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Statement of

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Office of Thrift Supervision

concerning

# Modernizing Bank Supervision and Regulation

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

March 19, 2009

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## I. Introduction

Good morning Chairman Dodd, Ranking Member Shelby and members of the Committee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on Modernizing Bank Supervision and Regulation.

It has been pointed out many times that our current system of financial supervision is a patchwork with pieces that date to the Civil War. If we were to start from scratch, no one would advocate establishing a system like the one we have cobbled together over the last century and a half. The complexity of our financial markets has in some cases reached mind-boggling proportions. To effectively address the risks in today's financial marketplace, we need a modern, sophisticated system of regulation and supervision that applies evenly across the financial services landscape.

The economic crisis gripping this nation and much of the rest of the world reinforces the theme that the time is right for an in-depth, careful review and meaningful, fundamental change. Any restructuring should take into account the lessons learned from this crisis.

Of course, the notion of regulatory reform is not new. When financial crisis strikes, it is natural to look for the root causes and logical fixes, asking whether the nation's regulatory framework allowed problems to occur, either because of gaps in oversight, a lack of vigilance, or overlaps in responsibilities that bred a lack of accountability.

Since last year, a new round of studies, reports and recommendations have entered the public arena. In one particularly notable study in January 2009 — Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U. S. Financial Regulatory System — the Government Accountability Office (GAO) listed four broad goals of financial regulation:

- Ensure adequate consumer protections,
- Ensure integrity and fairness of markets,
- Monitor the safety and soundness of institutions, and
- Ensure the stability of the overall financial system.

The OTS recommendations discussed in this testimony align with those goals.

Although a review of the current financial services regulatory framework is a necessary exercise, the OTS recommendations do not represent a realignment of the current regulatory system. Rather, these recommendations represent a fresh start, using a clean slate. They present the OTS vision for the way financial services regulation in this country should be. Although they seek to remedy some of the problems of the past, they do not simply rearrange the current regulatory boxes. What we are proposing is fundamental change that would affect virtually all of the current federal financial regulators.

It is also important to note that these are high-level recommendations. Before adoption and implementation, many details would need to be worked out and many questions would need to be answered. To provide all of those details and answer all of those questions would require reams beyond the pages of this testimony.

The remaining sections of the OTS testimony begin by describing the problems that led to the current economic crisis. We also cite some of the important lessons learned from the OTS's perspective. The testimony then outlines several principles for a new regulatory framework before describing the heart of the OTS proposal for reform.

## II. What Went Wrong?

The problems at the root of the financial crisis fall into two groups, non-structural and structural. The non-structural problems relate to lessons learned from the current economic crisis that have been, or can be, addressed without changes to the regulatory structure. The structural problems relate to gaps in regulatory coverage for some financial firms, financial workers and financial products.

### a. Non-Structural Problems

In assessing what went wrong, it is important to note that several key issues relate to such things as concentration risks, extraordinary liquidity pressures, weak risk management practices, the influence of unregulated entities and product markets, and an over-reliance on models that relied on insufficient data and faulty assumptions. All of the regulators, including the OTS, were slow to foresee the effects these risks could have on the institutions we regulate. Where we have the authority, we have taken steps to deal with these issues.

For example, federal regulators were slow to appreciate the severity of the problems arising from the increased use of mortgage brokers and other unregulated entities in providing consumer financial services. As the originate-to-distribute model became more prevalent, the resulting increase in competition changed the way all mortgage lenders underwrote loans, and assigned and priced risk. During the then-booming economic environment, competition to originate new loans was fierce between insured institutions and less well regulated entities. Once these loans were originated, the majority of them were removed from bank balance sheets and sold into the securitization market. These events seeded many residential mortgage-backed securities with loans that were not underwritten adequately and that would cause significant problems later when home values fell, mortgages became delinquent and the true value of the securities became increasingly suspect.

Part of this problem stemmed from a structural issue described in the next section — inadequate and uneven regulation of mortgage companies and brokers — but some banks and thrifts that had to compete with these companies also started making loans that were focused on the rising value of the underlying collateral, rather than the borrower's ability to repay. By the time the federal bank regulators issued the nontraditional mortgage guidance in September 2006, reminding insured depository institutions to consider borrowers' ability to repay when underwriting adjustable-rate loans, numerous loans had been made that could not withstand a severe downturn in real estate values and payment shock from changes in adjustable rates.

When the secondary market stopped buying these loans in the fall of 2007, too many banks and thrifts were warehousing loans intended for sale that ultimately could not be sold. Until this time, bank examiners had historically looked at internal controls, underwriting practices and serviced loan portfolio performance as barometers of safety and soundness. In September 2008, the OTS issued guidance to the industry reiterating OTS policy that for all loans originated for sale or held in portfolio, savings associations must use prudent underwriting and documentation standards. The guidance emphasized that the OTS expects loans originated for sale to be underwritten to comply with the institution's approved loan policy, as well as all existing regulations and supervisory guidance governing the documentation and underwriting of residential mortgages. Once loans intended for sale were forced to be kept in the institutions' portfolios, it reinforced the supervisory concern that concentrations and liquidity of assets, whether geographically or by loan type, can pose major risks.

One lesson from these events is that regulators should consider promulgating requirements that are countercyclical, such as conducting stress tests and lowering loan-to-value ratios during economic upswings. Similarly, in difficult economic times, when house prices are not appreciating, regulators could permit loan-to-value (LTV) ratios to rise. Other examples include increasing capital and allowance for loan and lease losses in times of prosperity, when resources are readily available.

Another important nonstructural problem that is recognizable in hindsight and remains a concern today is the magnitude of the liquidity risk facing financial institutions and how that risk is addressed. As the economic crisis hit banks and thrifts, some institutions failed and consumers whose confidence was already shaken were overtaken in some cases by panic about the safety of their savings in insured accounts at banks and thrifts. This lack of consumer confidence resulted in large and sudden deposit drains at some institutions that had serious consequences. The federal government has taken several important steps to address liquidity risk in recent months, including an increase in the insured threshold for bank and thrift deposits.

Another lesson learned is that a lack of transparency for consumer products and complex instruments contributed to the crisis. For consumers, the full terms and details of mortgage products need to be understandable. For investors, the underlying details of their investments must be clear, readily available and accurately evaluated. Transparency of disclosures and agreements should be addressed.

Some of the blame for the economic crisis has been attributed to the use of "mark-to-market" accounting under the argument that this accounting model contributes to a downward spiral in asset prices. The theory is that as financial institutions write down assets to current market values in an illiquid market, those losses reduce regulatory capital. To eliminate their exposure to further write-downs, institutions sell assets into stressed, illiquid markets, triggering a cycle of additional sales at depressed prices. This in turn results in further write-downs by institutions holding similar assets. The OTS believes that refining this type of accounting is better than suspending it. Changes in accounting standards can address the concerns of those who say fair value accounting should continue and those calling for its suspension.

These examples illustrate that non-structural problems, such as weak underwriting, lack of transparency, accounting issues and an over-reliance on performance rather than fundamentals, all contributed to the current crisis.

**b. Structural Problems**

The crisis has also demonstrated that gaps in regulation and supervision that exist in the mortgage market have had a negative impact on the world of traditional and complex financial products. In recent years, the lack of consistent regulation and supervision in the mortgage lending area has become increasingly apparent.

Independent mortgage banking companies are state-chartered and regulated. Currently, there are state-by-state variations in the authorities of supervising agencies, in the level of supervision by the states and in the licensing processes that are used. State regulation of mortgage banking companies is inconsistent and varies on a number of factors, including where the authority for chartering and oversight of the companies resides in the state regulatory structure.

The supervision of mortgage brokers is even less consistent across the states. In response to calls for more stringent oversight of mortgage lenders and brokers, a number of states have debated and even enacted licensing requirements for mortgage originators. Last summer, a system requiring the licensing of mortgage originators in all states was enacted into federal law. The S.A.F.E. Mortgage Licensing Act in last year's Housing and Economic Recovery Act is a good first step. However, licensing does not go far enough. There continues to be significant variation in the oversight of these individuals and enforcement against the bad actors.

As the OTS has advocated for some time, one of the paramount goals of any new framework should be to ensure that similar bank or bank-like products, services and activities are scrutinized in the same way, whether they are offered by a chartered depository institution, or an unregulated financial services provider. The product should receive the same review, oversight and scrutiny regardless of the entity offering the product. Consumers do not understand — nor should they need to understand — distinctions between the types of lenders offering to provide them with a mortgage. They deserve the same service, care and protection from any lender. The "shadow bank system," where bank or bank-like products are offered by nonbanks using different standards, should be subject to as rigorous supervision as banks. Closing this gap would support the goals cited in the GAO report.

Another structural problem relates to unregulated financial products and the confluence of market factors that exposed the true risk of credit default swaps (CDS) and other derivative products. CDS are unregulated financial products that lack a prudential derivatives regulator or standard market regulation, and pose serious challenges for risk management. Shortcomings in data and in modeling certain derivative products camouflaged some of those risks. There frequently is heavy reliance on rating agencies and in-house models to assess the risks associated with these extremely complicated and unregulated products. In hindsight, the banking industry, the rating agencies and prudential supervisors, including OTS, relied too heavily on stress parameters that were based on insufficient historical data. This led to an underestimation of the economic shock that hit the financial sector, misjudgment of stress test parameters and an overly optimistic view of model output.

We have also learned there is a need for consistency and transparency in over-the-counter (OTC) CDS contracts. The complexity of CDS contracts masked risks and weaknesses. The OTS believes standardization and simplification of these products would provide more transparency to market participants and regulators. We believe many of these OTC contracts should be subject to exchange-traded oversight, with daily margining required. This kind of standardization and exchange-traded oversight can be accomplished when a single regulator is evaluating these products. Congress should consider legislation to bring such OTC derivative products under appropriate regulatory oversight.

One final issue on the structural side relates to the problem of regulating institutions that are considered to be too big and interconnected to fail, manage, resolve, or even formally deem as problem institutions when they encounter serious trouble. We will discuss the pressing need for a systemic risk regulator with the authority and resources adequate to the meet this enormous challenge later in this testimony.

The array of lessons learned from the crisis will be debated for years. One simple lesson is that all financial products and services should be regulated in the same manner regardless of the issuer. Another lesson is that some institutions have grown so large and become so essential to the economic well-being of the nation that they must be regulated in a new way.

## III. Guiding Principles for Modernizing Bank Supervision and Regulation

The discussion on how to modernize bank supervision and regulation should begin with basic principles to apply to a bank supervision and consumer protection structure. Safety and soundness and consumer protection are fundamental elements of any regulatory regime. Here are recommendations for four other guiding principles:

1. ***Dual banking system and federal insurance regulator* —** The system should contain federal and state charters for banks, as well as the option of federal and state charters for insurance companies. The states have provided a charter option for banks and thrifts that have not wanted to have a national charter. A number of innovations have resulted from the kind of focused product development that can occur on a local level. Banks would be able to choose whether to hold a federal charter or state charter. For large insurance companies, a federal insurance regulator would be available to provide more comprehensive, coordinated and effective oversight than a collection of individual state insurance regulators.
2. ***Choice of charter, not of regulator* —** A depository institution should be able to choose between state or federal banking charters, but if it selects a federal charter, its charter type and regulator should be determined by its operating strategy and business model. In other words, there would be an option to choose a business plan and resulting charter, but that decision would then dictate which regulator would supervise the institution.

3. ***Organizational and ownership options*** — Financial institutions should be able to choose the organizational and ownership form that best suits their needs. Mutual, public or private stock and subchapter S options should continue to be available.
4. ***Self-sustaining regulators*** — Each regulator should be able to sustain itself financially through assessments. Funding the agencies differently could expose bank supervisory decisions to political pressures, or create conflicts of interest within the entity controlling the purse strings. 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.
5. ***Consistency*** — Each federal regulator should have the same enforcement tools and the authority to use those tools in the same manner. Every entity offering financial products should also be subject to the same set of laws and regulations.

## IV. Federal Bank Regulation

The OTS proposes two federal bank regulators, one for banks predominately focused on consumer-and-community banking products, including lending, and the other for banks primarily focused on commercial products and services. The business models of a commercial bank and a consumer-and-community bank are fundamentally different enough to warrant these two distinct federal banking charters.

The consumer-and-community bank regulator would supervise depository institutions of all sizes and other companies that are predominately engaged in providing financial products and services to consumers and communities. Establishing such a regulator would address the gaps in regulatory oversight that led to a shadow banking system of unevenly regulated mortgage companies, brokers and consumer lenders that were significant causes of the current crisis.

The consumer-and-community bank regulator would also be the primary federal regulator of all state-chartered banks with a consumer-and-community business model. The regulator would work with state regulators to collaborate on examinations of state-chartered banks, perhaps on an alternating cycle for annual state and federal examinations. State-chartered banks would pay a prorated federal assessment to cover the costs of this oversight.

In addition to safety and soundness oversight, the consumer-and-community bank regulator would be responsible for developing and implementing all consumer protection requirements and regulations. These regulations and requirements would be applicable to all entities that offer lending products and services to consumers and communities. The same standards would apply for all of these entities, whether a state-licensed mortgage company, a state bank or a federally insured depository institution. Non-compliance would be addressed through uniform enforcement applied to all appropriate entities.

The current crisis has highlighted consumer protection as an area where reform is needed. Mortgage brokers and others who interact with consumers should meet eligibility requirements that reinforce the importance of their jobs and the level of trust consumers place in them. Although the recently enacted licensing requirements are a good first step, limitations on who may have a license are also necessary.

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 may not be sufficient to protect consumers against abuses. This is particularly true as products and services, including mortgages, have become more complex.

The second federal bank regulator — the commercial bank regulator — would charter and supervise banks and other entities that primarily provide products and services to corporations and companies. The commercial bank regulator would have the expertise to supervise banks and other entities predominately involved in commercial transactions and offering complex products. This regulator would develop and implement the regulations necessary to supervise these entities. The commercial bank regulator would supervise issuers of derivative products. Nonbank providers of the same products and services would be subject to the same rules and regulations.

The commercial bank regulator would not only have the tools necessary to understand and supervise the complex products already mentioned, but would also possess the expertise to evaluate the safety and soundness of loans that are based on such things as income streams and occupancy rates, which are typical of loans for projects such as shopping centers and commercial buildings.

The commercial bank regulator would also be the primary federal supervisor of state-chartered banks with a commercial business model, coordinating with the states on supervision and imposing federal assessments just as the consumer-and-community regulator would.

Because most depositories today are engaged in some of each of these business lines, the predominant business focus of the institution would govern which regulator would be the primary federal regulator. In determining the federal supervisor, a percentage of assets test could apply. If the operations of the institution or entity changed for a significant period of time, the primary federal regulator would change. More discussion and analysis would be needed to determine where to draw the line between institutions qualifying as commercial banks and institutions qualifying as consumer-and-community banks.

## V. Holding Company Regulation

The functional regulator of the largest entity within a diversified financial company would be the holding company regulator. The holding company regulator would have authority to monitor the activities of all affiliates, to exercise enforcement authority and to impose information-sharing arrangements between entities in the holding company structure and their functional regulators. To the extent necessary for the safety and soundness of the depository subsidiary or the holding company, the regulator would have the authority to impose capital requirements, restrict activities, issue source-of-support requirements and otherwise regulate the operations of the holding company and the affiliates.

## VI. Systemic Risk Regulation

The establishment of a systemic risk regulator is an essential outcome of any initiative to modernize bank supervision and regulation. OTS endorses the establishment of a systemic risk regulator with broad authority to monitor and exercise supervision over any company whose actions or failure could pose a 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 would supplement, not supplant, the holding company regulator and the primary federal bank supervisor.

A systemic regulator would have the authority and resources to supervise institutions and companies during a crisis situation. The 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 the past year, it is essential that such a regulator have the ability to act as a receiver and to provide an orderly resolution to companies. Efficiently resolving a systemically important institution in a measured, well-managed manner is an important element in restructuring the regulatory framework. 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 and other entities in the United States to compete in today's global financial services marketplace is critical. The systemic risk regulator would 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.

Although the systemic risk regulator would not have supervisory authority over non-systemically important banks, the systemic regulator would need access to data regarding the health and activities of these institutions for purposes of monitoring trends and other matters.

## VII. Conclusion

Thank you again, Mr. Chairman, Ranking Member Shelby, and Members of the Committee, for the opportunity to testify on behalf of the OTS on Modernizing Bank Supervision and Regulation.

We look forward to continuing to work with the members of this Committee and others to fashion a system of financial services regulation that better serves all Americans and helps to ensure the necessary clarity and stability for this nation's economy.