

TESTIMONY OF

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On behalf of

AMERICANS FOR FINANCIAL REFORM

Re

**“EXAMINING REGULATORY RELIEF PROPOSALS FOR COMMUNITY FINANCIAL
INSTITUTIONS, PART II”**

Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

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Room 2128 Rayburn House Office Building



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Mr. Chairman and members of the committee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.

I will devote my time to four of the bills under discussion today. I will first discuss HR 3913, HR 5037, and “The Access to Affordable Mortgages Act of 2014”. AFR opposes these three bills. I will also discuss HR 4042, on the capital treatment of mortgage servicing rights. I note that Lauren Saunders is testifying on behalf of AFR as well as the National Consumer Law Center and others in opposition to HR 4986.

HR 3913

HR 3913 would amend Section 13 of the Bank Holding Company Act (often referred to as the ‘Volcker Rule’) to require that prior to any rulemaking under this section, agencies consider whether the regulation will promote ‘efficiency, competition, and capital formation’. This language is similar to the requirement placed on the Securities and Exchange Commission in the National Securities Market Improvement Act (NSMIA) in 1996. HR 3913 then goes well beyond the NSMIA language and bans any rulemaking under Section 13 that “would impose a burden on competition not necessary or appropriate in furtherance of the goals of this section”.

AFR has consistently opposed broad statutory mandates of this type. Such mandates are an open invitation to endless lawsuits by well-funded Wall Street interests seeking to overturn rules that may reduce their profits, even if they serve the public interest. The mandate in HR 3913 is particularly vague, broad, and far-reaching. This mandate could force the courts to effectively re-litigate the Volcker rule every time regulators took action. It is also significant that the mandate appears to prioritize ‘competition’ over other public interest considerations such as equity and financial stability.

Existing law such as the Administrative Procedures Act already provides ample opportunity for judicial review of agency decisions. Congress should not encourage further lawsuits through vague industry-friendly directives such as bans on any regulatory action that creates a ‘burden on competition’.

To the degree that HR 3913 rests on the premise that the Volcker Rule creates an excessive ‘burden on competition’, we would also disagree with this premise. The term ‘competition’ has several possible meanings. If what is meant is competitive balance in the financial markets, then we would argue that Volcker Rule limitations on the involvement of banks in proprietary trading improve competition. Bank trading activities are dominated by a small number of ‘too big to fail’ banks.¹ Multiple recent studies have found that these megabanks still have a funding advantage thanks to the belief that they continue to enjoy an implicit public subsidy.² Furthermore, as dominant dealers in a wide range of financial instruments, they play a central role in the financial markets, which gives them potentially significant informational advantages in proprietary trading. Restricting the proprietary trading activities of such banks should improve competitive balance, not harm it.

If what is meant by ‘competition’ is the international competitiveness of U.S. industry, we disagree with the claims of the U.S. Chamber of Commerce that Volcker Rule restrictions would harm competitiveness. Such claims ignore the 60-year period during which U.S. banks operated under Glass-Steagall restrictions which were much more far-reaching than those that apply under the Volcker Rule. This historical experience does not support the conclusion that divisions between investment and commercial banking have an impact on international competitiveness. Furthermore, important foreign jurisdictions such as the U.K. and E.U. are also moving to create new divisions between retail commercial banking and wholesale investment banking, such as the Vickers Commission ring-fencing requirements in the U.K. and the new European Commission proposals in the E.U.³ While these differ in their details from the Volcker Rule they will also create new barriers between financial market trading and retail banking activities. This reflects the broad-based global recognition that unrestricted universal banking can create unacceptable risks to the financial system.

HR 5037

HR 5037 would impose new reporting requirements and consultative duties on the Office of Financial Research (OFR). AFR opposes this legislation as both redundant and harmful.

The requirements are redundant in that the OFR already engages in extensive public reporting and consults frequently with member agencies, and is already subject to the full range of cyber-

¹ According to a GAO analysis, just six bank holding companies account for 88 percent of trading revenues among U.S. bank holding companies. See p. 13, General Accounting Office, “[Proprietary Trading: Regulators Will Need More Comprehensive Information to Monitor Compliance With New Restrictions When Implemented](#)”, Report to Congressional Committees, GAO-11-529, July, 2011.

² For a comprehensive list, see “[TBTF Subsidy For Large Banks – Literature Review](#)”, Prepared for Thomas M. Hoening, Vice Chairman, Federal Deposit Insurance Corporation, July, 2014. Available at <http://www.fdic.gov/news/news/speeches/literature-review.pdf>.

³ The Vickers Commission recommendations were passed into law in the U.K. as the Financial Services (Banking Reform) Act of 2013, available at <http://www.legislation.gov.uk/ukpga/2013/33/contents/enacted>. The nature and progress of European Commission proposals are summarized at http://ec.europa.eu/internal_market/bank/structural-reform/index_en.htm.

security requirements that apply to the U.S. Treasury through the Federal Information Management Security Act (FISMA).

They are harmful in that the specific reporting requirements in the bill would damage the OFR's ability to perform its critical mission of investigating and researching risks in the financial system. HR 5037 requires the OFR to provide a detailed advance description to the public of every report, guidance, working paper, data collection, or information request that it will conduct during the coming year, along with target dates for every meeting and information request associated with each such action. Besides being unrealistic, this requirement would provide a road map to Wall Street interests on how to lobby the OFR concerning each detail of its work in progress and each element of its information gathering.

The bill further requires OFR to make public the exact time, date, and nature of every consultation with any staffer of a member agency regarding any report, and to publish every recommendation made in such a consultation and whether this recommendation was taken. Making public each detail of every consultation would exercise a significant chilling effect on the willingness of member agency personnel to share full and frank views with the OFR regarding work in progress. The inability to provide any confidentiality regarding advice on what are often highly controversial issues would be damaging to the OFR's ability to gather information freely from member agencies. Even such powerful transparency laws as the Freedom of Information Act provide a deliberative process exemption to safeguard internal deliberation on work in progress. But HR 5037 would eliminate this basic protection for the OFR.

HR 5037 appears motivated by the assumption that OFR's current level of public transparency or consultation with member agencies is somehow inadequate. We disagree. OFR's annual reports and working papers provide significant detail on the agency's current and upcoming projects, as well as the agency's views on key risks and vulnerabilities affecting the financial system.⁴ The OFR director of course presents annual reports to Congress personally, giving ample opportunity for questions and information requests. More recently, the OFR has been required to provide quarterly reports to Congress on all spending undertaken and actions by each of its units in the past quarter.⁵

With respect to consultation with member agencies, the Treasury's recent (May 13th) letter to the House regarding the OFR's asset management report provides detailed documentation of such consultation.⁶ In the case of the asset management report, consultation with the Securities and

⁴ See for example the OFR's 2013 Annual Report, available at http://www.treasury.gov/initiatives/ofr/about/Documents/OFR_AnnualReport2013_FINAL_12-17-2013_Accessible.pdf. The report discusses the agency's upcoming research agenda and work plan in some detail.

⁵ Requirement added in Division E, Section 120(a) of the Consolidated Appropriations Act of 2014, HR 3547.

⁶ Fitzpayne, Alistair, Department of the Treasury, "Letter To Darrell Issa, Chairman, House Committee on Oversight and Government Affairs", May 13, 2014, available at <http://online.wsj.com/public/resources/documents/0514asset.pdf>.

Exchange Commission (SEC) included the exchange of at least 15 draft versions of the report, at least 13 separate meetings concerning the report, and additional informal consultations. SEC Chair Mary Jo White has stated that the SEC “commented extensively” on the report when it was in progress.⁷

The OFR’s mission of studying potential emerging threats to the U.S. financial system is a critical one. The failure to understand such emerging threats was a crucial contributor to the disastrous financial crisis of 2008, which cost the U.S. economy some 8 million jobs and trillions of dollars in economic losses.⁸ In order to perform its mission, the OFR must have and is intended to have independence from the political pressures that may affect member agencies. The way to improve the OFR’s work is to support its independence and its ability to act as a warning voice concerning threats that others may choose to overlook for political reasons. The changes in HR 5037 would have the opposite effect.

The Access To Affordable Mortgages Act of 2014

This legislation would exempt ‘higher-risk mortgages’ of \$250,000 or under from new appraisal requirements included in the Dodd-Frank Act, so long as such loans were held for at least three years on the balance of the lender.

This exemption is a bad idea. ‘Higher-risk mortgages’ refers to what were once called subprime mortgages -- loans made at higher than prime market rate that generally also include high-risk features such as high upfront fees, balloon payments, interest-only loans, negative amortization, or other risky features. Various types of fraud and predatory lending connected to the origination of subprime mortgages were a major cause of the 2008 financial crisis. Describing the situation, the Financial Crisis Inquiry Commission stated⁹:

“mortgage fraud... flourished in an environment of collapsing lending standards and lax regulation....One study places the losses resulting from fraud on mortgage loans made between 2005 and 2007 at \$112 billion....Lenders made loans that they knew borrowers could not afford and that could cause massive losses to investors in mortgage securities.”

In response to this experience, oversight of the mortgage market has been increased in several ways. New rules are designed to encourage mortgage loans that are properly aligned with the payment ability of the borrower and with the value of the underlying housing collateral. One such rule is the addition of a new requirement that lender obtain a written appraisal of any property used as collateral for a higher-risk mortgage, based on a physical visit to the property by

⁷ *Oversight of Financial Stability and Data Security, Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs*, 113th Congress, February 6, 2014, Testimony of Mary Jo White.

⁸ Americans for Financial Reform, “[AFR Briefing Paper: Costs of the Crisis](#)”, Washington, DC, May 2013; General Accounting Office, “[Financial Crisis Losses and Potential Impacts of the Dodd Frank Act](#)”, GAO 13-180, January, 2013.

⁹ Page xxii, Financial Crisis Inquiry Commission, “[The Financial Crisis Inquiry Report](#)”, January, 2011.

an independent and certified appraiser. This new requirement is intended to ensure that mortgage loans are properly collateralized. This protects both the lender, through adequate collateral for their loan, and the borrower, by preventing them from borrowing more than their home is worth.

By exempting mortgages of up to \$250,000 from appraisal requirements, this legislation would significantly undermine this important new regulatory protection. The \$250,000 exemption in this bill would include almost half of all new homes sold in the United States, and likely well over half of subprime or higher-risk mortgage loans.¹⁰ The requirement that a lender retain the loan on their balance sheet for at least three years does provide some additional protection. But data on subprime loan defaults shows significant increases in default past the 36 month point.¹¹

HR 4042

AFR does not have a position on HR 4042 at this time. The capital rule targeted for further study by HR 4042 would restrict mortgage servicing assets to at most 10 percent of common equity tier 1 capital. This is a significant change compared to the previous treatment of mortgage servicing rights. But it does not appear inconsistent with the rest of the regulatory capital framework given that the inclusion of most other types of intangible assets in common equity capital was eliminated completely in Basel III.

AFR feels that excessive leverage was a major contributor to the global financial crisis. By delaying the application of new capital treatment of mortgage servicing assets into 2016, HR 4042 would at least temporarily permit additional leverage in the banking system.

Some industry observers have pointed to new capital rules on mortgage servicing as a significant driver of migration of servicing rights from prudentially regulated banks to non-bank servicers. However, other market analysts disagree with this assessment, pointing to other constraints.¹² It is also worth noting that after the Dodd-Frank Act non-bank servicers are now regulated for consumer protection by the Consumer Financial Protection Bureau, and also that bank servicers did not perform well during and after the financial crisis.

We would also point out that prudential regulators carefully considered thousands of comments on their proposed rule regarding the U.S. implementation of new Basel III capital requirements. As a result of this examination, regulators chose to significantly ease capital requirements in many areas of the final rule, including the treatment of residential mortgages. But they did not modify the ceiling on mortgage servicing assets as a proportion of total capital. It is possible that

¹⁰ \$250,000 exceeds the average value of subprime mortgages in every year from 2001 to 2007. See Table 1 in Demyanyk, Yuliya S. and Van Hemert, Otto, "[Understanding the Subprime Mortgage Crisis](#)", December 5, 2008.

¹¹ See Figure 1 in Palmer, Christopher, "[Why Did So Many Subprime Borrowers Default During the Crisis: Loose Credit or Plummeting Prices?](#)", Massachusetts Institute of Technology, November, 2013.

¹² E.g. Boltansky, Isaac and Kevin Barker, "[Initial Basel III Reaction: Win For Mortgage Industry](#)", Compass Point Research and Trading, LLC. July 2, 2013. The report states, "we believe the vast majority of servicing that has traded over the past few years was primarily due to operational and regulatory constraints, not capital constraints. Thus, in our opinion, the finalized rules will have little impact on whether MSRs will trade or not".

much of the information requested in this bill has already been gathered by regulators as part of their previous consideration and could be made available without legislation and without a delay in the application of capital rules.

Finally, we would like to note our concern with the distinction between ‘systemic’ and ‘non-systemic’ banks advanced in HR 4042. The legislation limits the ‘systemic’ label to the eight U.S. G-SIFIs designated by international regulators. But these are hardly the only banks that could have a significant effect on the U.S. financial system, or present significant exposure to U.S. taxpayers through deposit insurance. As Federal Reserve Governor Tarullo pointed out in a recent speech, mid-size banks that are not G-SIFIs but hold more than \$10 billion in assets own more than one-third of U.S. commercial banking assets.¹³ As Governor Tarullo stated:

“If a number of these [mid-size] banks simultaneously came under pressure or failed, a harmful contraction of credit availability in significant regions or sectors of the economy could ensue, even if there were little chance of a financial crisis. Thus, particularly to the degree that there are correlations in the risks associated with loans held across such institutions, there should be a macroprudential objective in the regulation of at least some of these firms.”

Other Legislation Being Considered By The Committee Today

AFR does not have a position on HR 3240, HR 3374, HR 4626, or HR 5062.

Thank you for the opportunity to testify. Should you have further questions, I can be contacted at marcus@ourfinancialsecurity.org or (202) 466-3672.

¹³ Tarullo, Daniel, “[Rethinking The Aims of Prudential Regulation](#)”, Speech Delivered At the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014.