Consumer Federation of America

Testimony of

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Before the

Committee on Financial Services
United States House of Representatives

Regarding

Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

July 16, 2009

Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education. I greatly appreciate the opportunity to appear before you today to testify about the President's Plan for Financial Regulatory Reform.

The President's regulatory reform plan offers a sound foundation on which to build strong, comprehensive legislation to restore the integrity and stability of our nation's badly damaged financial system. Although there are gaps that will need to be filled and provisions that will need to be strengthened, the plan correctly identifies the necessary component parts of a comprehensive reform package. First and foremost, it recognizes the paramount importance of closing gaps in our financial regulatory system, ensuring that all aspects of the financial system are subject to an appropriate level of oversight. It seeks to strengthen regulations in areas where weak laws contributed to the near collapse of the financial system. It recognizes the important roles that consumer and investor protection play in ensuring not only the fairness but also the stability of the financial markets. And it seeks to reduce systemic risk through a combination of measures designed to better alert regulators to looming threats, improve the ability of financial institutions to survive periods of economic stress, and create a mechanism to allow for the orderly failure of non-bank financial institutions.

Despite its many positives, there are aspects of the plan that will require substantial work as the legislation to implement it takes shape in Congress over the coming months. The plan's provisions on credit rating agencies, in particular, are weak considering the central roles these agencies played in causing the current crisis. Also largely missing is a broad agenda of corporate governance reforms needed to restore effective board oversight and accountability at our public companies and financial institutions. Moreover, as the legislation is drafted to implement the Administration's derivatives plan, care will need to be taken to ensure that as much of the market as possible is traded on regulated exchanges and that dealers cannot easily evade the requirements for central clearing and exchange trading. Finally, if Congress pursues the Administration's plan of designating the Federal Reserve as the lead systemic risk regulator, it will need to address concerns that have been raised about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks, the agency's closed culture, and its lack of public accountability.

CFA has previously testified before this Committee in strong support of the President's proposal to create a new Consumer Financial Protection Agency and on the need for improved systemic risk oversight. Although this testimony will touch on both those topics, its primary focus will be on other aspects of the President's Plan, including provisions:

- to close gaps in the regulatory structure, in particular by regulating the over-the-counter derivatives market;

- to strengthen weak laws that contributed to the financial crisis, including by reforming credit rating agency practices; and

- to strengthen the protections investors receive in their interactions with the investment professionals they rely on for investment recommendations.

It will also address in greater detail than we have previously provided the reasons why credit-related insurance products should be regulated by the new CFPA.

Closing Gaps in the Regulatory System

One of the greatest strengths of the President's plan is its commitment to ensuring that all aspects of our financial system are subject to appropriate regulatory oversight. Moreover, the administration has recognized that it is not enough to provide systemic risk oversight of previously unregulated markets and institutions. Under the plan, all aspects of the financial system would be subject to some level of functional regulation based on basic principles of transparency and fair dealing. The most important and ambitious of the administration's proposals in this regard is its proposal for regulating the over-the-counter (OTC) derivatives markets. But the plan includes a variety of additional measures to close regulatory loopholes, including provisions to: require advisers to hedge funds and other private pools of capital to register with the Securities and Exchange Commission under the Investment Advisers Act; subject off-balance-sheet activities of banks to regulatory oversight; and give the SEC clear authority to oversee all aspects of the market in asset-backed securities.

To Be Effective, Regulatory Reform Legislation Must Close Existing Loopholes

The current crisis has provided a textbook illustration of why it is not only unwise, but irresponsible to allow regulated and unregulated systems to operate side-by-side, performing many of the same basic functions. First, allowing essential financial functions to be performed out of view of regulators allows risks to grow unnoticed until they reach a point where they spill over into the broader economy and threaten the entire financial system. Because of the opacity of the over-the-counter derivatives markets, for example, financial institutions developed complex webs of inter-connection through credit default swaps without either regulators' or market participants' fully grasping, until it was too late, the degree to which the entire system was vulnerable to the failure of a single institution. The ability of major banks to hold risky assets in off-balance-sheet special purpose entities blinded both the market and regulators to the degree of risk to which these institutions were exposed.

Another problem with the unregulated markets is that they lend themselves to manipulation and abuse. Specifically, unregulated markets allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. Evident since the earliest days of the derivatives markets, this problem took on a new dimension in the current crisis. Investment banks, for example, were able to sell subprime-related CDOs to pension funds and other institutional investors in private placements free from disclosure and other obligations of the regulated marketplace. And European banks used derivatives, often sold by AIG, to evade regulatory capital requirements. In fact, it has been suggested that the credit default swaps sold by AIG were, in many cases at least, simply a new version of the reinsurance-with-side-letters practices that had previously landed certain insurers in regulatory hot water, sold with "no correlation between 'fees' paid and the risk assumed" and

with an eye toward allowing financial institutions and public companies that purchased the swaps to "falsify [their] balance sheets and income statements."[1] Meanwhile, the lack of regulatory scrutiny of hedge funds left them vulnerable to accusations that they had manipulated the downfall of Bear Stearns and Lehman Brothers and left regulators unable to either prove or disprove those allegations or act thoughtfully in response.

The basic reasoning that has been used to justify the existence of an unregulated market is that sophisticated investors do not require the protection that regulation affords. According to this line of reasoning, these investors are capable both of protecting their own interests and of absorbing any losses should they fail to do so. That myth should have been dispelled back in the early 1990s, when Bankers Trust took "sophisticated" investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex formulas that the companies clearly didn't understand. Or when Orange County, California lost $1.7 billion, and ultimately went bankrupt, buying structured notes with borrowed money in what essentially amounted to a $20 billion bet that interest rates would remain low indefinitely. Or when a once-respected, conservative government bond fund, Piper Jaffray Institutional Government Income Portfolio, lost 28 percent of its value in less than a year betting on collateralized mortgage obligations that involved "risks that required advanced mathematical training to understand."[2]

All of these deals, and many others like them, had several characteristics in common. In each case, the brokers and bankers who structured and sold the deal made millions while the customers lost fortunes. The deals were all carried out outside the regulated securities markets. As a result, brokers were free of the suitability obligation in their dealings with institutional clients that, despite their best lobbying efforts throughout much of the 1990s, still applied in the regulated markets. Once the deals blew up, efforts to recover losses were almost entirely unsuccessful. And, in many of cases, strong evidence suggests that the brokers and bankers knowingly played on these "sophisticated" investors' lack of sophistication. In his 2003 book *Infectious Greed*, author Frank Partnoy offers the following illustration of the culture at Bankers Trust:

> As one former managing director put it, "Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, 'I can get [this customer] for all these points.' The senior guys would say, 'Yeah, ream him.'"[3]

More recent accounts suggest that little has changed in the intervening years. As *Washington Post* reporter Jill Drew described in a story detailing the sale of subprime CDOs:

> The CDO alchemy involved extensive computer modeling, and those who wanted to wade into the details quickly found that they needed a PhD in mathematics.

[1] The Institutional Risk Analyst, *AIG: Before Credit Default Swaps, There Was Reinsurance*, April 2, 2009.
[2] Frank Partnoy, *Infectious Greed*, *How Deceit and Risk Corrupted the Financial Markets*, Henry Holt and Company (New York), 2003, p. 123.
[3] Partnoy, p. 55, citing Brett D. Fromson, "Guess What? The Loss is Now … $20 Million: How Bankers Trust Sold Gibson Greetings a Disaster," *Washington Post,* June 11, 1995, p. A1.

> But the team understood the goal, said one trader who spoke on condition of anonymity to protect her job: Sell as many as possible and get paid the most for every bond sold. She said her firm's salespeople littered their pitches to clients with technical terms. They didn't know whether their pitches made sense or whether the clients understood.[4]

The sophisticated investor myth survived earlier scandals thanks to Wall Street lobbying and the fact that the damage from these earlier scandals was largely self-contained. What's different this time around is the harm that victimization of "sophisticated" investors has done to the broader economy. Much as they had in the past, "sophisticated" institutional investors have once again loaded up on toxic assets – in this case primarily mortgage-backed securities and collateralized debt obligations – without understanding the risks of those investments. In an added twist this time around, many financial institutions also remained exposed to the risk of these assets, either because they made a conscious decision to retain a portion of the investments, confident that they had fully hedged their risks, or because they couldn't sell off their inventory after the market collapsed. As events of the last year have shown, the damage this time is not self-contained; it led to a 50 percent drop in the stock market, a freezing of credit markets, and a severe global recession.

The President's Plan Includes Effective Measures to Plug Regulatory Gaps

The President's plan attempts to address both problems associated with unregulated markets: the ability of risks to grow undetected and the potential for abuse. It addresses the former problem both through its approach to systemic risk regulation, which gives a newly formed Financial Services Oversight Council authority to gather information from any financial firm, and through its requirement that all financial firms be subject to functional regulation by the appropriate regulatory authority. Hedge fund advisers, for example, would not only be required to register with the SEC; they would also be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability, provide confidential reports to regulators on their holdings, and submit to SEC compliance inspections. Originators of asset-backed securities would also have to provide more information regarding their securities' risk characteristics and the credit quality of the assets underlying the security over the life of the transaction. While this is intended to help investors and credit rating agencies better understand those risks, it should also prove beneficial to prudential regulators seeking to assess the safety and soundness of financial institutions that hold such securities.

Transparency, reporting, and record-keeping requirements are also essential tools for regulators seeking to rein in abusive conduct. For example, regulators seeking to determine whether hedge funds played a role in engineering the downfall of Bear Stearns and Lehman Brothers through a strategy based on naked short-selling or naked credit default swaps would benefit from the kind of reporting that would be required under the President's plan. Prudential regulators seeking to determine whether financial institutions under their jurisdiction were attempting to evade regulatory capital requirements would benefit from the new ability they would have under the President's plan to examine financial institutions on a consolidated basis, including their off-balance-sheet activities. Closing the many loopholes that have kept non-bank

[4] Jill Drew, "Frenzy," *Washington Post*, December 16, 2008, p. A1.

banks, such as Industrial Loan Companies, outside the financial regulatory system would have a similar effect.

For these reasons, CFA believes the comprehensive approach the President's plan takes to closing regulatory loopholes is an essential component of the plan that must be preserved in any final regulatory package.

Care Needed To Ensure Dealers Can't Undermine Derivatives Plan

As noted above, the most important of the plan's provisions to close regulatory loopholes is its proposal to regulate the OTC derivatives market. As described in the plan itself, and in somewhat greater detail in testimony from Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler and Securities and Exchange Commission (SEC) Chairman Mary Schapiro, the plan takes a two-pronged approach to regulating this market:

- all "standardized" derivatives would be required to be cleared through a regulated central clearinghouse and eventually to trade on regulated exchanges or regulated electronic trading systems;

- all derivatives dealers and major participants in the OTC derivatives market would be subject to a "robust" regulatory regime that includes registration and recordkeeping requirements, as well as "conservative" capital requirements, margin requirements, reporting obligations, and business conduct standards.

This two-pronged approach is designed to ensure that the plan covers "all dealers and all derivatives, no matter what type of derivative is traded or marketed."[5]

CFTC and SEC would share oversight authority under the plan. Although not all of the details have yet been worked out, it appears that the SEC would take the lead in regulating securities-based derivatives and the CFTC would take the lead in all other areas of the derivatives markets. The agencies would be given "clear, unimpeded" authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives. Again, it is essential that the regulatory authority provided includes the full complement of traditional regulatory tools to allow these agencies to effectively police both the market and market participants.

Finally, we are pleased that the plan gives some recognition to the problem described above: that the complexity of modern financial products has made old notions of investor sophistication obsolete. The plan directs the SEC and CFTC to strengthen limits on who can participate in the derivatives market or to better protect participants through additional disclosure requirements or standards of care. In recent testimony before the Senate Banking Committee, Chairman Schapiro provided greater detail on what the agencies are considering:

[5] Statement of Gary Gensler, Chairman, Commodity Futures Trading Commission, before the Senate Banking Subcommittee on Securities, Insurance, and Investment, June 22, 2009.

"The SEC and CFTC staff, together with other financial regulators, currently are considering a tiered approach to regulation, with scaling that could be based in the first instance on indicia of sophistication and financial thresholds, with requirements for additional disclosure and standards of care with respect to the marketing of derivatives to less sophisticated counterparties."[6]

We believe reconsideration along these lines is badly needed, and we urge Congress to give the agencies the authority they need to put any such changes into effect. This reconsideration should not stop with derivatives markets, however. Rather, Congress should direct the agencies to conduct a similar evaluation of all areas where the laws deny supposedly "sophisticated" investors the protections available in the regulated markets.

CFA believes the proposed plan on derivatives represents a dramatic improvement over the current situation. Whether investors and the markets reap the full benefits of this regulatory proposal will depend on several key factors, including how rigorous the capital and margin requirements for dealers turn out to be and how vigorously regulators enforce the business conduct rules and other rules to prevent market abuse. More fundamental factors that will determine success are: 1) how effective regulators are in preventing dealers from evading the central clearing and requirement through the use of customized contracts and 2) how forcefully they push to move as much as possible of the standardized markets onto regulated exchanges.

Regulating Standardized Derivatives Contracts: As Chairman Gensler recently stated in testimony before the Senate Securities Subcommittee, a major goal of the administration plan is to ensure that "all derivatives that can be moved into central clearing … be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems."[7] Currently, although most experts agree that the vast majority of the derivatives market either has been or could be standardized;[8] most derivatives consist of bilateral transactions between individual buyers and sellers that are not centrally cleared. As a result, the parties to the contract are at risk if the counterparty should default. Central clearing would reduce this risk, since the central clearinghouse would stand between the two parties and guarantee the performance of the trade.

To protect themselves, central clearinghouses use a variety of techniques to reduce risks, including setting initial margin requirements, marking transactions to market on a daily basis, and requiring daily posting of margin to cover any changes in value of positions. In essence, the central clearinghouses would centralize the risk that is now spread throughout the financial system in a complex web of interconnections between financial institutions. This, of course, makes the clearinghouses themselves a locus of systemic risk. To address this risk, the administration plan would require both systemic risk and prudential oversight of these institutions. Among other things, they would be required to establish and maintain "robust

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[6] Testimony Concerning Regulation of Over-the-Counter Derivatives by Mary Schapiro, Chairman, U.S. Securities and Exchange Commission, before the Senate Subcommittee on Securities, Insurance, and Investment, June 22, 2009.

[7] Ibid.

[8] See, for example, the June 4, 2009 testimony of Richard Bookstaber before the Senate Agriculture Committee on "Regulatory Reform and the Derivatives Markets."

margin standards and other necessary risk controls and measures."[9] Toward that end, Chairman Gensler has proposed strengthening the standards that currently apply to clearinghouses under the Commodity Exchange Act. Ensuring that these standards are truly "robust" will be essential if this plan is to be genuinely effective in reducing risks.

The Need for Exchange Trading: Some have argued that central clearing alone is sufficient to reduce risks in the system. In a speech delivered more than a decade ago, then CFTC Chairperson Brooksley Born emphasized the important role that the increased transparency that comes with exchange trading plays in reducing risks and combating abusive conduct. "Lack of price transparency may aggravate problems arising from volatile markets because traders may be unable accurately to judge the value of their positions or the amount owed to them by their counterparties," she said. "Lack of price transparency also may contribute to fraud and sales practice abuses, allowing OTC derivatives market participants to be misled as to the value of their interests."[10] This latter point helps to explain the vehemence of industry objections to the exchange-trading proposal, as it threatens what self-described conservative libertarian Christopher Whalen has called the "deliberate inefficiency of the OTC derivatives market."[11] After all, derivatives dealers who are able to earn several hundred basis points on an OTC contract may earn only a couple of points if the same contract is traded on an exchange.

Richard Bookstaber, a derivatives pioneer and author of the prescient book, *A Demon of Our Own Design – Markets, Hedge Funds, and the Perils of Financial Innovation,* summed up the argument in favor of exchange trading this way in recent testimony before the Senate Agriculture Committee:

> The proposal for a centralized clearing corporation, while a welcome step, is not sufficient … It may reduce counterparty concerns, but it will not provide the necessary level of standardization, transparency, price discovery and liquidity. To do all that, we need to have standardized derivative products, and have those products traded on an exchange. Standardization will address the complexity of derivatives. Exchange trading will be a major improvement in the transparency and efficiency, and will foster liquidity by drawing in a wider range of speculators and liquidity suppliers. These steps will shore up the market against the structural flaws that derivative-induced complexity has created.

Moreover, moving to exchange trading of most derivatives need not pose insurmountable difficulties. As Whalen noted in his Senate testimony: "Since many OTC contracts for currencies, interest rates or energy, for example, have observable cash markets upon which to base their pricing, moving these contracts to an exchange-traded format is a relatively easy matter that does not pose significant hurdles for the Congress, investors or regulators. Indeed, most market participants would welcome and benefit from such change."[12]

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[9] Gensler.

[10] Brooksley Born, CFTC Chairperson, "Regulatory Responses to Risks in the OTC Derivatives Market," before the ABA Committee on Federal Regulation of Securities, November 13, 1998.

[11] Statement of Christopher Whalen before the Senate Subcommittee on Securities, Insurance, and Investment, June 22, 2009.

[12] Ibid.

Because of the potential benefits exchange trading offers not only for price transparency and competition, but also for effective risk reduction and fraud prevention, we urge Congress to ignore the self-interested arguments of derivatives dealers and ensure that, as legislation is drafted to implement the administration plan, it includes the strongest possible provisions to require exchange trading of standardized derivatives as soon as that is feasible.

Restricting Unnecessary Customization: Even if Congress succeeds in adopting legislation requiring central clearing and exchange trading of all standardized derivatives, OTC derivatives dealers can be expected to try to evade these requirements through the use of "customized" contracts. While some have argued that the OTC market should be eliminated entirely, we are persuaded by the arguments of those, like Born and Bookstaber, who see a continued use for a customized market, but subject to tight constraints. As Bookstaber has argued, these restrictions should be designed to ensure that customization is used for a legitimate economic purpose and not just to game the system.

The administration has acknowledged the need to constrain unnecessary customization "to ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems."[13] Toward that end, Chairman Gensler has proposed establishing "objective criteria" that regulators could use "to determine whether, in fact, a swap is standardized."[14] Acceptance for trading by one regulated clearinghouse, for example, would create a presumption that the contract is standardized and must be centrally cleared. Other possible criteria include: the volume of transactions in the contract, the similarity of the terms of the contract to the terms in standardized contracts, whether any differences in terms from a standardized contract are of economic significance, and the extent to which any of the terms of the contract, including price, are disseminated to third parties.[15] Customized contracts would also carry higher capital and margin requirements to account for their greater risks.

While this is an excellent start, we believe additional constraints could and should be adopted to restrict the inappropriate use of customized contracts. For example, their use could be limited to highly sophisticated and knowledgeable parties, with at least one of those parties required to certify and able to demonstrate that it is entering the contract to hedge a legitimate business risk. In a similar vein, Bookstaber has proposed that investors who use non-standardized derivatives be required to disclose their holdings in such derivatives and to demonstrate both how they are being used and why they are being used in place of the standard instruments. Dealers in customized contracts could face heightened disclosure obligations, including an obligation to fully disclose risks and costs. Indeed, customization could carry a heightened standard of care to reflect both the advisory nature of that customization and the degree of reliance that exists in the relationship. These latter proposals should be taken up as part of the SEC and CFTC's reexamination of the criteria for participation in derivatives markets.

[13] Gensler testimony.
[14] Ibid.
[15] Ibid.

Other measures, such as banning certain abusive products or practices, deserve serious consideration. Whalen, for example, has argued that certain OTC products, including many CDS and CDOs, are inherently fraudulent. "If an OTC derivative contract lacks a clear cash basis and cannot be valued by both parties to the transaction with the same degree of facility and transparency as cash market instruments, then the OTC contract should be treated as fraudulent and banned as a matter of law and regulation," he said.[16] Others have argued that only investors with a direct interest in the underlying debt instrument should be permitted to purchase credit default swaps, or at least that those institutions that are backed by U.S. taxpayers should face such a limitation. Making a distinction between using swaps to allocate "genuine losses of wealth" and using them to bet on whether a particular company will fail, Benjamin Friedman explained in a recent article in *The New York Review of Books* how the latter practice can actually create huge economic losses that would not otherwise exist. "If those firms that bet incorrectly fail to pay what they owe – as would have happened if the government had not bailed out the insurance company AIG – the consequences might impose billions of dollars' worth of economic costs that would not have occurred otherwise," he wrote.[17] We believe proposals such as these deserve to receive a serious hearing as Congress considers the best way to regulate the OTC derivatives markets.

Finally, as it always does when faced with potentially effective regulation, the industry has threatened to take its business overseas if it faces tough regulation at home. One way to try to prevent that from happening is to work cooperatively with other countries to ensure a universally high level of regulation. As former CFTC Chairperson Born said more than ten years ago: "Global cooperation is essential to avoid a race to the bottom, in which individual regulatory authorities are afraid to enact even modest regulatory protections for fear of placing their domestic markets at a competitive disadvantage." Beyond global cooperation, however, we would urge Congress and the administration to consider whether there are additional restrictions that they can impose to prevent companies that are either located in the United States or wish to do business here from evading our regulatory requirements.

Self-Serving Industry Arguments Must Be Ignored: Industry has already begun to mount an all-out campaign to beat back the most important of these regulatory reforms. Perhaps sensing that derivatives users' arguments may be less suspect, derivatives dealers have recruited corporations to join them in making the case against "excessive regulation." Their argument boils down to this: too much regulation, and particularly limits on customization, would hurt market participants by restricting their ability or driving up their costs to hedge risks.

In assessing these arguments, however, members of Congress should be aware that, like derivatives dealers, some users of derivatives have strong incentives to retain a complex and opaque OTC market. Once again, Bookstaber has explained it best. Although customized derivatives can serve beneficial purposes, they have also come to be used "for less lofty purposes," he notes. In particular, "derivatives have been used to solve various non-economic problems, basically helping institutions game the system in order to:

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[16] Whalen testimony.

[17] Benjamin M. Friedman, "The Failure of the Economy and the Economists," The New York Review of Books, May 28, 2009.

- Avoid taxes. For example, investors use total return swaps to take positions in UK stocks in order to avoid transactions taxes.

- Take exposures that are not permitted in a particular investment charter. For example, index amortizing swaps were used by insurance companies to take mortgage risk.

- Speculate. For example, the main use of credit default swaps is to allow traders to take short positions on corporate bonds and place bets on the failure of a company.

- Hide risk-taking activity. For example, derivatives provide a means for obtaining a leveraged position without explicit financing or capital outlay and for taking risk off-balance sheet, where it is not as readily observed and monitored. Derivatives also can be used to structure complex risk-return tradeoffs that are difficult to dissect.

These non-economic objectives are best accomplished by designing derivatives that are complex and opaque, so that the gaming of the system is not readily apparent."[18]

Later Bookstaber adds, "For the bank, the more complex and custom-made the instrument, the greater the chance the bank can price in a profit, for the simple reason that investors will not be able to readily determine its fair value. And if the bank creates a customized product, then it can also charge a higher spread when an investor comes back to trade out of the product. For the trader, the more complex the instrument, the more leeway he has in his operation, because it will be harder for the bank to measure his risk and price his book. And for the buyer, the more complex the instrument, the easier it is to obfuscate everything from the risk and leverage of their positions to the non-economic objectives they might have in mind."[19]

Congress fell for these arguments once, when it adopted the Commodity Futures Modernization Act. That experience, and a clear eye for the self-interest behind industry's arguments, should prevent it from doing so again.

Strengthening Existing Market Regulations

In addition to closing regulatory gaps, the President's Plan includes several provisions to strengthen regulations in areas where weak laws contributed to the current crisis. Among these are measures to reduce the risk of unsound mortgage lending, improve transparency in the securitization market, address executive compensation practices that encourage excessive risk-taking, and reform credit rating agencies. Leaving aside the mortgage lending issue for the moment, which is addressed in the following section on the CFPA, each of these provisions falls short to a greater or lesser degree. The measures to reform credit rating agencies are particularly weak, especially when considered in proportion to the central role credit ratings played in causing the current crisis.

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[18] Bookstaber testimony.
[19] Ibid.

Asset-Backed Securities Should Not Be Sold Through Shelf-Registration

The plan's provisions to strengthen regulation of the securitization market include measures to dramatically improve the transparency of these instruments, which we strongly support. However, we believe more could and should be done in this area by prohibiting the sale of asset-backed securities through the shelf-registration process or, at the very least, reforming that process with regard to sales of asset-backed securities. Requiring such securities to be sold from a prospectus made available at least 24 hours before the sale would accomplish three important goals: it would improve the ability of investors to make an informed decision, reduce their need to rely on credit ratings to assess the risk of the securities, and require more meaningful due diligence on the part of underwriters. We believe all would be extremely beneficial.

Broader Corporate Governance Reforms Should Be Adopted

Among the many failures that contributed to the current crisis, one was a failure of board oversight that echoes similar failures at Enron and other public companies in an earlier round of scandals. Unfortunately, with a variety of higher profile issues on the table, momentum for reform in the wake of the Enron-WorldCom scandals ran out of steam before a robust agenda of corporate governance reforms could be adopted. A similar phenomenon appears to be at work in the President's plan, which includes only two proposals on corporate governance: one directing financial regulators to adopt rules on executive pay for financial institutions to reduce incentives to take excessive risks and better align managers' interests with those of long-term shareholders and a second requiring all public companies to allow a non-binding vote on executive pay.

While CFA supports both these measures, we believe it would be a grave error to miss yet another opportunity to adopt more far-reaching reforms. Among the top priorities should be legislation giving the SEC clear authority to reform the proxy access rules to make it easier for shareowners to nominate directors. Although the SEC has already taken up rules in this area, industry groups have made no secret of their intent to challenge any such rules in court. By clarifying the agency's authority to act, Congress could avoid the wasteful costs and pointless delays of litigation. Another important priority designed to make directors more accountable to shareholders is requiring majority votes in uncontested board elections. To supplement the administration's proposal on executive pay at financial institutions, Congress should also strengthen claw-back provisions on executive pay. These and other corporate governance reform proposals supported by CFA are described more fully in the agenda of ShareOwners.org included in Appendix A of this testimony.

Credit Rating Agency Reform Proposals Must Be Strengthened

Perhaps the weakest single aspect of the President's Plan is its failure to propose the kind of comprehensive reform of credit rating agencies that their repeated failures and central role in the financial system warrant. Instead, the plan proposes a handful of beneficial but modest changes: reducing reliance on ratings in regulations and supervisory practices, providing clearer differentiation between ratings on structured and other credit products, and requiring strengthened policies and procedures to manage and disclose conflicts of interest. While we

certainly support these proposals, we believe they stop well short of the steps needed to improve the reliability of ratings and the accountability of ratings agencies.

If complex derivatives and mortgage-backed securities were the poison that contaminated the financial system, it was their ability to attract high credit ratings that allowed them to penetrate every corner of the markets. Over the years, the number of financial regulations and other practices tied to credit ratings has grown rapidly. For example, money market mutual funds, bank capital standards, and pension fund investment policies all rely on credit ratings to one degree or another. As Jerome S. Fons and Frank Partnoy wrote in a recent *New York Times* op ed: "Over time, ratings became valuable … because they "unlock" markets; that is, they are a sort of regulatory license that allows money to flow."[20] This growing reliance on credit ratings has come about despite their abysmal record of under-estimating risks, particularly the risks of arcane derivatives and structured finance deals. Although there is ample historical precedent, never was that more evident than in the current crisis, when thousands of ultimately toxic subprime-related mortgage-backed securities and CDOs were awarded the AAA ratings that made them eligible for purchase by even the most conservative of investors.

Looking back, many have asked what would possess a rating agency to slap a AAA rating on, for example, a CDO composed of the lowest-rated tranches of a subprime mortgage-backed security. (Some, like economists Joshua Rosner and Joseph Mason, pointed out the flaws in these ratings much earlier, at a time when, if regulators had heeded their warning, they might have acted to address the risks that were lurking on financial institutions' balance sheets.)[21] Money is the obvious answer. Rating structured finance deals pays generous fees, and ratings agencies' profitability has grown increasingly dependent in recent years on their ability to win market share in this line of business. Within a business model where rating agencies are paid by issuers, the perception at least is that they too often win business by showing flexibility in their ratings. Another possibility, no more attractive, is that the agencies simply weren't competent to rate the highly complex deals being thrown together by Wall Street at a breakneck pace, but did so anyway. One Moody's managing director reportedly summed up the dilemma this way in an anonymous response to an internal survey: "These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both."[22]

The SEC found support for both explanations in its July 2008 study of the major ratings agencies.[23] That study documented both lapses in controls over conflicts of interest and evidence of under-staffing and shoddy practices: assigning ratings despite unresolved issues, deviating from models in assigning ratings, a lack of due diligence regarding information on which ratings are based, inadequate internal audit functions, and poor surveillance of ratings for continued accuracy once issued. Moreover, in addition to the basic conflict inherent in the issuer-paid model, credit rating agencies can be under extreme pressure from issuers, investors, and occasionally even regulators to avoid downgrading a company or its debt. With credit rating

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[20] Jerome S. Fons and Frank Partnoy, "Rated F for Failure," *New York Times*, March 16, 2009.

[21] Joseph R. Mason and Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?* (preliminary paper presented at Hudson Institute) February 15, 2007.

[22] Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" *New York Times,* December 7, 2008.

[23] U.S. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies,* July 2008.

triggers embedded in AIG's credit default swaps agreements, for example, a small reduction in rating exposed the company to billions in obligations and threatened to disrupt the CDS market. This fact clearly influenced regulators' decision to shore up the company finances in order to avoid such an outcome.

It is tempting to conclude, as many have done, that the answer to this problem is simply to remove all references to credit ratings from our financial regulations. This is the recommendation that Fons and Partnoy arrive at in their *Times* op ed. "Regulators and investors should return to the tool they used to assess credit risk before they began delegating responsibility to the credit rating agencies," they conclude. "That tool is called judgment." Unfortunately, Fons and Partnoy may have identified the only thing less reliable than credit ratings on which to base our investor protections. After all, even many institutional investors lack the sophistication to evaluate today's complex financial products. And it is difficult to see how simply eliminating existing ratings-based restrictions on their investment options will make these investors any more cautious, particularly in an environment in which they are under extreme pressure to boost returns.

The other frequently suggested solution is to abandon the issuer-paid business model on the grounds that it creates a massive conflict of interest. Simply moving to an investor-paid model suffers from two serious short-comings, however. First, it is not as free from conflicts as it may on the surface appear. While investors generally have an interest in receiving objective information before they purchase a security – unless they are seeking to evade standards they view as excessively restrictive – they may be no more interested than issuers in seeing a security downgraded once they hold it in their portfolio. Moreover, we stand to lose ratings transparency under a traditional investor-paid model, since investors who purchase the rating are unlikely to want to share that information with the rest of the world on a timely basis. SEC Chairman Schapiro indicated in her confirmation hearing before the Senate Banking Committee that she is interested in exploring other payment models designed to get around these problems. We believe Congress should encourage such a review as part of a comprehensive solution to the credit rating problem.

While it is easier to diagnose problems with the credit rating agencies than it is to prescribe a cure, we believe the important gatekeeper function ratings play in our financial system and the conflict of interest at the heart of their business model call for a far more robust program of regulatory oversight and accountability than either our current laws or the President's plan afford. The best approach, in our view, can be found in simultaneously reducing reliance on ratings, increasing accountability of ratings agencies, and improving regulatory oversight.

Reducing Reliance on Ratings: Without removing references to ratings from our legal requirements entirely, Congress and financial regulators could reduce reliance on ratings by clarifying, in each place where ratings are referenced, that reliance on ratings does not substitute for due diligence. Rather than identifying a set of investments in which institutions are free to invest, ratings should be viewed instead as identifying those investments that are out of bounds. The investor – whether a bank, a money market fund, or a pension manager – would still be responsible and accountable for conducting meaningful due diligence to determine that any investment they proposed to purchase met appropriate risk standards. Under such an approach,

no safe harbor should be accorded those who rely on a rating in making an investment selection. Although it is short on details, the Administration's plan appears to support such an approach, with its recommendation that reliance on ratings in regulations and supervisory practices should be reduced wherever possible. Moreover, its further recommendation that any such standards distinguish between ratings for structured products and ratings on more traditional debt instruments would be a useful supplement to this approach.

Increasing Rating Agency Accountability: The President's plan seeks to increase rating agency accountability by requiring more complete disclosures, including disclosure of performance measures for structured credit products "in a manner that facilitates comparisons across products and ratings." While we believe such disclosures can be useful in identifying agencies whose ratings for various types of credit products have been more or less reliable, we do not believe they can provide an adequate counter-balance to the massive conflict of interest at the heart of the rating agency business model. In our view, increased liability is the only factor with the potential to provide that counterweight. The goal should be to provide the incentive ratings agencies need to be rigorous in their ratings procedures and more willing to refuse to rate products whose risks they do not understand or cannot reasonably predict. It seems reasonable to assume, for example, that ratings agencies would have been less tolerant of the shoddy practices uncovered both in the SEC study and in congressional hearings if they had known that investors who relied on those ratings could hold them accountable in court for their failure to follow appropriate procedures or to conduct adequate due diligence.

Toward that end, Congress should eliminate the exemption from liability provided to rating agencies in Section 11 of the Securities Act and should further clarify that ratings are liable to the same degree as other gatekeepers, such as auditors of public companies, when they are reckless in failing to conduct an adequate investigation on which to base a rating. In addition, the SEC should be given additional authority to impose tough sanctions on ratings agencies for such failures.

Improving Regulatory Oversight of Ratings Agencies: Finally, while we appreciate the steps Congress took in 2006 to enhance SEC oversight of rating agencies, that legislation stopped far short of the comprehensive reform that we believe is needed in light of recent events. That earlier legislation was extremely useful in enabling the SEC study that identified short-comings in rating agency practices. However, new legislation is needed to give the agency greater authority to respond to those problems. Specifically, new legislation should authorize either the SEC or an independent regulatory body modeled on the Public Company Accounting Oversight Board to:

- review credit rating agency policies, practices, methodologies and procedures to ensure rating agency compliance with appropriate controls for determining credit ratings;

- require rating agencies to maintain records and make those records available to the SEC for review, including through review of individual ratings engagements, in order to ensure compliance;

- set standards in areas such as due diligence practices and post-rating surveillance and to ensure that conflict of interest and compliance practices are effective; and

- impose fines and other sanctions for violations.

To be clear, we are not proposing that regulators be given authority to specify or approve actual ratings methodologies. Rather, their authority should extend to the procedures rating agencies follow in applying those methodologies, such as obtaining sufficient data to support a rating or taking reasonable steps to verify that data. Furthermore, either the SEC or any new oversight body Congress should establish for this purpose must have sufficient funding to enable it to hire competent staff and carry out these functions effectively.

Strengthening these provisions of the President's Plan should be among Congress's top priorities as it fashions comprehensive legislation to reform financial regulation.

Enhancing Consumer and Investor Protections

One of the clear lessons of the current crisis is that failure to provide basic consumer and investor protections – in this case with regard to mortgage lending – can have a devastating effect on the safety and soundness of the financial system as a whole. Put another way, had regulators acted to rein in predatory and unsound mortgage lending when problems first began to emerge, the worst of the current crisis could likely have been avoided. One of the major strengths of the President's Plan is its clear recognition of this fact and the strong set of measures it proposes to strengthen consumer and investor protections going forward. In fact, the strongest and most crucial aspect of the entire regulatory reform plan may be its proposal to create a new Consumer Financial Protection Agency. However, the plan also includes much needed provisions to enhance investor protections, particularly when dealing with the financial intermediaries investors rely on for recommendations.

<u>CFPA Must Be Adopted Without Weakening Amendments</u>

We have testified before in strong support of the administration's proposal to create a new Consumer Financial Protection Agency (CFPA). Our July 14, 2009 testimony before the Senate Banking, Housing and Urban Affairs Committee provides greater details on why we support the Consumer Financial Protection Agency, how the agency should be structured and funded, the abuses that the CFPA would rectify, and rebuttals to arguments opposing the enactment of the CFPA (Here is a link to the testimony: http://www.consumerfed.org/pdfs/Travis_Plunkett_Testimony_CFPA_Senate_Banking_07-14-09.pdf.) Since then there have been several developments:

- Chairman Frank has introduced strong legislation to implement the administration's plan;

- the industry has made clear that they intend to pull out all the stops in opposing this legislation, including through a campaign of misinformation; and

- new evidence has emerged showing the need for this agency.

Consumers and the Economy Need the Consumer Financial Protection Agency

Although the CFPA would not be a panacea for all current regulatory ills, it would correct many of the most significant structural flaws that exist, realigning the regulatory architecture to reflect the unfortunate lessons that have been learned in the current financial crisis and sharply increasing the chances that regulators will succeed in protecting consumers in the future. The CFPA would be designed to achieve the regulatory goals of elevating the importance of consumer protection, prompting action to prevent harm, ending regulatory arbitrage, and guaranteeing regulatory independence.

The CFPA Would Be THE Agency Looking Out for Financial Consumers

The CFPA would have as its sole mission the development and effective implementation of standards that ensure that all credit products offered to borrowers are safe and not discriminatory. The agency would then enforce these standards for the same types of products in a transparent, uniform manner. Ensuring the safety and fairness of credit products would mean that the CFPA would not allow loans with terms that are discriminatory, deceptive or fraudulent. The agency should also be designed to ensure that credit products are offered in a fair and sustainable manner. In fact, a core mission of the CFPA would be to ensure the suitability of classes of borrowers for various credit products, based on borrowers' ability to repay the loans they are offered – especially if the cost of loans suddenly or sharply increase, and the terms of the loans do not impose financial penalties on borrowers who try to pay them off. As we've learned in the current crisis, focusing exclusively on consumer and civil rights protection would often be positive for lenders' stability and soundness over the long term. However, the agency would be compelled to act in the best interest of consumers even if measures to restrict certain types of loans would have a negative short-term financial impact on financial institutions.

The CFPA Would Stop Regulatory Arbitrage

The present regulatory system is institution-centered, rather than consumer-centered. It is structured according to increasingly irrelevant distinctions between the type of financial services company that is lending money, rather than the type of product being offered to consumers. Right now, financial institutions are allowed (and have frequently exercised their right) to choose the regulatory body that oversees them and to switch freely between regulatory charters at the federal level and between state and federal charters. Many financial institutions have switched charters in recent years seeking regulation that is less stringent. At the federal level, where major agencies are funded by the institutions they oversee, this ability to "charter shop," has undeniably led regulators like the OTS to compete to attract financial institutions by keeping regulatory standards weak. It has also encouraged the OTS and OCC to expand their preemptive authority and stymie efforts by the states to curb predatory and high-cost lending.

The "charter shopping" problem would be directly addressed through the creation of a single CFPA with regulatory authority over all forms of credit. Federal agencies would no longer compete to attract institutions based on weak consumer protection standards or anemic

enforcement of consumer rules. The CFPA would be required to focus on the safety of credit products, features and practices, no matter what kind of lender offered them.

The CFPA Would Set the Floor for National Consumer Protection Standards

As for regulatory competition with states, it would only exist to improve the quality of consumer protection. Therefore, the CFPA should be allowed to set minimum national credit standards, which states (as well as victimized consumers) could then enforce. States would be allowed to exceed these standards if local conditions require them to do so. If the CFPA sets "minimum" standards that are sufficiently strong, a high degree of regulatory uniformity is likely to result. With strong national minimum standards in place, states are most likely to act only when new problems develop first in one region or submarket. States would then serve as an early warning system, identifying problems as they develop and testing policy solutions, which could then be adopted nationwide by the CFPA if merited. Moreover, the agency would have a clear incentive to stay abreast of market developments and to act in a timely fashion to rein in abusive lending because it will be held responsible for developments in the credit market that harm consumers.

The CFPA Must Be Independent

The leadership of a CFPA would be held to account based on its ability to inform consumers and help protect them from unsafe products. In order to function effectively, the leadership would need to show expertise in and commitment to consumer protection. Crucial to the success of the agency would be to ensure that its funding is adequate, consistent, and does not compromise this mission. Congress could also ensure that the method of agency funding that is used does not compromise the CFPA's mission by building accountability mechanisms into the authorizing statute and exercising effective oversight of the agency's operations.

The CFPA Is Needed to Stop Inaction on Consumer Financial Protections

Current regulators may already have some of the powers that the new agency would be given, but they haven't used them. Conflicts of interest and a lack of regulatory will work against consumer enforcement. In our previous testimony, we detailed numerous actions and inactions by the federal banking regulators that have led to or encouraged unfair practices, higher prices for consumers, and less competition. That list has been updated and expanded and is included below.

- The Federal Reserve Board ignored the growing mortgage crisis for years after receiving Congressional authority to enact anti-predatory mortgage lending rules in 1994.

- The Office of the Comptroller of the Currency engaged in an escalating pattern of preemption of state laws that were designed to protect consumers from a variety of unfair bank practices and to quell the growing predatory mortgage crisis, culminating in its 2004 rules preempting both state laws and state enforcement of laws over national banks and their subsidiaries.

- As unfair credit card practices increased over the years, these agencies took little action except to propose greater disclosures, until Congress stepped in.

- The Federal Reserve has allowed Debit Card Cash Advances ("Overdraft Loans") without consent, contract, cost disclosure or fair repayment terms.

- The Fed has allowed a shadow banking system (Prepaid Cards) outside of consumer protection laws to develop and target the unbanked and immigrants. The OTS is allowing bank payday loans (which preempt state laws) on prepaid cards.

- Despite advances in technology, the Federal Reserve has refused to speed up availability of deposits to consumers.

- The Federal Reserve has supported the position of payday lenders and telemarketing fraud artists by permitting remotely created checks (demand drafts) to subvert consumer rights under the Electronic Funds Transfer Act.

- The Federal Reserve has taken no action to safeguard bank accounts from Internet payday lenders.

- The Banking agencies have failed to stop banks from imposing unlawful freezes on accounts containing Social Security and other funds exempt from garnishment.

- The Comptroller of the Currency permits banks to manipulate payment order to extract maximum bounced check and overdraft fees, even when overdrafts are permitted.

- The regulators have failed to enforce the Truth In Savings Act requirement that banks provide account disclosures to prospective customers.

- The Federal Reserve actively campaigned to eliminate a Congressional requirement that it publish an annual survey of bank account fees.

Modest Changes Are Needed to Strengthen the Administration's Proposal

Consumer Representation: The CFPA should have the authority to grant intervener funding to consumer organizations to fund expert participation in its stakeholder activities. The model has been used successfully to fund consumer group participation in state utility ratemaking. Second, a government chartered consumer organization should be created by Congress to represent consumers' financial services interests before regulatory, legislative, and judicial bodies, including before the CFPA. This organization could be financed through voluntary user fees such as a consumer check-off included in the monthly statements financial firms send to their customers. It would be charged with giving consumers, depositors, small investors and taxpayers their own financial reform organization to counter the power of the

financial sector, and to participate fully in rulemakings, adjudications, and lobbying and other activities now dominated by the financial lobby.[24]

Compensation Incentives: We recommend that the Administration's proposal deal more explicitly with incentives that are paid to employees working in the credit sector. An incentive system similar to one at the top is at work at the street level of the biggest banks. In the tens of thousands of bank branches and call centers of our biggest banks, employees - including bank tellers earning an average of $11.32 an hour - are forced to meet sales goals to keep their jobs and earn bonuses. Many goals for employees selling high-fee and high-interest products like credit cards and checking accounts have actually gone up as the economy has gone down. New rules need to restructure pay and incentives for front-line finance sector employees away from the current 'sell-anything' culture. The hundreds of thousands of front-line workers who work under pressure of sales goals need to be able to negotiate sensible compensation policies that reward service and sound banking over short-term sales.

Whistleblower protections: Risk-taking in the industry will quickly outpace regulatory coverage unless financial sector employees can challenge bad practices as they develop and direct regulators to problems. Whistleblowers are critical to combating fraud and other institutional misconduct. If we had previously had more protections for whistleblowers, we would have had more warning of the eventual collapse of Wall Street. The federal government needs to hear from and provide best practice whistleblower rights (consistent with those in the stimulus and five laws passed or strengthened last Congress) to protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare.

In addition, the following provisions of the legislation need to be fixed:

- The bill lacks any mechanism for holding wrongdoers accountable to individual consumers for violating rules or giving consumers remedies for harm when rules are violated.

- The bill gives the agency too much authority to decide that its rules or another federal statute preempts state laws.

- The ability to limit forced arbitration does not extend to state consumer protection laws. Because of preemption, only Congress can address arbitration abuses involving state claims.

- The prohibition on a usury cap could be read to limit the Agency's authority over high cost loans.

- Requiring cost/benefit analysis could tip the scales in industry's favor and invite litigation challenges to Agency rules. Disclosures that purport to help a consumer weigh risks could be used against consumers.

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[24] As his last legislative activity, in October 2002, Senator Paul Wellstone proposed establishment of such an organization, the Consumer and Shareholder Protection Association, S. 3143.

- The Agency should not have authority to create exemptions to the existing enumerated statutes beyond what is already in those statutes. Much narrower authority – for example, to alter requirements if necessary to simplify and create more understandable disclosures for pilot projects - might be appropriate.

The CFPA Should Have Jurisdiction Over Credit-related Insurance Products

The CFPA legislation proposed by the Administration and introduced by Chairman Frank would give the new agency jurisdiction over four credit-related insurance products: credit insurance, title insurance, mortgage insurance, and mortgage guarantee insurance (also known as private mortgage insurance since it is a form of credit insurance). (See Appendix B for a description of the various types of credit insurance.) All of these products are sold in connection with a credit transaction and are intertwined with loans. For this reason, we believe the CFPA should have the same authority over these products that it has over other credit-related financial products.

Under the legislation, the agency would not have jurisdiction over either investment-type products, such as annuities, or other personal insurance products, such as personal auto, residential property, and other consumer property and casualty insurance products. In general, CFA believes this is the appropriate division of responsibility, with three exceptions:

- We believe forced place insurance, which is also a form of credit-related insurance, should be covered by the CFPA.

- To prevent regulatory arbitrage, we believe products that are similar to credit insurance such as debt cancellation contracts sold by banks, should also be regulated by the CFPA. From a consumer's perspective, they are equivalent products, but they are regulated differently because federal banking regulators have declared them to be banking products. (For additional information on these products, see Appendix C.)

- We believe the CFPA should have the authority to advocate for and represent consumers of personal insurance products (such as auto or homeowners and other property insurance) before the state insurance regulators. Some have said that this consumer advocacy authority might rest with the proposed new Insurance Office within the Department of Treasury, but CFA believes consumer advocacy is better placed in CFPA, an agency whose mission is to protect consumers.

Problems for Consumers Buying Insurance Products Related to Lending Transactions

Reverse Competition Hurts Consumers: The dominant characteristic of insurance markets related to credit transactions throughout the country is *reverse competition.* The consumer who pays for the product does not select the insurer; rather, the parties receiving compensation for the insurance select the insurer. For example, an insurer might sell a credit insurance group policy to a lender. The lender then sells the credit insurance to the borrower on behalf of the credit insurer and issues a certificate of insurance under the group policy to the

borrower. This market structure leads insurers to bid for the lender's business by providing higher commissions and other compensation to the lender. As a result, greater competition for the lender's business leads to higher, often unfair prices of credit insurance to the borrower. In fact, CFA's Director of Insurance, J. Robert Hunter, was once at a credit insurance hearing in Virginia at which Prudential was asked why they wrote so little credit insurance in the state. The Prudential witness said they were non-competitive because their rates were "too low." The same sort of system holds in title insurance and mortgage guarantee insurance, which are covered under the President's plan, and forced-place insurance, which is not.

In addition to raising prices, reverse competition also harms consumers by limiting consumer choice, often to products that offer little real value to consumers. This results from the fact that, in a reverse-competitive market, the consumer is unable to effectively exert normal competitive pressure on the original seller of the product. In credit insurance, mortgage guarantee insurance, title and forced place insurance (but not mortgage insurance), the lender is almost always involved in the selection of the insurer, while the ultimate consumer – the borrower – is effectively limited to accepting or rejecting the package offered. If a consumer purchases a product and finances the purchase at one store or auto dealer, he or she cannot decide to go elsewhere to purchase the credit-related insurance for that loan. There is no marketplace for the insurance separate from the lender financing the purchase. As a result, lenders are able to dictate the terms of the credit insurance sale, determining what coverages will be offered, for example. Because the credit-related insurance transaction is typically a minor aspect (to the borrower) of a larger transaction – the loan to purchase a car, jewelry or furniture – consumers are willing to go along, particularly if they believe they must purchase the credit-related insurance to get the financing to buy the product they want.

As a result of this market dynamic, lenders rather than borrowers are the primary beneficiaries of credit-related insurance sales. First, the lender's loan is protected against events that impair the borrower's ability to repay. With credit-related insurance in place, the lender need not incur any costs to force payment from the surviving spouse or relative of a deceased borrower or from a borrower who has become disabled or unemployed. Second, the lender often gets substantial commission and other revenue from the insurance premium. Commissions and other compensation are typically 40 percent or more of the premium.

Consumers, on the other hand, often obtain little if any benefit. The best measure of overall value of credit insurance to consumers is the loss ratio – the ratio of benefits paid on behalf of the consumer to the premiums paid by consumers. Consumer groups have advocated regulation to ensure that consumers receive a loss ratio of at least 60 percent, meaning that, on average, at least 60 percent of the premiums paid by borrowers should be ultimately paid out in claim benefits on behalf of borrowers.

While the vast majority of states regulate credit insurance rates, most have done a poor job. The nationwide average loss ratio has been under 50 percent for credit life (46 percent in 2007[25]), in the mid 30s for credit disability, was 37 percent in 2007[26] for credit health insurance, under 30 percent for forced-place insurance, and in the single digits for credit unemployment and

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[25] Life Insurers Fact Book 2008, American Council of Life Insurance

[26] Ibid

near zero for credit family leave insurance. For many years, mortgage guaranty products had a very low loss ratio, less than 25 percent, until the ratio rose to 135 percent in 2007 in the midst of the current mortgage crisis. Similarly, title insurance loss ratios have been under 10 percent for many years. One study found, for example, that between 1995 and 2004, title insurance loss ratios averaged 4.6 percent and the loss ratio was below five percent eight out of ten years.[27] In 2008, the loss ratio "jumped" to 11.7 percent.[28]

In short, all of these products represent remarkably poor value for consumers. State regulators have, with a handful of exceptions,[29] utterly failed to rein in reverse competition and end the wholesale consumer abuse the practice represents. The special interest determination to hold off reform at any cost has proven highly effective. For these reasons, we believe America's consumers need CPFA to cover credit-related insurance products.

The agency should study credit-related insurance products to determine exactly what actions are needed to protect consumers from the ravages of reverse competition. The agency should, for example, be involved in the process of rate regulation by the states, advocating before the states for minimum loss ratios consistent with fair consumer value. The agency should also be advocating for states to develop real (as opposed to reverse) competition in these lines of insurance and should develop ideas for accomplishing this. Possible approaches might include: educating consumers about their rights to shop for alternative sources of coverage; breaking up the cartel-like control over information about who needs such insurance so that other providers of coverage could contact consumers in time to compete for the sale; and abolishing the kickback arrangements that leave low-priced competitors unable to sell their products.

The agency should seek to learn from those firms that are struggling to break down the walls with lower prices, but who are thwarted by the cartel relationships and big kickbacks, and from other agencies that have been successful in adopting reforms. Iowa, for example, succeeded in reforming the market for title insurance, and other nations have also apparently broken the cartel-like arrangements. These examples, and systems such as Torrens[30] rather than title insurance, should be reviewed for possible use in this country.

Plan Proposes Long-Sought Investor Protection Reforms

As a complement to its proposal to create a Consumer Financial Protection Agency, the President's plan authorizes and directs the Securities and Exchange Commission to strengthen investor protections in a number of ways long sought by investor advocates. Just last week, the administration sent Congress legislation designed to enact those reforms. CFA strongly urges quick passage of that legislation, once potentially serious weaknesses in the section on fiduciary

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[27] "Title Insurance Cost and Competition," Testimony of J. Robert Hunter, Director of Insurance, Before House Committee on Financial Services, Subcommittee on Housing and Community Opportunity, April 26, 2006.

[28] Missouri Department of Insurance, Financial Institutions and Professional Regulation, at http://www.insurance.mo.gov/reports/lossratio

[29] Examples include Iowa, which has successfully reformed title insurance, and New York and Maine, which have gotten considerable control of credit insurance costs through effective and reasonable maximum loss ratio regulation.

[30] Torrens is a system of registration of land titles that makes title insurance unnecessary.

duty are fixed. By helping to ensure that investors get the most out of their often scant investment dollars, this proposal should contribute to their individual well-being and retirement preparedness, which has been badly damaged by the recent crisis. By raising the standards that brokers must meet in dealing with clients and attacking conflicts of interest that encourage abuses, it would also improve the overall integrity of the capital markets.

Fiduciary Duty for Investment Advice: A centerpiece of the administration's plan to enhance investor protections is its language advocating a fiduciary duty for brokers who provide investment advice that is comparable to the duty investment advisers must abide by. This has long been a priority for CFA. Over the past two decades, in response to competition from both financial planners and discount brokers, full service brokers have transformed their business model into one that is, or at least appears to be, largely advice-driven. They have taken to calling their sales reps "financial advisers," offered investment planning services, and marketed their services based on the advice offered. The SEC permitted this transformation without requiring brokers to comply with the Investment Advisers Act provisions designed to govern such conduct. Instead, each time the SEC has had to make a choice between protecting investors and protecting the broker-dealer business model, it has chosen the latter. The President's plan attempts to reverse that trend, by ensuring that all those who offer advisory services are subject to the appropriate fiduciary standard of care and loyalty and by improving the quality of pre-engagement disclosure investors receive about these obligations.

The legislation risks undermining that goal by delegating to the SEC the job of writing rules to implement the fiduciary duty requirement and giving it broad leeway in doing so. While this may seem to be a logical approach, for investors to receive the full benefits of the President's plan, the SEC will have to get right the very issues it has mishandled for at least two decades. After all, the investor confusion this legislation is designed to address is not the inevitable result of industry changes; rather, it is the direct result of anti-investor policy decisions by the SEC over many years. We are encouraged by the commitment Chairman Schapiro has made to change that direction, and by the strong leadership Commissioner Aguilar has shown on the fiduciary duty issue.

However, to better ensure that the legislation delivers on the administration plan's promise of a full scale fiduciary duty for all investment advice, and not the "fiduciary duty lite" some in the brokerage industry have sought, some revision of the legislative language appears necessary. Specifically, the words fiduciary duty of care and loyalty that are referenced in the President's plan should be included in the legislative language itself, so that the fiduciary duty exists in law and not simply through the adoption of SEC rules. The "in substance" language in the legislation, which could be used to justify watering down that standard, should be removed. In addition, the SEC should be required, not simply authorized, to adopt the appropriate standards. Finally, Congress should clarify, preferably through the legislation itself but if not through accompanying report language, that: 1) the intent is to ensure no weakening of the fiduciary duty that currently applies to advisers and 2) that a fiduciary duty, once entered into, cannot easily be abandoned; brokers who are covered by a fiduciary duty when giving advice cannot escape that requirement when selling the products to implement that advice.

Compensation Reform: The President's plan backs up its provision on fiduciary duty for investment advice with a requirement that the SEC study industry sales practices and prohibit those compensation practices and conflicts of interest that it determines are not in investors' best interests. The securities industry is riddled with such conflicts, and the resulting damage to investors is significant. Conflict-laden compensation practices are behind the myriad sales abuse scandals that have constantly dogged the industry over the years, whether the instrument of choice was limited partnerships or mutual fund B shares, high-cost annuities or out-of-state 529 plans. These practices not only damage investors by increasing their costs and diverting often limited funds from their investment goals, they encourage a form of reverse competition in which investment products compete to be sold rather than bought, limiting the potential for market forces to discipline costs. Because investors typically rely heavily on the recommendations they receive, doing little if any additional research on such factors as costs and risks, they are particularly vulnerable to harm from these conflicts of interest. Like the provision on fiduciary duty, this provision of the legislation shows a welcome willingness to put investor interests over industry interests, even when it challenges industry's traditional way of doing business.

Improved Disclosure: One reason investors rely so heavily on the recommendations they receive from investment professionals is that the disclosures designed to aid them in understanding their investment options are neither timely nor well designed to convey the crucial information. The administration plan includes two important provisions to improve the quality of product disclosures that investors receive: first, it authorizes the Commission to conduct regular testing of disclosures to determine their effectiveness and second, it authorizes the Commission to require pre-sale disclosure for mutual funds. Based on the Commission's limited past experience with disclosure testing, we believe an expanded program to test both new and existing disclosures would be extremely illuminating both in revealing the limits of disclosure in conveying intended messages and in helping the Commission to develop more effective means of presenting information.

We also strongly support requiring pre-sale disclosure to assist mutual fund investors to make more informed investment decisions. While mutual funds are subject to more robust disclosure requirements than many competing investment products and services, the disclosures typically do not arrive until three days after the sale. This makes them essentially useless in helping investors to assess the risks and costs of the fund, as well as the uses for which it may be most appropriate. It should be obvious to anyone that, if we want investors to make informed decisions, they must receive the information they need to make that choice in a readable form and at a time when it can be factored in to the investment decision. We believe the ideal timing is at the point of recommendation; even point-of-sale disclosures may come too late to influence the investor. Moreover, today's information technology makes instant delivery of such information possible at virtually no cost, eliminating arguments the industry has previously used to oppose such requirements.

Although we strongly support the administration proposal on pre-sale disclosure for mutual funds, we are disappointed that it is so narrowly focused. While mutual funds are a logical place to start in adopting such reforms, given their wide use with average investors, reform should not stop there. We therefore encourage Congress to amend the administration

legislation to require the SEC to study the feasibility of requiring pre-sale disclosures of key information for all products and services recommended by investment professionals.

Pre-dispute Binding Arbitration Agreements: Another pro-investor provision in the administration's investor protection legislation is its language authorizing the SEC to ban or limit the use of pre-dispute binding arbitration clauses in broker and advisory contracts. As the President's plan cogently argues, asking investors to give away their right to choose the most appropriate means of resolving a dispute before a dispute has even arisen is patently unfair. Moreover, the requirement typical of brokerage contracts that any dispute be resolved in an industry-run arbitration system undermines confidence in the fairness of that system. While we believe arbitration will remain the resolution mechanism of choice for most investors, giving investors a choice of dispute resolution mechanisms offers two important benefits: it will allow cases that involve complex questions of law and require the procedural protections afforded by a formal trial to be resolved in court where they belong, and it will provide an incentive for the arbitration system to be run in a way that ensures investors view it as a fair, affordable and effective means of resolving disputes.

Strengthening SEC Enforcement Powers: Finally, the legislation includes several provisions to strengthen SEC enforcement powers. It authorizes the agency to bar regulated individuals who violate the securities laws from all aspects of the industry. So, for example, a broker who committed a serious violation could be barred from acting as either a broker or an adviser. It also would strengthen whistleblower protections and allow the agency to reward whistleblowers for information that is instrumental in uncovering a fraud and convicting the perpetrators. Finally, it clarifies and expands the agency's authority to act against those who aid and abet securities fraud. It does so by extending this authority to violations of the Exchange Act and the Investment Advisers Act and by clarifying that the knowledge requirement for bringing an aiding and abetting complaint can be satisfied by recklessness.

CFA strongly supports these provisions. We regret, however, that the administration's plan does not address the long-standing need to restore aiding and abetting liability in private actions, and we urge Congress to rectify this important oversight. (For more on this issue, see Appendix A.)

Systemic Risk Regulation

As we have noted in previous testimony (attached in Appendix D), CFA believes the most important steps Congress and the administration can take to reduce risk in the financial system are to close regulatory loopholes and strengthen functional regulation. Nonetheless, we also support strengthened systemic risk oversight as a supplement to traditional functional regulation of financial markets, institutions, products and practices.

The President's plan includes a number of the key characteristics we have identified as essential to effective systemic risk regulation:

- the Financial Services Oversight Council it proposes to create would have the ability to gather information from any financial firm, ensuring a properly broad scope of oversight;

- the largest, most interconnected, and highly leveraged institutions would face stricter regulation, including higher capital requirements and more robust consolidated supervision, with a goal of forcing them to "internalize the costs that their failure could pose;"

- it looks beyond mere size when determining whether an institution poses out-sized risks to the financial system, to include such important factors as leverage, reliance on short-term funding, and importance to the overall economy;

- it attempts to address the conflicts of interest that exist within complex financial holding companies, both by imposing greater constraints on transactions between banks and their affiliates and by tightening supervision of conflicts posed by proprietary trading and the operation of hedge funds;

- it includes corrective action authority, which would enable regulators to act before risks spin out of control and threaten an institution's failure; and

- it creates a mechanism to allow for the orderly failure of non-bank financial institutions and holding companies.

One aspect of the administration's plan that we believe is particularly important is the effort it makes to address conflicts of interest and potential risks within complex financial holding companies. For years, CFA opposed the repeal of the Glass Steagall Act on the grounds, among other things, that it risked creating financial institutions that were both subject to vast conflicts of interest and were too complex to regulate effectively. The current crisis has led some eminent experts, such as former Federal Reserve Chairman Paul Volcker and MIT Professor Simon Johnson, to conclude that institutions that are too big or too complex to fail are too big and too complex to exist and should be broken up.

While the administration's plan stops short of breaking up such institutions, it deserves credit for attempting to take a much tougher, more comprehensive approach to regulation of these institutions than was proposed in the original Gramm-Leach-Bliley Act. Moreover, its proposal to raise capital and other standards in order to force these institutions to internalize the costs of being big and complex is theoretically sound. Effective implementation of these provisions is essential to reducing systemic threats. It will require regulators to be much tougher in standing up to industry pressure than they have traditionally been willing to be, however. Should their efforts fail, there will no longer be any credible answer to those who argue for the restoration of much simpler financial institutions.

The administration plan deviates from our suggested approach in one important respect; it proposes to identify "systemically significant" institutions up-front and subject them to higher standards and more regulatory scrutiny. As we discuss in more detail in the attached testimony (see Appendix D), we are concerned that this approach may not be either practical or effective. The administration's failure to recognize the systemic risk posed by the failure of Lehman Brothers, for example, should provide ample evidence of the fallibility of such an approach,

particularly in light of the complex factors that contribute to systemic risk. While we agree that institutions that are larger, more inter-connected, more leveraged or otherwise engaged in riskier conduct should face higher capital standards, stricter risk management requirements, and enhanced regulatory oversight, we believe those heightened standards should ratchet up along a continuum rather than turn on or off according to a determination that a particular institution poses a systemic threat. Such an approach is in our view less susceptible to gaming, in which institutions attempt to manipulate risk factors to either avoid or trigger designation as a systemically significant institution based on their perception of the costs or benefits of such a designation.

Finally, CFA has not taken a position on what regulatory agency should have primary responsibility for systemic risk oversight. We have, however, identified concerns that we believe must be addressed if Congress chooses to go forward with the administration plan to make the Federal Reserve Board the chief systemic risk regulator. Chief among these are concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks, its closed culture and lack of public accountability, factors that, left unaddressed, are likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. The President's plan addresses this issue by requiring the Fed and Treasury Department, in consultation with outside experts, to suggest changes to better align the Fed's structure and governance with its authorities and responsibilities. Moreover, the plan puts that evaluation on a very tight time-frame, which should allow any proposed changes to be factored into the decision about whether and under what terms to delegate this new responsibility to the Fed.

Other concerns that need to be addressed include a potential conflict between the Fed's role setting monetary policy and the role of a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Moreover, combining these two functions within the same agency raises question about how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis). The evaluation recommended in the President's plan will need to directly address these issues of conflicting missions, and Congress will need to determine whether these potential conflicts are capable of being resolved.

Conclusion

A fundamental lesson of this crisis is that the basic regulatory philosophy that has dominated the past three decades was mistaken, that market forces cannot be relied on to rein in abuses, and that markets cannot be left to self-correct. The President's plan is based on a clear recognition of this lesson and responds by proposing a more comprehensive approach to regulation designed to address the market failures that make our system vulnerable to crisis.

Opponents of regulatory reform have argued that more regulation cannot solve a problem that poor regulation created. Taking that line, it is easy to poke holes in any single component of the overall regulatory plan and argue that, standing alone, it would not prevent a crisis similar to the one we now face. Moreover, all aspects of the plan are susceptible to the criticism that they

require regulators to make exactly the sort of tough, responsible decisions that they failed to make in the lead-up to the current crisis. In truth, unless there is a renewed commitment to tough regulation at our regulatory agencies, we risk making that prediction a reality.

After all, it is completely predictable that, if these proposals are adopted, financial institutions will soon be heard complaining to regulators, to Congress, and to members of the media that regulators are over-reacting, that restrictions are unreasonable, and that they are stifling innovation and undermining the institutions' ability to compete globally. This is the same litany of complaints that financial services firms have used successfully over the years to stave off effective regulation, and it is their success in advancing those arguments before Congress and the regulatory agencies that has brought our financial system to the brink of collapse. Unless Congress and regulators are willing to resist that industry pressure, the result is likely to be weak implementation of crucial aspects of the plan designed to promote the safety and soundness of the financial system.

The answer, however, is not to throw up our hands in defeat. On the contrary, this susceptibility of the regulatory system to industry influence highlights the need to enact the administration's *entire* regulatory plan intact, to fill in the gaps that need filling, and to strengthen those aspects of the plan that need strengthening. Only the most comprehensive, toughest plan has a chance of overcoming the weakness in implementation that will inevitably undermine the effectiveness of individual components of the plan.

Moreover, the more focus we place on regulating effectively early in the process – by banning harmful and risky credit practices, by providing effective day-to-day oversight of markets and institutions – the less reliant we will be on those aspects of the plan that are most vulnerable to industry influence, including the proposals for higher capital standards, for more rigorous risk management practices, and for systemic risk regulation. Thus, it is absolutely essential that Congress adopt the strongest possible legislation to provide that up-front regulation, particularly by creating a new Consumer Financial Protection Agency to rein in unsound lending practices, by adopting a comprehensive and effective system of regulation for OTC derivatives, and by reforming the credit rating agencies.

Industry opposition is certain to be fierce, particularly to those aspects of the plan that are most likely to force them to change long-standing practices or to loosen their grip on the regulatory apparatus. Already, they have fired up their lobbying operations using their tried and true anti-regulation arguments and misinformation practices. The administration has for the most part resisted those arguments and presented a plan for regulatory reform that, while imperfect, is both comprehensive in scope and thoughtful in many of its details. We urge Congress to take up that challenge and shepherd the bill to passage, filling in gaps and strengthening certain key provisions, while avoiding weakening amendments.

Appendix A:

SHAREOWNERS.ORG:

A SHAREOWNER AGENDA FOR RESTORING CORPORATE ACCOUNTABILITY

We seek to create better protections for the average American investor in the financial marketplace. The severe losses suffered by tens of millions of Americans in their portfolios, 401(k)s, mutual funds and traditional pension plans all point to the need for a new emphasis on shareowner rights and meaningful regulation in order to ensure the financial security of American families.

America has tried going down the road of financial deregulation and reduced corporate accountability. That path has proven to be a dead end that is now imperiling the financial well being of millions of long-term shareowners. Unfortunately, shareholders in America's corporations -- who actually should more correctly be thought of as "shareowners" -- have limited options today when it comes to protecting themselves from weak and ineffectual boards dominated by management, misinformation peddled as fact, accounting manipulation, and other abuses.

Under the disastrous sway of deregulation and lack of accountability, corporate boards and executives either caused or allowed corporations to undertake unreasonable risks in the pursuit of short-term financial goals that were devoid of real economic substance or any long-term benefits. In most cases, it is long-term shareowners -- not the deregulators and the speculators -- that are paying the price for the breakdown in the system.

It is time for America to get back on the road of prudent financial regulatory oversight and increased corporate accountability. ShareOwners.org recognizes the devastating impact that a lack of appropriate regulation and accountability has had on our economy. In order to restore the confidence of investors in our capital markets, it is now necessary to take the following steps:

I. **Strengthen the <u>regulation of the markets</u>.** Key reforms needed to protect the interests of shareowners include the following:

Beef up the Securities and Exchange Commission (SEC). Congress should assess the funding needs of the SEC and take steps to bring the agency as quickly as possible to

the point that it can fully carry out its mission of oversight of the markets and financial professionals in order to protect and advocate for investors. Among other priorities, the SEC should impose requirements for the disclosure of long and short positions, enhance disclosures for private equity firms bidding for public companies, and require both the registration of hedge fund advisors with the Commission as investment advisors and additional disclosures of the underlying hedge fund. Following the request of the Administration, the SEC should be given additional authority to create a full-fledged fiduciary standard for broker dealers, so that the interests of clients who purchase investment products comes before the self interest of the broker. The SEC Division of Enforcement should be unshackled to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action.

Clear the way for forfeiture of compensation and bonuses earned by management in a deceptive fashion. Legislation should be adopted to allow for the "clawing back" of incentive compensation and bonuses paid to corporate executives based on fraudulent corporate results, and should provide for enforcement through a private right of action. There is no reason why directors and executives should not give back ill-gotten gains when innocent shareowners are victimized by crippling losses. The outrageous bonuses at AIG, Morgan Stanley and other banks responsible for our financial meltdown were not deserved and should not be allowed to stand. If they know their compensation is on the line, corporate managers and directors will be less likely to engage in, or turn a blind eye toward, fraud and other wrongdoing.

Strengthen state-level shareowner rights. Corporation structures and charters are regulated under state law. The corporate law in most states has not clarified the rights, responsibilities and powers of shareholders and directors or ways that they should communicate outside of annual general meetings. If regulation to strengthen shareholder rights does not occur at the federal level, it will be up to the states to move forward. State corporate law should require proxy access, majority voting and the reimbursement of solicitation expenses in a board challenge. We would encourage robust competition among states for corporate charters based on a race to the top for improved shareowner rights. If necessary, federal law should be changed to allow for shareholders to call a special meeting to reincorporate in another state by majority vote, in order to avoid being shackled by the corporate state laws that put the interests of management ahead of shareowners.

Protect whistleblowers and confidential sources who expose financial fraud and other corporate misconduct. Confidential informants -- sometimes called "whistleblowers" -- are of immeasurable value in discovering and redressing corporate wrongdoing. The information provided by these individuals may be crucial to victims' ability to prove their claims. Often, these individuals only come forward because they believe their anonymity will be preserved. If their identities were known, they would be open to

retaliation from their employers and/or others with an interest in covering up the wrongdoing. Whistleblowers might lose their job or suffer other harm. Legislation is needed to clearly state that the corporate whistleblowers and other confidential informants will be protected when they step forward.

II. Increase the accountability of boards and corporate executives. Key reforms needed to protect the interests of shareowners include the following:

Allow shareowners to vote on the pay of CEOs and other top executives. Corporate compensation policies that encourage short-term risk-taking at the expense of long-term corporate health and reward executives regardless of corporate performance have contributed to our current economic crisis. Shareowners should have the opportunity to vote for or against senior executive compensation packages in order to ensure managers have an interest in long-term growth and in helping build real economic prosperity. The recently enacted stimulus bill requires all companies receiving TARP bail-out funds, nearly 400 companies, to include a "say on pay" vote at their 2009 annual meetings and as long as they hold TARP funds. It is now time for Congress to implement Treasury Secretary Geithner's plan for compensation reform by passing "say on pay" legislation for all companies and to make it permanent as the center piece of needed reforms to encourage executive accountability.

Empower shareowners to more easily nominate directors for election on corporate boards. (This is often referred to as "proxy access.") The process for nominating directors at American corporations is dominated today by incumbent boards and corporate management. This is because corporate boards control the content of the materials that companies send to shareholders to solicit votes (or "proxies") for director elections, including the identification of the candidates who are to be considered for election. The result is that corporate directors often are selected based on their allegiance to the policies of the incumbent board, instead of their responsiveness to shareowner concerns. Unless they can afford to launch an expensive independent proxy solicitation, shareowners have little or no say in selecting the directors who are supposed to represent their interests. The solution is to enable shareowners, under certain circumstances, to require corporate boards to include information about candidates nominated by shareowners in the company's proxy materials.

Require majority election of all members of corporate boards at American companies.
Corporate directors are the elected representatives of shareowners who are responsible for overseeing management. Under the default rule applicable to virtually every corporation in the United States, however, corporate directors can be elected with just a single affirmative vote, even if that director's candidacy is opposed by the overwhelming majority of shareowners. While a few corporations have adopted policies that would

require a director to receive support of the majority of shareowners in order to be elected, most corporations -- particularly those not in the S&P 500 -- have not. True majority voting should be mandatory in every uncontested director election at all publicly traded corporations.

Split the roles of chairman of the board and CEO in any company (1) receiving federal taxpayer funds or (2) operating under federal financial regulations. It already is the practice in most of the world to divide these two key positions so that an independent chairman can serve as a check on potential CEO abuses. Separation of the CEO and board chair roles helps to ensure good board governance and fosters independent oversight to protect the long-term interests of private shareowners, pension funds and institutional investors. A strong independent chair can help to address legitimate concerns raised by shareowners in a company. Splitting these roles and then requiring a prior shareowner vote to reintegrate them would be in the best interests of investors.

Stop the practice of brokers casting votes for shareowners in board elections. Brokers should no longer be allowed to vote on behalf of their clients in board of director elections. Stockbrokers who hold shares in their own name for their client investors have no real economic interest in the underlying corporation. Nevertheless, such brokers are permitted to vote these shares held in "street name" to elect corporate directors. Such brokers frequently can determine the leadership of corporate boards, even though they have no direct economic interest in the corporations. Moreover, brokers almost universally vote for managements' nominees and proposals and, in effect, interfere with shareowner supervision of the corporations they own.

Allow shareowners to call special meetings. Shareowners should be allowed to call a special meeting. Shareowners who own 5 percent or more of the stock of a company should be permitted, as they are in other countries, to call for a special meeting of all shareowners. They also should be given the right to call for a vote on reincorporation when management and corporate boards unduly use state laws detrimental to shareowner interests to entrench themselves further.

III. Improve financial transparency. Key reforms needed to protect the interests of shareowners include the following:

Crackdown on corporate disclosure abuses that are used to manipulate stock prices. Shareowners in securities fraud cases have always had the burden of proving that defendants' fraud caused the shareowners' losses. When corporate wrongdoers lie to shareowners and inflate the value of publicly traded stock through fraudulent and misleading accounting statements and other chicanery, those culpable parties should be

held responsible for the damage wrought on the investing public that is caused by their fraud. Defendants should not be allowed to escape accountability to their shareowners for fraudulent conduct simply by cleverly timing the release of information affecting a company's stock price.

Improve corporate disclosures so that shareowners can better understand long-term risks. To rebuild shareowner confidence regulators should emphasize transparency by creating more mechanisms for comprehensive corporate disclosure. The SEC should devote particular attention to the adequacy of disclosures concerning such key factors as credit risk, financial opacity, energy and climate risk and those reflecting the financial challenges to the economy as identified by the transition team and the new administration. The SEC should develop internal expertise on issues such as environmental, social, and governance factors that pose material financial risks to corporations and shareowners, and also to require disclosure of these types of risks.

Protect U.S. shareowners by promoting new international accounting standards. Our current financial crisis extends far beyond the borders of the US and has affected financial markets and investors across the globe. Part of the problem has been a race to the bottom in favor of a more flexible international accounting standard that would decrease disclosure protection for the average investor. The current crisis makes a compelling case for why we need to slow down the movement towards the use of international accounting standards that could provide another back door route to financial deregulation and further erode confidence in corporate book keeping. A slower time frame is necessary to protect shareowners and allow the administration to reach out to other governments that share a commitment to high accounting and transparency standards.

IV. Protect the <u>legal rights of defrauded shareowners</u>. Key reforms needed to protect the rights of shareowners include the following:

Preserve the right of investors to go to court to get justice. Corporate and financial wrongdoers in recent years have effectively denied compensation to victims of fraud by requiring customers to sign away their rights to access federal courts as individuals and participate with other victims in class actions when their individual claims are small. Absent the ability to proceed collectively, individuals have no means of redress because -- as the wrongdoers know -- it is frequently economically impossible for victims to pursue claims on an individual basis. The ability of shareowners to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Shareowners should have the right to access federal courts individually or as a member of a class action.

Ensure that those who play a role in committing frauds bear their share of the cost for cleaning up the mess. What is known as private "aiding and abetting" liability is well established in criminal law, and private liability for engaging in an unlawful and fraudulent scheme is widely recognized in civil law. In cases of civil securities fraud, however, judicial decisions effectively have eliminated private liability of so-called "secondary actors" – even when they knowingly participated in fraud schemes. Eliminating the private liability of such "secondary actors" as corporate accountants, lawyers and financial advisors has proven disastrous for shareowners and the economy. Most recently, in the sub-prime mortgage-backed securities debacle, bond rating agencies -- who were paid by the very investment bankers who created the securities they were asked to rate -- knowingly gave triple-A ratings to junk sub-prime debt instruments in order to generate more business from the junk marketers. The immunity from private liability that these culpable third parties currently enjoy should be eliminated.

Allow state courts to help protect investor rights. The previous decade saw the greatest shift in governmental authority away from the states and to the federal government in our history. The effect of this shift was to deny individuals their legal rights under state laws and to protect corporate defendants. Corporate interests and an administration devoted to the ideology of deregulation used the "doctrine of preemption" (that federal law supersedes state law) to bar action at the state level that could have stopped many of the abuses in sub-prime mortgage lending that are now at the heart of our economic crisis. Indeed, state attorneys general were blocked from prosecuting sub-prime lenders who violated state laws. The integrity of state law should be restored and both state officials and shareowners should be allowed to pursue remedies available under state law. Federal policy should make clear that state law exists coextensively with federal regulations, except where state law directly contradicts federal law.

Appendix B: Description of Consumer Credit Insurance Coverages

Credit insurance refers to a group of insurance products sold in conjunction with a loan or credit agreement. Credit insurance makes payments for the consumer to the lender for a specific loan or credit agreement in particular circumstances. The common types of credit insurance sold include:

- *Credit Life* pays off the consumer's remaining debt on a specific loan or credit card account if the borrower dies during the term of the coverage.
- *Credit Accident and Health,* also known as *Credit Disability,* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes disabled during the term of coverage.
- *Credit Involuntary Unemployment* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes involuntarily unemployed during the term of coverage.
- *Credit Personal Property* typically pays to repair or replace property that is serving as collateral for a loan.
- *Creditor-Placed Insurance* is auto or property insurance placed by a lender if the consumer fails to maintain the insurance required by the terms of the auto or home loan.
- *Credit Family Leave* makes monthly payments if the borrower goes on an approved family leave.
- *Credit GAP* pays the difference – or gap – between the amount owed on the auto loan and the amount paid by the insurance company on the auto insurance policy in the event there is an accident resulting in a total loss to the vehicle and the amount of insurance payoff is less than the amount owed on the loan. GAP is sometimes used as acronym for Guaranteed Auto Protection.
- *Non-Filing* pays the lender in the event loan documents have not been correctly filed.
- *Mortgage Guaranty* pays the lender in the event the borrower defaults on the mortgage loan.

Appendix C: Properly Regulating Insurance "Look Alike" Products

Many insurance products are perfect or near-perfect substitutes for financial products; it is logical for the CFPA to represent consumers on all substantively similar products.

Consumer credit insurance products are – from the consumer's perspective – equivalent to debt cancellation contracts and debt suspension agreements – products which federal banking regulators have declared to be banking products.

Debt Cancellation Contracts (DCCs) and related products like Debt Suspension Agreements (DSAs) are products sold in connection with a consumer loan and which promise to provide some debt relief to the consumer if certain events occur. The events triggering the benefit under the DCCs/DSAs are typically events that impair the borrower's income or place a financial burden on the borrower. DCCs/DSAs are part of the group of payment protection products that include credit insurance and which promise, among other things, to preserve the borrower's credit rating in adverse circumstances.

Since 2000, lenders have shifted their payment protection product offerings from credit insurance to DCCs/DSAs, initially in connection with credit cards and more recently in connection with closed-end loans. One of the earliest forms of DCC sold in connection with a closed-end loan was GAP Waiver sold in connection with auto loans.

To a consumer, DCCs and credit insurance are very similar – or even identical – products. For a one-time or monthly fee, DCC will cancel the debt or make monthly payments if certain events occur – just as credit insurance performs. For example, a credit card credit insurance program containing credit life, credit disability and credit involuntary unemployment coverages provides the identical benefits for a consumer as a DCC program for death, disability and involuntary unemployment.

The major difference between credit insurance and DCC is in regulatory oversight. Federal banking regulators have declared DCC to be a banking product and, consequently, not subject to state insurance regulation if sold by banks or credit unions with federal charters. Although state insurance regulators challenged these decisions, claiming that DCC was an insurance product, banks who sought the federal oversight of DCC and the federal agencies have prevailed in legal challenges. State regulation of DCCs offered by state-chartered financial institutions has generally followed the federal rules.

The rationale for not regulating DCC as an insurance product is that, unlike credit insurance, where a borrower, a lender and an insurance company are involved, there are only two parties involved with DCC – the borrower and the lender. The DCC is an addendum to the loan contract that states that, under certain circumstances, the lender will cancel the debt or the monthly payment. So, in theory, no insurance company need be involved.

In practice, DCC programs are administered in almost the same manner as credit insurance programs. Credit insurance companies provide the same administrative and sales

services as with credit insurance. The lender purchases a contractual liability policy from the credit insurance company, and this policy pays any claims made under the DCC program offered by the lender. Credit insurance companies, including CUNA Mutual, now sell and administer DCC programs as well as credit insurance programs.

The difference in regulatory oversight of DCC versus credit insurance is dramatic. With credit insurance, the products (policy forms) must be approved by state insurance regulators prior to use and the rates subject to prima facie maximum rate regulation. A credit insurer wishing to offer a national program must obtain approvals in all states and comply with different rates in all states as well as variations in product requirements among the states. Under rules promulgated by the Office of the Comptroller of the Currency (OCC) and other federal financial regulators, lenders can offer a single DCC product nationally. Lenders have moved from credit insurance to DCC for several reasons:

- No oversight or limitations on fees charged
- Few limitations on product design and benefit provisions – no restrictions on bundling, flexibility in product design
- Ability to use one product nationally
- No agent licensing requirements
- No form or rate filing requirements
- No premium taxes

DCCs and DSAs generally provide much worse value to consumers than credit insurance – higher prices, fewer benefits and fewer consumer protections. In prior reports and testimony, CFA has estimated the loss ratio for DCCs and DSAs to be less than 5%. In addition to lower benefit payouts, the administrative costs for DCCs are lower than for credit insurance because of the ability to utilize a single program across the states, the absence of product filings and approvals, and the absence of a premium tax.

Failure to allow the CFPA to represent insurance consumers will lead to regulatory arbitrage – the shifting of banking products to insurance products.

When the federal banking regulators declared debt cancellation contracts to be banking products – and not subject to state insurance regulation – lenders started changing their products from credit insurance to debt cancellation or debt suspension to take advantage of the more favorable (to lenders) regulatory structure for the debt cancellation and debt suspension products. This is one example of regulatory arbitrage – regulated entities playing off competing regulators for the most advantageous – to the regulated entities – regulatory regime. Failure to include credit-related insurance products under the jurisdiction of the CFPA would reverse that trend, encouraging financial institutions to shift from use of regulated bank products to less regulated insurance products. Consumers would be the losers.

Appendix D:

Consumer Federation of America

Testimony of Travis Plunkett
Legislative Director
Consumer Federation of America

Hearing on "Systemic Risk"

Before the
Committee on Financial Services
U.S. House of Representatives

March 17, 2009

Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

I greatly appreciate the opportunity to appear before you today to testify about one of the most important issues Congress will need to address as it develops a comprehensive agenda to reform our nation's failed financial regulatory system – how to better protect the system as a whole and the broader economy from systemic risks. Recent experience has shown us that our current system was not up to the task, either of identifying significant risks, or of addressing those risks before they spun out of control, or of dealing efficiently and effectively with the situation once it reached crisis proportions. The effects of this failure on the markets and the economy have been devastating, rendering reform efforts aimed at protecting the system against systemic threats a top priority.

In order to design an effective regulatory response, it is necessary to understand why the system failed. It has been repeated so often in recent months that it has taken on the aura of gospel, but it is simply not the case that the systemic risks that have threatened the global financial markets and ushered in the most serious economic crisis since the Great Depression arose because regulators lacked either sufficient information or the tools necessary to protect the financial system as a whole against systemic risks. (Though it is true that, once the crisis struck, regulators lacked the tools needed to deal with it effectively.) On the contrary, the crisis resulted from regulators' refusal to heed overwhelming evidence and repeated warnings about growing threats to the system.

- Former Congressman Jim Leach and former CFTC Chairwoman Brooksley Born both identified the potential for systemic risk in the unregulated over-the-counter derivatives markets in the 1990s.

- Housing advocates have been warning the Federal Reserve since at least the early years of this decade that securitization had fundamentally changed the underwriting standards for mortgage lending, that the subprime mortgages being written in increasing numbers were unsustainable, that foreclosures were on the rise, and that this had the potential to create systemic risks.

- The SEC's risk examination of Bear Stearns had, according to the agency's Inspector General, identified several of the risks in that company's balance sheet, including its use of excessive leverage and an over-concentration in mortgage-backed securities.

Contrary to conventional wisdom, these examples and others like them provide clear and compelling evidence that, in the key areas that contributed to the current crisis – unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system – regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in Born's case, were denied the authority they needed to rein in those risks.

Regulatory intervention at any of those key points had the potential to prevent, or at least greatly reduce the severity of, the current financial crisis – either by preventing the unsound mortgages from being written that triggered the crisis, or by preventing investment banks and other financial institutions from taking on excessive leverage and loading up their balance sheet with risky assets, leaving them vulnerable to failure when the housing bubble burst, or by preventing complex networks of counterparty risk to develop among financial institutions that allowed the failure of one institution to threaten the failure of the system as a whole. This view is well-articulated in the report of the Congressional Oversight Panel, which correctly identifies a fundamental abandonment of traditional regulatory principles as the root cause of the current financial crisis and prescribes an appropriately comprehensive response.

So what is the lesson to be learned from that experience for Congress's current efforts to enhance systemic risk regulation? The lesson is emphatically not that there is no need to improve systemic risk regulation. On the contrary, this should be among the top priorities for financial regulatory reform. But there is a cautionary lesson here about the limitations inherent in trying to address problems of inadequate systemic risk regulation with a structural solution. In each of the above examples, and others like them, the key problem was not insufficient information or inadequate authority; it was an unwillingness on the part of regulators to use the authority they had to rein in risky practices. That lack of regulatory will had its roots in an irrational faith among members of both political parties in markets' ability to self-correct and industry's ability to self-police.

Until we abandon that failed regulatory philosophy and adopt in its place an approach to regulation that puts its faith in the ability and responsibility of government to serve as a check on industry excesses, whatever we do on systemic risk is likely to have little effect. Without that change in governing philosophy, we will simply end up with systemic risk regulation that exhibits the same unquestioning, market-fundamentalist approach that has characterized substantive financial regulation to a greater or lesser degree for the past three decades.

If the "negative" lesson from recent experience is that structural solutions to systemic risk regulation will have limited utility without a fundamental change in regulatory philosophy, there is also a positive corollary. Simply closing the loopholes in the current regulatory structure, reinvigorating federal regulators, and doing an effective job at the day-to-day tasks of routine safety and soundness and investor and consumer protection regulation would go a long way toward eliminating the greatest threats to the financial system.

The "Shadow" Banking System Represents the Greatest Systemic Threat

In keeping with that notion, the single most significant step Congress could and should take right now to decrease the potential for systemic risk is to shut down the shadow banking system completely and permanently. While important progress is apparently being made (however slowly) in moving credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, *Infectious Greed,* a primary use of the "shadow" banking system – and indeed the main reason for its existence – is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So banks used unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks sold Mezzanine CDOs to pension funds in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter market without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

The basic justification for allowing two systems to grow up side-by-side – one regulated and one not – is that sophisticated investors are capable of protecting their own interests and do not require the basic protections of the regulated market. That myth has been dispelled by the current crisis. Not only did "sophisticated" institutional investors load up on toxic mortgage-backed securities and collateralized debt obligations without understanding the risks of those investments, but financial institutions themselves either didn't understand or chose to ignore the risks they were exposing themselves to when they bought toxic assets with borrowed money or funded long-term obligations with short-term financing. By failing to protect their own interests, they damaged not only themselves and their shareholders, but also the financial markets and the global economy as a whole. This situation simply cannot be allowed to continue. Any proposal to address systemic risk must confront this issue head-on in order to be credible.

Other Risk-Related Priorities Should Also Be Addressed

There are other pressing regulatory issues that, while not expressly classified as systemic risk, are directly relevant to any discussion of how best to reduce systemic risk. Chairman Frank has appropriately raised the issue of executive compensation in this context, and CFA supports efforts to reduce compensation incentives that promote excessive risk-taking.

Similarly, improving the reliability of credit ratings while simultaneously reducing our reliance on those ratings is a necessary component of any comprehensive plan to reduce systemic risk. Ideally, some mechanism will be found to reduce the conflicts of interest associated with the agencies' issuer-paid compensation model. Whether or not that is the case, we believe credit rating agencies must face increased accountability for their ratings, the SEC must have increased authority to police their ratings activities to ensure that they follow appropriate due diligence standards in arriving at and maintaining those ratings, and laws and rules that reference the ratings must make clear that reliance on ratings alone does not satisfy due diligence obligations to ensure the appropriateness of the investment.

In addition, CFA believes one of the most important lessons that have been learned regarding the collapse of our financial system is that improved, up-front product-focused regulation will significantly reduce systemic risk. For example, if federal regulators had acted

more quickly to prevent abusive sub-prime mortgage loans from flooding the market, it is likely that the current housing and economic crisis would not have been triggered. As a result, we have endorsed the concept advanced by COP Chair Elizabeth Warren and legislation introduced by Senator Richard Durbin and Representative William Delahunt to create an independent financial safety commission to ensure that financial products meet basic standards of consumer protection. Some opponents of this proposal have argued that it would stifle innovation. However, given the damage that recent "innovations" such as liar's loans and Mezzanine CDOs have done to the global economy, this hardly seems like a compelling argument. By distinguishing between beneficial and harmful innovations, such an approach could in our view play a key role in reducing systemic risks.

Congress Needs To Enhance the Quality of Systemic Risk Oversight

In addition to addressing those issues that currently create a significant potential for systemic risk, Congress also needs to enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of non-bank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain over the best way to accomplish that goal. The remainder of this testimony will address those key questions regarding such issues as who should regulate for systemic risk, who should be regulated, what that regulation should consist of, and how it should be funded. CFA has not yet reached firm conclusions on all of these issues, including on the central question of how systemic risk regulation should be structured. Where our position remains unresolved, we will discuss possible alternatives and the key issues we believe need to be resolved in order to arrive at a conclusion.

Should there be a central systemic risk regulator?

As discussed above, we believe all financial regulators should bear a responsibility to monitor for and mitigate potential systemic risks. Moreover, we believe a regulatory approach

that both closes regulatory loopholes and reinvigorates traditional regulation for solvency and consumer and investor protection would go a long way toward accomplishing that goal. Nonetheless, we agree with those who argue that there is a benefit to having some central authority responsible and accountable for overseeing these efforts, if only to coordinate regulatory efforts related to systemic risk and to ensure that this remains a priority once the current crisis is past.

Perhaps the best reason to have one central authority responsible for monitoring systemic risk is that, properly implemented, such an approach offers the best assurance that financial institutions will not be able to exploit newly created gaps in the regulatory structure. Financial institutions have devoted enormous energy and creativity over the past several decades to finding, maintaining, and exploiting gaps in the regulatory structure. Even if Congress does all that we have urged to close the regulatory gaps that now exist, past experience suggests that financial institutions will immediately set out to find new ways to evade legal restrictions.

A central systemic risk regulatory authority could and should be given responsibility for quickly identifying any such activities and assigning them to their appropriate place within the regulatory system. Without such a central authority, regulators may miss activity that does not explicitly fall within their jurisdiction or disputes may arise over which regulator has authority to act. CFA believes designating a central authority responsible for systemic risk regulation offers the best hope of quickly identifying and addressing new risks that emerge that would otherwise be beyond the reach of existing regulations.

Who should it be?

Resolving who should regulate seems to be the most vexing problem in designing a system for improved systemic risk regulation. Three basic proposals have been put forward: 1) assign responsibility for systemic risk regulation to the Fed; 2) create a new market stability regulator; and 3) expand the President's Working Group on Financial Markets (PWG) and give it an explicit mandate to coordinate and oversee regulatory efforts to monitor and mitigate systemic threats. Each approach has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation.

The Federal Reserve Board – Many people believe the Federal Reserve Board (the "Fed") is the most logical body to serve as systemic risk overseer. Those who favor this approach argue that the Fed has the appropriate mission and expertise, an experienced staff, a long tradition of independence, and the necessary tools to serve in this capacity (e.g., the ability to act as lender of last resort and to provide emergency financial assistance during a financial crisis). Robert C. Pozen summed up this viewpoint succinctly when he testified before the Senate Committee on Homeland Security and Governmental Affairs. He said:

> "Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system … If the Federal Reserve Board is going to bail out a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure."

Two other, more pragmatic arguments have been cited in favor of giving these responsibilities to the Fed: 1) its ability to obtain adequate resources without relying on the congressional budget process and 2) the relative speed and ease with which this expansion of authority could be accomplished, particularly in comparison with the challenges of establishing a new agency for this purpose.

Others are equally convinced that the Fed is the last agency that should be entrusted with responsibility for systemic risk regulation. Some cite concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks. Particularly when combined with the Board's closed culture and lack of public accountability, this conflict is seen as likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. Opponents of the Fed as systemic risk regulator also cite a conflict between its role setting monetary policy and its potential role as a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Another involves the question of how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis).

Others simply point to what they see as the Fed's long history of regulatory failure. This includes not only failures directly related to the current crisis – its failure to address unsound mortgage lending on a timely basis, for example, as well as its failure to prevent banks from holding risky assets in off-balance-sheet special purpose entities and its cheerleading of the rapid expansion of the shadow banking system – but also a perceived past willingness at the Fed to allow banks to hide their losses. According to this argument, Congress ultimately passed FDICIA in 1991 (requiring regulators to close financial institutions before all the capital or equity has been depleted) precisely because the Fed had been unwilling to do so absent that requirement.

Should Congress determine to give systemic risk responsibility to the Fed, we believe it is essential that you take meaningful steps to address what we believe are compelling concerns about this approach. Even some who have spoken in favor of the Fed in this capacity have acknowledged that it will require significant restructuring. As former Federal Reserve Chairman Paul Volcker noted in remarks before the Economic Club of New York last April:

> "If the Federal Reserve is also … to have clear authority to carry effective 'umbrella' oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability …, all backed by a stronger, larger, highly experienced and reasonably compensated professional staff."

CFA concurs that, if systemic risk regulation is to be housed at the Fed, systemic risk regulation must not be relegated to Cinderella status within the agency. Rather, it must be given a high

priority within the organization, and significant additional staff dedicated to this task must be hired who have specific risk assessment expertise. Serious thought must also be given to 1) how to resolve disputes between these two potentially competing functions of setting monetary policy and mitigating systemic risks, and 2) how to ensure that systemic risk regulation is carried out with the full transparency and public accountability that it demands.

A New Systemic Risk Regulatory Agency – Some have advocated creation of an entirely new regulatory agency devoted to systemic risk regulation. The idea behind this approach is that it would allow a singular focus on issues of systemic risk, both providing clear accountability and allowing the hiring of specialized staff devoted to this task. Furthermore, such an agency could be structured to avoid the significant concerns associated with designating the Fed to perform this function, including the conflict between monetary policy and systemic risk regulation.

Although it has its advocates, this approach appears to trigger neither the broad support nor the impassioned opposition that the Fed proposal engenders. Those who favor this approach, including Brookings scholar Robert Litan, tend to do so only if it is part of a more radical regulatory restructuring. Adding such an agency to the existing regulatory structure would "add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions," Litan said in recent testimony before the Senate Committee on Homeland Security and Governmental Operations. Moreover, even its advocates tend to acknowledge that it would be a challenge, and possibly an insurmountable challenge, to get such an agency up and running in a timely fashion.

Expanded and Refocused President's Working Group – The other approach that enjoys significant support entails giving an expanded version of the President's Working Group for Financial Markets clear, statutory authority for systemic risk oversight. Its current membership would be expanded to include all the major federal financial regulators as well as representatives of state securities, insurance, and banking officials. By formalizing the PWG's authority through legislation, the group would be directly accountable to Congress, allowing for meaningful congressional oversight.

Among the key benefits of this approach: the council would have access to extensive information about and expertise in all aspects of financial markets. The regulatory bodies with primary day-to-day oversight responsibility would have a direct stake in the panel and its activities, maximizing the chance that they would be fully cooperative with its efforts. For those who believe the Fed must play a significant role in systemic risk regulation, this approach offers the benefit of extensive Fed involvement as a member of the PWG without the problems associated with exclusive Fed oversight of systemic risk.

This approach, while offering attractive benefits, is not without its short-comings. One is the absence of any single party who is solely accountable for regulatory efforts to mitigate systemic risks. Because it would have to act primarily through its member bodies, it could result in an inconsistent and even conflicting approach among regulators. It also raises the risk that systemic risk regulation will not be given adequate priority. In dismissing this approach, Litan acknowledges that it may be the most politically feasible but he maintains: "A college of

regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing."

Despite the many attractions of this approach, this latter point is particularly compelling, in our view. Regulators have a long history of jurisdictional disputes. There is no reason to believe those problems would simply dissipate under this arrangement. Decisions about who has responsibility for newly emerging activities would likely be particularly contentious. If Congress were to decide to adopt this approach, it would need to set out some clear mechanism for resolving any such disputes. Alternatively, it could combine this approach with enhanced systemic risk authority for either the Fed or a new agency, as the Financial Services Roundtable has suggested, providing that agency with the benefit of the panel's broad expertise and improving coordination of regulatory efforts in this area.

FDIC – A major reason federal authorities were forced to improvise in managing the events of the past year is that we lack a mechanism for the orderly unwinding of non-bank financial institutions that is comparable to the authority that the FDIC has for banks. Most systemic risk plans seem to contemplate expanding FDIC authority to include non-bank financial institutions, although some would house this authority within a systemic risk regulator. CFA believes this is an essential component of a comprehensive plan for enhanced systemic risk regulation. While we have not worked out exactly how this should operate, we believe the FDIC, the systemic risk regulator, or the two agencies working together must also have authority to intervene when failure appears imminent to require corrective actions.

A Systemic Risk Advisory Panel – One of the key criticisms of making the Fed the systemic risk regulator is its dismal regulatory record. But if we limited our selections to those regulators with a credible record of identifying and addressing potential systemic risks while they are still at a manageable stage, we'd be forced to start from scratch in designing a new regulatory body. And there is no guarantee we would get it right this time.

A number of academics and others outside the regulatory system were far ahead of the regulators in recognizing the risks associated with unsound mortgage lending, unreliable ratings on mortgage-backed securities and CDOs, the build-up of excessive leverage, the questionable risk management practices of investment banks, etc. Regardless of what approach Congress chooses to adopt for systemic risk oversight, we believe it should also mandate creation of a high-level advisory panel on systemic risk. Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such a panel.

The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of

regulators and reduce the risks of group-think and complacency. We urge you to include this as a component of your regulatory reform plan.

Who should be regulated?

The debate over who should be regulated for systemic risk basically boils down to two main points of view. Those who see systemic risk regulation as something that kicks in during or on the brink of a crisis, to deal with the potential failure of one or more financial institutions, tend to favor a narrower approach focused on a few large or otherwise "systemically important" institutions. In contrast, those who see systemic risk regulation as something that is designed, first and foremost, to prevent risks from reaching that degree of severity tend to favor a much more expansive approach. Recognizing that systemic risk can derive from a variety of different practices, proponents of this view argue that all forms of financial activity must be subject to systemic risk regulation and that the systemic risk regulator must have significant flexibility and authority to determine the extent of its reach.

CFA falls firmly into the latter camp. We are not alone; this expansive view of systemic risk jurisdiction has many supporters, at least when it comes to the regulator's authority to monitor the markets for systemic risk. The Government Accountability Office, for example, has said that such efforts "should cover all activities that pose risks or are otherwise important to meeting regulatory goals." Bartlett of the Financial Services Roundtable summed it up well in his testimony when he said that:

> "… authority to collect information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (e.g., transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk."

The case for giving a systemic risk regulator broad authority to monitor the markets for systemic risk is obvious, in our opinion. Failure to grant a regulator this broad authority risks allowing risks to grow up outside the clear jurisdiction of functional regulators, a situation financial institutions have shown themselves to be very creative at exploiting.

While the case for allowing the systemic risk regulator broad authority to monitor the financial system as a whole seems obvious, the issue of whether to also grant that regulator authority to constrain risky conduct wherever they find it is more complex. Those who favor a narrower approach argue that the proper focus of any such regulatory authority should be limited to those institutions whose failure would be likely to create a systemic risk. This view is based on the sentiment that, if an institution is too big to fail, it must be regulated. While CFA shares the view that those firms that are "too big to fail" must be regulated, we take that view one step further. As we have discussed above, we believe that the best way to reduce systemic risk is to

ensure that all financial activity is regulated to ensure that it is conducted according to basic principles of transparency, fair dealing, and accountability.

Those like Litan who favor a narrower approach focused on "systemically important" institutions defend it against charges that it creates unacceptable moral hazard by arguing that it is essentially impossible to expand on the moral hazard that has already been created by recent federal bailouts simply by formally designating certain institutions as systemically significant. We agree that, based on recent events and unless the approach to systemic risk is changed, the market will assume that large firms will be rescued, just as the market rightly assumed for years, despite assurances to the contrary, that the government would stand behind the GSEs. Nonetheless, we do not believe it follows that the appropriate approach to systemic risk regulation is to focus exclusively on these institutions that are most likely to receive a bailout. Instead, we believe it is essential to attack risks more broadly, before institutions are threatened with failure and, to the degree possible, to eliminate the perception that large institutions will always be rescued. The latter goal could be addressed both by reducing the practices that make institutions systemically significant and by creating a mechanism to allow their orderly failure.

Ultimately, we believe a regulatory approach that relies on identifying institutions in advance that are systemically significant is simply unworkable. The fallibility of this approach was demonstrated conclusively in the wake of the government's determination that Lehman Brothers, unlike Bear Stearns, was not too big to fail. As Richard Baker, President and CEO of the Managed Funds Association, said in his testimony before the House Capital Markets Subcommittee, "There likely are entities that would be deemed systemically relevant … whose failure would not threaten the broader financial system." We also agree with NAIC Chief Executive Officer Therese Vaughn, who said in testimony at the same hearing, "In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it."

The factors that might make an institution systemically important are complex – going well beyond asset size and even degree of leverage to include such considerations as nature and degree of interconnectivity to other financial institutions, risks of activities engaged in, nature of compensation practices, and degree of concentration of financial assets and activities, to name just a few. Trying to determine in advance where that risk is likely to arise would be all but impossible. And trying to maintain an accurate list of systemically important institutions going forward, considering the complex array of factors that are relevant to that determination, would require constant and detailed monitoring of institutions on the borderline, would be extremely time-consuming, and ultimately would almost certainly allow certain risky institutions and practices to fall through the cracks.

How should they regulate?

There are three key issues that must be addressed in determining the appropriate procedures for regulating to mitigate systemic risk:

- Should responsibility and authority to regulate for systemic risks kick in only in a crisis, or on the brink of a crisis, or should it be an on-going, day-to-day obligation of financial regulators?

- What regulatory tools should be available to a systemic risk regulator? For example, should a designated systemic risk regulator have authority to take corrective actions, or should it be required (or encouraged) to work through functional regulators?

- If a designated systemic risk regulator has authority to require corrective actions, should it apply generally to all financial institutions, products, and practices or should it be limited to a select population of systemically important institutions?

When the Treasury Department issued its Blueprint for regulatory reform a year ago, it proposed to give the Federal Reserve broad new authority to regulate systemic risk but only in a crisis. Despite the sweeping scope of its restructuring proposals, Treasury clearly envisioned a strictly limited role within systemic risk regulation for regulatory interventions exercised primarily through its role as lender of last resort. Although there are a few who continue to advocate a version of that viewpoint, we believe events since the Blueprint's release have conclusively proven the disadvantages of this approach. As Volcker stated in his New York Economic Club speech: "I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn." We share that skepticism, convinced like the authors of the COP Report that, "Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools."

As noted above, most parties appear to agree that a systemic risk regulator must have broad authority to survey all areas of financial markets and the flexibility to respond to emerging areas of potential risk. CFA shares this view, believing it would be both impractical and dangerous to require the regulator to go back to Congress each time it sought to extend its jurisdiction in response to changing market conditions. Others have described a robust set of additional tools that regulators should have to minimize systemic risks. As the Group of 30 noted in its report on regulatory reform: "… a legal regime should be established to provide regulators with authority to require early warnings, prompt corrective actions, and orderly closings" of certain financial institutions. The specific regulatory powers various parties have recommended as part of a comprehensive framework for systemic risk regulation include authority to:

- Set capital, liquidity, and other regulatory requirements directly related to risk management;

- Require firms to pay some form of premium, much like the premiums banks pay to support the federal deposit insurance fund, adjusted to reflect the bank's size, leverage, and concentration, as well as the risks associated with its activities;

- Directly supervise at least certain institutions;

- Act as lender of last resort with regard to institutions at risk of failure;

- Act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition;
- Require corrective actions at troubled institutions that are similar to those provided for in FDICIA;
- Make regular reports to Congress; and
- Take enforcement actions, with powers similar to what Federal Reserve currently has over bank holding companies.

Without evaluating each recommendation individually or in detail, CFA believes this presents an appropriately comprehensive view of the tools necessary for systemic risk regulation.

Most of those who have commented on this topic would give at least some of this responsibility and authority – such as demanding corrective actions to reduce risks – directly to a systemic risk regulator. Others would require in all but the most extreme circumstances that a systemic risk regulator exercise this authority only in cooperation with functional regulators. Both approaches have advantages and disadvantages. Giving a systemic risk regulator this authority would ensure consistent application of standards and establish a clear line of accountability for decision-making in this area. But it would also demand, perhaps unrealistically, that the regulator have a detailed understanding of how those standards would best be implemented in a vast variety of firms and situations. Relying on functional regulators to act avoids the latter problem but sets up a potential for jurisdictional conflicts as well as inconsistent and delayed implementation. If Congress decides to adopt the latter approach, it will need to make absolutely clear what authority the systemic risk regulator has to require its regulatory partners to take appropriate action. Without that clarification, disputes over jurisdiction are inevitable, and inconsistencies and conflicts are bound to emerge. It would also be doubly important under such an approach to ensure that gaps in the regulatory framework are closed and that all regulators share a responsibility for reducing systemic risk.

Many of those who would give a systemic risk regulator this direct authority to demand corrective actions would limit its application to a select population of systemically important institutions. The Securities Industry and Financial Markets Association has advocated, for example, that the resolution system for non-bank firms apply only to "the few organizations whose failure might reasonably be considered to pose a threat to the financial system." In testimony before the House Capital Markets Subcommittee, SIFMA President and CEO T. Timothy Ryan, Jr. also suggested that the systemic risk regulator should only directly supervise systemically important financial institutions.

Such an approach requires a systemic risk regulator to identify in advance those institutions that pose a systemic risk. Others express strong opposition to this approach. As former Congressman Baker of the MFA said in his recent House subcommittee testimony:

> "An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against failure."

Unfortunately, the recent actions the government was called on to take to rescue a series of non-bank financial institutions has already created that implied backing. Simply refraining from designating certain institutions as systemically significant will not be sufficient to dispel that expectation, and it would at least provide the opportunity to subject those firms to tougher standards and enhanced oversight. As discussed above, however, CFA believes this approach to be unworkable.

That is a key reason why we believe it is absolutely essential to provide for corrective action and resolution authority as part of a comprehensive plan for enhanced systemic risk regulation. As money manager Jonathan Tiemann argued in a recent article entitled "The Wall Street Vortex":

> "Some institutions are so large that their failure would imperil the financial system. As such, they enjoy an implicit guarantee, which could … force us to nationalize their losses. But we need for all financial firms that run the risk of failure to be able to do so without causing a widespread financial meltdown. The most interesting part of the debate should be on this point, whether we could break these firms into smaller pieces, limit their activities, or find a way to compartmentalize the risks that their various business units take."

CFA believes this is an issue that deserves more attention than it has garnered to date. One option is to try to maximize the incentives of private parties to avoid risks, for example by subjecting financial institutions to risk-based capital requirements and premium payments. To serve as a significant deterrent to risk, these requirements would have to ratchet up dramatically as institutions grew in size, took on risky assets, increased their level of leverage, or engaged in other activities deemed risky by regulators. It has been suggested, for example, that the Fed could have prevented the rapid growth in use of over-the-counter credit default swaps by financial institutions if it had adopted this approach. It could, for example, have imposed capital standards for use of OTC derivatives that were higher than the margin requirements associated with trading the same types of derivatives on a clearinghouse and designed to reflect the added risks associated with trading in the over-the-counter markets. In order to minimize the chances that institutions will avoid becoming too big or too inter-connected to fail, CFA urges you to include such incentives as a central component of your systemic risk regulation legislation.

Conclusion

Decades of Wall Street excess unchecked by reasonable and prudential regulation have left our markets vulnerable to systemic shock. The United States, and indeed the world, is still reeling from the effects of the latest and most severe of a long series of financial crises. Only a fundamental change in regulatory approach will turn this situation around. While structural

changes are a part of that solution, they are by no means the most important aspect. Rather, returning to a regulatory approach that recognizes both the disastrous consequences of allowing markets to self-regulate and the necessity of strong and effective governmental controls to rein in excesses is absolutely essential to achieving this goal.