If that procedure does not yield the relief a consumer believes is warranted, litigation would remain available. This procedure would not amend substantive rights, it would merely be procedural. At the same time, it would encourage lenders and servicers to provide appropriate relief promptly. We suggest the following language:

> **(a) ABILITY TO CURE.**—No person shall be liable under the Truth in Lending Act or the Real Estate Settlement Procedures Act, or any implementing regulation of either, unless the person has first had notice and an opportunity to cure and has failed to do so, in accordance with the procedures in this section.
>
> **(b) REASONABLE NOTICE.**—Before any party can bring or authorize any claim, charge, or proceeding against a person for a violation, the party must provide the person with reasonable notice of each violation or potential violation.
>
> (1) The notice must be in writing, and must include all facts relevant to whether there is or may have been a violation that are reasonably known to the party and to all consumer or consumers involved or affected.
>
> (2) The person shall have 60 days after receiving such reasonable notice to cure any violation, or to explain that the person found no violation.

(3) After the 60-day response period, or after the person responds that the person found no violation if that is sooner, a party may bring a claim based on a violation.

(c) DEFINITIONS.—In this section, the following definitions apply:

(1) The term 'cure' means to pay a consumer for the consumer's actual economic losses directly resulting from a violation.

(2) The term 'person' includes but is not limited to any lender, creditor, servicer, service provider, settlement service provider, covered person, or assignee or agent of any of those, and any other person subject to liability for violations of the Truth in Lending Act or the Real Estate Settlement Procedures Act.

(3) The term 'violation' means any material violation of the Truth in Lending Act or the Real Estate Settlement Procedures Act, or any implementing regulation of either.

(d) NO INDEPENDENT LIABILITY.—Nothing in this section shall be construed as creating or permitting a right of action, standing, or liability that did not arise under the Truth in Lending Act or the Real Estate Settlement Procedures Act.

A significant benefit of this ability-to-cure procedure would be to reduce the litigation risk that currently permeates the CFPB's mortgage rules, deters private capital and prevents many sound loans from being offered and made.

Unknown UDAAPs Should Not be a Basis for Litigation or Penalty

The Dodd-Frank Act prohibits unfair, deceptive, and abusive practices ("UDAAPs"), but does not define these terms. The CFPB has authority to define them by regulation but has not done so, and has not even proposed to do so. Rather, the CFPB uses a regulate-by-enforcement-action approach. It brings charges of UDAAPs without defining them. That is, covered persons can be held accountable retroactively for doing something, but they do not know what is prohibited until after the fact.

We recommend that Congress require the CFPB to limit UDAAP enforcement actions to practices it has clearly defined by final regulation before the conduct occurs. We also recommend legislation providing that action in compliance with applicable law cannot be a UDAAP.

HMDA Privacy Risks Need to Be Addressed

The Dodd-Frank Act required collection and reporting of new data fields under the Home Lending Mortgage Disclosure Act ("HMDA"). The CFPB requires far more.

HMDA requires publishing data about mortgage loan applicants, under a statute that is 41 years old. The statute predates the information age, identity theft, and the risk that even data stripped of identifying information can still divulge the identities of individual consumers. HMDA data are one source of these risks to consumer privacy. Expanding the data included in HMDA reporting will increase the privacy risks in HMDA reporting.

The CFPB has not decided how it will protect the risks to consumer privacy inherent in the new HMDA reporting, or who will have access to the new data fields. That is, the CFPB decided what to require lenders to collect and report before addressing privacy risks and who will be able to access the data. This indicates that the CFPB did not conduct a cost-benefit analysis of its final rule because it has not finished deciding what the final rule will entail.

We suggest that Congress take a close look at the privacy risks inherent in HMDA data. As more data continuously become available, the risks to consumers continue to increase. We suggest that the new HMDA regulation not become effective until Congress has addressed how to protect consumer privacy.

The CFPB Complaint Database Creates Privacy Risks

The Dodd-Frank Act requires the CFPB to maintain a database of consumer complaints, which the CFPB makes available to the general public for free. The Federal Trade Commission ("FTC") also maintains complaint data. The FTC limits access to its database to government agencies, while the CFPB releases its data to the public. The FTC alerts consumers to their privacy policy, including that the FTC shares complaint information with government agencies, but not the public, "to investigate complaints, coordinate law enforcement investigations, cooperate with oversight investigations, or follow up on ID theft reports." The CFPB alerts consumers before they file a complaint that "We publish complaints in the Consumer Complaint Database (without personal information)." This is misleading because it fails to mention that the public can re-identify consumers and obtain their personal information from the CFPB complaint database by using public information. As with expanded HMDA data reporting, the CFPB's public complaint database increases the privacy risks to consumers. At a minimum, the CFPB should be clear that filing a complaint with the CFPB can increase the risk of privacy breaches.

The Dodd-Frank Act requires the CFPB to permit some but not all government agencies to access its complaint data, only if the agencies have appropriate privacy and information security standards:

> "[T]he Bureau shall share consumer complaint information with prudential regulators, the Federal Trade Commission, other Federal agencies, and State agencies, subject to the standards applicable to Federal agencies for protection of the confidentiality of personally identifiable information and for data security and integrity."[2]

The CFPB has provided access to its complaint information to any agencies regardless of their privacy protections and regardless of their information security standards, as well as to any member of the public. The CFPB's complaint database should be private as the FTC's is, and as Congress required.

Is FHA a Mortgage Insurance Program or is the False Claims Act a Revenue Source?

Beginning in 2012, the Department of Justice and the Department of Housing and Urban Development began pursuing False Claims Act litigation against FHA mortgage lenders for default losses.

The FHA program is designed to help homebuyers who are largely lower-income and who would not otherwise have credit available to them. The program draws private capital because FHA insures the loans against credit risk. FHA lending standards are not clear, so compliance is difficult.

The False Claims Act dates back to 1863, and was designed to remedy intentional fraud. In 2012, the government began using it in a new way against FHA lenders for unintentional or immaterial errors. This turned the law into a way of recovering the credit losses that the FHA program was intended to insure. This new use of the False Claims Act has caused lenders to pull back from FHA lending, to the detriment of those most in need of housing finance assistance.

The government will need to decide whether the FHA program will be a mortgage insurance program as Congress intended, or will be a revenue raiser for the federal Treasury. As long as there a risk that it will be the latter, FHA lending will be less available to those families the program was designed to assist.

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[2] Dodd-Frank Act § 1013(b)(3)(D), 12 U.S.C. § 5493(b)(3)(D).

The FDCPA is Redundant as to Consumer Mortgage Loans

The CFPB has indicated that it will propose a rule to implement the Fair Debt Collection Practices Act ("FDCPA"). The FDCPA will turn 40 years old this year, but the CFPB has not given any indication that it will produce a regulation that recognizes modern technology and newer laws. Rather, the CFPB has indicated that it will require debt collectors to take more steps to "validate" a debt than the FDCPA requires, and will require these expanded steps earlier than the FDCPA requires debt validation.

This is unfortunate because debt "validation" has no meaning as to mortgage loans. It has been made obsolete by the extensive mortgage laws that Congress, regulators, and the states have created in the past 40 years, requiring lenders and servicers to have full account information at all times. There is simply nothing more servicers can do to validate a mortgage loan than they are already required to do. Always-available online account access is the best way of enabling consumers to make sure their account information is accurate, but the FDCPA does not recognize this as a form of debt validation, and the CFPB has not indicated that it will recognize this in its FDCPA rulemaking. Even monthly account statements, which are more antiquated than online account access, would be more robust than an FDCPA debt validation procedure, but we have not seen any indication that the CFPB will permit the existence of monthly statements to serve as FDCPA debt validation.

All the FDCPA protections are applied to consumer mortgage loans by other laws. Applying an FDCPA regulation to mortgage loans would add regulation merely for the purpose of adding regulation, and would increase the cost of mortgage servicing, but would not bring consumer benefit. We recommend that the FDCPA not apply to consumer mortgage loans.

* * *

We look forward to working with the Committee on these important but difficult issues.

Thank you.

For further information, please contact:

Anne C. Canfield, Executive Director or Chris Harrington, Counsel
Consumer Mortgage Coalition
(202) 617-2101

Jim Nussle
President & CEO

Phone: 202-508-6745
jnussle@cuna.coop

601 Pennsylvania Avenue NW
South Building, Suite 600
Washington, D.C. 20004-2601

April 6, 2017

The Honorable Blaine Luetkemeyer
Chairman
Subcommittee on Financial Institutions and
Consumer Credit
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable William "Lacy" Clay
Ranking Member
Subcommittee on Financial Institutions and
Consumer Credit
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Luetkemeyer and Ranking Member Clay:

On behalf of America's credit unions, I am writing regarding the hearing entitled "Examination of the Federal Financial Regulatory System and Opportunities for Reform." The Credit Union National Association (CUNA) represents America's state and federally chartered credit unions and their 110 million members.

Credit unions accept that they must operate in a regulated environment. However, one-size-fits-all regulation does not work for Main Street—credit unions, small banks, and the consumers and small businesses they serve. It has created a rigged system, favoring the mega banks that can afford to comply with the "solutions" dreamt up in Washington—the very institutions that caused the crisis that hurt so many. Now, overregulation of small or less complex institutions is hurting consumers, costing them time and money, and limiting their choices. Local member-owned credit unions know their members better than Washington bureaucrats, which is why now is the time for Congress to enact regulatory reform that works for credit union members.

Credit Unions are Highly Regulated and Have a Long History of Inherent Protections for Consumers

Federally-chartered credits unions are supervised by the National Credit Union Administration (NCUA), and have additional and duplicative oversight from the Consumer Financial Protection Bureau (CFPB) if they have $10 billion or more in assets. Moreover, state-charted credit unions are regulated at the state level. Credit unions of all asset sizes must comply with most of the enumerated consumer financial laws under the CFPB's jurisdiction. This means they have been tasked with coming into compliance with the thousands of pages of new rules promulgated by the CFPB since it came into existence nearly six years ago. They are also subject to regulation from other agencies such as the Federal Communications Commission, the Department of Defense, the Department of Labor, and the U.S. Department of Treasury, just to name a few.

America's credit unions stand as a unique example of regulated entities because in addition to their safety and soundness requirements from their prudential financial regulator, their structure and mission provides inherent consumer protections in practice in the financial sector. In contrast to for-profit banks and non-depository lenders, credit unions are structured as member-owned, not-for-profit cooperatives. Instead of being owned by shareholders who may never step foot in the institution or use its services, credit unions are owned and controlled by their members. Any earnings are returned to the member-owners. This translates into lower rates on loans, lower fees on services, and higher returns on deposits. The existence of credit unions in the financial marketplace results in substantial savings for credit union members and users of for-profit lenders. While the CFPB continues to cite that it has returned $12 billion in total to consumers since its inception nearly six years

ago, credit unions return approximately $10 billion to their members each year. They do this while grappling with ever-increasing regulatory costs, which climbed 43% from 2010 to 2014 to $7.2 billion.

As a result of the different structure of credit unions, members can rely on being treated fairly by their credit union. Consumer Reports recently found that credit unions are among the highest-rated services they have ever evaluated, with 93% of their customers highly satisfied. It notes, "That satisfaction is driven by good customer service, not surprising when you consider that credit unions are owned and managed by their members." [1]

CFPB Director Richard Cordray has also recognized this fact, stating,

Almost always, they note that credit unions made consumer protection 'job one' long before our agency came to be, and we at the Consumer Bureau are well aware of it. We know that credit unions were not a culprit in the recent financial crisis. I saw that during my time as Ohio Treasurer and Ohio Attorney General, where I saw events unfold in real time. Credit unions did not underwrite the bad loans that sank the housing market. On the contrary, you upheld sound underwriting standards to protect consumers, even as it cost you customers and market share went to financial predators that circled those troubled waters. Your early warnings should have been heeded.[2]

Unfortunately, rather than recognizing credit unions for their good work and service to consumers, the CFPB has time and again over the last several years saddled credit unions with lengthy and overly complex rules, that should be tailored to address the abuse of consumers that caused the financial crisis. As we recently outlined in a letter to the full Committee, instead of listening to concerns credit unions have brought to its attention, the CFPB continues to deny the impact of its rulemakings on smaller financial institutions and continues to cite the minimal accommodations they have made for them, which have proven to be woefully inadequate.[3]

Credit unions were not the cause of the financial crisis, have had a minuscule number of complaints filed against them with the CFPB's consumer complaint database compared to others in the marketplace, and have proven to provide products and services that consumers want and need. It simply does not make sense that they are being treated the same as bad actors and that their ability to serve consumers has been harmed as a result.

As the Subcommittee considers changes to the regulatory structure for credit unions and other financial institutions, we urge you to maintain the NCUA as an independent agency; to make significant changes to the structure, authority and oversight of the CFPB; and to consider statutory changes related to the treatment of certain mortgage loans made by credit unions and clarification surrounding the CFPB's lack of jurisdiction surrounding insurance products.

The National Credit Union Administration Should Remain an Independent Agency

The NCUA has been regulating the credit union industry at the federal level for nearly five decades and has developed regulations and examination procedures that take into account the different size and structure of

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[1] Jeff Blyskal, *Choose the Best Bank for You*, Consumer Reports, *available at* http://www.consumerreports.org/banks-credit-unions/choose-the-best-bank-for-you/ (Dec. 4, 2015).
[2] Prepared Remarks of CFPB Director Richard Cordray at the Credit Union National Association, *available at* https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-credit-union-national-association/ (Feb. 23, 2016).
[3] Letter from CUNA President and CEO Jim Nussle to House Financial Services Committee Chairman Jeb Hensarling and Ranking Member Maxine Waters for the record of the hearing entitled, "The Semi-Annual Report of the Bureau of Consumer Financial Protection," *available at* https://www.cuna.org/Legislative-And-Regulatory-Advocacy/Legislative-Advocacy/Letters-and-Testimony/ (Apr. 5, 2017).

participants in the credit union system. The current funding mechanism of the agency has served it well throughout its history.

CUNA has grave concerns regarding any legislation that would subject the NCUA to the appropriations process. Credit unions and their members currently fund the NCUA and the National Credit Union Share Insurance Fund (NCUSIF) that provides the requisite safety net for the credit union industry. If for any reason NCUA or the NCUSIF requires additional funding, so long as the need is demonstrated transparently, credit unions—not taxpayers—are called on to provide the additional funds. Similarly, if NCUA's funding requirements diminish, credit unions should be required to pay less. This equitable funding is best preserved by maintaining current direct funding mechanisms through operating fees and earnings on the share insurance fund. Under the current system, credit unions are not required to pay for other areas of the federal government, nor are taxpayers called on to pay for NCUA operations; that system should remain.

While we have had concerns in recent years regarding the agency's budget, the agency has been responsive to these concerns thanks in large part to the oversight conducted by this Subcommittee and the full Committee. We have confidence in the Subcommittee and the Committee to continue to exercise an appropriate and effective oversight plan.

Maintaining a separate, independent federal regulator and insurer is critical to the continuation of the credit union system. It is pertinent that credit unions have an independent agency that understands their unique history and relationship with the millions of consumers they serve.

CFPB Needs Significant Structural Changes because the Bureau is Not Fulfilling its Obligation to Take into Consideration the Impact of its Rules on Credit Unions and Small Banks.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandates that when prescribing rules the CFPB shall consider the impact of proposed rules on covered persons, as described in section 1026 (which includes banks and credit unions).[4] The CFPB has failed to do this as we outlined in our letter earlier this week to the Committee.[5] While it continues to talk about "tailoring rules" for credit unions, there is evidence, much of which has been provided to the CFPB on numerous occasions, that credit unions have been harmed. The single director structure allows much of this feedback and data to be dismissed with little or no accountability.

The CFPB's Structure is Harming Credit Union Members and More Oversight Is Needed to Force the CFPB to Address This Fact

Since the beginning of the financial crisis, credit unions have been subject to more than 200 regulatory changes from more than a dozen federal agencies. These new rules total nearly 8,000 Federal Register pages, and counting. The constant stream of new regulations from the CFPB over the past several years has led to credit union staff time and other resources being taken away from serving members, and it has created many regulatory burdens for credit unions forcing the elimination of products. This has led to rising costs and fewer choices for credit union members, an unfortunate result since these regulatory changes were intended to address bad behavior credit unions never engaged in.

Furthermore, disparity in the cost impact of regulatory burden has accelerated the consolidation of the credit union system (and the banking sector), robbing consumers of financial institution choices. While the number of credit unions has been declining since 1970, the attrition rate has accelerated since 2010, after the Great

[4] Section 1022(b)(2)(A)(ii).
[5] Nussle (Apr. 5, 2017).

Recession and the creation of the CFPB. Indeed, 2014 and 2015 were among the top five years in terms of attrition rates since 1970, at 4.2% and 4.1%. Attrition rates at smaller credit unions have been especially high. In both 2014 and 2015, the attrition rate at credit unions with less than $25 million in assets (half of all credit unions are of this size) exceeded 6%. There is an indisputable connection between both the dramatically higher regulatory costs incurred by small credit unions and the increases in those costs since 2010, and their higher attrition rates.

Earlier this year, we surveyed credit union executives to measure the impact of these rules on credit union members. The findings indicate:

- Over half (55%) of credit unions that have offered international remittances sometime during the past five years have either cut back (27%) or stopped offering them (28%), primarily due to burden from CFPB regulations.

- More than four in 10 credit unions (44%) that have offered mortgages sometime during the past five years have either eliminated certain mortgage products or services (33%) or stopped offering them (11%), primarily due to burden from CFPB regulations. Credit unions with assets of less than $100 million are the asset group most apt to have dropped their mortgage program altogether.

- Truth in Lending Act and Real Estate Settlement Procedures Act (TILA-RESPA) Integrated Disclosure rules are far and away (80%) the single rule most negatively impacting credit unions that have offered mortgages. This is followed by the Qualified Mortgage rules (43%) and Mortgage Servicing (30%) and Home Mortgage Disclosure Act (HMDA) rules (19%). TILA-RESPA serves as the most troublesome rule for all asset groups. (Notably, many credit unions have not yet even turned their full attention to the requirements in the new HMDA rules so this impact is likely understated.)

- One in four credit unions (23%) that currently offer Home Equity Lines of Credit (HELOCs) indicate they plan to either curtail their HELOC offerings or stop offering them in response to the new HMDA rules.

- The clear majority of credit unions (93%) that either currently offer payday/small-dollar loans or are considering offering them indicate they will likely no longer consider introducing these loans if there are increased regulations (33%), will review the impact and then decide whether to continue the currently-existing offering (43%), or will likely discontinue the currently existing loan product (without an impact review) if there are increased regulations (17%).

CUNA Suggests the Following Reforms to the CFPB

The results are clear that consumers are losing options from credit unions, and the smallest credit unions are being hit the hardest. Common-sense reforms must be put in place during CFPB rulemakings to better protect credit unions from this system which is rigged in favor of Wall Street banks and other large nonbank financial services providers that caused the financial crisis. Accordingly, we recommend the following changes to the Bureau:

- **CFPB Five-Person Commission**

Modernizing the CFPB to include a multi-member Commission would enhance rulemaking by ensuring that diverse perspectives are included in final rules and prevent disruptions caused by personnel changes. Credit union members will benefit from policymaking that includes more voices.

- **Clarify CFPB Exemption Authority**

  Section 1022 of the Dodd-Frank Act provides the CFPB with authority to exempt 'any class of covered entity' from its rulemaking. The CFPB's failure to use this authority has harmed consumers seeking safe financial services, including remittances and mortgages, from credit unions. Congress should enact legislation to clarify that credit unions are exempt from CFPB rules unless the Bureau demonstrates credit unions are causing consumer harm.

- **Increase CFPB Supervisory Threshold**

  Credit unions and banks above $10 billion in total assets are subject to supervision by the CFPB, even though they are regulated for safety and soundness by federal (and in some cases) state regulators. Consumers would benefit from the CFPB focusing its supervisory resources on entities that present significant risk, particularly entities not already subject to regular supervision and examination. Congress should raise the supervisory threshold to $50 billion in assets and index the threshold for inflation.

The CFPB's Structure Combined with Unfettered UDAAP Authority Also Calls into Question Whether More Accountability is Necessary

The CFPB's structure combined with its Unfair Deceptive Abusive Acts and Practices Authority (UDAAP) allows it extremely broad authority to engage in nearly any policymaking desired, despite the absence of evidence of actual harm to consumers. For instance, in its proposed Payday and Small Dollar loan rule, the CFPB is attempting to sweep consumer-friendly credit union small dollar loan programs into the rule using its UDAAP authority.[6] The proposed rule imposes new, and extremely complex, requirements on credit unions despite little to no data suggesting these products have any pattern of harm to consumers. To the contrary, consumers have stated that credit union small dollar loans are often their safest and best option for credit.[7] Shockingly, certain small dollar loan programs developed by nonprofits for the main purpose of helping credit unions address the financial issues related to poverty and modest family income are determined by the CFPB to be unfair and abusive in accordance with its proposal.[8] Most confusing is the dichotomy that the CFPB itself admits that credit union small dollar loans are the most consumer-friendly option in the market,[9] yet still somehow finds it appropriate to sweep them into the rule claiming its UDAAP authority as a catch-all.

This is merely one example of the CFPB using its UDAAP authority as a catch-all, which creates uncertainty for credit unions, limits their due process rights, and can force them to constrict credit offerings. Arbitrary policies made outside the well-established procedures of administrative law create uncertainty and deter credit unions from offering products and services, and extending credit to borrowers, because the risk and exposure of non-compliance is stifling. Both consumers and financial institutions benefit when clear rules are created and enforced free of political divisiveness, with numerous voices at the table with various areas of expertise, and a solid understanding of current laws and policies.

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[6] Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47864, 47900 (July 22, 2016).
[7] Peace, Elizabeth. "Consumers Prefer Credit Unions to Payday Lenders," *Credit Union Times, available at* http://www.cutimes.com/2015/07/28/consumers-prefer-credit-unions-to-payday-lenders (July 28, 2015).
[8] NCUF, Payday Lending: A REAL Solutions® Implementation Guide, *available at* https://www.ncuf.coop/media/toolkits/REAL_Solutions_Payday_Loan_Toolkit_v032309.pdf (2009).
[9] Prepared Remarks of CFPB Director Richard Cordray, CFPB Field Hearing on Small Dollar Lending, *available at* http://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-richard-cordray-director-consumerfinancial-protection-bureau/ (June 2, 2016). "[The Bureau is] not intending to disrupt existing lending by community banks and credit unions that have found efficient and effective ways to make small-dollar loans to consumers that do not lead to debt traps or high rates of failure. Indeed, we want to encourage other lenders to follow their model."

The CFPB Has Also Engaged in Overreach Beyond the Authority Provided to It in the Dodd-Frank Act Thus Necessitating Greater Accountability

In its recent proposal for small dollar and payday loans, the CFPB proposed that voluntary insurance products, such as credit insurance, be included in the loan calculation of the annual percentage rate (APR). They proposed this despite the fact that insurance is not a loan, is not under the jurisdiction of the CFPB, and is regulated at the state level. The Bureau has further waded into the area of insurance by seeking a Request for Information which includes questions about the sale of credit insurance. Additionally, the CFPB has engaged in enforcement actions in this area.

Consumers, particularly those who may not have access to insurance products through work or elsewhere, may rely on their credit union for these products, but the Dodd-Frank Act did not provide the CFPB authority to regulate insurance products. Therefore, it is pertinent that there is transparency and clarity about how credit unions can serve these needs and help members prepare for unplanned events. Because of the CFPB's actions, credit unions have little clarity about their interest and other potential enforcement actions in this area. This raises serious due process concerns and highlights why the entire financial services marketplace should not be regulated at the whim of a single director who answers to no one. Accordingly, we support Chairman Sean Duffy's efforts to clarify the CFPB's authority with respect to persons regulated by a State insurance regulator, and for other purposes.

Credit Unions Should Have Parity for 1-4 Unit Non-Owner Occupied Residential Loans

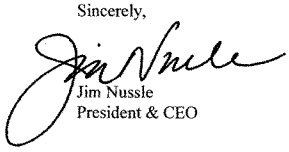
When a bank makes a loan for the purchase of a 1-4 unit non-owner occupied residential dwelling, the loan is classified as a residential real estate loan. However, if a credit union makes the same loan, it would be classified as a business loan and therefore subject to the member business lending cap. CUNA supports legislation amending the Federal Credit Union Act to provide an exclusion from the member business lending cap for these types of loans. Amending the Federal Credit Union Act would correct the disparity between banks and credit unions and enable credit unions to provide additional credit to borrowers seeking to purchase residential units. Credit unions would be better able to serve their members and more affordable housing would be available for Americans, including lower income renters.

Conclusion

Credit unions have long served as model participants in the financial services marketplace even by the CFPB's own admission. The regulatory framework they operated under when the NCUA served as their single regulator provided the necessary protections for credit union members, and balanced their unique structure and mission. As stated, with proper reforms and structural changes we hope that the CFPB could better align with its stated goals and provide greater transparency and protection to credit union members.

On behalf of America's credit unions and their 110 million members, thank you for your consideration of our views.

Sincerely,



Jim Nussle
President & CEO

NAFCU
3138 10th Street North
Arlington, VA 22201-2149
703.522.4770 | 800.336.4644
f: 703.524.1082
nafcu@nafcu.org | nafcu.org
National Association of Federally-Insured Credit Unions

April 5, 2017

The Honorable Blaine Luetkemeyer
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

The Honorable Wm. Lacy Clay
Ranking Member
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

Re: Tomorrow's hearing, "Examination of the Federal Financial Regulatory System and Opportunities for Reform"

Dear Chairman Luetkemeyer and Ranking Member Clay:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), the only trade association exclusively representing the federal interests of our nation's federally-insured credit unions, I write today in conjunction with tomorrow's subcommittee hearing entitled, "Examination of the Federal Financial Regulatory System and Opportunities for Reform." NAFCU appreciates the subcommittee holding this important hearing on the need for regulatory reform and relief.

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors such as credit unions, and this is why NAFCU was the only credit union trade association to oppose the CFPB having authority over credit unions. Unfortunately, many of our concerns about the increased regulatory burdens that credit unions would face under the CFPB have proven true. As expected, the breadth and pace of the CFPB's rulemaking is troublesome, and the unprecedented new compliance burden placed on credit unions has been immense. NAFCU continues to believe that credit unions should be exempted from CFPB rulemaking, with authority returned to the National Credit Union Administration (NCUA). As you examine the federal financial regulatory system, we urge you to support such a reform.

The impact of this growing compliance burden is evident as the number of credit unions continues to decline. Since the second quarter of 2010, we have lost more than 1,500 federally-insured credit unions – over 20% of the industry. The overwhelming majority of these were smaller institutions below $100 million in assets. While it is true that there has been a historical consolidation trend in the industry, the passage of the Dodd-Frank Act has accelerated this trend. In 2016, the industry lost 5.6 percent of credit unions, which represents the highest rate of consolidation in a single year since World War II. The fact is that many smaller institutions simply cannot keep up with the new regulatory tide and have had to merge or simply close their doors. This is why regulatory relief remains a top priority for our nation's credit unions.

It is with that in mind that we would also like to reiterate our support for comprehensive regulatory relief for community financial institutions, such as the relief found in *Financial CHOICE Act* proposed in the last Congress. This legislation contained key elements of regulatory relief, including repeal of the Durbin Amendment, reforms to the structure, power and rules of the CFPB, greater cost-benefit analysis of new regulations, and improvements to the examination process for credit unions.

NAFCU looks forward to working with this subcommittee and Congress as we work towards comprehensive regulatory relief for credit unions. We thank you for the opportunity to share our thoughts with you today. If you have any questions, or if my colleagues or I can be of assistance in any way, please do not hesitate to contact me or NAFCU's Senior Associate Director of Legislative Affairs, Chad Adams, at (703) 842-2265.

Sincerely,

Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Subcommittee on Financial Institutions and Consumer Credit

Property Casualty Insurers
Association of America
Advocacy. Leadership. Results.

Statement for the Record

Property Casualty Insurers Association of America (PCI)

Examination of Federal Financial Regulatory System and Opportunities for Reform

House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

April 6, 2017

444 North Capitol Street NW, Suite 801, Washington, DC 20001 Telephone 202-639-0490 Facsimile 202-639-0494 www.pciaa.net

The Property Casualty Insurers Association of America (PCI) is pleased to offer a statement for the record on ways to reform the Federal financial regulatory system. PCI is composed of 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write $202 billion in annual premium, 35 percent of the nation's property casualty insurance. Member companies write 42 percent of the U.S. automobile insurance market, 27 percent of the homeowners market, 33 percent of the commercial property and liability market and 34 percent of the private workers compensation market.

Our statement will focus on three issues: (1) the need redefine the role of the Federal Insurance Office (FIO); (2) the need to limit Federal Reserve Board oversight of insurance companies; and (3) the need to reform the system of regulation of systemic risk in nonbanks.

Eliminate Federal Insurance Office Intrusion in State Insurance Regulation

The Federal Insurance Office (FIO) has continually tried to insert itself into numerous state-run domestic insurance regulatory issues, undermining state insurance regulators and imposing burdensome, costly, and duplicative data calls on insurers. While the marketplace could benefit from a consistent U.S. federal voice in international insurance negotiations, FIO's record of advocacy internationally has been very mixed. If FIO's (or a successor entity's) international activity continues it needs strong safeguards, including a requirement to advocate consensus positions developed with the state insurance regulators who are ultimately responsible for supervising U.S. insurers. PCI strongly supported H.R. 5983 (114th Congress), the Financial CHOICE Act of 2016, passed by the House Financial Services Committee last year, that would terminate FIO while merging many of its activities with FSOC's independent insurance office into a new insurance advocate within Treasury. PCI encourages Congress and the Administration to consider further elimination of FIO's interference with domestic, state insurance regulation.

Domestic. State regulation of insurance has helped to create the world's largest, most competitive, financially sound and consumer protective insurance market in the world. This regulatory system showed its effectiveness during the financial crisis and since, assuring that the insurance sector continued to function well for consumers and act as a source of stability despite many challenges.

Congress generally recognized this performance in the Dodd-Frank Act by repeatedly reiterating that insurance was to remain regulated by the states. Unfortunately, Title V of the Dodd-Frank Act ultimately included provisions that cracked open the door to federal intrusion just enough to enable an unintended

and significant expansion of federal activity into purely domestic state insurance regulation. These provisions include unlimited authority for FIO to monitor all aspects of insurance, which FIO has used to justify data calls in areas extensively regulated by the state insurance regulators.

The Dodd-Frank Act also gave FIO unprecedented subpoena authority, which exceeds the authority given to any other non-regulator or office in the Treasury Department. Subpoenas generally are used by government agencies in formal administrative proceedings, enforcement actions, and Inspector General investigations. FIO has none of these powers or responsibilities that would justify its subpoena power.

To the extent that FIO continues a domestic role, it should focus on starting up the National Association of Registered Agents and Brokers (NARAB). NARAB was authorized Congress to streamline nationwide licensing of agents and brokers and has been strongly supported by consumers, regulators and the industry. However, almost no progress has been made in its establishment.

International. The primary intent of FIO created by Title V of the Dodd-Frank Act was to have a federal, U.S. voice to coordinate and represent internationally the U.S. state-based insurance regulatory system. Unfortunately, in some cases, FIO undermined the U.S. system internationally by advocating positions different from and even contrary to the state insurance regulators. FIO should be given more direction, from Congress or the Administration, to support the U.S. state-based regulatory system in international negotiations and achieve consensus with the state insurance regulators on negotiating goals and strategy – since they would ultimately have to implement most international commitments.

Solutions. PCI recommends that Congress take the following actions to re-focus FIO or a successor entity on international issues where it can play a helpful role in serving as an advocate for the U.S. state-based insurance regulatory system, while eliminating inappropriate Federal interference with state insurance regulation.

- FIO's authority to monitor insurance, conduct data calls and issue reports on domestic insurance matters should be eliminated from the statute.
- FIO's headcount should be limited to those necessary to support the U.S. system and state insurance regulators in international insurance negotiations.
- FIO should be statutorily required to develop coordinated views with the state insurance regulators in international insurance negotiations.
- FIO's subpoena power should be eliminated.

Eliminate Federal Reserve Board Duplicative Oversight of Insurance and Make Fed Holding Company Supervision Proportional to Identified Risks

Dodd-Frank gave the Federal Reserve Board authority over companies that have been declared systemically important financial institutions (SIFIs) as well as transferring oversight over financial holding companies with thrifts from the former Office of Thrift Supervision umbrella. While the Federal Reserve's regulatory capital standards are still being developed for these entities, its holding company oversight has been extremely intrusive, excessive, and costly. The Federal Reserve's supervision has also extended deeply and unnecessarily into areas that are already well-regulated by primary functional regulators. The costs to both the taxpayers and consumers far outweigh any benefit of the intrusive, costly and duplicative supervision, and the intrusion completely lacks proportionality to the risks involved.

Prior to the enactment of Dodd-Frank, federal regulators were required to defer to state insurance regulators with respect to any operating entities engaged in the business of insurance. For bank holding companies (BHCs) and savings and loan holding companies (SLHCs) that include insurers, Federal Reserve supervision of the group *at the holding company level* is not necessarily inappropriate. But while Dodd-Frank granted the Federal Reserve supervisory authority at the group level, the Fed has used this authority to interfere in what is appropriately a state insurance regulatory function.

Insurers with very small, *de minimis* community or trust banks that the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) already supervise, but have been subjected to Federal Reserve examinations that consume considerable time and resources. These insurers are questioned not only about their depository institutions and potential risks to the FDIC Deposit Insurance Fund (DIF), but about many unrelated insurance and commercial activities as well. For example, one PCI member that is a regional insurer with a very small trust bank testified that 25% of its regulatory and compliance staff time for the entire holding company is spent on communicating with the Federal Reserve even though the company's depository institution represents only 0.2% of the holding company's assets. There is no useful purpose in creating an additional layer of intrusive and costly Federal Reserve supervision of insurance for Main Street community operations.

If an insurance company is the top-level holding company, the entire group is under the supervision of state insurance regulators. In this case, Federal Reserve supervision at the group level is intrusive and inefficient.

The Federal Reserve should rely on the functional regulators that oversee the entire group (state insurance regulators at the insurance company or holding company level and the financial institution regulator that regulates the depository institution).

Solutions. The Bank Holding Company Act and the Home Owners' Loan Act should be amended to provide that that the Federal Reserve has no authority to make examinations or require reports of insurers that are controlled by a BHC or SLHC. Examination authority intrudes on the states, and the Federal Reserve can receive any reports that it needs from an insurer's state regulator. This exception should also apply to any holding company within the group that is exclusively engaged in controlling insurance companies. Such a company is "exclusively engaged" in controlling insurance companies if 90% or more of its assets consist of the assets of the insurers it controls. The Bank Holding Company Act and the Home Owners' Loan Act should also be amended to provide that an insurance company that (1) controls a bank or another bank holding company is not a bank holding company for purposes of the Bank Holding Company Act, or (2) controls a savings association or another savings and loan holding company is not a savings and loan holding company for purposes of the Home Owners' Loan Act, if it is principally engaged in the business of insurance. A company is principally engaged in the business of insurance if the company's assets attributable to the company's insurance activities are more than 50 percent of the consolidated assets of the company.

In the meantime, the Federal Reserve could help by ensuring that any Fed regulation of the business of insurance is proportional to the risk the holding company or any operating subsidiary poses to the FDIC DIF. The Federal Reserve should not otherwise concern itself with activities of the holding company or any affiliated insurance operating entity. Congress should exercise appropriate oversight over the Federal Reserve to make it clear that the it should not interfere inappropriately with state insurance regulation.

Despite its lack of insurance expertise, the Federal Reserve has endeavored to develop capital standards that are appropriate for insurers. One approach the Federal Reserve is considering is a "building block" approach, which aggregates current capital resources and requires capital based on each legal entity's jurisdictional requirements. In the case of U.S. insurers, those jurisdictional requirements are the NAICs risk-based capital (RBC) formulas. This is appropriate because it recognizes the existing and proven state-based regulatory system. Another approach under consideration by the Federal Reserve is a "consolidated approach," which requires development of group-level risk factors followed by a fully consolidated approach to determining capital resources and required capital. This is not consistent with the state-based approach and Congress should discourage the Federal Reserve from adopting it.

Reforming Nonbank Systemic Risk Regulation

Congress created the Financial Stability Oversight Council (FSOC) to identify and reduce systemic risk. Instead, FSOC has selectively targeted large state-regulated insurers for designations to vastly expand federal regulatory involvement in insurance. This violates of FSOC's own rules and due process while failing to provide designated companies with a roadmap to eliminate the systemic risk the FSOC perceives.

FSOC Rationale for Designations Unclear and Inconsistent. The non-bank systemic risk designation decisions handed down by FSOC have failed to state clearly the rationale for its decisions based on activities in which the firms engage. For example, a Federal District Court ruling overturning a nonbank designation found that the FSOC's Final Determination "hardly adhered to any standard when it came to assessing [the] threat to U.S. financial stability."[1] Not only does this call the integrity of the designation decision into question, but it has left all companies in the dark about what activities the FSOC considers systemically risky and thus provides no clear direction to companies on how to reduce systemic risk. *Thus, FSOC has failed to achieve the primary objective of Dodd-Frank, which was to identify and reduce systemic risk.*

A report released in February by the House Financial Services Committee's majority staff concluded that FSOC's non-bank designation process is "arbitrary and inconsistent" and that FSOC failed to follow its own rules and guidance. The report concluded that "FSOC is not fulfilling its statutory mandate of actually analyzing where companies are systemically risky."[2]

The Government Accountability Office (GAO), in a report released on November 20, 2014, identified several of the flaws in the FSOC's process.[3] Specifically, the GAO noted that "FSOC's public documents have not always fully disclosed the rationale for its determination decisions" and that "the lack of full transparency has resulted in questions about the process and may hinder accountability and public and market confidence in the process."[4] GAO also criticized FSOC for "using only one of two statutory determination standards (a company's financial distress, not its activities)" and noted that "FSOC may not be able to

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[1] *MetLife v. Financial Stability Oversight Council*, 177 F.Supp.3d, 219 at 237 (2016).
[2] Report Prepared by the Republican Staff of the Committee on Financial Services, U.S. House of Representatives, *The Arbitrary and Inconsistent FSOC Nonbank Designation Process* (February 28, 2017).
[3] Government Accountability Office, Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process, GAO Highlights Page, (November, 2014).
[4] *Id.*

comprehensively ensure that it had identified and designated all companies that may pose a threat to U.S. financial stability."[5]

PCI believes there is ample evidence in the Federal court decision, the Committee Staff Report, the GAO report, and elsewhere to support the conclusion that the current nonbank systemic risk designation process has not worked to identify systemic risk correctly and consistently or to eliminate it where FSOC believes it exists.

FSOC Insurance Experts Disregarded. When FSOC designated two insurers as systemically important, the FSOC's independent member having insurance expertise, Roy Woodall, filed strong dissents arguing that the FSOC had failed to appreciate differences between the banking and insurance industries and saw systemic risk in the insurance industry that does not exist. For example, in one dissent Mr. Woodall said the FSOC's analysis "relies on implausible, contrived scenarios as well as failure to appreciate fundamental aspects of insurance and annuity products, and, importantly, state insurance regulation and the framework of the McCarran Ferguson Act."[6] These views were echoed by FSOC's non-voting state insurance commissioner representative, Adam Hamm, who noted in his statement disagreeing with an insurer designation that the FSOC "fails to fully consider the range of mechanisms insurance regulators use to identify and address problems. . ." He noted that, in addition to protecting insurer solvency, these tools "also minimize the impact of any material financial distress on policyholders, other counterparties and the system." He said that, in disregarding the full scope of state insurance regulatory authorities, FSOC had misapplied Section 113 of the Dodd-Frank Act, which requires that "the Council appropriately take into account the degree to which the company is already regulated when making a determination that a company could pose a threat to the financial stability of the United States."[7] PCI agrees with Mr. Hamm's and Mr. Woodall's views.

It is alarming that non-insurance regulators on the FSOC so cavalierly would ignore the advice of the insurance experts Congress provided to it in considering questions of systemic risk posed by insurers. What is even more alarming is that, following these designations, the FSOC failed to provide clear direction on how these insurers could reduce the perceived risk.

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[5] *Id.*
[6] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., Views of the Council's Independent Member Having Insurance Expertise.
[7] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., Views of Adam Hamm, the State Insurance Commissioner Representative.

A primary purpose of the Dodd-Frank Act was to mitigate systemic risk to avoid a repeat of the 2008 financial crisis. It should follow that FSOC would place a high priority on providing sufficiently detailed and credible information to companies it designates. This information would allow a company's management to make decisions to reduce the company's exposure to systemic risk and to be delisted as a systemically important financial institution. FSOC's refusal to do this suggests that its members may be more interested in preserving the enhanced supervisory authority they obtain as a result of a systemic risk designation than in reducing systemic risks posed to the economy. As Mr. Woodall said in his dissent from an insurer designation, "[w]hile the Council's approach to designation triggers supervisory jurisdiction by the Board of Governors of the Federal Reserve System . . . it does little else to promote real financial system reform." This is not at all consistent with the goal of Congress in enacting Dodd-Frank.

Inappropriate Pre-Designations with Foreign Governments. There is substantial evidence that, before FSOC considered designation of some companies, members of the FSOC agreed with foreign regulators participating in deliberations of the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB) that certain of these firms would be designated as Global Systemically Important Institutions (G-SIIs). Thus, a subset of members of the FSOC who participated at the FSB committed the United States to a position before the full FSOC (including FSOC's chair) had even considered the question. Mr. Woodall was highly critical of this in his dissent from an insurer designation, stating "[a]n FSB meeting with only a few Council members' agencies participating should not decide that certain firms are systemically important; or conversely, that any firms are not systemically important, before the Council as a whole has decided those questions." He urged his fellow FSOC members "to not again allow the FSB to 'front-run' or pressure decisions that must be made first by the Council as a whole." He further charged that to do otherwise is "to undermine confidence in the Council itself; to be inconsistent with the intent of Congress; and to be patently unfair to those nonbank financial companies under review that must be afforded due process and fair dealing under U.S. law and procedures."[8] PCI agrees with Mr. Woodall's assessment. Ceding systemic risk designation authority to foreign governments or international organizations is not in the best interests of the United States, and there is no hint of any such intent in Dodd-Frank.

Insurance is Not Systemically Risky. There was widespread recognition during the legislative process that led up to the passage of Dodd-Frank that traditional insurance activities simply are not systemically risky.

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[8] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Views of the Independent Member Having Insurance Expertise.

Property casualty insurers, in particular, have low leverage, are not interconnected with other financial firms, do not pose a "run-on-the-bank" threat, are highly competitive with low market concentration, have low failure rates, and have their own effective and self-financed resolution system. These points were reiterated by Mr. Woodall in his dissents. They also have been noted by U.S. and foreign insurance regulators. The IAIS said in a 2011 report that "traditional insurance is unlikely to become a source of systemic risk."[9] In addition, Dr. Mary Weiss, a Distinguished Scholar with the Center for Insurance Policy and Research at the National Association of Insurance Commissioners, found in a 2010 report that "insurers are not instigators or the cause of systemic risk" and that "they do not require systemic risk regulation – any direct systemic risk regulation of insurers is unlikely to stem future systemic risk crises."[10] Nevertheless, the FSOC designated insurance companies as systemically risky and then refused to provide a coherent rationale for the decision or any meaningful direction on how to eliminate the perceived risk.

Solutions. PCI strongly supports proposals adopted by the House Financial Services Committee to terminate FSOC's authority to designate nonbanks as systemically important financial institutions (SIFIs). Instead of imposing ill-targeted federal bank regulation of large insurers that duplicates state insurance supervision and increases costs with no benefit to consumers or insurer solvency, FSOC should work with state insurance regulators and other financial regulators to identify and mitigate and reduce systemically risky activities should they exist.

Conclusion

The FIO has involved itself in domestic regulatory issues in ways that intrude on state regulatory authority and which ignore the record the states have established in protecting consumers. FIO's domestic functions should be eliminated and it should be re-focused on serving as an advocate for the U.S. state-based insurance regulatory system in international regulatory discussions.

The Federal Reserve's authority to regulate BHCs and SLHCs that include insurers has been intrusive and does nothing to protect consumers. The state-based insurance regulatory system has proven itself successful and effective, and Congress should ensure that the Federal Reserve does not interfere with it. While some *proportional* Federal Reserve group supervision at the holding company level may be appropriate, the regulation of insurance operating entities should be left to the states.

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[9] International Association of Insurance Supervisors, *Insurance and Financial Stability*, pg. 6, (November, 2011)
[10] Mary A. Weiss, Ph.D, Distinguished Scholar, Center for Insurance Policy and Research of the National Association of Insurance Commissioners, *Systemic Risk and the Insurance Sector*, (February 23, 2010).

By failing to achieve the primary goal assigned to it by Congress, FSOC has failed to protect taxpayers from the risk of future financial crises while imposing unwarranted burdens and costs on companies that do not, in fact, pose systemic risk. Not only does this create additional costs for consumers, but it also fails to protect them from the negative economic implications of the next crisis. Because the FSOC has not utilized its nonbank systemic risk designation authority wisely and, in particular, has declined to focus its activities on reducing perceived systemic risk, the FSOC's authority to designate nonbanks as systemically important should be eliminated. Federal and state financial regulators could still consider whether nonbank financial institutions pose systemic risk but should not be burdened with the FSOC's current conflict of interest under which providing clear rationales on how to identify and eliminate systemic risk requires them to relinquish their enhanced supervisory authority.