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The 111th Congress
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Statement of Congressman Kurt Schrader on Financial Regulatory Reform
(Wall Street Accountability)

Almost 80 years ago, the lessons learned by the onset of the Great Depression led Congress to draw a strict line between commercial banks and investment "banks". That line, made law by the Glass-Stegall Act, has been terminated in the last decade. The feeling then was that by spreading risk for loans and investments among many players, risk would be reduced for the system as a whole. The system was in fact self-regulating. And housing prices and commercial real estate would only go up in value.

These fictions died an ugly death in October of 2008. Over the next year and a half, 3 million Americans would lose their jobs, 10 percent would face foreclosure and loss of their home and farms were locked into crippling high fuel and feed costs while facing low value for their goods and drastically reduced export opportunities. When it was all said and done, 30-50 percent of Americans wealth would be eliminated and bank failures loomed the likes of which we had not seen since the Great Depression.

The need for systemic regulatory reform of our financial system became obvious. Could we do it without overreaching? Would the hubris of Wall Street win out? Would it just be political theater? The bill that passed the House in the fall was a well intentioned first step that fell short of meaningful reform and was full of empty political rhetoric.

The Wall Street reform bill, the conference agreement that merges the House and Senate bills together, is significantly stronger than the legislation that passed out of the House earlier this year. The Wall Street reform legislation contains some provisions that I am concerned about, and there is still some of the inevitable government overreaching that follows a catastrophe of this magnitude. Yet, Wall Street's ability to bet our savings on high flying derivatives and hedge funds has been severely curtailed. Clearer lines are drawn between your deposits and the financial institutions investment funds. It's not Glass-Steagall, but it's much better than what we had. Hedge funds must now register and face scrutiny. Complex financial deals like derivatives and swaps must be cleared over an open exchange so investors, regulators and you know what is actually going on. Banks are required to actually verify that you have the ability to repay the loan you are applying for. Those same banks, credit unions and mortgage brokers must retain at

least a 5 percent stake in any bundling and selling of securities or mortgages. Unfortunately, there are still a few exceptions that could pose problems a few years from now when lessons learned may be forgotten.

Here are some specifics.

The new Consumer Finance Protection Bureau consolidates multiple financial regulatory agencies under one roof avoiding duplication and conflicting rules. The CFPB will be housed in the Federal Reserve as opposed to being a stand-alone agency as proposed in the House version of this legislation. This should enable good fiscal and financial oversight of this new consumer agency that may not have extensive business or financial expertise in judging the appropriateness of certain financial products. Similarly, the CFPB will be a brake on the current system's unbridled fascination with the lenders perspective of the financial world which may help provide early warning of potential financial problems. And small businesses were specifically excluded from the CFPB's purview to avoid more red-tape for struggling entrepreneurs that were victims of the financial collapse, not the cause.

The new Financial Stability Oversight Council will attempt to monitor and focus on systemic risk in our financial system. It finally has the Fed, CFTC, SEC, FDIC, OCC and new CFPB all in the same room to identify emerging risks. While I am skeptical that the same experts that didn't see this financial tsunami coming before will do so now, it is better to structure the Council so that different regulators can challenge each others' conventional wisdom to avoid complacency. The Council is tasked with recommending to the Fed increasingly strict rules for capital, leverage, liquidity, and risk management as companies grow in size and complexity. With a 2/3 vote they can require nonbank financial companies be regulated by the Fed if they are perceived to pose systemic financial risk such as AIG did before the government's intervention. Also, a 2/3 vote cast by members of the Council can require the Fed to increase regulation on large complex companies that pose a systemic risk by requiring that they divest themselves of some of their holdings.

The legislation makes it implicitly clear to the Treasury that taxpayer money cannot go to save failing financial companies or to cover liquidation costs. Large complex financial companies are required periodically to submit plans for their rapid and orderly shutdown should the company go under. Shareholders and creditors will bear the losses in liquidation, not taxpayers, and management will be removed. As the FDIC unwinds a company, the FDIC can only front the amount of money that it expects to get repaid from the assets of the failing company being liquidated. The Federal Reserve is prohibited from any emergency lending to individual entities, putting an end to the Fed's sole authority to orchestrate bail outs.

The complex derivatives and swaps market is now completely overhauled. Trades cleared by the CFTC were never a problem. The un-cleared "naked" swaps and SEC trades were a different story. SEC management is considerably beefed up. There is a mandatory annual assessment of the SEC's internal supervisory controls and a GAO study of SEC management to limit the likelihood of another Madoff-type scandal. Some appropriately characterize what takes place on the futures market as legalized gambling; now, these transactions are transparent and cleared by regulators to identify systemic risk to our financial system. My House Agriculture Committee's

derivatives bill was the basis for the derivatives provisions in the final product. The CFTC and SEC have clearer jurisdictions to make sure appropriate regulation of all trades occurs. All swap dealers and major swap participants are defined and subject to capital requirements. Un-cleared trades will have to post larger margins. Foreign exchange swaps will be regulated like all other Wall Street contracts which is important as this is the second largest component of the swaps market. Two huge improvements over the House legislation were included in the final financial reform bill. Proprietary trading has been severely curtailed. Your banks risky hedge fund and private equity trading is limited to 3 percent of their book of business. That should reduce proprietary trading by 50 percent or more. Your bank must also spin off its riskiest derivative/swap investments to an affiliate or competitor in an effort to keep banks on financially sound footing.

Large hedge funds are now regulated as they must now register with the SEC. No regulator is currently able to collect information on the size and nature of these firms or calculate the risks they pose to the broader economy.

More controversially, small businesses are protected from unreasonable and heretofore unassailable debit card fees. The original Senate bill only allowed financial institutions to recoup the costs of transactions and ignored the fact that these fees have to incorporate fraud costs they incur. The final bill added the ability for financial institutions to compute their fees transparently but include not just the costs but the risk involved. This should be a winner for merchants, consumers and lenders.

Credit rating agencies that missed the mark wildly over the last few years are also held accountable. This legislation empowers the SEC to require credit card agencies to disclose their methodologies for credit ratings. Also, the agencies now have to consider information in their ratings from sources other than the organizations seeking to be rated. The conference agreement restricts conflict of interest by prohibiting compliance officers from working on ratings, methodologies or sales, allows investors to bring private rights of action against ratings agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts, and establishes a new SEC board that will make random assignments to prevent issuers of asset backed-securities from picking the credit agency they think will give them the highest rating. In a win for consumers, the legislation allows those denied credit or loans due to the credit scores with FREE access to their credit reports.

The Wall Street reform legislation contains some provisions to rein in excessive executive compensation, especially in down markets. These provisions are always problematic as the market usually finds a way around them. Shareholders are given a 'non-binding' vote on executive pay and proxy access to nominate directors. The legislation does direct the SEC to require companies to provide charts that compare their executive compensation with stock performance over a five year period. And the bill requires that public companies set policies to take back executive compensation if it was based on inaccurate financial statements that don't comply with accounting standards.

Finally, controls are established to make sure financial firms retain risks when they "securitize" different financial products. Securitization has been touted as a way to spread risk and provide

'liquidity' in the market. Hypothetically, if your mortgage, by itself, is too risky for your bank to approve, your bank could bundle several mortgages with similar risk and sell them to a second party who is willing to take the risk that you will make your mortgage payments. In theory this would cause more money to flow into the system making the banks more likely to lend you the money for your house. Obviously financial lenders were largely irresponsible in the years leading up to October 2008, and these risky bundles of securities became toxic assets as people began to default on their loans. The Senate bill, unlike the House bill, specifically requires lenders to verify the borrower's ability to pay back a loan. Both bills now require a lender to retain a 5 percent capital credit risk in any investment they approve. Unfortunately, there are exceptions. But the goal is that if an investment does not pan out the originator would lose outright along with the people they sold it to. Currently, they only have to package a bunch of mortgages/loans and sell them to someone else for a profit without any ongoing stake in the viability of that package.

So, on balance the Wall Street reform bill contains common sense regulations and transparencies we should have had all along. Most Americans probably assumed as much. Though the bookkeeping for large financial institutions will increase dramatically, I believe that this is appropriate given how much America has suffered from their benign neglect. In my Agriculture Committee I was struck with the absolute disdain and lack of compassion for America that Wall Street and the Mercantile Board of Exchanges had last spring when they testified in one of our hearings. Their view was that everything worked fine. Excesses had been corrected and all was right with the world. They chose to ignore the fact that farms and homeowners had gone bankrupt, much of middleclass America's wealth was gone and millions of American's lost their job, business and home. Their elitism was offensive.

Reasonable, meaningful reform was long overdue.