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TESTIMONY

EXAMINING LEGISLATIVE PROPOSALS TO PRESERVE CONSUMER CHOICE AND FINANCIAL INDEPENDENCE

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House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

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Chairman Neugebauer, Ranking Member Clay, and members of the Subcommittee: thank you for the opportunity to discuss the set of legislative proposals under consideration today. I am not able to take a position on these bills, but I will discuss some ways in which these proposed legislative changes could

- encourage financial institutions to take responsibility for their decisions,
- limit bank regulators' discretion and enhance regulatory accountability, and
- update the regulatory framework to enable it to operate more effectively.

Financial regulation should consist of clear, consistently enforced rules within which customers and financial institutions can freely interact. A well-functioning market enables people who need financing to obtain it efficiently and at a competitive price. Market forces reward financial companies that serve consumers well and discipline firms that fail to provide products and services in a form and at a price that consumers want.

It is hard to design financial regulations that enable the market to function as it should—rewarding firms that serve consumers well and eliminating companies that do not. A statute or regulation may work differently in practice than its drafters anticipated, particularly as the circumstances in which it operates change. Revisiting statutes and regulations periodically to reflect changed circumstances or to respond to unintended consequences is a useful exercise that can lead to more efficient and effective financial regulation.

H.R. 1210: AMENDING THE QUALIFIED MORTGAGE RULES

Dodd-Frank's "qualified mortgage" and "ability-to-repay" provisions are designed to ensure that financial institutions do not make loans to people who cannot afford to repay them. A subset of mortgages known as qualified mortgages enjoy a presumption that a lender has satisfied the ability-to-repay requirements. Changes to these

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rules are warranted to ensure that consumers are able to get mortgages that are tailored appropriately to their needs and their risk profiles.

Although many factors are at work in the mortgage market, the qualified mortgage rules have affected the financing options available to homebuyers. In a survey of small banks conducted in summer 2013 by the Mercatus Center at George Mason University, approximately 30 percent of respondents planned to make only qualified mortgages and a third were uncertain whether they would make nonqualified mortgages.[1] Lenders, likely driven in part by liability concerns, are not making loans that fall outside the qualified mortgage definition. The National Association of Realtors reported that in the first quarter of 2015, only 1.2 percent of originated mortgages did not fit the definition of qualified mortgages.[2] Many respondents in the Mercatus survey expressed confusion and concern about the qualified mortgage rules and anticipated these rules would shape and perhaps shrink their future mortgage offerings.[3] A third of the National Association of Realtors survey respondents reported being "unable to close mortgages due to a requirement of the qualified mortgage rule" in the first quarter of 2015.[4] Residential mortgages were the product or service most often identified by surveyed banks as a candidate for discontinuation as a result of Dodd-Frank.[5] A recent study by the John F. Kennedy School of Government at Harvard University documents the falling share of bank participation in mortgage originations; depository institutions accounted for approximately 72 percent of new purchase mortgage originations in 2014, compared to more than 90 percent in 2010.[6]

Regulatory dictation of loan terms and underwriting practices is not the most effective way of ensuring that a borrower will have the ability to repay. More effective incentives arise in an environment where a financial institution retains the downside of the borrower failing to repay. Under H.R. 1210, mortgages that depository institutions hold in their own portfolios would be deemed qualified mortgages. A financial institution that retains a loan's credit and interest-rate risk has a keen interest in engaging in thorough, sound underwriting to determine the borrower's ability to repay. Allowing a financial institution to make a customer-specific lending decision on a loan it intends to hold in its portfolio can be a more effective way of protecting consumers than regulatory attempts to micromanage mortgage terms with inflexible standards.

H.R. 1553 AND H.R. 1941: EXAMINATIONS

Regulatory reforms should be accompanied by reforms in the examination process. Banking regulators are required to conduct annual, on-site, full-scope examinations of insured depositories.[7] These on-site examinations require regulators and examined institutions to make substantial time and resource commitments. The burden of these exams falls disproportionately on smaller institutions.[8] The existing statutory framework recognizes the

1. Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring Under Dodd-Frank?* 52 (Mercatus Ctr. at Geo. Mason U., Working Paper, 2014), *available at* http://mercatus.org/sites/default/files/Peirce_SmallBankSurvey_v1.pdf.
2. National Association of Realtors, 6th Survey of Mortgage Originators 4 (May 2015), *available at* https://www.scribd.com/document_downloads/266800139?extension=pdf&from=embed&source=embed.
3. Peirce et al., *supra* note 1, at 51–53.
4. National Association of Realtors Survey, *supra* note 2, at 6.
5. *Id*. at 30.
6. Marshall Lux & Robert Greene, *What's Behind the Non-bank Mortgage Boom?,* Fig. 4 (Harvard Kennedy School M_RCBG Associate Working Paper Series, Working Paper No. 42, 2015), *available at* http://www.hks.harvard.edu/content/download/76403/1714118/version/1/file/Final_Nonbank_Boom_Lux_Greene.pdf.
7. 12 U.S.C. § 1820(d)(1) (2013).
8. *See, e.g*., Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, A Tiered Approach to Regulation and Supervision of Community Banks, Speech at the Community Bankers Symposium (Nov. 7, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20141107a.htm (acknowledging that "supervision can be burdensome, because community banks have a smaller balance sheet across which to amortize compliance costs"). Efforts are underway to get a more precise understanding of the role that regulation and supervision are playing in spurring consolidation in the banking industry. *See, e.g.*, Ron J. Feldman & Peter Schreck, *Assessing Community Bank Consolidation* (Federal Reserve Bank of Minneapolis Economic Policy Paper, Feb. 6, 2014), *available at* https://www.minneapolisfed.org/research/economic-policy-papers/assessing-community-bank-consolidation.

disproportionate burden by extending the examination cycle for small, healthy financial institutions to 18 months.[9] Raising the minimum size of banks eligible for this longer exam cycle from $500 million to $1 billion—as set forth in H.R. 1553—would reflect the reality that it is not only the smallest community banks that are suffering under regulatory and supervisory burdens.[10] The threshold increase would be consistent with other statutory and regulatory efforts to lighten the burden on community banks without compromising safety and soundness considerations.[11]

Regardless of their frequency, examinations are not worthwhile unless they are timely, thorough, rooted in carefully employed judgment[12] rather than inflexible checklists, and consistent across institutions. A robust, objective process for raising concerns about low-quality exams is one way to increase exam quality. H.R. 1941 would establish a new interagency mechanism for examination oversight, including a new appeals process.

An *intra*-agency appeals process already exists at some financial regulators, but examination concerns remain. In the words of University of Alabama School of Law professor Julie Hill, who extensively researched the appeals processes of four financial regulators, the appeals process is "a dysfunctional and seldom used system."[13] The existing appeals mechanisms do not provide an effective check on bank examiners. As Professor Hill notes, both financial institutions and regulators have an interest in a good examination process:

> Pursuing unnecessary enforcement actions diverts regulatory attention from pressing problems. If a financial institution expends significant time and effort addressing an erroneous determination, it may prevent the institution from addressing other important matters. Moreover, allowing erroneous [Material Supervisory Determinations] to persist undermines the credibility of the supervisory process.[14]

Professor Hill's finding that appeals are rare is consistent with the strong incentives for financial institutions to defer to the regulators that exercise continuing power over their businesses.[15] Even with anti-retaliation measures in place, it is very difficult to second-guess a regulator. Financial institutions would be more likely to avail themselves of an external, third-party appeals process such as the one set forth in H.R. 1941. Clarifying the interaction between the intra-agency and interagency appeals process would help to ensure that the new process has

9. 12 U.S.C. § 1820(d)(4).
10. *See, e.g.*, Peirce et al., supra note 1; Marshall Lux & Robert Greene, *The State and Fate of Community Banking* (Harvard Kennedy School M_RCBG Associate Working Paper Series, Working Paper No. 37, 2015), *available at* http://www.hks.harvard.edu/content/download/74695/1687293/version/1/file/Final_State_and_Fate_Lux_Greene.pdf; Tanya D. Marsh, *Reforming the Regulation of Community Banks After Dodd-Frank*, 90 Ind. L.J. 180 (2015).
11. For a discussion of some of these initiatives, see Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System, Speech at the Annual Community Bankers Conference (May 14, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/powell20150514a.htm.
12. Legislative attempts to constrain the legitimate exercise of bank examiners' judgment with regard to safety-and-soundness matters should be avoided.
13. Julie Andersen Hill, *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations* 4 (Univ. of Alabama, Working Paper, 2014) (Wash. U. L. Rev. (forthcoming 2015)), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2494634&download=yes.
14. *Id.* at 10.
15. Former BB&T CEO John A. Allison described, for example, the inability of his bank to resist regulatory pressure to participate in the Troubled Asset Relief Program:

> When TARP passed, the day afterwards, I got a call from our regulator, because I was a known opponent to TARP, the only large bank that was vocally opposed to TARP, and I got a very interesting message. This is a regulator of the FDIC. He says, "Listen, you know, John, BB&T has way more capital than you need by traditional capital standards; however, we decided we need new capital standards. We don't know what those new capital standards are going to be; however, we're confident that you don't have enough capital under these new standards unless you take the TARP money. And we've got an audit team ready to come in tomorrow, and we're pretty confident you will fail this audit unless you take the TARP money," and we said, "We'll take the TARP money."

John A. Allison & Wayne A. Abernathy, *The Financial Crisis and the Free Market Cure: A Conversation with John A. Allison*, 14 Engage 43, 45 (2013).

its desired effect.

H.R. 766 AND H.R. 1413: OPERATION CHOKE POINT

Through the examination process and less formal methods, financial regulators influence the business decisions of the institutions they oversee. Operation Choke Point—a cooperative effort between the Department of Justice and banking regulators to cut off certain firms' access to the banking system—is one example of how regulators can usurp banks' day-to-day management functions.

Absent overriding national security concerns, financial institutions—not their regulators—should decide which customers to serve. The FDIC seems to have recognized this principle in guidance it issued earlier this year, in which it "encourages institutions to take a risk-based approach in assessing individual customer relationships rather than declining to provide banking services to entire categories of customers."[16] Even with this guidance in place, the FDIC's participation in Operation Choke Point and its recent expressions of discomfort with certain industries suggest the need for clear statutory guidelines.[17]

H.R. 766, which constrains banking regulators' ability to direct depository institutions to terminate customer accounts, and H.R. 1413, which prevents federal agencies from interfering with gun and ammunition manufacturers' access to the financial system, would provide clear guidelines to regulators. These bills would give banks greater ability to choose their own customers, but financial institutions might instead continue to avoid stigmatized customer groups for fear of being second-guessed by examiners.

H.R. 2287: NATIONAL CREDIT UNION ADMINISTRATION BUDGET TRANSPARENCY

The National Credit Union Administration (NCUA) plays an important regulatory role but avoids basic accountability measures. For example, the NCUA does not routinely conduct economic analysis of its rules.[18] Moreover, the NCUA funds itself with credit union fees. Without the discipline of the congressional appropriations process, the NCUA's budget-setting process is not transparent. The NCUA is not subject to the healthy constraint of having to justify its spending decisions.

NCUA board member J. Mark McWatters, in his dissent from the 2015 budget, called for greater budget transparency and a public notice-and-comment process for the budget:

> As a Board, we should remain mindful that we are spending other peoples' money—that is, the scarce resources of federal and state chartered credit unions and their members. Any allocation of these funds should follow only after thoughtful reflection as to the necessity of the expenditures and whether the costs have been undertaken in the most efficient, effective, transparent, and fully accountable manner.[19]

H.R. 2287 would establish a formal process to provide greater budget transparency and to provide an opportunity for the NCUA to obtain valuable public feedback on its budget priorities.

16. FDIC, Statement on Providing Banking Services, Financial Institution Letter 5-2015 (Jan. 28, 2015), *available at* https://www.fdic.gov/news/news/financial/2015/fil15005.pdf.
17. *See, e.g.*, Michael B. Benardo, Chief, Cyber Fraud & Financial Crimes Section, Division of Risk Management Supervision, FDIC, Third Party Payment Processing Relationships 3 (Sept. 17, 2013), *available at* http://oversight.house.gov/wp-content/uploads/2014/05/Appendix-1-of-2.pdf (HOGR-3PPP000348) (listing "High Risk Merchants/Activities" including "Ammunition Sales," "Firearms/Fireworks Sales," "Pay Day Loans," and "Tobacco Sales"). *See also* Hester Peirce, *Operation Choke Point's Back Door*, PointofLaw.com (June 14, 2014), available at http://www.pointoflaw.com/archives/2014/06/operation-choke-points-back-door.php.
18. For a discussion of the NCUA's economic analysis, *see* Hester Peirce, *Economic Analysis by Federal Financial Regulators*, 9 Geo. Mason J.L., Econ. & Pol'y, 569, 593–94 (2013).
19. J. Mark McWatters, Board Member, NCUA, Statement on the 2015 Operating Budget (Nov. 20, 2014), *available at* http://www.ncua.gov/News/Press/SP20141121McWatters2015BudgetStatement.pdf.

H.R. 1737 AND H.R. 1266: BUREAU OF CONSUMER FINANCIAL PROTECTION ACCOUNTABILITY

The Bureau of Consumer Financial Protection (CFPB), although newly created by Dodd-Frank, has adopted the bad habits of agencies that have been around much longer. One of these practices is the use of "backdoor rulemaking"—employing methods other than notice-and-comment rulemaking to impose obligations on companies.[20] Guidance documents, which agencies use to inform regulated entities about the agencies' expectations, are a common form of backdoor rulemaking. Guidance documents can be useful compliance guides for regulated entities, but they can also take on the character of formal rules.

The CFPB has issued numerous guidance documents. One that attracted particular attention pertains to auto lending.[21] Dodd-Frank exempted auto dealers from CFPB jurisdiction.[22] The guidance reached them by effectively imposing broad new fair-lending standards on the indirect lenders with whom auto dealers work.[23] Although couched in the soft language of suggestion, rather than the unwavering language of prescription, the guidance laid out specific steps for indirect lenders to take.[24] The companies and individuals affected by the guidance did not have an opportunity to comment before the guidance was issued. Although H.R. 1737 does not preclude the CFPB from conducting rulemaking through guidance documents, it signals the value of the notice-and-comment process and economic analysis for substantial guidance documents.

The fact that a single director heads the CFPB heightens backdoor rulemaking concerns. Any pronouncement from the agency's director has the appearance of being the agency's official position. By contrast, an offhand comment by the chairman of a commission-led agency looks less like a regulatory pronouncement, since official agency positions are established through commission votes.

The single-director model is problematic for other reasons. The CFPB's broad jurisdiction touches many parts of the economy and affects the ability of consumers to access affordable financial products. The agency's structure affects the way it carries out this mission. Particularly because of other constraints on the CFPB's accountability, one person makes decisions affecting the American public and large swaths of the financial industry. If the lone director uses less formal means than rulemaking to affect change, the director need not even seek anyone else's counsel.

As George Mason School of Law professor and Mercatus senior scholar Todd Zywicki has explained, the CFPB's single-director structure is atypical:

> Although single individuals head many departments and agencies, most (such as cabinet secretaries) serve at the pleasure of the president and are removable by the same. In contrast, multimember commissions, whose members serve for fixed terms and are removable only for cause, typically head independent agencies. In the rare instances in which a single director, such as the Comptroller of the Currency, serves as the head of an agency with formal de jure protection from removal, it appears that as a de facto matter, such heads serve at the pleasure of the president.

20. *See, e.g.*, John D. Graham & James Broughel, *Confronting the Problem of Stealth Regulation* (Mercatus Ctr. at Geo. Mason U., Mercatus on Policy, 2015), *available at* http://mercatus.org/sites/default/files/Graham-Stealth-Regulations-MOP.pdf; Hester Peirce, *Regulating Through the Back Door at the Commodity Futures Trading Commission* (Mercatus Ctr. at Geo. Mason U., Working Paper, 2014), *available at* http://mercatus.org/publication/regulating-through-back-door-commodity-futures-trading-commission.
21. CFPB, CFPB Bulletin 2013-02: Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act (Mar. 21, 2013), *available at* http://www.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf.
22. Dodd-Frank § 1026 [12 U.S.C. § 5519 (2013)].
23. For a discussion of the legal and practical implications of the guidance, *see* Morrison Foerster, CFPB Fair Lending Guidance for Indirect Auto Lenders—It's Not Just About Cars (June 4, 2013), *available at* media.mofo.com/files/Uploads/Images/130604-CFPB-Auto-Lenders.pdf.
24. *See, e.g.*, CFPB, *supra note* 21, at 4–5 (noting that "indirect auto lenders that retain dealer markup and compensation policies *may wish* to address the fair lending risks of such policies by implementing systems for monitoring and corrective action") (emphasis added).

> Moreover, these single-director agencies usually do not hold broad policymaking responsibilities but instead are involved in expertise-based regulation, such as supervising the safety and soundness of banks or the scientific process of the Food and Drug Administration.[25]

Consistent with this standard approach, early advocates of a consumer financial protection agency anticipated that it would have a commission structure.[26]

A commission structure would allow rules and enforcement actions to reflect multiple viewpoints. The commission could deliberate different theories of consumer protection publicly. By incorporating different views, the commission structure would not suffer from the dramatic director-to-director policy swings that are likely to characterize the agency in its current form. H.R. 1266, by introducing the commission structure, could bring long-term consistency, predictability, and balance to the CFPB.

H.R. 1660, H.R. 2091, H.R. 2213, AND H.R. 2643: REGULATORY STREAMLINING

Financial regulation needs periodic updating to reflect changing conditions on the ground for regulators and regulated entities. The remaining set of legislative proposals makes these types of adjustments. H.R. 2643 would make it easier for state financial regulators to access criminal records housed at the Federal Bureau of Investigation. Similarly, H.R. 2091 would enable state child support enforcement officials to obtain consumer credit reports without giving the consumer the standard 10 days' notice—a requirement that enables delinquent parents to game the system. H.R. 1660, which would enable federal savings associations to engage in the same activities as national banks without shifting to a national bank charter, is consistent with regulatory streamlining efforts being undertaken by the Office of the Comptroller of the Currency in the Economic Growth and Regulatory Paperwork Reduction Act process. Finally, H.R. 2213 would recognize widespread lender implementation difficulties in connection with new CFPB mortgage disclosure rules by allowing lenders additional time to comply.[27]

CONCLUSION

This package of legislative proposals affords an opportunity to revisit the existing regulatory framework. The proposed changes include measures that could encourage financial institutions to take responsibility for their lending decisions, could limit bank regulators' discretion by enhancing regulatory accountability, and could streamline the regulatory framework to enable it to operate more effectively.

25. Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace*, 81 Geo. Wash. L. Rev. 856, 873–74 (2013) (footnotes omitted).
26. *See, e.g.*, Dep't of the Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation 58 (2009) ("The [Consumer Financial Protection Agency] will have a Director and a Board. The Board should represent a diverse set of viewpoints and experiences."), http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf; Consumer Financial Protection Agency Act of 2009, H.R. 3129, 111th Cong., 1st Sess. § 112 (2009) (proposing a board structure for the proposed Consumer Financial Protection Agency). *See also* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. Pa. L. Rev. 100–01 (2008) ("propos[ing] the creation of a new federal regulator—a Financial Product Safety Commission or a new consumer credit division within an existing agency (the FRB or FTC)") (emphasis added); Elizabeth Warren, *Unsafe at Any Rate,* Democracy: A Journal of Ideas (Summer 2007), *available at* http://www.democracyjournal.org/5/6528.php?page=all (advocating a "Financial Product Safety Commission" modeled on—and perhaps located within—the Consumer Product Safety Commission).
27. *See* Trey Garrison, *It's Official: CFPB Will Grant Grace Period on TRID Enforcement: Open-Ended Grace Period Protects Institutions Acting in "Good Faith"*, HousingWire.com (June 3, 2015), *available at* http://www.housingwire.com/articles/34081-its-official-cfpb-will-grant-grace-period-on-trid-enforcement (reporting surveys demonstrating widespread implementation delays).