PUBLIC CITIZEN Celebrating 40 Years of Progress

May 20, 2015

Senate Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510
Via email:

Dear Senator,

Public Citizen opposes the Financial Regulatory Improvement Act because it contains a sprawling number of provisions that threaten to undermine basic safeguards needed to protect consumers and prevent another financial meltdown, many of which were put into place 5 years ago with the passage of the Dodd-Frank Wall Street Reform Act.

This bill emerges amid a persistent campaign from the banking sector, which willfully ignores the fact that the industry operates under an extraordinary public subsidy. Unlike any other business, banks exploit credit made cheap by taxpayer-backed FDIC insurance. In exchange for this subsidy, the public correctly expects that banks not fail.

That's different from other industries, where creative destruction may be a necessary byproduct of progress—a once successful smart-phone manufacturer is destroyed when another firm improves the technology. But the failure of a bank of any size doesn't signal progress; it signals mismanagement in the deployment of the bank's subsidized, FDIC-insured deposit liabilities.

We welcome the declared opposition of all Democrats on this committee as well as the White House to this effort to roll back needed financial law.

What follows are comments about a few of the specific sections of the proposed law.

$500 billion Supervision Threshold

Title II raises from $50 billion to $500 billion the asset size of bank holding companies that would be subjected to heightened supervisory standards. This means, in practice, that 29 of the largest 34 banks may be considered with no more diligence than a community bank. While regulators should take the necessary steps to ensure that no bank fails, it is especially important to ensure the stability of the nation's largest banks. It is not clear that the failure of a bank with nearly $500 billion would leave little imprint on the financial and real economies. We have no good experiment to examine, nor is such an experiment desirable. The largest failure to date was that of Washington Mutual. That failure took place during the financial crisis, so one cannot make conclusions that WaMu's failure did or did not contribute to the contagion. But one result is indisputable; that failure was lamentable. Heightened regulation, as now provided in Dodd Frank, might have prevented WaMu's devolution into reckless lending. One of the key new tools is additional capital. This means that banks must fund themselves with relatively more shareholder equity and relatively less debt. This might mean lower returns for this greater proportion of shareholder equity, but it would not mean a lower credit-making capacity for the bank. The committee's choice, then, is this: Should current statutes remain that aim to prevent the failure of 29 of the nation's largest banks? Or should they be rescinded so as increase shareholder returns. We believe the answer is clear and we oppose this provision.

FSOC amendments

Section 301 would open meetings of the Financial Stability Oversight Counsel (FSOC) to all members of the government body of the agencies whose principals are formal members. As it is, FSOC is a half-measure designed to combat regulator arbitrage whereby firms attempt to exploit gaps in regulation, or advantage the political frictions inherent in commission-structured agencies. Ideally, financial regulation would be conducted by a far more streamlined group of overseers. The Volcker Alliance recently made recommendations along this line, which deserves committee attention.[1] This provision goes in the opposite direction, and would undermine the efficiency of the Counsel.

Volcker Rule Exemption

Section 115 proposes to exempt banks with less than $10 billion in assets from the Volcker Rule prohibition on propriety trading. Banks have long been tempted to direct their cheap, subsidized deposits to high return investments. As Sen. Charles Schumer (D-N.Y.) wrote in 1987, "Left free to speculate in the 1920's, banks naturally looked where profits seemed highest, and were inevitably drawn into risky propositions."[2] With the advent of FDIC insured credit for the bank, the stakes for the public in this gambling was raised. "No one could complain if banks renounced their Federal insurance and then competed evenly against securities firms. But the banks simply should not be allowed to gamble with taxpayer insured dollars."

Currently, small banks aren't major speculators. And regulators could exempt small banks from reporting requirements if they're not engaged in speculation. Federal Reserve guidelines already provide this kind of relief. [3] But sensible relief through reduced reporting requirements should not be confused with a license to gamble with insured deposits. Without such a prohibition, speculators could exploit this cheap source of funding.

[1] See "Reshaping the Financial Regulatory System," (April 2015), available at: https://volckeralliance.org/resources/reshaping-financial-regulatory-system

[2] "Don't Let Banks Become Casinos," by Charles Schumer, New York Times, (1987) available at: http://www.nytimes.com/1987/08/26/opinion/don-t-let-banks-become-casinos.html

[3] See Federal Reserve advisory, available at: http://www.federalreserve.gov/aboutthefed/boardmeetings/volcker-rule-community-bank-20131210.pdf

Mortgage Accountability

Section 106 provides a safe harbor from litigation for banks that make mortgages that abuse borrowers. (Under the CFPB 's current rules for such a safe harbor, known as Qualified Mortgages or QM, lenders must insure that the borrower's debt to income is no more than 43%, the loan is fully amortizing, and the term is no longer than 30 years.) The only safeguard this section provides is that such mortgages remain in the bank's portfolio (or the portfolio of another firm that purchases the mortgage-- the mortgage may not be securitized). While it is true that many of the liar loans leading to the 2008 crash were securitized, which severed the creditor from the risk, banks can still make predatory, high risk loans they retain in their portfolios. Banks that traffic in high risk loans might make initial profits through origination charges and high interest rate income. But loans that are poorly underwritten (to borrowers who ultimately cannot repay) may be abusive. Borrowers should be able hold such abusive lenders to account, a remedy that will ultimately keep a bank safer.

Dodd-Frank Review

Section 125 provides for a review by the agencies of rules mandated under Dodd-Frank. This section serves little purpose other than to further slow Wall Street reform given that many of the rules haven't been finalized or implemented. The practical result of this bill would be to add more delay into an already irresponsibly long process to protect Main Street America from the economic damage of a reckless Wall Street. New rules for Wall Street have no place in a review process that is supposed to target old rules.

Manufactured Housing

Section 108 raises from 8.5 percent to 10 percent the amount of interest above the average prime offering rate that manufactured housing lenders can charge. Unlike other housing, manufactured housing generally markets to lower income buyers; and such housing does not generally appreciate in value. By charging high interest rates, this sector exploits a cynical business model whereby all customers in this sector pay higher rates to compensate for those who ultimately are unable to repay their loans. The better course would be for manufactured housing purveyors to improve underwriting so that defaults are minimized, not cross-subsidized through usurious rates.

This bill will mostly benefit Clayton Homes, a division of Berkshire Hathaway, which is the leading manufactured housing firm and is profitable. A recent investigation revealed troubling loan practices: "Buffett's mobile home empire promises low-income Americans the dream of homeownership. But Clayton relies on predatory sales practices, exorbitant fees, and interest rates that can exceed 15 percent, trapping many buyers in loans they can't afford and in homes that are almost impossible to sell or refinance."[4] A Senate banking committee concerned, as this provision suggests, about "protecting access" to this type of housing must investigate this market before enabling more predatory practices.

[4] "Warren Buffett's mobile home empire preys on the poor," by Seattle Times, available at: http://www.publicintegrity.org/2015/04/03/17024/warren-buffetts-mobile-home-empire-preys-poor

Stock-based compensation

Section 602 provides that small firms may compensate employees with up to $10 million collectively in company stock without complete financial information about the firm. Employees who are compensated in stock (instead of additional cash) should be entitled to be informed about the financial condition of their company, as any investor should insist. In a real sense, such employees are creditors. Other company creditors, such as the firm's bank or major supplier, insist on such information. But this measure reduces stock-compensated employees to a class below these other creditors.

Defenders of this measure reference the potential for leakage of propriety information. There's little evidence of this problem. Further, it wouldn't be in the interest of an employee-owner to divulge critical information to a rival, especially if it would undermine the value of the stock. The greater problem is the firm that might issue paper of dubious value to their employees.

Public Citizen does support several provisions. For example, we believe that the president of the New York Federal Reserve Bank should be nominated by the President of the United States and confirmed by the Senate. In fact, all such reserve bank presidents should be so appointed. We also support amendments we believe will be offered by Sen. David Vitter (D-La.). One of these would terminate the ability of Goldman Sachs and Morgan Stanley to traffic in commodities, thus restoring the separation of banking and commerce. We also support the Sen. Vitter's likely amendment which would require the Federal Reserve to charge real interest rates when it bails out banks during crisis. The committee would well serve the nation by approving these measures separately.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org, or 202.580.5626

Sincerely,

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