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Statement of

John E. Bowman
Acting Director, Office of Thrift Supervision

regarding the

Administration's Financial Regulatory Reform Proposal

before the

Committee on Financial Services
United States House of Representatives

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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's Proposal) and H.R. 3126 – The Consumer Financial Protection Agency Act of 2009. It is my pleasure to address the Committee for the first time in my role as Acting Director of the Office of Thrift Supervision (OTS).

We applaud the dedication and diligence this Committee has devoted to achieving proper protections for consumers of financial products. We appreciate the Committee's efforts to enact legislation quickly in response to the current financial crisis.

II. Goals of Regulatory Restructuring

OTS supports all of the fundamental objectives that are at the heart of the Administration's Proposal. In this testimony, I will discuss OTS's view on how those objectives would best be met. In many ways, we agree with the approach of the Administration's Proposal, but in others, we think an alternative would be more effective and workable. Let me be clear at the outset: the recent turmoil in the financial services industry has exposed major gaps and other significant weaknesses that must be addressed. We fully agree that the time to act is now, that fundamental reform is essential and that no current part of the financial regulatory system should be "off the table" during the reform debate.

The OTS believes there are four key principles essential to accomplishing true and lasting reform:

(1) **Protect Consumers —** One federal agency whose central mission is the regulation of financial products should establish the rules and standards for all consumer financial products rather than the current myriad of agencies with fragmented authority and a lack of singular accountability;

(2) **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.

(3) **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 an implicit federal government backing to prevent its collapse — and thereby gaining an unfair advantage over its more vulnerable competitors.

(4) **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.

We believe that each element of the Administration's Proposal should be evaluated based on whether or not that element addresses one of these principles. By performing such an analysis, we can assess whether any single provision would truly solve the problems at hand.

I will examine these principles one-by-one, examine how HR 3126 and the Administration's Proposal would address it and describe the OTS's perspective.

III. Protect Consumers

The events of recent years have demonstrated that the nation's financial system needs to clarify the boundaries set by the federal government to ensure that consumers are treated fairly. Consumer protection performed consistently and judiciously fosters a thriving banking system that fulfills the financial services needs of the nation.

1. Administration's Proposal

The Proposal, as outlined in H.R. 3126 (the Bill), calls for the establishment of the Consumer Financial Protection Agency (CFPA) to regulate the offering of consumer financial products and services. The CFPA would acquire the consumer protection authority and staff of the current Federal Banking Agencies (FBAs), 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.

2. OTS's View

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.

This regulator would replace consumer-regulation-writing parts of the current system of multiple agencies, such as the Department of Housing and Urban Development, the Federal Trade Commission, the Federal Reserve, the Federal Deposit Insurance Corporation, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency and the OTS, each having segments of a fragmented framework for regulatory oversight and each possessing its own perspectives and priorities. The current 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.

Unlike the Bill, the OTS recommends retaining 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 rulemaking authority, as well as regulation, examination and enforcement power over entities engaged in consumer lending that are not insured depository institutions.

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.

The OTS also believes the proposed consumer protection legislation would effectively end the consistent, nationwide system of federal standards. Such a change would require 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 different 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 cause a drag on 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.

Finally, although OTS respects the Bill's objectives of establishing rules that could require financial institutions to provide consumers with options among various financial products or services to enable consumers to make informed choices about features, terms and risks that are best for them, 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. Finally, we are concerned about the consumer protection agency defining standards for financial products (e.g. 30-year fixed rate mortgages).

OTS does not believe that federal regulators should dictate the types of products that lenders must offer.

Historically, federal consumer protection policy has been based on the premise that if consumers are provided with enough information, they will be able to choose products and services that meet their needs. Although timely and effective disclosure remains necessary, disclosure alone is not always sufficient to protect consumers against abuses. Some practices that are found to be unfair and deceptive should be banned outright, as the OTS and other regulators demonstrated by approving final rules in late 2008 prohibiting unfair credit card practices. 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.

To address these concerns, OTS suggests providing the CFPA with the authority to issue rules that would require institutions to present the terms, features and risks associated with financial products and services they offer to a consumer along with a description about how products or services in the same class, or of the same type, might also fit the consumers needs.[1] For example, if the institution offered the consumer an overdraft protection program, they would also present information on an overdraft line of credit, whether the institution offered the latter product or not. Similarly, if the institution offered an adjustable rate mortgage with the potential for significant payment increases, the institution might also provide information about fixed rate mortgages.

The requirement for financial institutions would be to present consumers with a description of a different option(s), not to offer products mandated by the CFPA. OTS believes this approach addresses the concern that has been raised about consumers failing to receive the benefit of information and choices among financial products and services, or being steered to higher cost, more complex forms of credit because they were not presented with choices. However, this approach would prevent the risk of unintentionally inhibiting innovation in financial products and services by mandating product offerings that may raise safety and soundness risks and concerns for institutions.

IV. Establish Uniform Regulation

Establishing uniform regulation would address the gaps in regulatory oversight that led to a shadow banking system that was a significant cause of the current crisis. For

[1] [1] The federal banking agencies adopted a related approach in the development of the "Interagency Illustrations of Consumer Information for Nontraditional Mortgage Products" where the agencies provided model illustrations that financial institutions could use to inform consumers about the terms, features and risks of nontraditional mortgage products such as Interest Only loans and Payment Option ARMs in comparison to convention 30 year fixed rate mortgages. The illustrations were designed to help consumers comparison shop and choose the best mortgage to fit their needs. (http://edocket.access.gpo.gov/2007/pdf/07-2859.pdf).

example, during the height of the real estate boom, in September 2006, the Mortgage Bankers Association estimated that state-licensed mortgage brokers were originating 70 percent of subprime mortgages. Another example is the prevalence of unregulated products — credit default swaps — that generated an enormous stockpile of unexpected risk at one of America’s largest companies. It is essential that a nationwide system of regulation apply, so all players and products in the mortgage market and other financial markets compete by the same sets of rules.

1. Administration’s Proposal

The consumer protection requirements, regulations and standards developed by the CFPA would apply to all entities that offer lending products and services to consumers and communities, whether a state-licensed mortgage company, a state bank or a federally insured depository institution. For nonbanks, the CFPA would address non-compliance through uniform enforcement.

The Administration’s 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.” Specifically, the Proposal would require originators and sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures and align compensation of market participants with longer term performance of the underlying loans. It would also increase the transparency and standardization of securitization markets and strengthen the regulation of credit rating agencies.

2. OTS’s View

The OTS strongly supports closing gaps in regulation, whether the gaps apply to mortgage originators or derivative products such as credit default swaps. These gaps are points of vulnerability that weaken the entire financial system and threaten its viability.

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, including credit default swaps, resulted in part from over-reliance on credit rating agencies.

The OTS has also spoken out many times in public 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 recommends 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.

Mortgage brokers should also meet eligibility requirements that reinforce the importance of their jobs and the level of trust consumers place in them. Although the recently enacted S.A.F.E. Mortgage Licensing Act is a good first step, limitations on who may have a license are also necessary.

The OTS is also concerned that under the Administration's Proposal, the CFPA might not be empowered to adequately protect consumers from abuses by nonbanks, and that banks and thrifts might continue to be more heavily regulated than nonbank firms offering similar products and services. It is not clear under the Administration's Proposal how or how often the consumer protection agency would examine nonbanks. The nonbanking sector contributed significantly to the problems leading to the present financial crisis. Mortgage brokers and nonbank providers of financial services were not always effectively regulated by the states. Nonbank providers of financial services should be required to comply with the same standards and be subject to the same rigor of examination and enforcement as insured depository institutions; if not, the abuses that led to today's economic turmoil could recur.

V. Create Ability to Supervise and Resolve Systemically Important 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."

1. Administration's Proposal

The Proposal would establish a systemic risk regulator and a new oversight council to address systemic risk and oversee systemically important firms.

2. OTS's View

The OTS agrees that 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. For systemically important institutions, the systemic risk regulator should supplement, not supplant, the holding company regulator and the primary federal bank supervisor.

We also support the establishment of a council with all primary federal banking regulators represented to provide valuable insight and experience to the systemic risk regulator.

The systemic risk regulator should have ready access to funding sources that would provide the capability to resolve problems at these institutions, including providing liquidity when needed.

Given the events of recent years, it is also 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 or nonbanks. 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.

VI. Ensure Changes to Financial Regulatory System Address Real Problems

There is little dispute that the ad hoc framework of financial services regulation cobbled together over the last century-and-a-half is not ideal. Different parts of the system were created to respond to the needs of the time. However, the current system has generally served the nation well over time, despite economic downturns such as the current one. We must ensure that in the rush to address what went wrong, we do not try to "fix" non-existent problems.

1. Administration's Proposal

The Proposal would establish a new agency, the National Bank Supervisor (NBS), by merging the Office of the Comptroller of the Currency, which charters and regulates national banks, and the OTS, which charters federal thrifts and regulates thrifts and their holding companies. The Federal Reserve would supervise all bank holding companies and the thrift charter would be abolished. The unrestricted interstate branching currently permitted by thrifts would apply to all banks.

2. OTS's View

The OTS does not believe the case has been made for abolishing the agency. Two rationales have been made to support this proposal: 1) The OTS was the regulator of the largest insured depository institutions that failed during the current economic turmoil, and, 2) Financial institutions "shopping" for the most lenient regulator have flocked to OTS supervision and the thrift charter. Both of those arguments are incorrect.

There are four reasons why the first assertion is untrue:

First, the OTS regulates financial institutions that historically make mortgages for Americans to buy homes. By law, thrift institutions must keep most of their assets in home mortgages or other retail lending activities. 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 and a plunge in rates of real estate investment. The crisis hit OTS-regulated institutions particularly hard because their business models focus on the hardest hit segment of the U.S. economy.

Second, the largest failures among OTS-regulated institutions during this crisis have concentrated their mortgage lending in California and Florida, two of the states most damaged by the real estate decline. These states have had significant retraction in the real estate market, including double-digit declines in home prices and record rates of foreclosure.[2] Although the hindsight of today is 20/20, no one predicted during the peak of the boom in 2006 that nationwide home prices would plummet by more than 30 percent.

Third, failures by insured depository institutions have been no more severe among OTS-regulated thrifts than among institutions supervised by other federal banking regulators. OTS-regulated Washington Mutual, which failed in September 2008 at no cost to the deposit insurance fund, was the largest bank failure in U.S. history because anything larger has been deemed "too big to fail." By law, the federal government can

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[2] See Office of Thrift Supervision Quarterly Market Monitor, May 7, 2009 (http://files.ots.treas.gov/131020.pdf).

provide “open-bank assistance” only to prevent a failure. Institutions much larger than Washington Mutual, for example, Citigroup and Bank of America, had collapsed, but the federal government prevented their failure by providing open bank assistance. The “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.*

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

The argument about regulator shopping, or arbitrage, seems to stem from the conversion of Countrywide Bank, which left the supervision of the OCC in March 2007 — after the height of the housing and mortgage boom — and came under OTS regulation. Countrywide made most of its high-risk loans before that time.

An often-overlooked fact is that a few months earlier, 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). No one has suggested that Citibank changed its charters to seek more lenient regulation.

In the last 10 years (1999-2008), 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 from the thrift charter to other charter types.

If regulatory arbitrage is indeed a major issue, it would be an issue between a federal charter and the charters of the 50 states, as well as among the states. Under the Administration’s Proposal, the possibility of such arbitrage would continue.

We disagree with any suggestion that banks converted to the thrift charter because OTS was a more lenient regulator. Instead, institutions chose the charter type that best fit their business model.

The OTS is also concerned that the NBS would, particularly in times of stress, focus most of its attention on the largest institutions, leaving mid-size and small institutions in the back seat.

With regard to holding company regulation, OTS believes that commercial banks, thrifts and other consumer and community lenders that have non-systemic holding companies should have strong, consistent supervision by a single regulator.

OTS agrees with retaining the dual banking system, but 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. A number of innovations have resulted from the kind of focused product development that can occur on a local level. Banks and thrifts would be able to choose whether to operate with a federal charter or a state charter.

Also, each federal regulator would continue to sustain itself financially through assessments. We do not believe the argument that a self-sustaining system makes regulators susceptible to undue influence from regulated institutions. As history shows, funding federal regulatory agencies through appropriations may expose bank supervisory decisions to undue influence from political pressures. An agency that supervises financial institutions must control its funding to make resources available quickly to respond to supervision and enforcement needs. For example, when the economy declines, the safety-and-soundness ratings of institutions generally drop and enforcement actions rise. These changes require additional resources and often an increase in hiring to handle the larger workload. Such additional resources should not be dependent on a Congressional budget cycle.

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

Stock and mutual savings associations generally are smaller institutions that have strong ties to their communities. Many thrifts never made subprime or Alt-A mortgages; rather they adhered to traditional, solid underwriting standards. 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 change their business models would not only be costly, disruptive and punitive for thrifts, but would also deprive credit-worthy U.S. consumers from the credit they need to become homeowners and the extension of credit this country needs to stimulate the economy.

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. For the first quarter 2009, mutual thrifts reported a return on average assets (ROA) of 0.42 percent, while stock thrifts reported an ROA of 0.04 percent. We see every reason to preserve the mutual institution charter and no compelling rationale to eliminate it.

VII. Conclusion

In conclusion, we support the goals of the Administration to create a system of financial regulation that ensures protections for consumers, while building a strong framework to prevent the type of financial crisis that we have just endured.

Although we disagree with some of the details, we agree that the time is now to reform the framework that governs the financial services industry.

Thank you again, Mr. Chairman, Ranking Member Bachus, and Members of the Committee, for the opportunity to testify on behalf of the OTS on the Administration's Financial Regulatory Reform Proposal.

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