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STATEMENT of

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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Chairman Frank, Ranking Member Bachus, and Members of the Committee, I appreciate this opportunity to discuss the Administration's Proposal for reforming and restructuring the regulation of financial services in the United States.[1] The events of the last two years – including the unprecedented distress and failure of financial firms, the accumulation of toxic subprime assets in our financial system, and the steep rise in foreclosures – have exposed gaps and weaknesses in our regulatory framework. The Proposal put forward by the Treasury Department for strengthening that framework is thoughtful and comprehensive. I support many of its proposed reforms, but I have significant concerns with two parts of it, *i.e.*, (1) the scope of authority of the newly proposed Consumer Financial Protection Agency (CFPA), and its related elimination of uniform national standards for national banks; and (2) the proposed broad authority of the Federal Reserve, as systemic risk regulator, to override authority of the primary banking

[1] *See* U.S. Department of the Treasury, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (June 2009) (the Proposal), available on the Treasury Department's Financial Stability website at www.financialstability.gov/docs/regs/FinalReport_web.pdf.

supervisor. Both relate to the way in which important new authorities would interact with the essential functions of the dedicated prudential banking supervisor.

My testimony begins with a brief summary of the key parts of the Proposal we generally support, but then focuses more extensively on our two major areas of concern. We will, of course, be happy to provide additional comments as detailed legislative language on other parts of the Proposal becomes available.

I. Key Provisions Supported by the OCC

Set forth below are key parts of the Proposal that we generally support, which are not intended to be an exhaustive list of the Proposal's suggested reforms.

- **Establishment of a Financial Stability Oversight Council.** This council would consist of the Secretary of the Treasury and all of the federal financial regulators, and would be supported by a permanent staff. Its general role would be to identify and monitor systemic risk, and it would have strong authority to gather the information necessary for that mission, including from any entity that might pose systemic risk. We believe that having a centralized and formalized mechanism for gathering and sharing systemically significant information, and making recommendations to individual regulators, makes good sense.
- **Enhanced authority to resolve systemically significant financial firms**. The Federal Deposit Insurance Corporation (FDIC) currently has broad authority to resolve a distressed systemically significant depository institution in an orderly manner. No comparable resolution authority exists for large bank holding companies, or for systemically significant financial companies that are not banks, as we learned painfully with the problems of such large financial companies as

Bear Stearns, Lehman Brothers, and AIG. The Proposal would extend resolution authority like the FDIC's to such nonbanking companies, while preserving the flexibility to use the FDIC or another regulator as the receiver or conservator, depending on the circumstances. This is a sound approach that would help maximize orderly resolutions of systemically significant firms.

- **Designation of the Federal Reserve as the consolidated supervisor of all systemically significant financial firms.** Working with the OCC and the other bank regulators, the Federal Reserve Board already has strong authority as consolidated supervisor to identify and address problems at large, systemically significant bank holding companies. In the financial crisis of the last two years, the absence of a comparable authority with respect to large securities firms, insurance companies, and government-sponsored enterprises that were not affiliated with banks proved to be an enormous problem, as a disproportionate share of the financial stress in the markets was created by these institutions. The lack of a consistent and coherent regulatory regime applicable to them by a single regulator helped mask problems in these nonbanking companies until they were massive. And gaps in the regulatory regime constrained the government's ability to deal with them once they emerged. The Proposal would extend the Federal Reserve's consolidated bank holding company regulation to systemically significant nonbanks in the future, which would appropriately address the regulatory gap. However, as discussed below, one aspect of this part of the proposal goes too far, *i.e.*, the new Federal Reserve authority to "override" the primary banking supervisor, which would undermine the authority – and the accountability – of the banking supervisor for the soundness of banks that anchor systemically significant holding companies.

- **Strengthened regulation of systemically significant firms, including through higher capital requirements and stronger liquidity requirements.** We support the concept of imposing more stringent prudential standards on systemically significant financial firms to address their heightened risk to the system and to mitigate the competitive advantage they could realize from being designated as systemically significant. However, in those instances where the largest asset of the systemically significant firm is a bank – as may often be the case – the primary banking supervisor should have a strong role in helping to craft the new standards.

- **Effective merger of the Office of Thrift Supervision (OTS) into the Office of the Comptroller of the Currency (OCC), with a phase-out of the federal thrift charter.** In proposing to restructure the banking agencies, the Proposal appropriately preserves an agency whose only mission is banking supervision. This new agency would serve as the primary regulator of federally chartered depository institutions, including the national banks that comprise the dominant businesses of many of the largest bank holding companies. To achieve this goal, the Proposal would effectively merge the OTS into the OCC. It would also eliminate the federal thrift charter – but not the state thrift charter – with all federal thrifts required to convert to either a national bank, state bank, or state thrift, over the course of a reasonable transition period. (State thrifts would then be treated as state "banks" under Federal law.) We believe this approach to the agency merger is preferable to one that would preserve the federal thrift charter, with federal thrift regulation being conducted by a division of the merged agency. With the same deposit insurance fund, same prudential regulator, same holding company regulator, and a narrower charter (a national bank has all the powers of a federal thrift plus many others), there would no longer be a need for a separate federal thrift charter. In addition, the approach in the Proposal avoids the considerable practical complexities and costs of administering two separate statutory and regulatory regimes that are largely redundant in many areas, and needlessly different in others. Indeed, if the federal thrift charter is not preserved, we see no reason for the government to incur the cost of changing the 146-year-old name of the agency as the Office of the Comptroller of the Currency, since the sole mission of the agency would remain the supervision and regulation of national banks. Finally, it is critical that the legislation implementing this aspect of the Proposal be unambiguously clear that the new agency is independent from the Treasury Department and the Administration to the same extent that the OCC and OTS are currently independent.[2]

- **Changes in accounting standards that would allow banks to build larger loan loss reserves in good times to absorb more losses in bad times.** One of the problems that has impaired banks' ability to absorb increased credit losses while continuing to provide appropriate levels of credit is that their levels of loan loss reserves available to absorb such losses were not as high as they should have been

[2] For example, current law provides the OCC with important independence from political interference in decision-making in matters before the Comptroller, including enforcement proceedings; provides for funding independent of political control; enables the OCC to propose and promulgate regulations without approval by the Treasury; and permits the agency to testify before Congress without the need for the Administration's clearance of the agency's statements.

entering the crisis. One reason for this is the currently cramped accounting regime for building loan loss reserves, which is based on the concept that loan loss provisions are permissible only when losses are "incurred." The Proposal calls for accounting standard setters to improve this standard to make it more forward looking so that banks could build bigger loan loss reserves when times are good and losses are low, in recognition of the fact that good times inevitably end, and large loan loss reserves will be needed to absorb increased losses when times turn bad. The OCC strongly supports this part of the Proposal. In fact, I co-chaired an international task force under the auspices of the Financial Stability Board to achieve this very objective on a global basis, which we hope will contribute to stronger reserving policy both here and abroad.

- **Enhanced consumer protection.** The Proposal calls for enhanced consumer protection standards for consumer financial products through new rules that would be written and implemented by the new Consumer Financial Protection Agency. The OCC supports strong, uniform federal consumer protection standards. While we generally do not have rulewriting authority in this area, we have consistently applied and enforced the rules written by the Federal Reserve (and others), and, in the absence of our own rulewriting authority, have taken strong enforcement actions to address unfair and deceptive practices by national banks. We believe that an independent agency like the CFPA could appropriately strengthen consumer protections, but we have serious concerns with the CFPA as proposed. We believe the goal of strong consumer protection can be accomplished better through CFPA rules that reflect meaningful input from the federal banking agencies and are truly uniform. We also believe that these rules should continue to be implemented by the federal banking agencies for banks, under the existing, well established regulatory and enforcement regime, and by the CFPA and the states for nonbank financial providers, which today are subject to different standards and far less actual oversight than federally regulated banks. This is discussed in greater detail below.

- **Stronger regulation of payments systems, hedge funds, and over-the-counter derivatives, such as credit default swaps.** The Proposal calls for significant enhancements in regulation in each of these areas, which we support in concept. We will provide more detailed comments about each, as appropriate, once we have had more time to review the implementing legislative language.

II. Key Concerns

Let me now turn to the two parts of the proposal with which I have the most significant concerns: the CFPA; and the broad proposed authority for the Federal Reserve, as systemic risk regulator, to override the primary banking supervisor in its fundamental supervisory duties.

A. The Proposed Consumer Financial Protection Agency

Today's severe consumer credit problems can be traced to the multi-year policy of easy money and easy credit that led to an asset bubble, with too many people getting loans that could not be paid back when the bubble burst. With respect to these loans – especially mortgages – the core problem was lax underwriting standards. Inadequate consumer protections – such as inadequate and ineffective disclosures – contributed to this problem, because in many cases consumers did not understand the significant risks of complex loans that had seductively low initial monthly payments. Both aspects of the problem – lax underwriting and inadequate consumer protections – were especially acute in loans made by nonbank lenders that were not subject to federal regulation.

Making a loan that cannot be repaid is obviously bad for the borrower, but it is also fundamentally unsound banking. The fact that the underwriting and consumer dimensions of the mortgage problem are so intertwined makes it especially important to be clear about where the problems were – and where they were not – in developing the best solutions.

For example, some have suggested that the Community Reinvestment Act (CRA) caused the subprime lending crisis. That is simply not true. As the Administration's Proposal expressly recognizes, and as I have testified before, far fewer problem mortgages were made by institutions subject to CRA – that is, federally regulated depository institutions – than were made by mortgage brokers and originators that were not depository institutions. The Treasury Proposal specifically notes that CRA-covered depository institutions made only 6 percent of recent higher-priced mortgages provided to lower-income borrowers or in areas that are the focus of CRA evaluations.[3] Moreover, our experience with the limited portion of subprime loans made by national banks is that they are performing better than non-bank subprime loans. This belies any suggestion that the banking system, and national banks in particular, were any sort of haven for abusive lending practices.

I want to acknowledge that H.R. 3126, which incorporates the CFPA portion of the Proposal, addresses one significant concern about the scope of the proposed new agency's authority. The Treasury Proposal would have transferred to the CFPA the

[3] Proposal, *supra* note 1, at 69-70.

responsibility for administering CRA. H.R. 3126, as introduced earlier this month by Chairman Frank, retains that responsibility in the federal banking agencies. I believe that is the right approach. CRA is not a consumer protection law. Instead, it is a law that, at its core, encourages depository institutions – and only depository institutions – to lend in their communities. The terms of the statute strongly link that lending to safety and soundness – which is one reason that the statute has worked well and an important reason why the federal banking agencies should continue the successful work they have done to implement it.

In terms of changes to financial consumer protection regulation, legislation should be targeted to the two types of fundamental gaps that fueled the current mortgage crisis. The first gap relates to consumer protection rules themselves, which were written under a patchwork of authorities scattered among different agencies; were in some cases not sufficiently robust or timely; and importantly, were not applied to all financial services providers, bank or nonbank, uniformly. The second gap relates to implementation of consumer protection rules, where there was no effective mechanism or framework to ensure that nonbank financial institutions complied with rules to the same extent as regulated banks. That is, the so-called "shadow banking system" of nonbank firms, such as finance companies and mortgage brokers, provides products comparable to those provided by banks, but is not subject to comparable oversight. This shadow banking system has been widely recognized as central to the most abusive subprime lending that fueled the mortgage crisis.

A new Consumer Financial Protection Agency could be one mechanism to target both the rulewriting gap and the implementation gap. In terms of the rulewriting gap, all existing consumer financial protection authority could be centralized in the CFPA and strengthened as Congress sees fit, and that authority could be applied to all providers of a particular type of financial product with rules that are uniform. In terms of the implementation gap, the CFPA could be focused on supervision and/or enforcement mechanisms that raise consumer protection compliance for nonbank financial providers to a similar level as exists for banks – but without diminishing the existing regime for bank compliance. And in both cases, the CFPA could be structured to recognize legitimate bank safety and soundness concerns that in some cases are inextricably intertwined with consumer protection – as is the case with underwriting standards.

Unfortunately, the Proposal's CFPA falls short in addressing the two fundamental consumer protection regulatory gaps. In terms of the rulewriting gap, it does provide a mechanism for centralized authority and stronger rules that could be applied to all providers of financial products. But the rules would not be uniform; that is, because the Proposal authorizes states to adopt different rules, there could be fifty different standards that apply to providers of a particular product or service, including national banks. As I will discuss further below, these differences would needlessly raise the cost of compliance, and therefore the cost of consumer products and services.

In terms of the implementation gap, the Proposal does not provide any specific direction for how the CFPA would put in place a supervision and enforcement framework to address fundamental compliance problems in the shadow banking system. Indeed, instead of focusing only on the daunting challenge of actually regulating this largely unsupervised sector, the Proposal would dilute both CFPA and state examination and enforcement resources by extending them to already regulated depository institutions as well. In addition, by transferring all consumer compliance examination and enforcement responsibilities from the depository institution regulators to the CFPA, the Proposal would create a less effective system for consumer protection oversight of those institutions. And in all of this, the Proposal's attempt to completely divorce consumer protection from safety and soundness raises real potential problems.

Let me address each of these issues in greater detail through the prism of the CFPA's key regulatory powers: rulewriting; and the implementation of rules through examination, supervision, and enforcement.

1. Rulewriting

As noted, to address the rulewriting gap, the Proposal's CFPA provides a mechanism for centralizing authority and adopting stronger financial protection rules that would apply to all providers of financial products. Our two fundamental concerns are that the rules actually applied under the CFPA scheme would not be uniform; and that a stronger role for federal banking supervisors is needed in writing the rules in order to provide better protection for consumers when they obtain financial products, while ensuring safe and sound banking practices in providing those products.

a. Lack of Uniform Rules and National Bank Preemption

A core principle of the Proposal is its recognition that consumers benefit from uniform rules.[4] Yet this very principle is expressly undermined by the specific grant of authority to states to adopt different rules; by the repeal of uniform standards for national

[4] *See, e.g.,* Proposal, *supra* note 1, at 69 (discussing the proposed CFPA, observing that "[f]airness, effective competition, and efficient markets require consistent regulatory treatment for similar products," and noting that consistent regulation facilitates consumers' comparison shopping); and at 39 (discussing the history of insurance regulation by the states, which "has led to a lack of uniformity and reduced competition across state and international boundaries, resulting in inefficiency, reduced product innovation, and higher costs to consumers.").

banks; and by the empowerment of individual states, with their very differing points of view, to enforce federal consumer protection rules – under all federal statutes – in ways that might vary from state to state. In effect, the resulting patchwork of federal-plus-differing-state standards would effectively distort and displace the federal agency's rulemaking, even though the CFPA's rule would be the product of an open public comment process and the behavioral research and evaluative functions that the Proposal highlights. In particular, for the first time in the nearly 150-year history of the national banking system, federally chartered banks would be subject to this multiplicity of state operating standards, because the Proposal sweepingly repeals the ability of national banks to conduct any retail banking business under uniform national standards.

This is a profound change and, in my view, the rejection of a national standards option is unwise and unjustified, especially as it relates to national banks. Given the CFPA's enhanced authority and mandate to write stronger consumer protection rules, there should no longer be any issue as to whether sufficiently strong federal consumer protection standards would be in place and applicable to national banks. In this context there is no need to authorize states to adopt different standards for such banks. Likewise, there would be no need to authorize states to enforce federal rules against national banks – which would inevitably result in differing state interpretations of federal rules – because federal regulators already have broad enforcement authority over such institutions and the resources to exercise that authority fully.

More fundamentally, we live in an era where the market for financial products and services is often national in scope. Advances in technology, including the Internet and the increased functionality of mobile phones, enable banks to do business with customers in many states. Our population is increasingly mobile, and many people live in one state and work in another – the case for many of us in the Washington, D.C. metropolitan area.

In this context, regressing to a regulatory regime that fails to recognize the way retail financial services are now provided, and the need for an option for a single set of rules for banks with multi-state operations and multistate customers, would discard many of the benefits consumers reap from our modern financial product delivery system. The Proposal's balkanized approach could give rise to significant uncertainty about which sets of standards apply to institutions conducting a multistate business, generating major legal and compliance costs, and major impediments to interstate product delivery.

This issue is very real. There are a number of areas in which complying with different standards set by individual states would require a bank to determine which state's law governs – the law of the state where a person providing a product or service is located, the law of the home state of the bank employing that person, or the law of the state where the customer is located. It is far from clear how a bank could do this based on objective analysis, and any conflicts could result in penalties and litigation in multiple jurisdictions.

Examples include rules regarding compensation practices for individuals providing a particular financial product, or permissible rates of interest for bank services. Today the maximum permissible interest rate is derived from the bank's home state, but states could claim that it should be the rate of the state in which the customer resides, or the rate of the location where the loan is made. States could have different standards for exerting jurisdiction over interest rates, creating the potential for the laws of two or more states to apply to the same transaction. And even if the bank gets this all figured out for a particular customer, and for all the product relationships it has with the customer, that would all change if the customer moved.

Such uncertainties have the real potential to confuse consumers, subject providers to major new potential liabilities, and significantly increase the costs of doing business in ways that will be passed on to consumers. It could also cause product providers to pull back where increased costs erase an already thin profit margin – for example, with indirect auto lending across state lines – or where they see unacceptable levels of uncertainty and potential risk.

Moreover, a bank with multi-state operations might well decide that the only sensible way to conduct a national business is to operate to the most stringent standard prevailing in its most significant state market. It should not be the case that the decision by a state legislature about how products should be designed, marketed, and sold should effectively replace a national regulatory standard established by the federal government based on thorough research and an open and nationwide public comment process.

Finally, subjecting national banks to state laws and state enforcement of federal laws is a potentially crippling change to the national bank charter and a rejection of core principles that form the bedrock of the dual banking system. For nearly 150 years, national banks have been subject to a uniform set of federal rules enforced by the OCC, and state banks have been subject to their own states' rules. This dual banking system has worked, as it has allowed an individual state to serve as a "laboratory" for new approaches to an issue – without compelling adoption of a particular approach by all states or as a national standard. That is, the dual banking system is built on individual states experimenting with different kinds of laws, including new consumer protection laws, that apply to state banks in a given state, but not to state banks in all states and not to national banks. Some of these individual state laws have proven to be good ideas, while others have not. When Congress has believed that a particular state's experiment is worthwhile, it has enacted that approach to apply throughout the country, not only to all national banks, but to state banks operating in other states that have not yet adopted such laws. As a result of this system, national banks have always operated under an evolving set of federal rules that are at any one time the same, regardless of the state in which they are headquartered, or the number of different states in which they operate. This reliable set of uniform federal rules is a defining characteristic of the national bank charter, helping banks to provide a broader range of financial products and services at lower cost, which in turn can be passed along to the consumer.

The Proposal's CFPA, by needlessly eliminating this defining characteristic, will effectively "de-nationalize" the national charter and undermine the dual banking system. What will be the point of a national charter if all banks must operate in every state as if they were chartered in that state? With many consumer financial products now commoditized and marketed nationally, it is difficult to understand the sense of replacing the option of enhanced and reliable federal standards that are uniform, with a balkanized "system" of differing state standards that may be adopted under processes very different from the public-comment and research-based rulemaking process that the CFPA would employ as a federal agency.

b. Inadequate Input by Banking Supervisors into Rulemaking

The Proposal would vest all consumer protection rulewriting authority in the CFPA, which in turn would not be constrained in any meaningful way by safety and soundness concerns. That presents serious issues because, in critical aspects of bank supervision, such as underwriting standards, consumer protection cannot be separated from safety and soundness. They are both part of comprehensive and effective banking supervision. Mortgage lending provides a good example. There is no doubt that abusive marketing and ineffective disclosure practices contributed to the build-up of harmful subprime loans. However, the core of the subprime crisis was an underwriting failure – loans made based on lax underwriting standards. Transparent disclosure regimes alone cannot solve that problem, just as sound underwriting does not guarantee that consumers will understand financial products and make informed choices. The integration of both perspectives is essential to effective, comprehensive supervision.

Despite this integral relationship, the Proposal as drafted would allow the CFPA, in writing rules, to dismiss legitimate safety and soundness concerns raised by a banking supervisor. That is, if a particular CFPA rule conflicts with a safety and soundness standard, the CFPA's views would always prevail, because the legislation provides no mechanism for striking an appropriate balance between consumer protection and safety and soundness objectives. The premise for this result seems to be that the CFPA (and the states, for that matter) will always opt for consumer protection rules that are more stringent from a safety and soundness perspective than rules that would be adopted by the safety and soundness supervisor. Not only is this premise counterintuitive – it is, after all, the safety and soundness supervisor's job to protect safety and soundness – but it is also not difficult to imagine circumstances in which the CFPA or a state adopts a rule in the name of consumer protection that would increase safety and soundness concerns, especially in the area of underwriting standards. For example, the CFPA could require a lender to offer a standardized mortgage that has simple terms, but also has a low down payment to make it more beneficial to consumers. That type of rule could clearly raise safety and soundness concerns, because lower down payments are correlated with increased defaults on loans – yet a safety and soundness supervisor would have no ability to stop such a rule from being issued.

In short, as applied to depository institutions, the CFPA rules need to have meaningful input from banking supervisors – both for safety and soundness purposes and because bank supervisors are intimately familiar with bank operations and can help ensure that rules are crafted to be practical and workable. A workable mechanism needs to be specifically provided to incorporate legitimate operational and safety and soundness concerns of the banking agencies into any final rule that would be applicable to insured depository institutions. Moreover, I do not believe it is sufficient to have only one banking supervisor on the agency's board, as provided under the Proposal; instead, all the banking agencies should be represented, even if that requires expanding the size of the board.

2. Implementation: Supervision, Examination, and Enforcement

Consumer protection rules are implemented through examination, supervision, and/or enforcement. In this context, the Proposal fails to adequately address the implementation gap I have previously described because it fails to carefully and appropriately target the CFPA's examination, supervision, and enforcement jurisdiction to the literally tens of thousands of non-depository institution financial providers that are either unregulated, or very lightly regulated. These are the firms most in need of enhanced consumer protection regulation, and these are the ones that will present the greatest implementation challenges to the CFPA. Yet rather than focus the CFPA's implementation responsibilities on solely these firms, the Proposal would effectively dilute both the CFPA's and the states' supervisory and enforcement authorities by extending them to already regulated banks. To do this, the Proposal would strip away all consumer compliance examination and supervisory responsibilities – and for all practical purposes enforcement powers as well – from the federal banking agencies and transfer them to the CFPA. And, although the legislation is unclear about the new agency's responsibilities for receiving and responding to consumer complaints, it would either remove or duplicate the process for receiving and responding to complaints by consumers about their banks. The likely results will be that: (1) nonbank financial institutions will not receive the degree of examination, supervision, and enforcement attention required to achieve effective compliance with consumer protection rules; and (2) consumer protection supervision of banks will become less rigorous and less effective.

In relative terms, it will be easy for the CFPA to adopt consumer protection rules that apply to all providers of financial products and services. But it will be far harder to craft a workable supervisory and enforcement regime to achieve effective implementation of those rules. In particular, it will be a daunting challenge to implement rules with respect to the wide variety and huge number of unregulated or lightly regulated providers of financial services over which the new CFPA would have jurisdiction, *i.e.*, mortgage brokers; mortgage originators; payday lenders; money service transmitters; check cashers; real estate appraisers; title, credit, and mortgage insurance companies; credit reporting agencies; stored value providers; financial data processing, transmission, and storage firms; debt collection firms; investment advisors not subject to SEC regulation; financial advisors, and credit counseling and tax preparation services, among other types of firms. Likewise, it will be daunting to respond to complaints from consumers about these types of firms. Last year, the OCC helped almost 100,000 consumers who had questions or complaints only about their banks. The CFPA is guaranteed to receive far more, given the vastly broader scope of its jurisdiction.

Yet, although the Proposal would give the CFPA broad consumer protection authority over these types of financial product and service providers, it contains no framework or detail for examining them or requiring reports from them – or even knowing who they are. No functions are specified for the CFPA to monitor or examine even the largest of these nonbank firms, much less to supervise and examine them as depository institutions are when engaged in the same activities. No provision is made for registration with the CFPA so that the CFPA could at least know the number and size of firms for which it has supervisory, examination, and enforcement responsibilities. Nor is any means specified for the CFPA to learn this information so that it may equitably assess the costs of its operations – and lacking that, there is a very real concern that assessments will be concentrated on already regulated banks, for which size and operational information is already available.

In short, the CFPA has a full-time job ahead to supervise, examine, and take enforcement actions against nonbank firms in order to effect their compliance with CFPA rules. In contrast, achieving effective compliance with such rules by banks is far more straightforward, since an extensive and effective supervisory and enforcement regime is already in place at the federal banking agencies. It therefore makes compelling sense for the new CFPA to target its scarce implementation resources on the part of the industry that requires the most attention to raise its level of compliance – the shadow banking system – rather than also try to undertake supervisory, examination, and enforcement functions with respect to depository institutions.

Similarly, state consumer protection resources, which are subject to the same severe budgetary pressures affecting state governments generally, would be best focused on examining and enforcing consumer protection laws with respect to the nonbank financial firms that are unregulated or lightly regulated – and have been the disproportionate source of financial consumer protection problems. If states targeted their scarce resources in this way, and drew on new examination and enforcement resources of the CFPA that were also targeted in this way, the states could help achieve significantly increased compliance with consumer protection laws by nonbank financial firms. Unfortunately, rather than have this focus, the Proposal's CFPA would stretch the states' enforcement jurisdiction to federally chartered banks, which are already subject to an extensive examination and enforcement regime at the federal level. We believe this dilution of their resources is unnecessary, and it will only make it more difficult to fill the implementation gap that currently exists in achieving effective compliance of nonbank firms with consumer protection rules.

Finally, I firmly believe that, by transferring all consumer protection examination, supervision, and enforcement functions from the Federal banking agencies to the CFPA, the Proposal would create a supervisory system for banks that would be a less effective approach to consumer protection than the integrated approach to banking supervision that exists today. As previously discussed, safety and soundness is not divorced from consumer protection – they are two aspects of comprehensive bank supervision that are complementary. The removal of all supervision and examination authority from the bank regulators would create fundamental fissures in the supervision of banks' retail businesses. Likewise, if it is the intention of the proposal to remove from the banking agencies the responsibility for receiving and responding to consumer complaints, it will remove a window into potential safety and soundness problems. For example, sometimes consumers raise fairness concerns about products that also present serious business risks. Consumers can be an early warning system for consumer protection problems and for safety and soundness problems.

Today, the banking agencies conduct safety and soundness and consumer compliance examinations on a coordinated basis. Information obtained from exams in one area can lead to follow-up supervisory activities in another. Disclosure deficiencies, aggressive marketing practices, or poor new product development can be symptoms of broader risk control failures that can injure both customers and bank soundness. And credit underwriting weaknesses, which are a core safety and soundness issue, can also constitute the real consumer protection issue of whether consumers are systematically provided credit that they cannot afford. Armed with safety and soundness examination information, bank supervisors have exercised real clout under current law to achieve consumer protection compliance through their ongoing examination presence.

Attached to my testimony are summaries of our actual supervisory experience, drawn from supervisory letters and examination conclusion memoranda, which show the real life linkage between safety and soundness and consumer protection supervision. I believe these summaries demonstrate that the results would be worse for consumers and the overall prudential supervision of these banks if bank examiners were not allowed to assess and address both safety and soundness and consumer protection issues as part of their integrated supervision.

Complaints that banking supervisors did not do enough to protect consumers are fundamentally more about whether consumer protection <u>rules</u> were sufficiently robust and timely, and less about whether supervisors adequately enforced the rules that were in place, which they generally did. The appropriate way for the CFPA to address these complaints is through its enhanced rulemaking function, <u>not</u> its examination, supervision, and enforcement functions.

Indeed, we believe that transferring bank examination and supervision authority to the CFPA will not result in more effective supervision because the new agency will never have the same presence or knowledge about the institution. Our experience at the OCC has been that effective, integrated safety and soundness and compliance supervision grows from the detailed, core knowledge that our examiners develop and maintain about each bank's organizational structure, culture, business lines, products, services, customer base, and level of risk; this knowledge and expertise is cultivated through regular on-site examinations and contact with our community banks, and close, day-to-day focus on the activities of larger banks. An agency with a narrower focus, like that envisioned for the CFPA, would be less effective than a supervisor with a comprehensive grasp of the broader banking business.

B. Systemic Regulator's Authority to Override Primary Banking Supervisor

Let me now turn to our other major concern with the Proposal, as we have seen it to date. As previously discussed, the Proposal would establish the Federal Reserve Board as the systemic supervisor by providing it with enhanced, consolidated authority over a "Tier 1" financial holding company – that is, a company that poses significant systemic risk – and all of its subsidiaries. In essence, this structure builds on and expands the current system for supervising bank holding companies, where the Board already has consolidated authority over the company, and the prudential bank supervisor is responsible for direct bank supervision.

In testimony provided earlier this year, I urged strongly that Congress, in reforming financial services regulation, preserve a robust, independent bank supervisor that is solely dedicated to the prudential oversight of depository institutions. I continue to believe that the benefits of dedicated, strong prudential supervision are significant. Dedicated supervision assures there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives. Responsibility is well defined, and so is accountability.

In practice, many of the companies likely to be designated as Tier 1 financial holding companies will have at their heart very large banks, many of which are national banks. Because of their core role as financial intermediaries, large banks have extensive ties to the "federal safety net" of deposit insurance, the discount window, and the payments system. Accordingly, the responsibility of the prudential bank supervisor must be to ensure that the bank remains a strong anchor within the company as a whole. Indeed, this is our existing responsibility at the OCC, which we take very seriously through our continuous on-site supervision by large teams of resident examiners in all of our largest national banks. As a result, the bank is by far the most intensively regulated part of the largest bank holding companies, which has translated into generally lower levels of losses of banks within the holding company versus other companies owned by that holding company – including those large bank holding companies that have sustained the greatest losses.

In the context of regulatory restructuring for systemically significant bank holding companies, preserving a fundamental role for the prudential supervisor of the bank means that its relationship with the systemic supervisor should be complementary; it should not be subsumed or overtaken by the systemic supervisor. Conflating the two roles undermines the bank supervisor's authority, responsibility, and accountability, and would further stretch the role of the Board.

Parts of the Proposal are consistent with this type of complementary relationship between the Board and the prudential bank supervisor. For example, the Board would be required to rely, as far as possible, on the reports of examination prepared by the prudential bank supervisors. This approach reflects the practical relationship that the OCC has with the Board today, a relationship that has worked well, in part because the lines of authority between the two regulators are appropriately defined. And it has allowed the Board to use and rely on our work to perform its role as supervisor for complex banking organizations that are often involved in many businesses other than banking. It is a model well suited for use in a new regulatory framework where the Board assumes substantial new responsibilities, including potential authority over some Tier 1 companies that do not have bank subsidiaries at all.

In one crucial respect, however, the Proposal departs dramatically from that model and is not consistent with its own stated objective of maintaining a robust, responsible, and independent prudential supervisor that will be accountable for its safety and soundness supervision. That is, the Proposal provides the Board with authority to establish, examine, and enforce more stringent standards with respect to the subsidiaries of Tier 1 financial holding companies – including bank subsidiaries – in order to mitigate systemic risk posed by those subsidiaries. This open-ended authorization would allow the Board to impose customized requirements on any aspect of the bank's operations at any time, subject only to a requirement for "consultation" with the Secretary of the Treasury and the bank's primary federal or state supervisor. This approach is entirely unnecessary and unwarranted in the case of banks already subject to extensive regulation. It would fundamentally alter the relationship between the Board and the bank supervisor by superseding the bank supervisor's authority over bank subsidiaries of systemically significant companies, and would be yet another measure that concentrates more authority in, and stretches the role of, the Board.

In addition, while the Proposal centralizes in the Board more authority over Tier 1 financial holding companies, it does not address the current, significant gap in supervision that exists <u>within</u> bank holding companies. In today's regulatory regime, a bank holding company may engage in a particular banking activity, such as mortgage lending, either through a subsidiary that is a bank or through a subsidiary that is not a bank. If engaged in by the banking subsidiary, the activity is subject to <u>required</u> examination and supervision on a regular basis by the primary banking supervisor. However, if it is engaged in by a nonbanking subsidiary, it is potentially subject to examination by the Federal Reserve, but regular supervision and examination is not required. As a policy matter, the Federal Reserve had previously elected not to subject such nonbanking subsidiaries to full bank-like examination and supervision on the theory that such activities would inappropriately extend "the safety net" of federal protections from banks to nonbanks.[5] The result has been the application of uneven standards to bank and nonbank subsidiaries of bank holding companies. For example, in the area of mortgage lending, banks were held to more rigorous underwriting and consumer compliance standards than nonbank affiliates in the same holding company. While the Board has recently indicated its intent to increase examination of nonbank affiliates, it is not clear that such examinations will be required to be as regular or extensive as the examination of the same activities conducted in banks.

I believe that such differential regulation and supervision of the same activity conducted in different subsidiaries of a single bank holding company – whether in terms of safety and soundness or consumer protection – doesn't make sense and is an invitation to regulatory arbitrage. Indeed, leveling the supervision of all subsidiaries of a bank holding company takes on added importance for a "Tier 1" financial holding company because, by definition, the firm as a whole presents systemically significant risk.

One way to address this problem would be to include in legislative language an explicit direction to the Board to actively supervise nonbanking subsidiaries engaged in banking activities in the same way that a banking subsidiary is supervised by the

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[5] *See, e.g.,* Chairman Alan Greenspan, "Insurance Companies and Banks Under the New Regulatory Law," Remarks Before the Annual Meeting of the American Council of Life Insurance (November 14, 1999) ("The Gramm-Leach-Bliley Act is designed to limit extensions of the safety net, and thus to eliminate the need to impose bank-like regulation on nonbank subsidiaries and affiliates of organizations that contain a bank."), available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/speeches/1999/19991115.htm.

prudential supervisor, with required regular exams. Of course, adding new required responsibilities for the direct supervision of more companies may serve as a distraction both from the Board's other new assignments under the Proposal as well as the continuation of its existing responsibilities.

An alternative approach would be to assign responsibility to the prudential banking supervisor for supervising certain non-bank holding company subsidiaries. In particular, where those subsidiaries are engaged in the same business as is conducted by an affiliated bank – mortgage or other consumer lending, for example –the prudential supervisor already has the resources and expertise needed to examine the activity. Affiliated companies would then be made subject to the same standards and examined with the same frequency as the affiliated bank. This approach also would ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.

Conclusion

The OCC appreciates the opportunity to testify on proposed regulatory reform, and we would be pleased to provide additional information as the Committee continues its consideration of this important Proposal.

Attachment
to the Statement of John C. Dugan

Examples of How Safety and Soundness
and Consumer Protection Supervision are Linked

Although the Administration's Proposal to create the CFPA is intended to implicate only consumer protection and not safety and soundness, and is premised on a neat division of the two disciplines, supervision of the two areas is inextricably linked. In the OCC model, the two disciplines are interwoven, sometimes performed by the same staff, especially in community banks, and sometimes by integrated teams of specialists. In either case, supervision in one area informs the other in important ways.

The following examples are derived from OCC examiners' supervisory letters and examiner conclusion memoranda and actual examination experience.[6] They demonstrate real-life examples of the interrelationship of safety and soundness and consumer protection supervision in the bank supervision process. This integrated and effective supervisory approach would be dismantled under the Consumer Financial Protection Agency proposal.

EXAMPLE 1: ***A safety and soundness examination of mortgage origination practices identified a potentially significant consumer protection issue.***

During a safety-and-soundness examination of the credit scoring models used in mortgage origination at a bank, the OCC's quantitative modeling expert noted that models being developed for future use included variables that raised potential fair lending risks. Because the modeling expert was part of the group within the OCC that provides modeling support for fair lending examinations, the modeling expert was familiar with fair lending law considerations. The OCC expert discussed this issue with the quantitative modelers working for the bank, who articulated technical reasons for the inclusion of the variables, related to building more consistent models. The OCC expert was able to discuss the issues in depth with the bank, helping to identify potential alternatives for use in the scoring model. The bank revised the model under development and potential fair lending issues thus were avoided.

[6] Supervisory letters typically are provided to bank management at the conclusion of an examination to address exam findings, note violations of law or regulations, or matters requiring attention (MRAs), which are issues that do not necessarily involve violations, but that the OCC requires the bank to nonetheless address. Examiner conclusion memoranda are internal documents prepared at the conclusion of an exam to document examination results.

EXAMPLE 2: ***An examination for fair lending compliance risk resulted in an MRA requiring an enterprise-wide consumer protection (fair lending) risk management program.***

During an examination to evaluate the bank's fair lending compliance risk management program and test compliance with fair lending laws and regulations, examiners found that the bank had not designated fair lending as an enterprise-level risk and did not manage fair lending risk cohesively across the company. Although management maintained an enterprise-level fair lending policy statement, a formal enterprise-level risk management program was not in place. Examiners conveyed the expectation that the bank would have a cohesively stated and implemented mission across all business units, with standard monitoring processes and metrics to measure effectiveness. Examiners required management to submit a detailed action plan to address the issues raised.

EXAMPLE 3: ***A joint safety and soundness and consumer compliance examination of nontraditional mortgage products identified violations related to consumer protection.***

During a joint safety and soundness and consumer compliance examination of nontraditional mortgage products where the primary objective of the review was to assess compliance with OCC Bulletin 2006-41- *Guidance on Nontraditional Mortgage Product Risks****,*** examiners also evaluated whether nontraditional mortgage disclosures matched the illustrations set forth in OCC Bulletin 2007-28 – *Illustrations of Consumer Information*. Additionally, examiners conducted a concurrent review of stated income products and loans with low or no documentation to determine if the risks involved in these products were sufficiently mitigated. While the exam focused on both safety and soundness and consumer protection issues, the sole violation noted during the exam involved a consumer protection issue. The option ARM payment change notice did not comply with 12 CFR 226.20(c) because it did not include the new interest rate, the prior interest rate and all other rates that applied since the last payment change. The notice also did not include the corresponding index values. It did not indicate if the new payment disclosed any forgone rate increases or if it would fully amortize the loan over the remaining term. As a result of issues identified by examiners, a corrected disclosure form was created and reviewed by examiners during the examination.

EXAMPLE 4: ***A joint safety and soundness and consumer compliance examination of credit cards resulted in an MRA related to consumer protection.***

During a joint safety and soundness and compliance review to assess the adequacy of processes relative to underwriting, account management, collections, and compliance with the credit card Account Management Guidance (OCC Bulletin 2003-1), examiners evaluated credit policies and procedures, controls over a vendor relationship, the quality of MIS, and the bank's marketing plan. Concurrently, examiners also conducted a consumer compliance review that focused on assessing the bank's own testing of controls in place to ensure compliance with the various consumer protection regulations applicable to credit card lending. While the exam focused on both safety and soundness and consumer protection issues, the sole MRA noted during the exam involved a consumer protection issue. Examiners noted that although the bank had agreed to an action plan for developing appropriate consumer compliance controls, a thorough consumer compliance vendor management program and file testing process had yet to be implemented. Examiners required that the bank develop a comprehensive consumer compliance vendor management program that included file testing for compliance with all applicable consumer protection regulations.

EXAMPLE 5: ***Review of a consumer credit unit required an integrated team of safety and soundness, information technology (IT), and consumer compliance examiners.***

During a review of a bank's consumer credit unit, the OCC utilized safety and soundness, IT, and compliance examiners to specifically address the quantity and direction of portfolio credit risk; assess underwriting practices, including compliance with the *Subprime Mortgage Lending* guidance outlined in OCC Bulletin 2007-26; and evaluate collateral valuation methodologies. Examiners also evaluated credit quality assurance reviews, exception tracking systems, and control systems. Other areas assessed in this joint review included model risks associated with the collection and origination scorecards; marketing practices and controls; the adequacy of management information systems (MIS); loss forecasting methodologies, with an emphasis on the ACL process; information technology systems within the bank, with a focus on the consumer credit unit.

EXAMPLE 6: ***Review of subprime mortgage products required an integrated team of safety and soundness and consumer compliance examiners.***

During the joint safety and soundness and compliance examination of a bank's subprime mortgage products, the primary objective was to assess the propriety of loan origination and risk management processes. Examiners focused on current underwriting and also reviewed controls established to ensure consumer protection against steering and predatory lending practices. Examiners assessed compliance with banking laws, regulations, and guidance, including recent guidance on subprime products. Examiners tested a sample of subprime loans to assess underwriting and consumer protection processes, reviewed written policies and procedures, and also assessed processes used to measure and monitor subprime mortgage performance.

EXAMPLE 7: ***Consumer complaints received by the agency about a third-party service provider triggered a comprehensive review by safety and soundness and consumer compliance examiners of a bank's relationships with that provider***

During a joint safety and soundness and compliance review of a bank's relationships with a third-party service provider, examiners also reviewed other third-party marketing relationships in existence for the businesses. Examiners reviewed policies and procedures covering due diligence and performance monitoring of third-party marketing relationships. The primary objective was to identify all of the bank's business relationships with this provider and the bank's respective due diligence efforts to monitor and control reputation and compliance/legal risks from these relationships. Products were reviewed to evaluate how they were being marketed, the accuracy and transparency of disclosures to the customer, and whether the products offered value to the consumer. This review was conducted because the third-party provider and its programs were the subject of several recent consumer complaints received by the OCC. It also took into account findings from an earlier credit card UDAP review of marketing, disclosures, and internal controls.

EXAMPLE 8: ***A safety and soundness review of a bank's internal audit function found weaknesses in the compliance audit function.***

During an annual review of a bank's internal audit program, safety and soundness examiners focused on evaluating the scope of audit work performed, the effectiveness of following up and validation activities, and the adequacy of management reporting. Test work was completed using the customary integrated approach of having each functional team complete an assessment of audit work in their areas of expertise. The scope of these reviews focused on work paper samples, call program databases, and corrective action databases.

Examiners identified areas for improvement in compliance audit functions. Examiners noted that an overall "state of compliance" for each significant consumer protection regulation would be beneficial to bank executive management in determining compliance risk areas and spending priorities.

The bank's approach to compliance auditing entailed a highly decentralized line of business approach. Examiners noted that related to the lack of an overall compliance roll-up, the compliance audit process would also benefit from improved scoping of higher risk products/services and deeper analysis of activity and associated risks. Because audit testing occurred almost exclusively as part of the line of business audits, examiners noted that few audit resources were dedicated to review specific compliance risks associated with individual products or services.

EXAMPLE 9: ***A safety and soundness examination of nontraditional mortgages (NTM) and home equity loans resulted in a series of consumer-protection-related recommendations.***

During a safety and soundness review of a bank's consumer finance unit to assess compliance with regulatory guidances including non-traditional, subprime, and home equity mortgages, examiners assessed the adequacy of risk management oversight and control systems. Examiners specifically targeted underwriting of near-prime broker originated, interest only mortgage loans, subprime broker originated mortgage loans, and subprime retail mortgage loans. The examiners reviewed risk management MIS, third party monitoring, and mortgage loss mitigation and workout programs. During the review the safety and soundness examiners noted consumer protection issues.

While the combined disclosures provided adequately addressed the requirements indicated in the Statement on Subprime Guidance (OCC Bulletin 2007-26) and in the Interagency NTM guidance, examiners determined that it was based on the proposed, not final illustrations. Additionally, examiners identified that the system which generated the disclosures at the time of application for certain loans was not updated as intended with the combined disclosure.

Examiners made the following consumer protection related recommendations to bank management.

The bank should revise the nontraditional mortgage disclosure, *Consumer Finance Division Comparison of Sample Mortgage Features*, to fully comply with OCC Bulletin 2007-28, provide better consistency with other ARM disclosures, and address computation errors. Additionally, bank management should verify the accuracy of the numbers disclosed in the comparison table. Examiners identified small computational errors in numbers in the table under the interest only 5/1 ARM example and an error in the balloon loan footnote.

Examiners also recommended that quality assurance expand its interest-only mortgage review checklist to verify that the NTM disclosure was provided. Additionally, examiners recommended that the bank verify that all software systems are updated with the most current version of the disclosures when changes occur.

EXAMPLE 10: ***During a trust examination, a number of consumer protection issues were identified.***

During a fiduciary review of a bank's personal trust area, trust examiners identified consumer protection MRAs.

Examiners noted that bank management needed to ensure that trust accounts were properly compensated for income lost as a result of bank errors. Examiners identified one account in a sample where an errant transaction resulted in the nominal loss of interest income. The bank did not reimburse the account for the lost income, as required by internal policy. In addition, there was not a process in place to identify errant transactions and ensure that proper compensation is made to an account. Examiners required bank management to compensate the account noted in the sample and identify tools to be used to ensure that similar situations be detected and resolved appropriately going forward.

Examiners further noted that bank management needed to compensate customer accounts for the loss of earnings from the untimely posting of mutual fund dividends and capital gains. Examiners also noted that management needed to establish or modify policies and procedures to define the remedial measures to be taken in similar situations going forward. The untimely posting of payments negatively impacted the accounts involved and benefited the bank. Examiners required bank management to properly compensate all accounts impacted by the posting problems and ensure appropriate policies and procedures were in place to govern recurrences.