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Testimony of Ellen Seidman
Director, Financial Services and Education Project, New America Foundation
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Senator Schumer, Representative Maloney and members of the Committee, thank you very much for this opportunity to testify before you concerning the regulatory implications of and guidance we can take from the current market failures. My name is Ellen Seidman, and I am the Director of the Financial Services and Education Project in the Assets and Ownership Program at the New America Foundation. Our project is focused on the development and implementation of policies that will encourage responsible consumer financial services, enabling consumers to use our powerful financial system to build, rather than destroy, their assets.

I also continue to serve as Executive Vice President, National Program and Partnership Development, at ShoreBank Corporation, the Chicago-based bank that is the nation's first and largest community development bank holding company and its largest community development financial institution. I also serve on the Boards of two other large and well respected community development financial institutions, the Low Income Investment Fund and Coastal Enterprises, Inc. Each of these companies is both devoted to and in fact provides responsible financial services for lower income communities, businesses and individuals in the parts of the country they serve.

From 1997 through most of 2001, I was the Director of the Office of Thrift Supervision, the federal agency that regulates the savings and loan industry. I draw on all these experiences for many of the points and recommendations I make today.

Before I get to recommendations, let me step back a moment and consider how we got here. I think there are three root causes: the unsustainable buildup of systemic risk; an antiquated, uneven and frequently ineffective regulatory system; and a loss of alignment between serving customers well and standard business practices.

First, we have allowed systemic risk to build up to what has obviously become an intolerable level. The risks include those that were known but hidden—from consumers, from investors, from participants in the system, from regulators; risks that were unknown, often because firms had created such a degree of complexity that even the best efforts at ferreting out risk would have failed; and risks that were unknowable—the model failures that Chairman Volcker talked about in his Economic Club of New York speech. Excessive leverage and reliance on short-term funding to support long-term assets exacerbated the impact of these risks.

Second, we have both tolerated and allowed to grow a regulatory structure that has two major failures. First, entities performing the same kinds of functions are regulated very differently, with the general effect that business practice flowed downhill to the practices of the least regulated. But second, we have not focused our regulatory attention tightly enough on what really matters. Is finding every last SAR violation really more important than making sure that the recourse on SIVs is adequately capitalized? Or that borrowers have an ability to repay? Our regulatory system has become simultaneously unduly complex, ineffective where it counts, and excessively burdensome on some of the least risky and most consumer-friendly elements of the system.

Getting this balance right is hard. In my tenure at OTS, I know we sometimes got it right, as when we stepped in early to keep thrifts from engaging in payday lending. Sometimes we got it wrong, most spectacularly in the Superior Bank failure. And sometimes we did things that seemed right at the time but had, in retrospect, some negative unintended consequences. An example of this is the sub-prime guidance all the regulators issued in 2001 that to my mind was in part responsible for pushing sub-prime lending out of banks and into less regulated affiliates. But the fact that it's hard means that we'll sometimes get it wrong, not that we are excused from trying.

Third, we have lost incentives for financial institutions to provide high quality, consumer friendly products that provide long-term value. This is a result with many causes: the originate-and-sell business model that, especially when tied to brokering at the front and CDOs on the back, has separated the interests of borrower and lender and of principal and agent; not extending the affirmative service mandate of CRA beyond banks and thrifts; the manner in which CRA and other consumer protections were—or weren't—enforced; failure of financial literacy to keep up with a fast-changing financial world; and not focusing our imagination and creativity on ways to help consumers gravitate to products and services that are beneficial to them while also profitable to providers.

This is not just being nice to consumers. As should be obvious from the mess we're in now, the financial viability of institutions is inextricably linked to that of their customers—including consumers. To give just one example, with the advent of the secondary market, the long-term fixed-rate fully-amortizing mortgage should have been a dynamite product: lenders get to charge for long-term use of money that is likely to be used for a much shorter period and borrowers get a steady, predictable payment schedule that builds equity. Somehow that's not what happened.

So what do we need to do? In the face of the mess families, communities, companies and markets now confront, I believe the critical question is how can we reestablish in our financial markets and companies a long-term, quality-oriented culture that incents all parties to focus their attention on:

- products and services that benefit both lender and borrower;

- complete, accurate and transparent risk assessment and management; and
- profitability and growth that is sustainable over the long term?

Obviously this is not a job solely for a regulatory system, and it is just as obviously not easy. But I think if we set this as a goal, we will have a standard to measure our thoughts and proposals against.

I suggest six critical strategies:

- First, **Effective Enforcement:** the will and financial wherewithal to enforce the laws and regulations we establish. Without this, we are not only allowing bad things to continue to grow, we are fooling ourselves into believing we've resolved problems. And this is not only an issue at the federal level, but also at the state level, where regulatory agencies are frequently starved for resources.
- Second, **Risk Assessment,** namely concentration on enhanced risk knowledge and transparency: within organizations, among organizations, for the public, and to and among regulators, both domestically and internationally. We can no longer afford to have institutions that do not know their own level of risk and that of their counterparties—and regulators who are also in the dark. As noted, this will not be perfect; there will always be unknown and unknowable risks, but let's at least get rid of the hiding.
- Third, **Capital Adequacy,** with increased capital all around. This has three critical effects. First, capital serves as the penultimate guard against institutional collapse. Second, because capital is at risk, it serves to mitigate against excessive and foolish risk-taking, of the "heads I win, tails you lose" variety. Third, if all entities in the system are required to hold a greater amount of capital, demand for returns based on financial leverage should diminish. And by the way, it's time to recognize that in an uncertain world, loss reserves are in practice part of the capital structure and to allow them to serve a counter-cyclical function by building up during good times so they can be drawn down during the bad that will inevitably follow.
- Fourth, **Enhanced Responsibility,** a system where all players have skin in the game, realigning the interests of borrowers, lenders and all those in the chain between money provided and money used. For institutions, it's capital in part, but an explicit continuing residual interest in sold assets whose value depends on future performance should also be considered. And certainly we need to do something about compensation systems—both individual and institutional—that do not recognize back-end risk. What if deferred compensation for executive officers were required to be haircut if the bank received a CAMELS rating of 3 or lower within the following two years—with equivalent sanctions for non-banks? And certainly the days of paying mortgage brokers up-front fees with no hold-back for performance should be over. In this connection, I urge Congress to move ahead with consideration of the two sets of bills related to the mortgage crisis that are pending: those dealing with regulation of the market and those responding to the crisis for homeowners, communities and the markets.
- Fifth, **Regulatory Consistency** across entities that are performing the same tasks, such as providing consumer credit or brokering significant financial services for

consumers, and/or have access to the same kinds of benefits, such as the discount window. At the same time, we need to be cognizant of actual risk and relate it to actual burden. Regulation is a fixed and a hidden cost, and smaller institutions both have fewer options for dealing effectively with regulators and smaller budgets within which to absorb the costs. Again, this is tough, but in enhancing regulation, as I believe we need to do, especially with respect to risk management and consumer protection, it's essential that we not destroy the financial viability of the smaller institutions closest to the people, including community development financial institutions, credit unions and community banks and thrifts.

- Finally, **Aligning Incentives with Practices** that treat customers fairly and equitably, before, during and after their purchase of financial services. There are many ways to do this, including not only consumer protection legislation and regulation—and let me voice my support here for the regulators to stay strong as they move toward final rules under HOEPA, TILA and the Federal Trade Commission Act and for Congress to move forward on pending legislation—but also establishment of a suitability standard for those selling or brokering significant consumer credit products; an enhanced and more broadly applicable Community Reinvestment Act; public information systems that extend beyond the Home Mortgage Disclosure Act to enable the public and the media to see who's being served, who's doing it well and who's doing it badly; improving financial literacy; and barrier removal and incentives to help consumers do the right things, such as the pension opt-out provisions that were incorporated into the Pension Protection Act of 2006.

As markets begin to stabilize or we reach what I suspect will be temporary lulls in foreclosures or house price declines, it will be easy to fall back into believing that the status quo is acceptable, that changing it is too hard, or that enhanced regulation of consumer products will hurt consumers by limiting choice. Such a result would be not only dangerous and a mistake, but also a waste of the trauma and turmoil we've been through. Let's instead use this experience to learn, think creatively, and act.