Embargoed until
September 23, 2009, at 2:00 p.m.

Statement of

John E. Bowman
Acting Director, Office of Thrift Supervision

regarding

Federal Regulator Perspectives on Financial Regulatory Reform Proposals

before the

Committee on Financial Services
United States House of Representatives

September 23, 2009

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W.
Washington, DC 20552
202-906-6288

Testimony on

Federal Regulator Perspectives on Financial Regulatory Reform Proposals

Before the Committee on Financial Services

United States House of Representatives

September 23, 2009

Statement of John E. Bowman

Acting Director, Office of Thrift Supervision

I. Introduction

Good afternoon, Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for the opportunity to testify today on the Administration's Proposal for Financial Regulatory Reform (Administration Proposal). We appreciate the Committee's efforts to improve supervision of financial institutions in the United States. We share the Committee's commitment to reforms to prevent any recurrence of the significant challenges facing the financial sector.

In my testimony this afternoon I will discuss several aspects of financial regulatory restructuring. Some of the proposals are necessary to ensure that we do not experience another financial crisis. Conversely, there are other proposals which, in our view, do not address the causes of the financial crisis and will not shield the nation from another one.

II. Goals of Regulatory Restructuring

The recent turmoil in the financial services industry has exposed major regulatory gaps and other significant weaknesses that must be addressed. Our evaluation of the specifics of the Administration Proposal is predicated on whether or not those elements address the core principles the Office of Thrift Supervision (OTS) believes are essential to accomplishing true and lasting reform:

1. **Ensure Changes to Financial Regulatory System Address Real Problems —** Proposed changes to financial regulatory agencies should be evaluated based on whether they would address the causes of the economic crisis or other true problems.
2. **Protect Consumers —** One federal agency should have as its central mission the regulation of financial products and that agency should establish the rules and standards for all consumer financial products.
3. **Establish Uniform Regulation —** All entities that offer financial products to consumers must be subject to the same consumer protection rules and regulations, so under-regulated entities cannot gain a competitive advantage over their more regulated counterparts. Also, complex derivative products, such as credit default swaps, should be regulated.
4. **Create Ability to Supervise and Resolve Systemically Important Firms —** No provider of financial products should be too big to fail, achieving through size and complexity implicit federal government backing to prevent its collapse — and thereby gaining an unfair advantage over its less insulated competitors.

As a general matter the OTS supports all of the fundamental objectives that are at the heart of the Administration Proposal. Based on our analysis using these principles, we believe certain aspects of the Administration Proposal and other proposals do not address real problems and do nothing to prevent a future crisis. We will discuss these proposals including the elimination of the thrift charter, the dismantling of the Office of the Comptroller of the Currency (OCC) and OTS to create the National Bank Supervisor, the consolidation of the Federal banking agencies (FBAs), and the elimination of certain exceptions to the Bank Holding Company Act of 1956 (BHCA). We will also discuss the elements of the Administration Proposal that address and ameliorate real problems and, where appropriate, make alternative suggestions or express concern with some of the proposal's provisions.

III. Elements of Financial Regulatory Restructuring

A. Administration Proposal to Eliminate the Thrift Charter

The OTS does not support the provision in the Administration Proposal to eliminate the federal thrift charter and require all federal thrift institutions to change their charter to the National Bank Charter or a state bank. We believe the business models of federal banks and thrift institutions are fundamentally different enough to warrant two distinct federal banking charters.

It is important to note that elimination of the thrift charter would not have prevented the current mortgage meltdown, nor would it help solve current problems or prevent future crises. Savings associations generally are smaller institutions that have strong ties to their communities. Many thrifts never made higher risk mortgages such as low-documentation loans. Most thrifts did not participate in the private originate-to-sell model; they prudently underwrote mortgages intending to hold the loans in their own portfolios until the loans matured.

Forcing thrifts to convert to banks or state chartered savings associations would not only be costly, disruptive and punitive for thrifts, but could also make credit less available to credit-worthy U.S. consumers, limiting homeownership and stimulation to the economy.

We also strongly support retaining the mutual form of organization for insured institutions. Generally, mutual institutions are weathering the current financial crisis better than their stock competitors. The distress in the housing markets has had a much greater impact on the earnings of stock thrifts than on mutual thrifts over the past year. Through the first two quarters of 2009, mutual thrifts reported a return on average assets (ROA) of 0.34 percent, while stock thrifts reported an ROA of negative 0.31 percent. We see every reason to preserve the mutual institution charter and no compelling rationale to eliminate it.

OTS also supports retention of the dual banking system with both federal and state charters for banks and thrifts. This system has served the financial markets in the United States well. The states have provided a charter option for banks and thrifts that have not wanted to have a federal charter. Banks and thrifts should be able to choose whether to operate with a federal charter or a state charter.

B. Proposed Consolidation of the Regulators

The Administration has proposed abolishing both the OCC and the OTS, and transferring functions of the two agencies to a new agency called the National Bank Supervisor.

Some members of Congress propose further consolidation, merging not only the OTS and the OCC, but also the prudential regulatory functions of the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC), which share supervisory authority with the states over state-chartered banks.

The OTS opposes both of these proposals for several reasons, the first of which is fundamental: these proposals do not address the very real problems that led to the current financial crisis and, instead of improving the supervision of insured depository institutions, threaten to make it worse.

1. Institution Failures

There is no evidence that regulatory consolidation would have prevented failures among banks and thrifts, or made the financial crisis any less severe.

Failures by insured depository institutions during the financial crisis have cut across all types and sizes of institutions, and all charter types.

In terms of numbers of bank failures during the crisis, most banks that have failed were state-chartered institutions, whose primary federal regulator is not the OTS.

In terms of the largest failures, some were regulated by the OTS. Washington Mutual, which failed in September 2008 at no cost to the deposit insurance fund, was the largest bank failure in U.S. history. However, institutions much larger than Washington Mutual — for example, Citigroup and Bank of America — collapsed, but the federal government prevented their failures by authorizing open bank assistance. By law, this assistance can be granted only to prevent failure. These “too big to fail” institutions are not regulated by the OTS. The OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were *allowed to fail.*

Another important point is that “ground zero” in the financial crisis is the home mortgage sector and consumer lending, the traditional bread-and-butter of the thrift industry. The economic crisis grew out of a sharp downturn in the residential real estate market, including significant and sustained home price depreciation, a protracted decline in home sales, a plunge in rates of real estate investment, and a sharp increase in unemployment rates. By law, thrifts must keep a majority of their assets in home mortgages and other consumer retail lending activities. OTS-regulated institutions were particularly affected because their business models focus on this segment of the marketplace. Although today's hindsight is 20/20, no one predicted during the peak of the housing boom in 2006 that nationwide home prices would plummet by more than 30 percent.

Also, the two largest failures among OTS-regulated institutions during the crisis concentrated their mortgage lending in California, one of the states most damaged by the real estate decline. California has had significant retraction in the real estate market, including double-digit declines in home prices and record rates of foreclosure.

2. Regulatory Arbitrage

One of the most frequently cited rationales for consolidation of bank and thrift regulatory agencies is to prevent regulatory arbitrage, or institutions "shopping" among regulators to find the one most to their liking.

Currently, the U.S. has 54 chartering authorities: each of the 50 states, the District of Columbia, Puerto Rico, plus the OTS, and the OCC. The Administration proposal would reduce the number from 54 to 53 by merging the OTS and OCC. Similarly, the more far reaching proposal to create a single federal bank regulator would also only reduce the number from 54 to 53. Moreover, although not a chartering authority, both of these proposals would add the new Consumer Financial Protection Agency (CFPA). Either proposal would presumably leave the door open for arbitrage between federal and state charters, and among the charters of the states. If arbitrage were truly an overriding concern, the issue of arbitrage would be addressed across-the-board.

The OTS disagrees with the suggestion that banks have converted to the thrift charter because OTS was a more lenient regulator. Institutions chose the charter type that best fit their business model. The argument about arbitrage stems largely from the conversion of Countrywide, which left the supervision of the OCC and the FRB in March 2007 and came under OTS regulation. This conversion took place after the height of the housing and mortgage boom; Countrywide made most of its high-risk loans through its holding company affiliates before receiving a thrift charter.

An often-overlooked fact is that a few months before Countrywide's conversion, in October 2006, Citibank converted two thrift charters from OTS supervision to the OCC. Those two Citibank charters totaled more than $232 billion — more than twice the asset size of Countrywide ($93 billion).

Citibank and Countrywide changed their charters based on their respective business models and operating strategies. Any suggestion that either company sought to find a more lenient regulatory structure is without merit.

Moreover, figures on charter conversions over the past decade demonstrate that there has been no stampede to OTS supervision. To the contrary, from 1999 to 2008, there were 45 more institutions that converted away from the thrift charter (164) than converted to the thrift charter (119). Of those that converted to the OTS, more than half were state-chartered thrifts (64). In dollar amounts during the same 10-year period, $223 billion in assets converted to the thrift charter from other charter types and $419 billion in assets converted away from the thrift charter to other charter types.

3. Diversity of Viewpoints

No single regulator has a monopoly on good ideas about financial regulation and how best to protect consumers. A relatively small agency such as the OTS can take a leadership role that can result in meaningful reform. For example, the OTS took the lead in 2007 in initiating a rulemaking process to prohibit unfair credit card practices. This initiative culminated in the adoption of a final interagency rule, later followed by Congressional passage of legislation.

Before the OTS acted, the approach to addressing such credit card practices was to provide consumers with information to help them compare and shop among competing products. The OTS determined that although improving consumer disclosures was a good step, some harmful practices could not be addressed effectively through improved disclosure alone.

Recognizing this, the OTS initiated a rulemaking process to address unfair or deceptive practices prohibited by the Federal Trade Commission Act. On August 6, 2007, the agency issued an advance notice of proposed rulemaking, requesting comment on the adequacy of the agency's current rules. Based on a review of comments from consumer advocates, industry representatives, members of Congress and the general public, agency officials began working to issue a Notice of Proposed Rulemaking and invited the FRB and National Credit Union Administration (NCUA) to join the effort. A combined approach would provide consumers with uniform protections regardless of which type of financial institution issued their credit card.

In May 2008, the three agencies issued a Notice of Proposed Rulemaking that generated 66,000 comments and led to a final rule the following December. The rule banned practices often cited as unfair to consumers, such as raising interest rates on existing credit card balances when consumers were paying their credit card bills on time. The rule also required that consumers receive a reasonable amount of time to make their credit card payments, prohibited payment allocation methods that unfairly maximized interest charges and, in the subprime credit card market, limited fees that reduced the credit available to consumers.

This rulemaking process is just one example of how the diversity of federal financial institution regulators produces a diversity of viewpoints, opinions and approaches that inform and enrich supervision and improve decision-making.

The current regulators act as checks and balances on one another, ensuring that decisions are well-thought out and reflect divergent opinions. Such a dynamic is on display routinely among the members of the FDIC Board, where the FDIC, the OCC and the OTS are all represented.

4. Cost to the Industry

The bank and thrift industry is stabilizing but significant challenges remain. Industry health is improving but, after a debilitating recession, it is by no means robust. In this climate, the last thing government should do is impose unnecessary costs on the recovering industry.

However, that is exactly what the consolidation proposals would do. Thrifts would need to convert to banks and thrift holding companies would have to convert to bank holding companies, racking up legal bills and consulting costs.

Thrifts would also need to spend money to overhaul their financial reporting systems to generate quarterly Call reports, instead of the current quarterly Thrift Financial Reports.

In return for these sizable industry investments, U.S. taxpayers would get nothing. None of the four federal regulators receives appropriations from Congress, so consolidation would not lower budget outlays or reduce the tax burden by a single cent.

In fact, it is likely that the industry would pass these costs on to consumers in the normal course of business.

Given these factors, members of Congress should consider whether the costs are worth any benefits. In the rush to address what went wrong, policy-makers should not try to “fix” non-existent problems, or attempt to fix real problems with flawed solutions. There is no useful purpose or efficiency to be gained by putting together regulatory agencies that do not fit together. Doing so will detract from the resources necessary to regulate efficiently a significant segment of the financial industry. Submerging agencies into a large bureaucracy will make it harder to hone in on issues unique to different types of institutions.

5. Focus on Big Banks

The trillion-dollar mega-banks of today have almost nothing in common with the thousands of small community banks that dot the countryside across America. The mega-banks are vast and complex, assessing their risks through high-tech computer models, conducting large commercial transactions and compartmentalizing their operations according to business line.

Although the mega-banks control the lion’s share of banking assets in this country, most of the banks in America are not mega-banks. Small community banks are far greater in number. They have traditional business models, knowing their customers and meeting the everyday financial needs of families and small businesses. Mega-banks are fundamentally different. They are nationwide financial firms and global conglomerates engaged in much more complex transactions.

What does a $100 million thrift that offers mortgages, small business loans and other types of small consumer loans within its local community have in common with a complex bank involved in structured transactions and complicated derivatives?

If these two very different types of businesses are supervised by a single regulator, there is a very real danger of the needs of the community-oriented majority being pushed to the back seat by the enormous asset size, risk and complexity of the big banks.

Regulatory policymaking functions that have successfully kept consumer-and-community lenders safe and sound would be subsumed within a single, large bureaucratic hierarchy. A bureaucracy dealing with institutions of such disparate financial weight would necessarily gravitate toward using its time and resources primarily on the most massive institutions that posed the greatest risk to the financial system. In times of stress, this concentration on large banks would be most evident. The resulting loss of independent regulatory policymaking by the division of the new bureaucracy assigned to smaller consumer-and-community-based institutions would not well serve the public that continues to depend on community banks to meet its day-to-day financial needs.

Consumer and community lenders — part of the financial fabric of this nation — could suffer not only from inattention, but also the weight and cost of regulations designed to address the risks of much more complex institutions. The necessary "differential regulation" for institutions that are fundamentally different may disappear. The result could be that instead of talking in person with a mortgage loan officer in a bank lobby, prospective homeowners would have no choice but to be directed to dial a toll-free number into the telephone bank of a complex nationwide institution. A loss of relationship banking would be a loss for all financial services consumers.

It is critical that all regulatory agencies be structured and operated in a manner that ensures the appropriate supervision and regulation of all depository institutions, regardless of size or complexity.

6. Future of the OTS

The thrift charter and the type of financial institution based on it have well served this country's need for consumer-and-community financial services through good times and bad since the charter was created in 1933. If the thrift industry continues to exist and fulfill its mission, an independent OTS is the federal agency best equipped to regulate, supervise and examine that industry.

Thrifts generally are traditional consumer and community lenders, and thrifts historically have exerted strong, beneficial and stabilizing leadership in American communities. Thrifts generally keep the loans they make in their portfolios and in general were not the lenders that contributed to the mortgage meltdown by making untenable loans and securitizing them. Thrifts tend to be small, local, conservative lenders that provide home mortgages, car loans and other day-to-day financial services to people in the cities, towns, suburban and rural areas across America.

Thrifts are required by law to concentrate on consumer retail lending activities. During the current financial crisis, trouble surfaced and worsened when home mortgage lending often became a means for nonbanks to churn profits without regard to the long-term viability of mortgages, instead of a core business of banks and thrifts to help credit-worthy Americans become homeowners.

In the second quarter of 2009, OTS-regulated institutions originated $62.4 billion in home mortgages, which is their highest volume of originations since the third quarter of 2007. Many large banks have not yet returned to a significant level of lending due to their continuing need to increase capital and prepare for risks from a downturn in the commercial real estate market. For OTS thrifts, net income in the second quarter returned to positive territory, while commercial banks were still running in the negative, with a net loss of $3.7 billion.

The OTS employs a considerable pool of expert examiners, experienced legal practitioners, and economists who constitute the most highly qualified team in the nation to evaluate and regulate the risks involved in a concentration in mortgage lending.

Dismantling the OTS and folding it into a larger entity would threaten the independent policy judgment and specialized skills that the OTS has developed over the past 20 years to measure and monitor interest rate risk. The OTS has an internally designed, developed, and run interest rate risk model, as well as specialized examination procedures designed to assess the risks of housing lenders.

The nation benefits from having a federal banking agency dedicated to regulating institutions focused primarily on responsible mortgage lending. If home ownership remains a national policy objective, it makes sense to retain a federal banking agency that specializes in appropriate regulation of housing lenders.

C. Administration Proposal to Eliminate the Exceptions in the Bank Holding Company Act for Thrifts and Special Purpose Banks

1. Elimination of the Exception in the Bank Holding Company Act for Thrifts

Because a thrift is not considered a "bank" under the BHCA,[1] the FRB does not regulate entities that own or control only savings associations. The OTS supervises and regulates such entities pursuant to the Home Owners Loan Act (HOLA).

As part of the recommendation to eliminate the federal thrift charter, the Administration Proposal would also eliminate the savings and loan holding company

[1] 12 U.S.C. 1841(c)(2)(B) and (j).

(SLHC). The Administration's draft legislation repeals section 10 of the HOLA concerning the regulation of SLHCs and also eliminates the thrift exemption from the definition of "bank" under the BHCA. A SLHC would become a bank holding company (BHC) by operation of law and would be required to register with the FRB as a BHC within 90 days of enactment of the act.

Notably, these provisions also apply to the unitary SLHCs that were explicitly permitted to continue engaging in commercial activities under the Gramm-Leach-Bliley Act of 1999.[2] Such an entity would either have to divest itself of the thrift or divest itself of other subsidiaries or affiliates to ensure that its activities are "financial in nature."[3]

The Administration justifies the elimination of SLHCs, by arguing that the separate regulation and supervision of bank and savings and loan holding companies has created "arbitrage opportunities." The Administration contends that the intensity of supervision has been greater for BHCs than SLHCs.

Our view on this matter is guided by our key principles, one of which is to ensure that changes to the financial regulatory system address real problems. We oppose this provision because it does not address a real problem. As is the case with the regulation of thrift institutions, OTS believes that entities became SLHCs based on the business model of the entity.

---

[2] 12 U.S.C. 1467a(c)(9)(C).
[3] 12 U.S.C. 1843(k).

The suggestion that the OTS does not impose capital requirements on SLHCs is not correct. Although the capital requirements for SLHCs are not contained in OTS regulations, savings and loan holding company capital adequacy is determined on a case-by-case basis for each holding company based on the overall risk profile of the organization. In its review of a SLHC's capital adequacy, the OTS considers the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, support the level and composition of the parent company's and subsidiaries' debt, and support business plans and strategies.

On average, SLHCs hold more capital than BHCs. The OTS conducted an internal study comparing SLHC capital levels to BHC capital levels. In this study, OTS staff developed a Tier 1 leverage proxy and conducted an extensive review of industry capital levels to assess the overall condition of holding companies in the thrift industry. We measured capital by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio. Based on peer group averages, capital levels (as measured by both the Equity/Assets ratio and a Tier 1 Leverage proxy ratio) at SLHCs were higher than BHCs, prior to the infusion of Troubled Assets Relief Program funds, in every peer group category. The consistency in results between both ratios lends credence to the overall conclusion, despite any differences that might result from use of a proxy formula.

As this study shows, the facts do not support the claim that the OTS does not impose adequate capital requirements on SLHCs. The proposal to eliminate the SLHC exception from the BHCA is based on this and other misperceptions. Moreover, in our view the measure penalizes the SLHCs and thrifts that maintained solid underwriting standards and were not responsible for the current financial crisis. The measure is especially punitive to the unitary SLHCs that will be forced to divest themselves of their thrifts or other subsidiaries.

The OTS supervises both thrifts and their holding companies on a consolidated basis. Under the Administration Proposal, thrifts and their holding companies would be supervised by different agencies. We believe the prudential supervisor of thrifts should continue to regulate their holding companies, except in the case of a thrift that is systemically significant.[4]

SLHC supervision is an integral part of OTS oversight of the thrift industry. OTS conducts holding company examinations concurrently with the examination of the thrift subsidiary, supplemented by offsite monitoring. For the most complex holding companies, OTS utilizes a continuous supervision approach. We believe the regulation of the thrift and holding company has enabled us to effectively assess the risks of the consolidated entity, while retaining a strong focus on protecting the Deposit Insurance Fund.

The OTS has a wealth of expertise regulating thrifts and holding companies. We have a keen understanding of small, medium-sized and mutual thrifts and their holding companies. Consolidated supervision is particularly important for these entities because

[4] With respect to this question we express our opinion only concerning thrifts and their holding companies. We express no opinion as to banks and BHCs.

separate regulation of the thrift and holding company would be especially costly, burdensome and inefficient for them. We are concerned that if the FRB became the regulator of these holding companies, it would focus most of its attention on the largest holding companies to the detriment of small and mutual SLHCs.

With regard to holding company regulation, OTS believes thrifts with non-systemic holding companies should have strong, consistent supervision by a single regulator. Conversely, a systemically important SLHC should be regulated by the systemic regulator. This is consistent with our key principle that any financial reform package should create the ability to supervise and resolve all systemically important financial firms.

2. Elimination of the Exception in the Bank Holding Company Act for Special Purpose Banks

The Administration Proposal would also eliminate the BHCA exceptions for a number of special purpose banks, such as industrial loan companies, credit card banks, trust companies, and the so-called "nonbank banks" grandfathered under the Competitive Equality Banking Act of 1987. Neither the FRB nor OTS regulates the entities that own or control these special purpose banks, unless they also own or control a bank or thrift. As is the case with unitary SLHCs, the Administration Proposal would force these entities to divest themselves of either their special purpose banks or other entities. The

Administration's rationale for the provision is to close all the so-called loopholes under the BHCA and to treat all entities that own or control any type of a bank equally.

Once again our opinion on this aspect of the Administration Proposal is guided by the key principle of ensuring that changes to the financial regulatory system address real problems that caused the crisis. There are many causes of the financial crisis, but the inability of the FRB to regulate these entities is not one of them. Forcing companies that own special purpose banks to divest one or more of their subsidiaries is unnecessary and punitive. Moreover, it does not address a problem that caused the crisis or weakens the financial system. Accordingly, we do not support this provision.

D. Creation of the Consumer Financial Protection Agency

The Administration Proposal, as outlined in H.R. 3126 (the Bill), calls for the establishment of the CFPA to regulate the offering of all consumer financial products and services. The CFPA would acquire the consumer protection authority and staff of the current FBAs and the NCUA, including rulemaking, examination and enforcement regarding consumer protection issues. CFPA regulations would serve as a floor, not a ceiling, with respect to state laws; states would be empowered to enforce CFPA rules. Finally, CFPA would define standards for "plain vanilla" products (e.g., 30-year fixed rate mortgages) that are simple and have straightforward pricing. All providers and intermediaries would be required to offer these products prominently, alongside other products they may offer.

1. Rulemaking Authority

The OTS supports consolidating rulemaking authority over all consumer protection regulation in one federal regulator. This regulator should be responsible for promulgating all consumer protection regulations that would apply uniformly to all entities that offer financial products, whether an insured depository institution, state-licensed mortgage broker or mortgage company.

Under the current system multiple agencies, including, but not limited to, the Department of Housing and Urban Development, the Federal Trade Commission, the FRB, the FDIC, the NCUA, the OCC and the OTS, each have consumer rule writing functions. This system has led to inconsistent regulation, a lack of accountability and, too often, a lack of timely action to implement regulations for the laws passed by Congress to protect consumers.

2. Uniform Regulation

As the Administration Proposal notes, in the years immediately preceding the financial crisis, 94 percent of the high cost mortgages were originated outside of the regulated banking industry. As a general matter, these entities are not examined and are not subject to the same regulatory scrutiny with respect to consumer protection laws and regulations to the same extent as depository institutions. One of the causes of the financial crisis was the inability of the regulatory system to protect consumers from inappropriate financial practices of nonbank lenders. Effective supervision and regulation of nonbank financial providers would go a long way to ameliorating this problem.

As the OTS has advocated for some time, one of the paramount goals of any new framework should be to ensure that similar bank or bank-like products, services, and activities are treated in the same way in a regulation, whether they are offered by a chartered depository institution or an unregulated financial services provider. The product should receive the same review, oversight, and scrutiny regardless of the entity offering the product. Consumers do not understand — nor should they need to understand — distinctions between the types of lenders offering to provide them with a mortgage. They deserve the same service, care, and protection from any lender. The “shadow bank system,” where bank or bank-like products are offered by nonbanks using different standards, should be subject to as rigorous supervision as banks.

3. Authority over Depository Institutions

Unlike the Bill, the OTS recommends retaining primary consumer-protection-related examination and supervision authority for insured depository institutions with the FBAs and the NCUA. The OTS believes that the CFPA should have primary examination and enforcement power over entities engaged in consumer lending that are not under the jurisdiction of the FBAs.

Safety and soundness and consumer protection examination and enforcement powers should not be separated for insured depository institutions because safety-and-soundness examinations complement and strengthen consumer protection. By separating safety-and-soundness functions from consumer protection, the CFPA and an FBA could each have gaps in their information concerning an institution. Neither agency would see a complete picture, to the detriment of both consumer protection and safety and soundness.

Moreover, in its desire to protect consumers, the CFPA could require actions by a depository institution that would be potentially unsafe or unsound. This could lead to potential conflicts with the FBA. For example, the consumer agency might direct an institution to offer mainly 30-year, fixed rate mortgages that would be friendly to consumers. However, a concentration in these types of mortgages could create safety and soundness concerns by increasing interest rate risk and lowering capital, thereby resulting in fewer loans available for consumers.

Separating consumer regulation from safety and soundness could also result in inefficiencies and possible duplication in supervision. A bank or thrift would be examined by its primary federal regulator and, in addition, could be examined by the consumer protection agency. A state chartered institution may have yet another layer of supervision and examination. Moreover, in the case of very large institutions, the systemic regulator would also apply a layer of supervision under the Administration's Proposal.

4. Nationwide Standards

The proposed consumer protection legislation would effectively end the consistent, nationwide system of federal standards by requiring banks and thrifts to comply with potentially inconsistent consumer protection laws in all 50 states, as well as local governments. State attorneys general could interpret and enforce CFPA rules differently. Federal institutions would have to comply with a patchwork of state regulatory regimes, which would subject them to significant compliance and legal costs, and the constant threat of litigation. This could result in additional costs to consumers and might affect the financial system and the economy during a time when the economic health of the nation is a paramount concern.

Without federal preemption to ensure a consistent set of regulations and policies to protect consumers nationwide, the consumer protection agency would be unable to write simple, understandable disclosures to be applied nationwide. Whatever disclosures the agency might develop to address federal requirements would need to be supplemented with state (and local) disclosures. All of the foregoing could lead ultimately to unintended results, including more complex and lengthier disclosures for consumers, two-to-three sets of disclosures (federal, state and local) with different and perhaps inconsistent information, higher-cost financial services for consumers and perhaps the elimination of some services altogether. OTS believes that where there is strong federal consumer law, preemption should be retained, and where strong nationwide protections are not in place, they should be established.

5. Standard Products

The Bill is designed to establish rules to ensure that consumers are provided with options among various financial products or services to enable them to make informed choices about features, terms and risks that are best for them. Nonetheless, we are concerned about the consumer protection agency defining standards for financial products and services that would require institutions to offer certain products (e.g. 30-year fixed rate mortgages). The imposition of such a requirement could result in safety and soundness concerns and stifle credit availability and innovation.

OTS does not believe that federal regulators should dictate the types of products that lenders must offer. Although we believe strongly that government regulators should prohibit products or practices that are unfair to consumers, the government should not be overly prescriptive in defining lenders' business plans or mandating that certain products be offered to consumers.

Defining standards for financial products would put a government seal of approval on certain favored products and would effectively steer lenders toward these products. It could have the unintended consequence of fewer choices for consumers by stifling innovation and inhibiting the creation of products that could benefit consumers and financial institutions.

E. Supervision and Resolution of Systemically Important Firms

The Administration Proposal would provide for the consolidated supervision and regulation of any systemically important financial firm regardless of whether the firm owns an insured depository institution. The authority to supervise and regulate systemically important firms would be vested in the FRB. The FRB would be authorized to designate systemically important firms if it determined that material financial distress at the company could pose a threat, globally or in the United States, to financial stability or the economy during times of economic stress.[5] The FRB, in consultation with

[5] The FRB would be required to base its determination on the following criteria:

> "(i) the amount and nature of the company's financial assets;
> "(ii) the amount and types of the company's liabilities, including the degree of reliance on short-term funding;
> "(iii) the extent of the company's off-balance sheet exposures;
> "(iv) the extent of the company's transactions and relationships

Treasury, would issue rules to guide the identification. Systemically important firms would be subjected to stricter and more conservative prudential standards than those that apply to other BHCs, including higher standards on capital, liquidity and risk management. They would also be subject to Prompt Corrective Action.

The Administration Proposal also calls for the creation of a Financial Services Oversight Council (Council) made up of the Secretary of the Treasury and all of the Federal financial regulators. Among other responsibilities, the Council would make recommendations to the FRB concerning institutions that should be designated as systemically important. Also, the FRB would consult the Council in setting material prudential standards for such firms and in setting risk management standards for systemically important systems and activities regarding payment, clearing and settlement.

The Administration Proposal provides a regime to resolve systemically important firms when the stability of the financial system is threatened. The resolution authority would supplement and be modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act. The Secretary of the Treasury could invoke the resolution authority only after consulting with the President and upon the written recommendation of two-thirds of the members of the FRB, and the FDIC or SEC as appropriate. The Secretary would have the

---

with other major financial companies;
"(v) the company's importance as a source of credit for households, businesses and State and local governments and as a source of liquidity for the financial system;
"(vi) the recommendation, if any, of the Financial Services Oversight Council; and
"(vii) any other factors that the Board deems appropriate.

TitleII, Section 204. Administration Draft Legislation.
http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf

ability to appoint a receiver or conservator for the failing firm. In general, that role would be filled by the FDIC, though the SEC could be appointed in certain cases. In order to fund this resolution regime, the FDIC would be authorized to impose risk-based assessments on systemically important firms.

OTS's views on these aspects of the Administration Proposal is guided by our key principle that any financial reform package should create the ability to supervise and resolve <u>all</u> systemically important financial firms. The U.S. economy operates on the principle of healthy competition. Enterprises that are strong, industrious, well–managed and efficient succeed and prosper. Those that fall short of the mark struggle or fail and other, stronger enterprises take their places. Enterprises that become "too big to fail" subvert the system when the government is forced to prop up failing, systemically important companies — in essence, supporting poor performance and creating a "moral hazard."

The OTS agrees there is a pressing need for a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose unacceptable risk to financial stability. The systemic risk regulator should have the ability and the responsibility for monitoring all data about markets and companies, including, but not limited to, companies involved in banking, securities and insurance.

We also support the establishment of a strong and effective Council. Each of the financial regulators would provide valuable insight and experience to the systemic risk regulator.

We also strongly support providing a resolution regime for all systemically important firms. Given the events of recent years, it is essential that the federal government have the authority and the resources to act as a conservator or receiver and to provide an orderly resolution of systemically important institutions, whether banks, thrifts, bank holding companies or other financial companies. The authority to resolve a distressed systemically important firm in an orderly manner would ensure that no bank or financial firm is "too big to fail." A lesson learned from recent events is that the failure or unwinding of systemically important companies has a far reaching impact on the economy, not just on financial services.

The continued ability of banks, thrifts and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator should be charged with coordinating the supervision of conglomerates that have international operations. Safety and soundness standards, including capital adequacy and other factors, should be as comparable as possible for entities that have multinational businesses.

F. Strengthening Supervision and Regulation of Securitization Markets

One of the factors contributing to the financial crisis was the lack of incentives for lenders and securitizers to consider the performance of the underlying loans after asset backed securities were issued. Once these loans were originated, the majority of them were removed from bank balance sheets and sold into the securitization market. These events seeded many residential mortgage-backed securities with loans that were not underwritten adequately and that caused significant problems later when home values fell, mortgages became delinquent and the true value of the securities became increasingly suspect.

In response to this problem, both the Administration Proposal and the Mortgage Reform and Anti-Predatory Lending Act of 2009 (H.R. 1726) as passed by the House, would require creditors to retain an economic interest in a material portion (at least 5 percent) of the credit risk of certain mortgage loans that the creditor transfers, sells, or conveys to a third party. The FBAs would have the authority to make exceptions and to apply the risk retention provisions to securitizers.

The OTS has spoken out many times about how, under the current regulatory environment, nonbank mortgage originators are not subject to prudential regulation and have very little stake in the performance of a loan after origination. Many of the recent excesses in the mortgage market might have been avoided if all mortgage originators had a significant, vested interest in the performance of loans they originated. The OTS has long recommended linking compensation for loan originators to responsible underwriting practices to assure that they offer appropriate loans to borrowers who have a reasonable prospect of repaying the loan. Mortgage brokers should receive their commission in separate installments over a predetermined period based on the continued good performance of the mortgage. We believe this requirement would result in more sustainable mortgages.

In another effort to ensure that loans are adequately underwritten, in September 2008 the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale were forced to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

The Administration Proposal would also bring markets for all derivatives and asset-backed securities "into a coherent and coordinated regulatory framework that requires transparency and improves market discipline." It would also increase the transparency and standardization of securitization markets and strengthen the regulation of credit rating agencies.

The OTS is on record supporting regulation of derivative products such as credit default swaps, where tremendous risk exposure has been disguised in opaque and complex ways. We also believe that many of the recent problems associated with derivatives resulted in part from over-reliance on credit rating agencies.

IV. Conclusion

In conclusion, we support the goals of the Administration and this Committee to create a reformed system of financial regulation that fills regulatory gaps and prevents the type of financial crisis that we have just endured. We believe that in the near term Congress can enact legislation that fulfills such goals. Such legislation should include: 1) The creation of an agency dedicated to establishing regulations applicable to all providers of consumer financial products; 2) A mechanism to supervise and resolve systemically important firms; and 3) The strengthening of regulation of securitization markets.

Thank you again, Mr. Chairman, Ranking Member Bachus and Members of the Committee for the opportunity to testify on behalf of the OTS.

We look forward to working with the Members of this Committee and others to create a system of financial services regulation that promotes greater economic stability for providers of financial services and the nation.