

TESTIMONY OF  
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On behalf of the  
CONFERENCE OF STATE BANK SUPERVISORS

On  
“REGULATOR PERSPECTIVES  
ON FINANCIAL REGULATORY REFORM PROPOSALS”

Before the  
FINANCIAL SERVICES COMMITTEE  
UNITED STATES HOUSE OF REPRESENTATIVES

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## INTRODUCTION

Good afternoon, Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. My name is Joseph A. Smith, Jr. I am the North Carolina Commissioner of Banks and the Chairman of the Conference of State Bank Supervisors (CSBS).

Thank you for inviting CSBS to return today to continue our discussion on financial regulatory reform proposals. CSBS looks forward to working with Congress and the Obama Administration toward a reform plan that makes meaningful and sustainable improvements to our financial system, while strengthening the existing characteristics that have proven to be critical to serving the public and strengthening the economies of local communities and our nation as a whole.

It is clear to the members of CSBS that some form of financial regulatory reform is necessary. The legacy of this crisis could be a highly concentrated and consolidated industry that is too close to and intertwined with the federal government and too distant and unresponsive to the needs of consumers and communities. That need not be the future of our financial industry, though it is where we are heading. The states' concern about this outcome must not be dismissed as a "turf battle". It is a response to a grave concern that a centralized banking system and industry are in conflict with the health of our state and local economies, the financial wellbeing of our citizens and the future of our locally-based free enterprise banking system that has served our country well. The growing belief that this evolving system is "rigged" to the disadvantage of the average citizen erodes the confidence that is necessary to govern. No amount of sophisticated lobbying by the beneficiaries of consolidation should blur our vision of the threats that it poses or silence this important debate.

To avoid that outcome, Congress needs to realign the regulatory incentives around consumer protection, enhance the “checks and balances” inherent in our dual-banking system, and directly address and end “too big to fail.” To safely and effectively meet the financial needs of the American people, we need a diverse industry with seamless oversight, not a handful of mega-banks answering to a captive behemoth regulator.

The objectives of regulatory restructuring must be to promote and maintain a financial services industry that is safe, sound, diverse, and competitive. This industry must serve consumers with a wide array of understandable services and products that meet a broad range of financial and borrowing needs, and consumers must have confidence in a legal and regulatory structure that protects them from abusive products or providers. The financial regulatory structure must create incentives for innovation and prudent growth, but it also must have robust safeguards to prevent excessive risk-taking and leveraging to preserve the stability of the system and to protect taxpayers from potentially unlimited liability for failed firms.

Unfortunately, many provisions of the Obama Administration’s plan for financial regulatory reform are inconsistent with these objectives. In particular, CSBS is concerned that the Administration’s plan inadequately addresses the systemic risks posed by large, complex financial institutions. The Administration’s plan leaves open the real prospect of creating a bifurcated industry, with one class of systemically significant large institutions that enjoy real and perceived federal preferences, and the remaining institutions that lack the scale and scope to merit an implicit link to the government and the market advantages such a link confers. This disparate treatment is unsustainable and likely would drive non-systemic institutions to the margins or even out of business. Further, other aspects of the Administration’s proposal warrant

further discussion and detail in order to determine whether and how they will serve our broader goals and objectives.

My testimony today will largely be an update from my previous appearance before this Committee on July 24, 2009. My testimony will present our perspective on these issues, discussing five main elements: (1) the proposal to create a new Consumer Financial Protection Agency; (2) concerns about excessive concentration of federal regulatory power; (3) the proposal to apply new federal fees to state-chartered banks over \$10 billion in assets; (4) proposals to improve systemic risk oversight; and (5) proposals to improve supervision of large, interconnected financial firms.

**A FEDERAL CONSUMER FINANCIAL PROTECTION AGENCY SHOULD BE FOCUSED ON RULEMAKING AND MUST REFLECT THE IMPORTANT ROLE OF THE STATES IN CONSUMER PROTECTION**

The Administration's proposed Consumer Financial Protection Agency (CFPA) would be a single primary federal supervisor charged with protecting consumers of credit, savings, payment, and other financial products and services, and with regulating providers of these products and services.

CSBS supports the creation of the CFPA, in concept, and its goals. Public confidence is an essential element of our financial system, and restoring this confidence must be a central goal of this reform effort. Consumer protection standards for all financial service or product providers, such as those to be promulgated by the CFPA, are an important step in restoring and maintaining this public confidence.

Effective consumer protection requires preserving and enhancing the role of the states in setting and enforcing consumer protection standards. Any proposal to create a federal consumer financial protection agency must preserve for states the ability to set higher, stronger consumer protection standards. The Administration's proposal, as well as H.R. 3126, does just that—

explicitly providing that federal consumer protection standards constitute a “floor” for state action. This provision is vital, and any change to the legislation that preempts the ability of the states to adopt consumer protection measures would significantly undermine the very consumer protection goals that H.R. 3126 seeks to serve. To be clear, it would be unacceptable for any federal consumer protection agency to deny states the ability act either in the absence of federal standards or where federal standards do not sufficiently address consumer protection concerns. If the CFPA’s rules were to be made preemptive, or classes of institutions exempted from state consumer protection laws, that would be worse than the status quo and we would be compelled to actively oppose its creation.

As introduced, H.R. 3126 creates a system of regulatory checks and balances that will lead to more effective consumer protection and that need not result in the so-called “patchwork quilt.” The rhetoric about this provision does not comport with reality. We are very aware of the needs of businesses to operate efficiently across state lines. State-chartered banks across the country do so every day, and regulators coordinate and innovate in order to efficiently oversee such operations. In North Carolina alone, we have several state-chartered institutions that operate successfully in multiple states—from coast-to-coast and in between. Efforts to preempt the field for consumer protection laws are not simply about efficiency. This is a strategy to end, once and for all time, the system that has been responsible for developing and testing consumer protections at the state level that have served as the model or impetus for federal action.

Our experience has been that thoughtful and deliberate federal standards will obviate the need for the states to act and, instead, will enable the states to respond to local developments and emerging risks and practices, many of which are occurring outside the depository world. The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) is one very

recent example of a how this “floor not ceiling” approach has led to strong and uniform standards. The S.A.F.E. Act, passed on July 31, 2008, gave the states one year—until July 31, 2009—to pass legislation to meet minimum licensing and registration requirements for loan originators. The states have risen to the challenge and have unified under a Model State Law. As of today, 49 states and the District of Columbia have enacted or introduced legislation implementing the S.A.F.E. Act. Special recognition must go to Ranking Member Bachus, who first developed the S.A.F.E. Act and its state-federal model for regulation and supervision.

H.R. 3126 restores an important balance between state and federal law that has been undermined in recent years by preemptive regulatory actions inconsistent with explicit Congressional mandates. Congress has repeatedly rejected the option of applying broad preemption to national banks. As recently as 1994, with the passage of the Riegle-Neal Interstate Branching Act, Congress explicitly stated that state consumer protection laws applied to national bank branches. It has only been in the past decade that some federal banking agencies have sought to preempt state consumer protection laws by regulatory fiat. So, to be clear, any effort to make either the CFPA or any federal banking agency preemptive for national banks is a rollback of current law.

Additionally, any federal consumer protection legislation must ensure that state authorities continue to have the power to enforce applicable state and federal laws for all financial entities operating within their borders, regardless of charter type. The Supreme Court recently affirmed this authority with its decision in *Cuomo v. Clearing House Association*, and CSBS supports the provisions of the Administration’s proposal and of H.R. 3126 codifying this decision into federal law.

The strong affirmation in the Administration's proposal and H.R. 3126 of the states' role in consumer protection must be reinforced with a significant emphasis on effective and timely coordination and information sharing between federal and state regulators. Any legislation must include explicit mandates and mechanisms for this coordination and information sharing.

To enhance consumer protection while minimizing regulatory and supervisory inefficiencies, the CFPA's primary focus should be on effective and timely rulemaking and data-gathering. CSBS shares the concerns of others about separating consumer compliance regulation from prudential supervision. We see the two as not necessarily in conflict, but rather—with appropriate checks and balances in place—mutually supporting and reinforcing. Consumer complaints not only identify trends, practices, or products that harm consumers, but also indicate that an institution may be operating in an unsafe or unsound manner. Similarly, an institution that is well capitalized, well managed, and safe and sound effectively provides consumer protection by ensuring that consumer accounts are secure. Separating these two policy goals could eliminate this benefit.

Establishing another primary federal examining authority also risks creating additional unnecessary regulatory burdens, especially for state-chartered depository institutions that are already subject to both federal and state regulatory oversight. While we agree that more comprehensive and consistent consumer protection oversight across all providers of financial services will benefit the financial system and consumers, we also believe that regulatory reform should not create regulatory burdens that distort the playing field.

As such, State Banking Commissioners believe that prudential regulators should continue to examine for safety and soundness and consumer protection compliance, with the CFPA retaining back-up examination and enforcement powers to act in a timely and effective manner

when primary prudential or enforcement bodies fail to exercise their authority or where regulatory gaps exist. Similarly, the CFPA should have back-up enforcement powers; with the prudential federal and state regulatory authorities and state attorneys general sharing primary enforcement authority. This back-up enforcement authority will enable the CFPA to take action when prudential or law enforcement authorities have failed to act, without displacing or duplicating existing cooperative enforcement efforts.

This back-up authority should include clearly articulated thresholds and timelines for action that, if not met by prudential and/or enforcement authorities, trigger action by the CFPA. And, the CFPA needs sufficient enforcement resources to prevent regulatory arbitrage or under-enforcement, but it would be unnecessary, and possibly counterproductive, for it to attempt to lead all enforcement efforts on a routine basis.

This structure will allow the CFPA to accomplish its essential consumer protection mission and objectives, but with a smaller, more efficient agency that leverages the existing resources, relationships, and capabilities of prudential and law enforcement authorities at both the state and federal level. The requirement of timelines and standards that prudential and/or enforcement authorities must meet strengthens accountability in the system and better aligns regulatory incentives with consumer protection goals. The CFPA, as CSBS envisions it, would be armed with the necessary data and information to set effective federal minimum consumer protection standards and to collaborate with state and other federal agencies to ensure these standards are being met by all financial market participants.

CSBS believes it crucial that any federal consumer protection proposal include a mechanism for the federal agency to consult with state authorities in developing and implementing these new standards and regulations. While the Administration's proposal and



H.R. 3126 clearly recognize the important role of the states in consumer protection, neither makes provision for state input into the CFPA's rulemaking process. Recent history shows that state officials often bring important prudential and compliance perspectives to consumer protection issues that federal agencies may lack; therefore, it is essential that reform legislation include a provision for mandated consultation between the CFPA and state banking regulators. This would also help ensure a balanced regulatory approach across state and federally chartered and licensed institutions.

In addition to a mandated consultative role for state banking regulators in the CFPA's rulemaking, we believe that the CFPA Board should include one member with state bank supervisory experience. This mirrors the structure of the current FDIC Board and would help ensure a diversity of regulatory perspectives and equitable treatment across different business models and classes of institutions.

Finally, we have significant concerns about the funding burdens of creating a new federal agency. Both the Administration's proposal and H.R. 3126 authorize the CFPA to collect fees and assessments. CSBS is concerned that the institutions that we oversee will bear a disproportionate financial burden. To avoid this, any legislation must require the CFPA to develop a means for equitably spreading the financial burden across the industry without depleting already limited state regulatory resources. Our proposal for a CFPA focused primarily on rulemaking, with existing prudential regulators maintaining their examination responsibilities and authorities, alleviates this concern somewhat as it envisions a smaller agency.

**CREATING A MONOLITHIC FEDERAL REGULATOR WOULD SIGNIFICANTLY WEAKEN THE FINANCIAL SYSTEM**

Some policymakers are discussing the creation of a single monolithic federal banking regulator that would go beyond the Administration's proposal of merging the Office of the

Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) into a new agency, the National Bank Supervisor (NBS). Those advocating further regulatory consolidation propose moving the examination and supervision responsibilities of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) in a new single federal regulator. Creating a monolithic regulator as a means of improving financial regulation relies on the faulty assumption that regulatory consolidation leads to a stronger and safer banking system. In fact, the exact opposite is true: such a proposal would increase the fragility of the financial system by increasing industry consolidation, eliminating needed checks and balances, and subordinating the interests of the consumer to the business goals of a handful of mega-banks.

The creation of a monolithic regulator would drastically undermine the community banking system in the U.S., and would greatly weaken the entire financial system as a result. The U.S. financial system's diversity has been a key to its resilience and stability, and community banks are the bedrock of this diversity and resiliency. Throughout the market convulsions of the past two years, thousands of local and regional banks have continued to make credit available to individuals and businesses alike. This ongoing lending activity has prevented a complete economic collapse and has driven economic recovery and development in localities and states throughout the country.

A single monolithic regulator located in Washington would lack an understanding and appreciation of the local and regional needs that community bankers address day-in and day-out. Instead, it would be far too easy for a distant single regulator to focus on its largest, most complex, riskiest, and most politically prominent institutions.

The inevitable result of this is further industry consolidation. Since the natural tendency of a single regulator would be to tailor its regulatory approach to its largest institutions and to

devote the bulk of its resources to overseeing such institutions, CSBS is concerned smaller institutions, the majority of which are state-chartered, would be severely disadvantaged. Eventually, smaller institutions would simply be unable to compete in an environment where all regulations and examinations are geared towards the behemoth money-center banks. The community banks that have led our economy towards recovery would ultimately be gobbled up by the very institutions that currently survive on government and taxpayer subsidies. This outcome would result in the institutionalization of “too big to fail.”

In addition to the destruction of the community banking system through industry consolidation, the creation of a monolithic regulator would eliminate checks and balances in financial supervision. As British Lord Acton wrote in 1887, “Power tends to corrupt, and absolute power corrupts absolutely.” Our Founding Fathers were wise enough to recognize that those granted power may abuse this power, unless subject to checks upon their authority.

State-chartered institutions benefit from the constructive give and take between their state and federal regulators. The financial system itself has benefited from the debate among state and federal regulators. For example, during the debate over the Basel II capital rules, CSBS and the FDIC advocated for the necessity of a leverage ratio in measuring bank capital. Without the inclusion of the leverage ratio, it is conceivable that our largest institutions would have entered the financial crisis with a lower regulatory capital requirement than they did, making them even more vulnerable to the market downturn. Consolidating existing authority of several agencies under one regulator would severely undermine this system of checks and balances.

The financial crisis has illustrated clearly the need for greater market discipline. Related to this, there needs to be a focus on enhancing and reinforcing regulatory discipline and avoiding a structure that facilitates regulatory capture. Different regulators bring different perspectives

and skill sets that enhance—not reduce—regulatory performance and accountability. And, there is a key difference between a regulator that is also a chartering authority and a regulator that is not a chartering authority. In this regard, the state regulatory system and state-chartered institutions benefit from the involvement of the Federal Reserve and the FDIC. While the views of regulators can certainly conflict, a healthier and more dynamic regulatory environment exists when there is a diversity of regulatory perspectives and authorities are compelled to coordinate and cooperate with one another. Having more than one regulator increases the likelihood that troubling products or practices will be identified early and responses will be timely.

Ultimately, CSBS is concerned the creation of a single federal regulator would be the beginning of the end of the state system: as consolidation accelerates, smaller institutions will be further disadvantaged, and the largest and most politically influential institutions will reinforce the primacy of the federal system. Consumers and the industry will be best served by more coordination and cooperation between regulators, not by the elimination of regulators through consolidation.

#### **NEW FEDERAL FEES ON STATE-CHARTERED BANKS OVER \$10 BILLION WOULD LEAD TO INDUSTRY CONSOLIDATION**

The Administration’s regulatory restructuring plan also includes a proposal that the FDIC and the Federal Reserve charge for their examinations of state-chartered banks over \$10 billion in assets. CSBS believes this proposal is discriminatory, will damage the dual-banking system by causing further consolidation into the nation banking system, and will not add any additional supervisory oversight to the banking system.

The new examination fee will be in addition to what state banks already pay for supervision. The proposed new fee would be a third payment on top of the fees state-chartered banks pay to their primary regulators and to the FDIC’s Deposit Insurance Fund. In effect, the

new fee would be a prejudicial tax imposed on state banks. Ultimately, this proposal seeks to push all banks over \$10 billion into the national banking system and will undoubtedly lead to further consolidation of the financial industry.

The current exam fee and regulatory structure for state-chartered institutions provides for efficient and effective regulation. State-chartered banks currently pay exam fees to their state banking regulators. States vary in their methods of calculating exam fees, but state exam fees for state-chartered institutions of a given size are generally lower than those of a similarly sized federally-chartered institution. Further, like all federally-insured depositories, state-chartered banks pay deposit insurance premiums to the FDIC. State-chartered banks that are members of the Federal Reserve System are required to hold stock in their regional Federal Reserve Bank.

Additionally, all federally-insured depositories—regardless of charter—are subject to consistent requirements regarding frequency of examinations. In the case of state-chartered institutions, state banking regulators have arrangements with the FDIC and the Federal Reserve for joint or alternating exams, providing an added regulatory perspective.

The Administration's proposal to collect additional examination fees for state-chartered institutions is not a new idea. To date, both Democratic and Republican controlled Congresses have rejected similar proposals on eight separate occasions. Further, and perhaps most notably, the FDIC and Federal Reserve also have rejected the need for exam fees. The FDIC and Federal Reserve have had the authority to charge for examinations, but they have chosen not to, and have never supported this proposal.

Another area of concern for the states is that this proposal means higher costs for the vast majority of the banking industry with no additional safety and soundness supervision. Contrary to its stated goal, this proposal has the perverse consequence of eroding supervision.

State-chartered institutions over \$10 billion in assets will move to the national system to avoid fee duplication, leaving only the smallest institutions in the state system. As a result, over 80% of industry assets would be under the national bank regulators with the states still regulating 70% of all institutions, funded only by an assessable base of 20% of industry assets. The fixed costs of supervision at the state level will be spread across a much smaller asset base, causing the fees on smaller institutions to rise.

Meeting the funding needs of improved federal financial regulation and avoiding regulatory arbitrage are important objectives. However, imposing an unfair assessment only on larger state-chartered institutions does not make meaningful progress toward either objective. Despite the claims, this proposal's financial benefits for smaller institutions are, at best, questionable. Unfortunately, this proposed fee structure will result in higher exam fees for smaller institutions. Instead of continuing to punish community banks for the risky practices of the nation's largest banks, policy makers should focus on ensuring that the largest, most complex and problematic institutions bear more of the cost of regulation through fees such as the proposed systemic risk assessment.

#### **THE FINANCIAL SERVICES OVERSIGHT COUNCIL SHOULD INCLUDE REPRESENTATIVES OF STATE FINANCIAL REGULATORS**

The Administration's plan proposes the creation of a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve Board on the identification of Tier 1 financial holding companies (FHCs), and provide a forum for resolving jurisdictional disputes between regulators. The states agree on a need for a council of multiple regulators charged specifically with the coordination of supervisory efforts to limit the systemic risk posed by certain financial firms.

We are concerned that the current proposal does not include a provision for state involvement in the Financial Services Oversight Council. The proposed Council would include the Treasury Department, the Federal Reserve Board, the proposed NBS, the proposed CFPB, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the FDIC, and the Federal Housing Finance Agency, but no state financial regulator. Given the Council's broad mission, the exclusion of state financial regulators will seriously curtail the Council's view of the financial system and emerging risks. A lack of state participation will impede the Council's stated goals and is simply unacceptable.

The vast majority of insured financial institutions operating within the United States are currently chartered and regulated by the states. States also have oversight of those financial service providers that are not affiliated with a depository institution, such as mortgage brokers, money services businesses, check cashers, and consumer finance companies. States have primary regulatory and supervisory authority over insurance companies, some of which have proven to pose systemic challenges to other financial institutions. Because of our proximity to and knowledge of the entities we regulate, the local economic conditions and consumers, states are often the first to identify emerging trends, practices, products or threats that impact the financial system. An Oversight Council that does not include some mechanism for state involvement will not be informed by this knowledge and proximity and, accordingly will be less likely to fulfill its statutory mission.

The existing Federal Financial Institutions Examination Council (FFIEC) coordinates examination policies and procedures among the federal banking agencies, with input from a State Liaison Committee. CSBS recommends that the Financial Services Oversight Council incorporate a similar State Liaison Committee, comprising state regulators of banks, insurance

companies, securities firms, and mortgage companies. This State Liaison Committee could include other state regulators as needed, to address the regulatory requirements of related industries, such as payday lenders, prepaid funeral contracts, check cashing, money transmitters, real estate appraisers, or any other state-regulated financial service.

The State Liaison Committee would work with the Financial Services Oversight Council through designated staff, but should also provide voting members to the Council. These members would communicate the State Liaison Committee's deliberations on emerging risks and practices. The state members would also serve as a conduit of information from the Council to the state regulatory agencies. This approach would not only encourage a consistent approach to regulation among all state and federal agencies, but also help to identify gaps in regulation or supervision.

**AN EFFECTIVE RESOLUTION REGIME FOR SYSTEMICALLY SIGNIFICANT INSTITUTIONS SHOULD BE FOCUSED ON MANAGING FAILURES IN AN ORDERLY FASHION AND MUST ALLOW FIRMS TO FAIL**

The President's plan recommends the creation of a resolution regime based on the FDIC's systemic risk exception; that is, a system that would prevent the disorderly closure of a failing bank holding company, including Tier 1 FHCs, if that closure would have serious adverse effects on the financial system or the economy. CSBS supports this recommendation, but has concerns with the procedure outlined by the Administration's proposal.

Under the current proposal, the resolution regime could be initiated by the Treasury, the Federal Reserve, the FDIC or the SEC. Resolution authority would be invoked after consultation with the President and a 2/3 majority of the Federal Reserve Board and the FDIC Board of Directors, but the Treasury would hold the ultimate authority over whether and how to resolve a failing firm, with broad authority to take any necessary action.



Under the proposal, the resolution regime would have the ability to establish conservatorship or receivership for a failing firm. In addition, however, the regime could stabilize a failing institution by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm. In short, the resolution regime would be allowed to use current subsidization techniques to prop up failing institutions. If this provision is written into law, it will effectively allow all systemic institutions to evade the consequences of their risky business practices or unsafe decisions.

If we hope to avoid future calamities that leave taxpayers on the hook for billions of dollars, Congress must not allow the resolution regime to have the power to bail out failing institutions. Firms that are not able to remain in business without taxpayer subsidies must fail. The resolution regime's priority should be to manage these failures in an orderly fashion.

Therefore, we recommend that the FDIC be designated conservator or receiver of any institution that comes under this new resolution regime. Additionally, an institution receiving either a systemic exemption to prompt corrective action or funding from the Federal Reserve's emergency lending facility should automatically be transferred to FDIC conservatorship. The FDIC is an independent agency that has the expertise and experience with managing and/or resolving troubled and failing institutions.

#### **REGULATORY STRUCTURES AND INCENTIVES MUST NOT ENCOURAGE THE EMERGENCE OF "TOO BIG TO FAIL" INSTITUTIONS**

The Administration's plan would grant the Federal Reserve Board authority and accountability for consolidated supervision and regulation of Tier 1 FHCs. The prudential standards for Tier 1 FHCs would be stricter and more conservative than those applicable to other financial firms, in order to account for the greater risks that their potential failure would impose on the financial system.

CSBS agrees in principle that the regulatory system would benefit from a single agency tasked with supervising systemically significant financial institutions. While the Federal Reserve Board's current authority as "umbrella supervisor" under Gramm-Leach-Bliley would make the Federal Reserve Board a logical candidate for the systemic risk regulator, CSBS does have some concerns regarding the Federal Reserve Board's ability to serve in this capacity.

Under current statutes, the Federal Reserve has extensive authority to serve as the umbrella supervisor for the financial services industry. Further, we do not believe that any other single agency is a better candidate for this role. That said, we think that consolidated supervision in a single agency eliminates valuable checks and balances to the system and effectively minimizes resources and expertise that should be applied to this crucial activity. We suggest, therefore, that any agency charged with supervising and regulating these large, interconnected institutions must report, in turn, to the Financial Services Oversight Council. Requiring the systemic risk regulator to consult with and perhaps even seek approval from the Council will maintain the system of checks and balances and will provide the responsible agency with an array of external opinions and experience.

More broadly, however, the Administration's plan appears to concede that some Tier 1 FHCs will always be "too big to fail." We do not agree with this assumption. The current crisis has proven that our regulatory structure was simply not capable of properly supervising the nation's largest firms. When it became evident these firms were insolvent, the federal government felt obligated to prop them up, as their failure would have far-reaching, systemic consequences. This decision was difficult, but necessary. The government's subsidization of these institutions has cost American taxpayers billions of dollars and left our government and nation facing tremendous residual liabilities.

As long as some financial institutions are considered too big or too important to fail, no regulatory regime will be able to regulate or supervise them effectively. Instead of repeating these actions in the future, CSBS urges Congress to prevent these firms from becoming too big to fail in the first place. While we believe the Administration's proposal to impose more stringent prudential standards upon Tier 1 FHCs will provide some disincentive from becoming "too big to fail," eventually firms will evade these standards, just as they maneuvered around deposit caps.

We believe it is necessary for Congress to outline these higher prudential standards clearly to ensure that they discourage an institution from becoming "too big to fail" and to demonstrate the real market cost of being a systemically significant institution. We recommend that Congress consider the following requirements for all Tier 1 FHCs:

1. Minimum consolidated capital requirements, including a minimum leverage capital ratio, above the minimums required for other bank holding companies. Regular issuance of non-government guaranteed subordinated debt should, in general, be a component of these requirements with exceptions subject to the approval of the consolidated supervisor.
2. Maintenance of a liquidity risk management plan that is approved at least annually by the consolidated supervisor.
3. Higher PCA standards than are required for non-systemic firms.
4. Maintenance of a liquidation plan that is approved at least annually by the consolidated supervisor.
5. Payment of regular assessments into a fund established for the purpose of resolving Tier 1 holding companies. The assessment will be set annually, or more

frequently as events warrant, by the Financial Services Oversight Council. The fund would be managed by the FDIC separately from the DIF. The fund can be used to facilitate the resolution of Tier 1 FHCs or supplement the deposit insurance fund in times of broad economic stress.

### **FINANCIAL REGULATION MUST BE COUNTER-CYCLICAL**

As we work to restructure our system of financial regulation, we also need to evaluate the process of financial supervision. We are in need of an approach to financial supervision which is more counter-cyclical. To fully achieve this, we need a forward looking supervisory approach and we need to require the industry to build capital and reserves during good economic times when they can most afford to do so. We also believe it is necessary to provide some relief from current accounting and regulatory constraints that make it more difficult to restructure stressed institutions than is necessary.

To achieve our supervisory objectives, we need a change in examination philosophy. The current examination approach, while it includes an institution's policies and practices, is largely driven by quantitative factors. We need a more proactive approach which utilizes informal and formal enforcement powers to address weaknesses in an institution's practices and asset concentrations, regardless of the earnings performance and quantifiable condition of the bank.

In making this assessment, there is tremendous value in the perspective of local public officials and examiners who live and work in these communities. These are the regulators who have the best access to local markets and commercial activity. My colleague, Sarah Bloom Raskin from Maryland, talks about the "crab count" as a key economic driver for many of her banks on the eastern shore. My colleagues in the Midwest are familiar in real time with

agricultural output and the value of farm land. In North Carolina, we are in constant touch, directly and through a broad-based Banking Commission membership, with local businesses, governments and consumers. All of us are also in constant touch with community and regional banks, through which we obtain valuable information regarding local and regional economic conditions. This information is obtained and used at the local level well before it reaches the national economic databases.

Fortunately, the states have examination personnel with the skills and ability to implement this new approach. However as leaders, we must have the political courage to support their judgments. This can be very difficult when the economy is strong and banks are making money.

We must develop better tools for off-site monitoring. The banking industry has a well established and robust system of quarterly data reporting through the FFIEC's Report of Condition and Income (Call Report). This provides excellent data for use by all regulators and the public. We need to explore greater standardization and enhanced technology to improve the timeliness of the data, especially during times of economic stress.

We will not be able to, nor should we desire, to eliminate all problems in banks. While they are regulated and hold the public trust, financial firms are largely private enterprises. They should be allowed to take risks, generate a return for shareholders, and suffer the ramifications when they miscalculate. In contrast to institutions deemed too big to fail, this process works for a majority of institutions. Our best protections during an economic decline are strong reserves and high capital standards. Bank regulators need to regain control over the accounting rules as they pertain to a bank's allowance for loan and lease losses. The widely expected approach that the level of reserves should track with the quality of the loan portfolio, left community banks in

the cross hairs of the accounting profession and some of the federal regulators who criticized banks for not being able to fully support their high level of reserves. As a result, I believe some banks entered this recession with far fewer reserves than they would have preferred.

We support the Treasury Department's September 3 announcement of core principles for regulatory capital standards. Higher capital standards, especially for systemically significant firms, will enhance the stability of the financial system. The Administration calls for high quality forms of capital in all firms and substantially higher capital requirements for Tier 1 FHCs. This is a significant step towards increasing the cost of being a significant risk to the financial system, as firms are forced to internalize the costs of this risk.

The largest institutions have long promised that their size and complexity minimized their risks, allowing them to hold lesser amounts of capital. According to the FDIC, as of December 31, 2007, banks over \$10 billion in assets had an average leverage capital ratio of 7.41%. This was 200 basis points (b.p.) less than banks with assets between \$1 billion and \$10 billion, 256 b.p. less than banks with assets between \$100 million and \$1 billion, and an astonishing 610 b.p. less than bank with assets less than \$100 million. As the financial crisis was unfolding and the serious economic recession began, our largest institutions were poorly positioned leading to the extraordinary assistance by the federal government to protect the financial system. Even with this assistance, this differential continues today with the largest institutions holding considerably less capital than the overwhelming majority of the industry. Meaningful, higher capital standards are a must to provide the foundation for counter-cyclical regulation and should be adopted immediately.

As we work to improve capital standards, Congress should also investigate the effectiveness of Prompt Corrective Action (PCA) during the recent crisis. We believe there is

sufficient evidence that the requirements of PCA have caused unnecessary failures and more costly resolutions.

Congress should also consider how the deposit insurance fund can help to provide a counter-cyclical approach. We believe Congress should authorize the FDIC to assess premiums based on an institution's total assets, which is a more accurate measure of the total risk to the system. Congress should revisit the cap on the fund and require the FDIC to build the fund during strong economic times and reduce assessments during periods of economic stress. This type of structure will help the whole industry when they need it most.

#### ***DE NOVO INTERSTATE BRANCHING***

CSBS supports the Administration's proposal to eliminate the remaining restrictions on interstate banking. While Riegle-Neal intended to leave this decision in the hands of the states, inconsistencies in federal law have created contradictory rules about how financial institutions can branch across state lines. The contradictions affect state-chartered banks disproportionately. Federally-chartered savings institutions are not subject to *de novo* interstate branching restrictions, and creative interpretations from the Comptroller of the Currency have exempted most national banks as well. The Administration's proposal would restore competitive equity by allowing *de novo* interstate branching for all federally-insured deposit institutions.

#### **RETAINED ECONOMIC INTEREST ("SKIN IN THE GAME")**

The Administration's proposal includes a requirement that loan originators or sponsors retain an economic interest in a material portion of the credit risk for any such loan that the creditor transfers, sells or conveys to a third party. As we have no experience with such a requirement, we do not know what the impact will be, but it is not unreasonable to imagine such

a requirement could reshape the mortgage industry and have a significant impact upon credit availability.

In our experience, corporate risk alone may not alter our outcomes. Both bank and nonbank lenders that seemingly had “skin in the game” made risk decisions that resulted in their failure. And more would have failed if not for government intervention. It is possible that risk retention could have the opposite of the desired effect. It could result in an industry consolidation that creates more banks that are considered too big to fail that pose even greater and seemingly intractable risks to our financial system and economy. Additionally, from our state perspective it is not difficult to imagine an industry so consolidated and systemic that it is seemingly unaccountable to consumers.

If the goal is to encourage sound underwriting and good origination practices there may be better and more holistic ways to revise the current system of originations. One possible idea would be to limit an originator’s upfront earnings potential by spreading a future income stream out over the life of the loan. Our belief is that the transparency provided by unique identifiers applicable to the entire industry of originators also provides important incentives and checks on poor lending standards and abusive practices.

## **CONCLUSION**

CSBS applauds this Committee and the Administration for seeking a comprehensive response to the obvious need for improvement in our system of financial regulation. We now look to the members of this Committee to bring your specialized knowledge and legislative experience to this proposal in order to ensure that it accomplishes its stated objective: a system to ensure a safer, sounder financial system that provides fair, stable access to credit and investment to all sectors of our economy.



We look forward to working with you toward a solution that reduces systemic risk, assures fairness for consumers, preserves the unique diversity of our financial system, and enhances state-federal coordination to create a seamless network of supervision for all industry participants.

Thank you again for the opportunity to share our views this afternoon. I look forward to any questions you may have.