Office of Thrift Supervision
Department of the Treasury

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July 23, 2009

The Honorable Spencer Bachus
Ranking Member
U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Ranking Member Bachus:

Thank you for your letter dated July 13, 2009, concerning H.R. 3126 the Consumer Financial Protection Agency Act of 2009. This bill would establish the Consumer Financial Protection Agency (CFPA) to regulate the provision of consumer financial products and services. Except in limited circumstances, the Federal banking agencies (FBAs) and the Federal Trade Commission (FTC) would cease to have consumer protection authority with respect to consumer financial products and services.

The legislation is intended to increase the protection of consumers from financial abuse. We wholeheartedly support the goal of this legislation. Nonetheless, we are concerned that creating a separate regulator for all aspects of consumer protection may not recognize the important business linkage between consumer protection and safety and soundness. OTS examination programs recognize the linkage, and for the past seven years we have conducted comprehensive examinations to assess institutions' risk management programs, business strategies, operations, and compliance and consumer protection programs.

The current financial crisis is the result of numerous failures, including the failure of the FBAs to identify and respond to problems in a timely manner. Improvements in consumer protections are necessary in order to ensure that similar problems do not occur in the future.

We believe that one of the core causes of the financial crises was the lack of supervision and regulation of non-bank lenders. Among other things, these lenders are not examined and are not subject to regulatory scrutiny with respect to consumer protection laws and regulations in the same manner as depository institutions. H.R. 3126 would allow the CFPA to examine non-bank lenders for compliance with the full panoply of consumer protection laws and regulations. We believe this is a step in the right direction. However, we continue to believe that the FBAs should comprehensively examine and supervise insured depository institutions.

Your letter poses a number of questions for our consideration. Our answers to those questions follow.

1. **<u>What problem would be addressed by the creation of a CFPA that is not or cannot be addressed by the current system of financial institution and product regulation?</u>**

One of the causes of the financial crisis was the inability of the regulatory system to protect consumers from inappropriate financial practices. In particular, effective supervision and regulation of nonbank financial providers would go a long way to ameliorating this problem.

The Administration's regulatory restructuring proposal noted that 94 percent of the high cost mortgages occurred outside of the regulated banking industry. As a general matter, these entities are not examined and are not subject to the same regulatory scrutiny with respect to consumer protection laws and regulations to the same extent as depository institutions. Short of creating a new agency, Congress could enact legislation mandating that <u>all</u> providers of financial products and services are subject to examination for compliance with consumer protection laws and regulations and are subject to the same Federal supervision and oversight with respect to the provision of such products and services.

2. **<u>How would the new consumer protection standards established in H.R. 3126 impact the availability of credit for consumers? Would any particular category of consumers be affected more than others?</u>**

The CFPA's objectives explicitly include ensuring that, "markets for consumer financial products or services operate fairly and efficiently with ample room for sustainable growth and innovation" and that "*traditionally underserved consumers and communities* have access to financial services". <u>See</u> section 121(b). (emphasis added)

Moreover, the CFPA would operate under rulemaking standards that require it to consider potential costs and benefits to consumers. <u>See</u> Section 122(b)(2)(A). Losing access to credit would certainly be a "cost" to consumers. However, we are concerned that the new agency could operate in a manner that would limit business options and constrain financial services products and innovations.

The legislation appears to attempt to mitigate such concerns and address a potentially adverse impact on credit availability by requiring the CFPA, in proscribing rules, to consult with the FBAs or other federal agencies for consistency with prudential, market or systemic objectives. <u>See</u> Section 122(b)(2)(B). However, it is unclear how much weight such consultations would carry and how any conflicts or differences of opinion would be resolved.

H.R. 3126 would also require the CFPA to issue rules or guidance that apply where a firm offers "alternative" products of the same type or class as "standard" products. "Standard" products are generally defined to include products whose terms and features are transparent to consumers, pose lower consumer risks, and where a comparison of benefits and costs to less

straight forward products is readily available. The CFPA would be empowered to adopt rules that would apply to firms that offer both standard and more complicated "alternative" products, including warnings about heightened risks of alternative consumer financial products or services and providing consumers with a meaningful opportunity to decline the "standard" product or service before accepting alternative products and services.

Although the legislation appears to run the risk of steering consumers into "one size fits all" products and limiting consumer choice, it is difficult to assess the potential impact on credit availability prior to the development of these and other rules identified in H.R. 3126.

3. **One of the directives given to the proposed agency is to coordinate with a variety of other agencies, both state and federal, to "promote consistent regulatory treatment of consumer and investment products." However, the legislation would permit individual states to pass laws that will differ from federal law. What would be the impact on consumers and the institutions you regulate if individual states can impose additional and different standards?**

Several negative consequences for consumers and institutions likely will result if individual states are permitted to impose additional and different standards for consumer and investment products.

First, a patchwork quilt of differing state laws governing different products would undoubtedly develop. It would be extremely difficult for federal saving associations, which are authorized to exercise their lending powers in accordance with a uniform federal framework of regulation, to comply with such a wide range of differing, and potentially conflicting, state laws on various consumer and investment products.

Second, efforts by depository institutions to comply with differing state laws would likely be expensive and time consuming, and could increase the cost of making credit available to consumers. For institutions, the result would be burdensome; for consumers, obtaining credit may become more expensive.

Third, some institutions may decide to limit lending activities to certain states, stop lending in other states, or significantly cut back on offering consumer loans and investment products, with the result that credit and other products may become less readily available to consumers. Consumers also may have fewer potential lending sources.[1]

Fourth, the notion that individual states could pass laws that are different from federal law is inconsistent with the concept of "promot[ing] consistent regulatory treatment of consumer

[1] We note however that the CFPA's objectives explicitly include ensuring that, "markets for consumer financial products or services operate . . . with ample room for sustainable growth and innovation" and that "traditionally underserved consumers and communities have access to financial services". See section 121(b).

and investment products" as specifically set forth in the Administration's regulatory restructuring plan. Similarly, the CFPA would not be able to write consumer-friendly disclosures that can be used nationwide, as is required by H.R. 3126, if states can impose additional requirements. Whatever disclosures the CFPA promulgates to address federal requirements would need to be supplemented with state (and local) disclosures.

Finally, in the case of conflicting state laws, institutions may find it difficult to determine which of two or more conflicting state laws governs a specific situation, particularly if each state asserts that its law applies. In sum, there could be significant effects on both consumers and institutions if individual states are permitted to pass laws that differ from the federal laws that apply to federal savings associations.

4. **The legislation envisions the separation of safety and soundness regulation from consumer protection regulation. How would this separation impact the safety and soundness of banking institutions? How would it enhance or undermine safety and soundness, in your view?**

The separation of safety and soundness and consumer protection regulation poses significant regulatory challenges and would create an unnecessary burden on financial institutions. OTS conducts one comprehensive examination of both safety and soundness and consumer protection. This comprehensive examination is designed to efficiently and effectively provide an overall assessment of an institution's risk profile. Consumer protection is an integral part of an institution's business. Consumer protection issues can create significant risks and can have significant impacts on an institution's safety and soundness.

A sound risk management program must identify, measure, monitor, and control the risks inherent in an institution's various products and lines of business. If an institution's risk management program does not do this, then the institution is operating in an unsafe and unsound manner regardless of whether the shortfall is in consumer compliance or safety and soundness. Dividing the regulation of safety and soundness and consumer protection would undermine the safety and soundness of the banking system and weaken a regulator's ability to formulate a complete assessment of a financial institution's risk profile. There is a strong connection between consumer protection problems in institutions and safety and soundness issues. For example, an increase in consumer complaints is often a leading indicator of a safety and soundness problem.

The bifurcation of prudential and consumer protection regulation in separate agencies may lead to conflicts among the agencies. Moreover, neither agency may have the benefit of complete information with respect to a particular institution. This bifurcation of regulation may ultimately result in increased costs for financial institutions and weaker regulatory authority in general.

5. **<u>Does your agency have a separate consumer protection compliance examination force? If not, how could the consumer compliance examination function be transferred to a new agency and what would be the impact of the transfer on your safety and soundness supervision?</u>**

The OTS examination force includes accredited compliance examiners. In addition, a number of OTS's safety-and-soundness examiners are also trained in compliance issues and become involved in compliance assessments. We view compliance and consumer protection as a vital and integral aspect of an institution's business. Poor compliance policies and practices present a serious safety and soundness issue and are often an indicator of other operational risks. As such, OTS conducts a single comprehensive examination of both safety and soundness and consumer protection areas. The comprehensive examination is efficient and effective and provides a more complete assessment of an institution's risk profile. The transfer of the consumer compliance examination function to a new agency would create significant supervisory challenges and may cause unnecessary burden on financial institutions.

6. **<u>H.R. 3126 requires coordination and consultation between the CFPA and the Federal banking agencies. However, it does not offer a framework or mechanism in the event there is not a consensus. Please comment on any legal problems or challenges that would be presented by this proposal.</u>**

In the event of a conflict between the CFPA and the prudential regulator, the depository institution would be left without a clear direction as to which practice to follow. For example, the CFPA could mandate that an institution offer a particular product to certain consumers and the prudential regulator could later deem that offering that product in that circumstance was not appropriate. Indeed, in a period of rapidly rising interest rates, certain fixed rate mortgages could be inappropriate for the institution to keep in portfolio. If the CFPA and the prudential regulator could not reach agreement, the institution could be engaging in unsafe or unsound practices.

Despite the good faith efforts of the prudential regulators and the CFPA, bifurcating consumer protection regulation from safety and soundness may ultimately lead to conflicts between the agencies, with financial institutions and consumers stuck in the middle. At a minimum, there would be delays until such conflicts were resolved. Absent a specific statutory method for resolution, conflicts between Federal government agencies are resolved by the Department of Justice Office of Legal Counsel (OLC). This process, however, is lengthy, and the OLC has no expertise in regulation of financial institutions, products or services.

7. **<u>H.R. 3126 provides for each of the Federal banking agencies to transfer consumer financial protection functions to the new agency. Such functions are defined to mean "research, rulemaking, issuance of orders or guidance, supervision, examination, and enforcement activities, powers, and duties relating to the provision</u>**

of consumer financial products and services". Please identify all of the functions within your agency that would be transferred under this provision? Does it affect underwriting standards for mortgage loans? Insider lending rules? Lending limits? Anti-money laundering compliance? If so, what would be the impact of the transfer on safety and soundness?

The intended scope for the transfer of consumer financial protections functions is unclear. Section 161(a) would transfer all consumer financial protection functions, as well as powers and duties relating to consumer financial protection functions from OTS and the other federal banking agencies to the CFPA. "Consumer financial protection functions" is broadly defined in section 161(d) to mean "research, rulemaking, issuance of orders or guidance, supervision, examination, and enforcement activities, powers, and duties relating to the provision of consumer financial products and services, including the authority to assess and collect fees for those purposes, other than functions under the Community Reinvestment Act." The only exception indicated in section 161(b) is the authority of the OTS and the other federal banking agencies to exercise "backstop enforcement authority" against an institution under section 122. Otherwise, section 161(c) would prohibit OTS and the other federal banking agencies from assessing and collecting fees to cover the cost of conducting consumer financial protection functions.

The definition of "consumer financial protection functions" is so broad that it could potentially be read to prohibit OTS and the other federal banking agencies from retaining any staff with consumer law expertise to handle necessary duties such as advising agency officials on whether rules and guidance on safety and soundness and operational issues, or applications for new activities or new institutions, raise consumer law issues. If the broad ban on assessing and collecting fees were to apply to such necessary services, the OTS and other FBAs could not pay for such services unless funds were appropriated and made available for such a purpose.

While section 101(16) lists certain "enumerated consumer laws," the transfer of functions under section 161(a) appears to go well beyond responsibilities under laws on this list. Indeed, a multitude of laws beyond the "enumerated consumer laws" apply to the provision of consumer financial products and services. Some of these are consumer laws that are closely related to those on the list but not mentioned in the bill, such as the fair lending provisions of the Fair Housing Act, the Homeowners Protection Act of 1998, the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, and the Telephone Consumer Protection Action of 1991. Others are requirements not generally regarded as consumer laws but that certainly relate to consumer financial products and services, such as loan underwriting standards, insider lending rules, lending limits, and anti-money laundering compliance. These requirements have very significant safety and soundness and operational implications for institutions, which would be beyond the jurisdiction, expertise and mission of the CFPA as described in the bill. If the bill were interpreted to prohibit OTS and the other federal banking agencies from exercising authority involving safety and soundness or operational matters when related to consumer

financial products or services, an enormous loophole would be created that would expose institutions and the public to huge risk.

8. Does the proposed CFPA get at the heart of what caused the mortgage crisis?

In previous testimony,OTS[2] provided the following analysis that is germane to the discussion of whether the proposed CFPA gets to the heart of what caused the mortgage crisis.

> 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.
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> 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.
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> 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.

Further, OTS cited the competition in the mortgage market between regulated and less regulated entities that fostered, in some cases, the lack of transparency for consumer products and the development of complex residential mortgages whose risks were little understood. For consumers, OTS testified, the full terms and details of mortgage products need to be understandable. For investors, the underlying details of their investments must be clear, readily

[2] "Modernizing Bank Supervision and Regulation", Committee on Banking, Housing and Urban Affairs, United States Senate, March 19, 2009.

available and accurately evaluated. Transparency of disclosures and agreements should be addressed. As was stated:

> 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.
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> 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.

In summary, OTS fully supports the concept of an "umbrella" regulation of mortgages that would cover all entities that offer residential mortgages from **both a safety and soundness as well as consumer protection perspective**. It has been our experience that both elements are important, and the presence of both objectives within a single entity provides a useful dynamic tension between the two goals of safety and soundness and consumer protection. Therefore, while we support an overarching regulatory framework for residential mortgages that addresses

the root causes of the current mortgage crisis, we do not think that a separate agency that only addresses consumer protection issues is the appropriate response.

9. **H.R. 3126 provides for the agency to approve "standard" financial products and services. What would be the impact of this proposal on product innovation, especially when you consider the risks, expenses, and compliance requirements (e.g., disclosure and opt-out requirements) associated with the creation or sale of other than standard products?**

Without the benefit of a better explanation of the features and terms of a "standard" financial product, it is difficult to answer this question. On its face, any requirement to offer a standard product to a consumer considering an alternative product will cost a lender more in terms of time and up front costs. However, giving a consumer more than one choice is a good business practice. In the short term, we believe this approach may have a negative impact on product innovation. In the longer term, the impact is unknown.

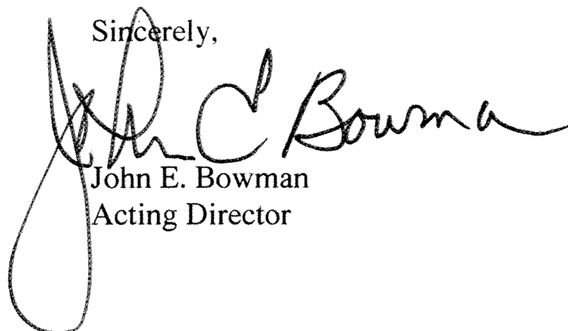
10. **What will be the impact on consumers if banking and some insurance products are subject to regulation by the new agency, but economically similar investment products are subject to a different form of regulation by the SEC?**

The FBAs often work together to develop rules and regulations that are consistent among the agencies. From our practical experience, we believe the CFPA could work together with the SEC to ensure that comparable rules and regulations are developed for products that are economically similar. Section 116 provides for such coordination, as appropriate, to promote consistent regulatory treatment of consumer and investment products and services. In our opinion, this approach recognizes that products that are economically similar may not be identical in terms of execution of contract benefits, risks, product features, contractual terms and legal precedents.

However, there is always the risk that the CFPA will see its mission of protecting consumers as substantially different than the SEC's mission of protecting investors and will not work together with the SEC. Therefore, this is another area of potential conflict among regulators.

Your thoughtful questions raise important issues that Congress should consider in its deliberations of H.R. 3126. We hope that our responses are helpful. If you have questions or wish to discuss this information further, please do not hesitate to contact me or Barbara Shycoff, Managing Director of External Affairs at (202) 906-6288.

Sincerely,



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