

Introduction

Good morning, Chairperson Warren and members of the Congressional Oversight Panel. My name is Sarah Bloom Raskin, and I am the Maryland Commissioner of Financial Regulation. I also serve as the Chair of the Conference of State Bank Supervisors (CSBS) Legislative Committee and of the CSBS Task Force on Regulatory Restructuring. I am pleased to be here today to offer a state perspective on our nation's financial regulatory structure -- its strengths and its deficiencies, and suggestions for reform.

Before I begin, I would like to commend the GAO for its self-initiated report on this challenging topic and for its outreach to the many stakeholders in this complex structure. As the GAO report details, states play a significant role in almost all aspects of financial regulation. My comments, however, will reflect my own experience as a state regulator of banking, mortgages and consumer finance.

As we work through a federal response to this financial crisis, including the TARP, I hope we carry forward a renewed understanding that the concentration of financial power and a lack of transparency are not in the long-term interests of our financial system, our economic system or our democracy. This lesson is one our country has had to learn in almost every generation, and I hope that the current lesson will benefit future generations. Yes, our largest and most complex institutions seem critical to our global competitiveness; but this nation's true long-term competitive edge has always been its

meritocracy and its freedom of opportunity – the economic democracy of the marketplace.

While changing our regulatory system will be far from simple, some fairly simple concepts should guide these reforms. In evaluating any governmental reform of our financial regulatory system, we must ask these questions:

- does it preserve and enhance transparency?
- does it preserve and enhance accountability?
- does it promote the public interest?
- does it address the systemic risks that threaten balanced growth, fair competition, and the stable flow of commerce?

We have often heard – as you may hear today -- that the consolidation of financial regulation at the federal level is the “modern” answer to the challenges our financial system. I am here to challenge this assumption, and ask you to challenge it as well. For your consideration, I have attached a set of goals that state regulators have endorsed, through CSBS, for regulatory reform.

Background on State Supervision

As you may know, states charter and regulate more than 70 percent of all U.S. banks, in coordination with the FDIC and Federal Reserve. The rapid consolidation of the industry over the past decade, however, has created a system in which a handful of large national banks control the vast majority of assets in the system. The more than 6,000 banks

supervised and regulated by the states now represent less than 30 percent of the assets of the banking system. While these institutions may be smaller than the vast international organizations now making headlines, they are critical to the communities they serve, and are sometimes the only source of credit for local households, businesses, and farms.

Since the enactment of nationwide banking in 1994, the states, working through CSBS, have developed a highly coordinated system of state/state and state-federal bank supervision. This is a model that has served this nation well, embodying our uniquely American dynamic of checks and balances – a dynamic, I suggest, that has been missing from certain areas of federal financial regulation, with devastating consequences.

The dynamic of state and federal supervision for state-chartered banks allows for new businesses to enter the market, while maintaining consistent nationwide standards and systemic risk assessment and moderation.

In addition to regulating banks, my office supervises the residential mortgage industry, as do most state banking departments. All 50 states and the District of Columbia now provide some regulatory oversight of the residential mortgage industry. The states currently manage over 88,000 mortgage company licenses, over 68,000 branch licenses, and approximately 357,000 loan officer licenses. Over the past five years, the states have worked, again through CSBS, to coordinate the multistate supervision of the mortgage industry in a manner similar to the structure we have created for commercial bank supervision.

The Roots of our Financial Crisis

While many have said that this financial crisis started in the housing sector, I suggest that it culminated in housing -- that the bursting of our housing bubble was not a cause but an effect, and one that exposed an unsustainable system of finance. Housing policies may have enabled this crisis, but they did not cause it.

In short, we subjected housing to the boom-and-bust cycles of the capital markets. When the housing bubble burst, it proved what we had long suspected: that the leverage created by the boom was unsustainable; that the network of interdependence among our largest financial institutions was unmanageable; and that the lack of transparency of financial innovations such as the over-the-counter credit derivatives greatly amplified the risks to the system.

As always, the warning signs always seem much clearer in hindsight, but warning signs were visible to those of us who were looking. The bankruptcy of Orange County, the collapse of Long Term Capital Management and the Asian, Mexican and Russian debt crises were all object lessons in the dangers of a lack of transparency, excessive leverage and unmanageable systemic risk. At the state level, we battled predatory lenders for almost a decade, only to be told that our local concerns were less important than the demands of the modern global marketplace. It is an old saying among bank regulators

that our job is to take away the punch bowl once the party really gets going. That is not an easy call to make, and it was particularly difficult in the run-up to this financial crisis, as both Wall Street and monetary policy were spiking the punch bowl.

Yes, the current crisis has both revealed and created weaknesses and gaps in our regulatory system; but even more, I submit that it reveals the gap in regulatory and political will in Washington. Perhaps the resilience of our financial system during previous crises gave policy makers and regulators not only a false sense of security, but also a greater willingness to defer to powerful interests in the financial industry who assured them that all was well.

It may be, as the GAO asserts, that gaps in our complex regulatory structure made it more difficult to understand the gravity of the risks that were building in the system. The failings that we see, however, were not failures of structure, but failures of execution. I do not want to discount the need for significant regulatory changes, but those reforms will not address the underlying problems if we fail to understand and address why the federal system did not adequately respond to warning signs.

From the state perspective, it has not been clear for many years exactly who was controlling the punch bowl. What is clear is that the nation's largest and most influential financial institutions have themselves been major contributing factors in our regulatory system's failure to respond to this crisis. At the state level, we have sometimes perceived an environment at the federal level that is skewed toward facilitating the business models

and viability of our largest financial institutions rather than promoting the strength of the consumer or our diverse economy.

If this bias does exist, consolidation of regulatory authority at the federal level could leave our regulatory more vulnerable to regulatory capture.

More specifically, regulatory capture by a variety of interests – philosophical, intellectual or otherwise – becomes more rather than less likely with a consolidated regulatory structure. It was the states that attempted to check the unhealthy evolution of the mortgage market and apply needed consumer protections to subprime lending. And it was the states and the FDIC that were a check on the flawed assumptions of the Basel II capital accord. The lesson of this crisis should be that these checks need to be enhanced, not eliminated.

We cannot reduce systemic risk by building a bigger system, and we find ourselves here today because the federal government has so far proved itself incapable of managing systemic risk. While this crisis has demanded a dramatic response from the federal government, the short-term result of many of these programs, including the TARP, has been to create even larger and more complex institutions and greater systemic risk. These responses have created extreme disparity in the treatment of financial institutions, with the government protecting those deemed to be too big or too complex to fail at the expense of smaller institutions, and perhaps of the diversity of our financial system.

Our state-chartered banks may be too-small-to-care at the federal level – but where I sit, in our cities and communities, they are too important to ignore. It is exactly the same dynamic that told us that the plight of the individual homeowner trapped in a predatory loan was less important than the needs of an equity market hungry for new mortgage-backed securities. I cannot help but believe the outcome of this attitude will be equally devastating.

I do not agree with the GAO report's unstated assumption that federal regulatory reforms can address the systemic risk posed by our largest and most complex institutions. If these institutions are too large or complex to fail, the government must give preferential treatment to prevent these failures, and that preferential treatment distorts and harms the marketplace, with potentially disastrous consequences.

To return to the housing element of this crisis, our experience with Fannie Mae and Freddie Mac exemplifies this problem. Large systemic institutions such as Fannie and Freddie inevitably garner advantages and political favor, and the lines between government and industry blur in ways that do not reflect American values of fair competition and merit-based success.

Certainly, significant weaknesses exist in our current regulatory structure. Disagreement among federal agencies has made it more difficult to respond to problems, and the federal government's unique role in chartering financial institutions has created a sometimes unhealthy unbalanced competition with the states. As GAO has noted, incentives need to

be better aligned to promote accountability, a fair and competitive market, and consumer protection.

Needed Regulatory Reforms

Systemic Supervision/Capital Requirements

As we evaluate our regulatory structure, we must examine the linkages between the capital markets, the traditional banking sector and other financial services providers. Our top priority for reform must be a better understanding of systemic risks. The federal government must facilitate the transparency of financial markets if we are to create a financial system in which stakeholders can understand and manage their risk. Congress should establish clear expectations about which regulatory authority or authorities are responsible for assessing risk and for using the necessary regulatory tools to address and mitigate risk.

Congress and the regulatory agencies must also consider how the federal government itself may actually contribute to systemic risk -- either by promoting greater industry consolidation or through policies that may increase risks to the system. As I suggested earlier, there may be some institutions whose size or complexity make their risks too large to effectively manage or regulate. Regulators and Congress should contemplate whether breaking up these institutions is in the best interest of the marketplace and the public.

From my perspective as a bank regulator, capital and leverage ratios are essential tools for managing risk. Federal regulation needs to prevent capital arbitrage among institutions that pose systemic risks, and financial institutions whose activities or relationships pose these risks should hold more capital, not less.

Facilitate Orderly Failures of Institutions that Pose Systemic Risks

The FDIC, in the case of insured depositories, and the Federal Reserve, for non-depository systemic institutions, must have the authority and resources to manage the failure of institutions that pose the largest systemic risks in an orderly manner. Since the creation of the FDIC, the states and the federal government have been able to address failures in a manner that both preserves market discipline and consumer confidence. This standard should apply to all institutions.

A Roadmap for Unwinding Federal Liquidity Assistance and Systemic Responses

Treasury and the Federal Reserve must provide a plan for how to unwind the various programs established to provide liquidity and prevent systemic failure. In particular, you asked if these programs are consistent with or advance needed systemic reforms.

My response is, “I hope not.” Unfortunately, attempts to avert crisis through liquidity programs have focused on the needs of the largest institutions, without considering the unintended consequences for our diverse system of financial institutions. Put simply, the government is now in the business of picking winners and losers. In the extreme, these

decisions determine survival, but they also affect the overall competitive landscape and relative health and profitability of institutions. The federal government should develop a plan that promotes fair and equal competition, rather than sacrificing the diversity of our financial industry to save those deemed systemic.

Preserve and Enhance Checks and Balances/Forge a New Era of Cooperative Federalism

The state system of chartering and regulation has always been a key check on the concentration of financial power, as well as a mechanism to ensure that our banking system remains responsive to local economies' needs and accountable to the public. The state system has fostered a diversity of institutions that has been a source of stability and strength for our country. To promote a strong and diverse system of banking – one that can survive inevitable economic cycles and absorb failures – preservation of state-chartered banking should be a high priority.

One lesson we should learn from this crisis is that nationalization of supervision and applicable law is not the answer. For those who were listening, the states provided plenty of warning signs. The flurry of state predatory lending laws and new state regulatory structures for lenders and mortgage brokers funded by banks and the capital markets were indicators that things were not right in our mortgage lending industry. It would be a cruel irony to respond to this lesson by eliminating the early warning signs that the states provide. Just as checks and balances are a vital part of our democratic government, they

serve an equally important role in our financial regulatory structure. The United States boasts one of the most powerful and dynamic economies in the world because of those checks and balances, not despite them.

Most importantly, it serves the consumer interest to preserve the states' role in financial regulation. While I recognize that the mortgage market is a nationwide industry with international implications, local economies and individual homeowners are most affected by mortgage market fluctuations. State regulators must remain active participants in mortgage supervision because of our knowledge of local economies, and our ability to react quickly and decisively to protect consumers.

A single regulator might have all the authority imaginable, but never use it – or use it in a way that cripples the system. The key to the success of our financial system is not only authority, but also accountability. What our founders recognized when establishing our federal system remains as true now as it was 230 years ago – the federal government needs to be accountable. Leading up to this crisis, the states tried to serve this function, but were too often silenced by federal regulatory preemption.

Congress needs to clarify that consumer protections apply equally to all market participants. State laws should not and cannot be preempted for a favored class of institutions. To preserve a responsive system, the states must be able to continue to innovate in consumer protections and regulation.

The federal government would better serve our economies and consumers by advancing a new era of cooperative federalism. The SAFE Mortgage Licensing Act enacted by the last Congress provides a model for the federal government in achieving systemic goals of high regulatory standards and a nationwide regulatory roadmap while preserving state authority for innovation and enforcement.

I have attached CSBS congressional testimony on the challenges posed by preemption and background on the SAFE Act.

Consumer Protection/Enforcement

More, rather than fewer, resources are needed to promote consumer protection. Congress should establish a mechanism among the financial regulators for identifying and responding to emerging consumer issues. This mechanism, perhaps through the FFIEC, should include active state regulator and law enforcement participation and develop coordinated responses. The coordinating federal entity should report to Congress regularly. The states must retain the right to pursue independent enforcement actions against all financial institutions as an appropriate check on the system.

Mortgage Origination and Lending

The states have invested considerable effort and resources over the past five years to address regulatory gaps in our system of mortgage lending. I've attached a document

highlighting the numerous state initiatives to improve mortgage regulation as well as charts showing trends in state enforcement actions. Of note, in 2007 the states took nearly 6,000 enforcement actions against mortgage brokers and lenders.

As previously mentioned, last year Congress helped further the goal of closing regulatory gaps through passage of the SAFE Mortgage Licensing Act, which established minimum licensing and regulatory standards and created mechanisms and set expectations for greater state/state and state/federal regulatory coordination.

Congress should complete this process by enacting a federal predatory lending standard. A federal standard should allow for further state refinements in lending standards and be enforceable by state and federal regulators. Additionally, a federal lending standard should clarify expectations of the obligations of securitizers.

Foreclosure Prevention/Mortgage Servicing

States have also led the way in efforts to hold mortgage servicers more accountable. This is an area where, at a minimum, more cooperative federalism is needed. In July 2007 state attorneys general and bank regulators, concerned about growing foreclosures and frustrated with a lack of transparency in servicer loss mitigation activities, began a dialogue with the largest subprime servicers in the U.S. This led to a data collection effort by the states to better understand how servicers were working with borrowers to prevent a snowballing foreclosure crisis. The initial federal response was to tell federally regulated

servicers not to respond to state requests for information. Our collective objective of avoiding foreclosure and the deepening of the housing crisis would be much better served if the Treasury and its regulatory agencies worked more cooperatively toward this goal. I have attached testimony on this topic and reports from the State Foreclosure Prevention Working Group.

Conclusion

Chairperson Warren and members of the panel, the task before us is a daunting one. The current crisis is the result of well over a decade's worth of policies that promoted consolidation, uniformity, preemption and the needs of the global marketplace over those of the individual consumer.

If we have learned nothing else from this experience, we have learned that big organizations have big problems. As you consider your responses to this crisis, I ask that you consider reforms that promote diversity and create new incentives for the smaller, less troubled elements of our financial system, rather than rewarding the largest and most reckless.

At the state level, we are constantly pursuing methods of supervision and regulation that promote safety and soundness while making the broadest possible range of financial services available to all members of our communities. We appreciate your work toward this common goal, and thank you for inviting us to share our views today.