AFR Americans for Financial Reform

TESTIMONY TO HOUSE FINANCIAL SERVICES COMMITTEE

Subcommittee on Financial Institutions And Consumer Credit

December 7, 2017

Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, state and local organizations who have come together to advocate for stronger and more effective oversight of the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, and faith based groups.[1]

AFR came together in 2009 as a response to the disastrous financial crisis of 2008. During the financial collapse and the Great Recession that followed, almost nine million workers lost their jobs, almost seven million families lost their homes, and the nation lost over $10 trillion in economic wealth.[2]

One of the lessons learned in the financial crisis was the importance of strong financial regulatory protections in preserving economic growth and well-being, and the significance of even what appear to be technical details of regulation in protecting consumers and preserving financial stability. Prior to the 2008 crisis, very few people would even have been aware of seeming regulatory minutiae such as the classification of payments to mortgage brokers under TILA and RESPA, or the treatment of bank liquidity guarantees to special purpose vehicles under regulatory capital rules. Yet weak rules in these areas caused grave harm to consumers and the public during the crisis.

In response to the crisis, the Dodd-Frank Act significantly strengthened key regulatory authorities and mandates, and created an independent bureau to enforce consumer protections in financial markets. Contrary to industry claims, the financial industry has not been harmed by the implementation of these new protections. Since Dodd-Frank was passed, the financial sector has grown more quickly than other segments of the economy, growing from 6.6% to 7.4% of total value added in the economy. In 2016, banking industry revenues rose to record levels. The fraction of community banks showing a profit increased from 78.8% in 2010, the year Dodd-Frank was passed, to 95.7% in 2016.[3]

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[1] A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/
[2] Americans for Financial Reform, "The Costs of the Crisis", July, 2015. http://bit.ly/2jeY6fx
[3] Federal Deposit Insurance Commission, Quarterly Banking Report, Q4 2010 and Q4 2016, https://www.fdic.gov/bank/analytical/qbp/

As the table below shows, another metric of the health of the banking sector, the growth rate of bank commercial lending, has also exceeded historical averages since the passage of Dodd-Frank in 2010. While recent commercial lending growth rates are below the risky and unsustainable levels recorded immediately before the crisis, they still exceed long-run historical averages, and growth rates in business lending are especially rapid.

PERIOD	REAL ANNUAL GROWTH RATES IN BANK LENDING	
	TOTAL	BUSINESS LENDING
Historical Average: 1973-2016	3.7%	2.7%
Pre Financial Crisis: 2003-2008	7.4%	7.6%
Post Dodd-Frank: 2011-2016	4.1%	8.9%

SOURCE: Federal Reserve Release H-8, AFR calculations.

In light of the extraordinary damage created by the 2008 financial crisis and the lack of evidence for an economically harmful effect of post-crisis regulations, it is very disappointing that the bills under consideration by the Subcommittee today would uniformly and dangerously lower regulatory protections for consumers and for the economy. As we learned during the crisis, such deregulation can have grave negative impacts on the public. Below, we analyze each of the bills under consideration.[4]

HR 2570, the Mortgage Fairness Act of 2017

HR 2570 would amend the Truth in Lending Act (TILA) to exempt payments to a mortgage broker from the definition of "points and fees" if such payments were reimbursed by the buyer through changes in the mortgage interest rate rather than directly through a separate charge.

This change would make it easier for lenders to steer homeowners into high-cost, abusive deals on certain mortgages, notably home equity lines of credit and construction loans. It would exempt "yield spread premiums" (YSPs), or payments from the lender to the mortgage broker reimbursed by increasing the borrower's interest rate, from tests used to determine whether a loan counted as a high cost mortgage loan. Currently, a mortgage loan may be classified as a high cost loan either due to interest rate on the loan or the level of "points and fees" charged on

[4] Bills are considered in order of bill number, and do not reflect priority of concern.

the loan. The inclusion of YSPs as "points and fees" in the current high cost mortgage test discourages the charging of such fees to the buyer.

YSPs often act as what are effectively kickbacks to the mortgage broker from the lender in exchange for an increased interest rate -- a pernicious form of incentive payment that has been shown to contribute to steering, discrimination, and lending without regard to ability to repay.[5] These potential abuse of these kickbacks is such a significant issue that Dodd-Frank restricted YSPs for more typical, "closed-end" home mortgages. But they are still legal in other loans--like home equity lines of credit and certain construction loans. Home equity lines of credit are often used for second mortgages and can be used to purchase homes.

The high-cost loan rules currently discourage kickbacks on loans where they are still allowed because these payments count toward the coverage threshold based on points and fees. By exempting YSPs from this trigger, HR 2570 would create an incentive for loan originators to steer borrowers to overpriced loans that did not have high-cost loan protections.

Omitting YSPs makes it easier to charge higher prices to consumers. For example, a YSP that led to raising the interest rate from 5% to 5.25%, on a thirty year, $300,000 loan would generate over $16,600 more in interest payments over the life of the loan, some portion of which would be paid to the broker as a result of selling a higher interest rate loan. This is an extraordinarily high additional payment and a significant cost to the borrower. Yet if HR 2570 were passed it would not be counted as a fee at all for the purposes of classifying the loan as high cost.

Supporters of this bill point out that these YSP payments are incorporated into the interest rate paid by the borrower, and that there is also an interest rate threshold test used for classifying a loan as high cost. But this does not justify a carve-out of these fees from the points and fees threshold for high-cost loan protections. The two high cost thresholds are alternatives -- either a loan meets the test due to its interest rate or due to the points and fees test. Accordingly, inclusion of the yield spread premium in the points and fees threshold is not redundant or double counting, as claimed by advocates of HR 2570. It would be relatively easy for mortgage originators to use YSPs to charge high fees while evading the interest rate trigger for high cost loans, by charging fees that raise the interest rate to a point just short of the threshold for high cost loan classification.

In sum, carving out YSPs from the high-cost coverage rules would promote abusive loan steering and price gouging.

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[5] Burlingame, Laurie and Jackson, Howell E., Kickbacks or Compensation: The Case of Yield Spread Premiums (February 19, 2009). Stanford Journal of Law, Business & Finance, Vol. 12, p. 289, 2007. Available at SSRN: https://ssrn.com/abstract=1346548

<u>HR 3179, The Transparency and Accountability for Business Standards Act</u>

HR 3179 would impose additional administrative barriers to action on Federal banking agencies in cases where they wished to issue prudential regulations that were more stringent than those laid out by international regulatory bodies such as the Basel Committee on Banking Supervision (BCBS).

This bill would be a bad idea at any time, but it seems particularly misplaced today, when many are claiming to advance an "America First" agenda in economic policy. Indeed, HR 3179 could be accurately described as an "America Last" bill, as its effect would be to reduce our sovereign ability to protect the American economy and financial system against the negative effects of poor decisions made by international bodies.

The purpose of international bodies such as the BCBS or the Financial Stability Board is not to directly dictate rules to individual member states, but instead to come to general agreement on a minimum "floor" for prudential standards. Such a floor facilitates international commerce by giving some assurance that cross-border banking activity does not expose well capitalized banks to foreign bank counterparties that are dangerously undercapitalized or risky.

If Basel rules were instead conceived as dictating to member countries the strongest level of safety and soundness that could be required, this would result in imposing on each country the lowest common denominator acceptable to the more than two dozen nations that are members of the Basel Committee. Such an arrangement would lead to a very dangerous limitation on the ability of individual nations, particularly the United States, to address risks of financial instability in their own financial systems.

This risk is particularly salient for the U.S. today, given the weaknesses in the European banking system. The prominent role of European countries in the Basel process means that it is difficult to reach international agreements setting standards that European banks find it difficult to meet. The European banking system is far weaker than the U.S. system, with banks less profitable, less well capitalized, and the system at greater risk of a potential banking crisis.[6] Investors understand this and are more reluctant to provide capital to European banks, expressing grave concerns about the state of their balance sheets.[7] This in practice means that Basel rules can be deeply influenced by the desire of European regulators to avoid placing stress on very weak and in some cases perhaps even insolvent banks. Subordinating U.S. bank regulations to what is attainable in a Basel consensus would be an extremely dangerous move.

HR 3179 does not of course explicitly forbid U.S. regulators from exceeding Basel minimum standards. However, the requirement for special additional analysis to justify such action is

[6] The Economist, "American Banks Have Recovered Well, Many European Banks Much Less So", Economist Special Report, May 6, 2017; http://econ.st/2sek3hJ

[7] http://fortune.com/2016/08/03/europe-hsbc-deutsche-bank-mess/

clearly designed to discourage them from doing so. Furthermore, the listed considerations for the analysis are exclusively focused on the costs to regulated entities and the financial system, and do not include any of the costs to the economy that could be created by inadequate prudential rules. Such an analysis would be weighted from the beginning against taking stronger action than the Basel minimum.

In fact, regulators have already performed considerable analysis on existing U.S. prudential rules, and this analysis supports the decision to exceed Basel minimum standards. A recent and comprehensive Federal Reserve analysis of the costs and benefits of capital standards finds that current U.S. capital requirements are at the bottom end of the estimated range of optimal (net benefit maximizing) capital standards.[8] This implies that the so-called "gold plated" or "super equivalent" regulatory standards set by U.S. bank regulators are very well justified by cost-benefit analysis; in fact significantly higher standards could be justified. In contrast, the study implies that Basel minimum capital standards for large banks cannot be justified on a cost-benefit basis.

Unfortunately, even regulations that are very well justified analytically could be overturned or undermined by the kind of requirements in HR 3179. The statutory analytic requirements in HR 3179 could and would be used as the basis for lawsuits by large Wall Street banks seeking to weaken safety and soundness regulations to increase their own profits. Modeling the effects of regulation on the economy is heavily dependent on assumptions, and it is easy to pay consultants to develop a model that will minimize benefits and exaggerate costs. Indeed, an extensive analysis of economic studies of financial regulations led one Harvard professor to describe the state of cost-benefit analysis as "quantified guesstimation."[9] Courts judging lawsuits based on cost-benefit analysis may not be expert in the quantitative analysis of financial regulation, but their decisions in lawsuits enabled by bills like HR 3179 could strip away important financial protections advocated by expert regulators.

<u>HR 3746, the Business of Insurance Regulatory Reform Act of 2017</u>

Section 1027(f) of the Consumer Financial Protection Act of 2010 (Title X of the Dodd-Frank Act) limits the CFPB's regulatory authority over "the business of insurance" and limits its regulatory powers with respect to a person regulated by a State insurance regulator. However, those limitations do not apply, and the Consumer Financial Protection Bureau (CFPB) can still apply regulatory authority over insurance companies when they are "engaged in the offering or

[8] Firestone, Simon, Amy Lorenc and Ben Ranish,. "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US," Finance and Economics Discussion Series 2017-034, March 31, 2017. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034
[9] Coates, IV, John C., "Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications", May 7, 2014, Yale Law Journal, Forthcoming; Harvard Public Law Working Paper No. 14-33. Available at SSRN: https://ssrn.com/abstract=2434103

provision of any consumer financial product or service" or subject to any "enumerated consumer laws" (e.g., the Fair Credit Reporting Act, TILA, HMDA, RESPA, among other).

HR 3746 amends this section in a manner that would greatly narrow and call into question the CFPB's authority to regulate entities engaged in the business of insurance. If HR 3746 were passed, it would eliminate or sharply curtail the CFPB's ability to investigate and enforce consumer abuses in the many consumer financial markets that involve both lending and insurance sales. There are numerous products and activities that span the insurance/credit divide in this manner, including credit insurance sold with loans, title insurance sold with home mortgages, auto GAP insurance, and many other instances. Limits on CFPB authority would be particularly severe in cases where lenders owned insurance companies, or insurance companies engaged directly in credit-related activities, ranging from lending to reporting information to credit bureaus. Below, we give a more detailed example of the way the limitations in HR 3746 would have damaged the CFPB's ability to investigate and punish the Wells Fargo scheme to sell unnecessary insurance to its auto credit customers.

HR 3746 as drafted is somewhat ambiguous.[10] One plausible interpretation is that the bill completely deprives the CFPB of jurisdiction over firms that are "regulated by a State insurance regulator" and "engaged in the business of insurance," even if such a firm offered or provided a consumer financial product or was otherwise subject to the laws transferred to the CFPB's authority. This reading would strike a fundamental blow to the CFPB and the underlying principles that motivated its creation. The CFPB is premised on the idea there should be one national set of consumer protection rules for credit-related products, which are enforced and implemented consistently by one agency, irrespective of the identity of the individual or charter type of the firm who is selling those products. This functional approach to defining the CFPB's jurisdiction creates a level-playing field for firms selling credit-related products, while preventing the type of regulatory arbitrage that was so prominent before Dodd-Frank, when similar products were regulated very differently depending on who sold them.

In direct contravention of these principles, this interpretation of HR 3746 would allow insurers and other persons engaged in the business of insurance to sell the very same financial products as other firms and individuals, but to be shielded from scrutiny by the CFPB. This result would not only produce potential competitive advantages for insurance entities over non-insurers with respect to the sale of consumer financial products, but it would also create the risk of dangerous regulatory arbitrage that could produce a race to the bottom in consumer protections. Firms and individuals seeking to avoid CFPB scrutiny could simply funnel their sales of consumer financial products through an insurer. If the language of the legislation remains as drafted, we expect firms

[10] The rest of the analysis of HR 3746 in this testimony is greatly indebted to discussions with Professor Daniel Schwarcz of the University of Minnesota Law School.

seeking to avoid regulation of abusive practices to argue for this interpretation.

A second, less aggressive reading of HR 3746 would be that the CFPB's enforcement authority does not extend to the business of insurance when an entity is regulated by state insurance regulator, even though the CFPB does retain some authority over such an entity's credit-related products and services. Under this second reading, HR 3746 adopts a strong presumption that, in close cases, the CFPB's authority should be curtailed in favor of the authority of state insurance regulators. Under current law the CFPB already does not have jurisdiction over insurance products or "persons" regulated by a state regulator, except to the extent that such person is offering or providing consumer financial services or subject to laws that the CFPB is authorized to enforce. But under the less aggressive reading, HR 3746 would greatly limit any CFPB authority at the borderline between credit-related products and the business of insurance.

This more narrow interpretation would still significantly limit the CFPB's capacity to develop a consolidated approach to investigation and enforcement of consumer abuses that span credit-insurance boundary lines. Effectively regulating products and practices that span this regulatory perimeter requires a single regulator to have the capacity to investigate, understand, and penalize these practices. By contrast, if the authority of a regulator is sharply curtailed when products or practices cross cut the insurance/credit divide, then the regulator may be unable to understand or address the broader set of abusive or unfair patterns or practices. This is true even if a different regulator (or set of regulators) is entrusted with policing practices and products on the other side of the borderline. The problem is that regulators on either side of the divide will only see a part of the broader practice or scheme, and so may fail to appreciate its implications or scale. Even worse, these artificial boundaries are likely to promote regulatory arbitrage that is specifically designed to exploit these restrictions in regulators' authority.

To take just one example of the ways in which insurance is involved in consumer lending, take the case of Wells Fargo's sale of unnecessary auto insurance to its auto credit customers. As has been well-documented in the popular press, Wells Fargo allegedly required customers who financed their cars with the bank to purchase unnecessary and expensive insurance, in many cases failing to provide those customers with mandated disclosures and refusing to cancel the duplicative insurance even after customers provided evidence that they were independently insured. The scheme allegedly relied on a partnership with National General Insurer. According to the NY Times, "when customers financed cars with Wells Fargo, the buyers' information would go to National General, which was supposed to check a database to see if the owner had insurance coverage. If not, the insurer would automatically impose coverage on the customers' accounts, adding an extra layer of premiums and interest to their loans."[11]

[11] Morgenson, Gretchen, "Wells Fargo Forced Unwanted Auto Insurance on Borrowers", *New York Times,* Business Section, July 27, 2017. http://nyti.ms/2uHZfkc

Under current law, the CFPB is rightly allowed to take action against National General if the reported facts are accurate and the insurer acted unfairly or abusively. Even though National General is a "person regulated by a state insurance regulator," it also was "engaged in the …provision of [a] consumer financial…service."[12] In particular, National General was not just providing insurance, but also determined which Wells Fargo borrowers required insurance to protect the underlying loan collateral. Determining whether a borrower is maintaining insurance on collateral underlying a loan or instead must be "force-placed" into coverage is a quintessential function of a loan servicer.

This result – that the CFPB could proceed against National General in connection with its role in the Wells Fargo auto insurance scandal – is entirely appropriate. In order to fully respond to the auto insurance abuse scheme, the Bureau must be able to understand how, and if, Wells Fargo worked with National General to cheat consumers in connection with the servicing of auto loans, or whether it alone was responsible for these abuses. Moreover, the CFPB has particular expertise with respect to the obligations of loan servicers, expertise that state insurance regulators would not have. This makes the CFPB a sensible regulator to take enforcement actions against National General to the extent that it violated these obligations.

By contrast, it is probable that under either of the interpretations of H.R. 3746 described above, the legislation would have eliminated the CFPB's capacity to take action or investigate National General in connection with the auto insurance scandal at Wells Fargo. Not only might National General invoke the presumption against CFPB enforcement against an entity engaged in the business of insurance, but it might claim that checking records to determine the existence of borrowers' independent coverage of loan collateral constitutes the "business of insurance." This result, in turn, could not only immunize National General from wrongdoing in connection with the Wells Fargo auto insurance abuses, but could also undermine the capacity of the CFPB to fully understand the nature of the abuses at Wells Fargo and take appropriate remedial measures.

Preserving the CFPB's capacity to address consumer abuses that span the insurance / credit divide, such as those involving Wells Fargo's auto insurance scheme, would not limit the authority of state insurance regulators. To the extent that a state insurance regulator deemed National General to have violated state insurance laws in connection with the Wells Fargo scheme, it could take appropriate action against the insurer irrespective of the CFPB's actions.

In general, the argument made by proponents of HR 3746 that CFPB enforcement authority at the borderline between credit and insurance somehow harms the authority of state insurance regulators is not true. Although overlapping *supervisory* authority among different regulators can create various inefficiencies, overlapping *enforcement* authority with respect to consumer abuses involving activities that are close to a regulatory perimeter, such as the insurance/credit divide, is

[12] 12 USC 5517 (2)

entirely appropriate. Such overlapping enforcement authority does not create large costs for most firms, because the overlap is only relevant if there is a potential consumer protection problem requiring enforcement. Moreover, the inherent difficulty that all regulators face in identifying consumer protection problems that span traditional regulatory perimeters suggests that it is appropriate to take countervailing measures to police against such violations. Overlapping enforcement authority is one commonly used and effective way to increase the likelihood that regulators will detect abuses.

HR 4464, the Common Sense Credit Union Capital Relief Act of 2017

The bill would eliminate the National Credit Union Administration's (NCUA) "Risk-Based Capital" rule requiring credit unions taking certain risks to hold capital in proportion to those risks. The rule is scheduled to go into effect in January, 2019.

It is appropriate for Congress and regulators to seek to limit negative impacts of unnecessary or unjustifiably burdensome regulations on small credit unions. However, at the same time Congress should be aware that credit unions hold $1.3 trillion in assets, almost all of which are Federally insured and thus involve public exposure. Currently the Credit Union Share Insurance Fund holds only $13.2 billion to cover losses on insured credit union deposits, a ratio of just one cent on each dollar of assets.[13] Any significant losses on insured deposits due to credit union insolvency would trigger the need for solvent credit unions to pay significant amounts into the insurance fund, and/or create public exposure that could require greater government resources from taxpayers.

This is not just a theoretical danger. During the financial crisis dozens of credit unions failed, and the Federal government was forced to place large "wholesale" credit unions into public conservatorship due to large unexpected losses on subprime mortgage securities.[14]

According to the NCUA the final risk based capital rules exempts all small credit unions with under $100 million in assets, accounting for 76 percent of credit unions nationally. Such small credit unions should experience no impact of the new rules. Furthermore, among the 1,489 credit unions with over $100 million in assets subject to the rule, just 16 credit unions would be downgraded in their capitalization classification due to the new risk based asset requirements. Thus, only about one-quarter of one percent of all credit unions nationally would be required to take significant action to improve their safety and soundness due to the new rule.[15]

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[13] National Credit Union Administration, "Industry At A Glance, June 2017. https://www.ncua.gov/analysis/Pages/industry/industry-at-a-glance-june-2017.pdf

[14] Maremont. Mark and Victoria McGrane, "Credit Unions Bailed Out", *Wall Street Journal,* September 25, 2010. http://on.wsj.com/2j2Jin9

[15] National Credit Union Administration, "Frequently Asked Questions: Risk Based Capital Rule", https://www.ncua.gov/Legal/Documents/RBC/RBC-Final-Rule-FAQs.pdf

We recommend that Congress work with the NCUA to investigate means of assisting credit unions that are less extreme than simply repealing new risk based capital rules.

Comprehensive Regulatory Review Act

This legislation would modify the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) by greatly shortening the cycle on which regulations must be reviewed and inserting a large number of additional factors regulators would be required to consider.

Currently the EGRPRA regulatory requirement is simple, direct, and clear. The statute requires regulators to ask the public for comment on aspects of regulations that are "outdated, unnecessary, or unduly burdensome", and to do so not less than once every ten years. After review of these comments regulators must "eliminate unnecessary regulations to the extent such action is appropriate". The Comprehensive Regulatory Review Act (the "Act") would shorten the time requirement for regulatory review to not less than once per five years, and would add significant language requiring regulators to limit regulatory costs on businesses.

We believe both of these changes are unnecessary and would be harmful to the public interest. The language inserted into EGRPRA by the Act would significantly slant regulatory consideration away from a true comparison of the costs and benefits of regulation and toward an attempt to minimize costs for regulated entities, without considering benefits to the public. For example, Section 4(3) of the Act changes the mandate on regulators from simply eliminating "unnecessary regulations", and requires them to "eliminate unnecessary regulations and *tailor other regulations…in a manner that limits the regulatory compliance impact, liability risk, and other burdens"* (Additions in italics). Missing here is any consideration of the public benefits that are the justification for creating the regulations in the first place, and which regulators should be seeking to preserve. Likewise, the additional regulatory considerations inserted in Section 4(2) of the Act require regulators to consider the impact of regulations on regulated entities ("covered persons"), without any consideration of the effect of regulations on the broader public, the economy as a whole, or even on the customers of regulated entities.

The change in the minimum required regulatory review cycle from ten years to five years is also inappropriate, as the compliance costs of new regulations are front-loaded while benefits to consumers and the public are weighted toward later periods when businesses have fully complied with the new requirements.

The Comprehensive Regulatory Review Act is unnecessary and harmful.