Proposal: 1814(AG65) Regulatory Capital Rule: Risk-Based Capital Surcharges GSIB BHCs; Systemic Risk (FR Y-15)

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From: Anonymous

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Subject: Risk-Based Capital Surcharges for Global Systemically Important BHCs; Systemic Risk Report (FR Y-15)

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Proposal: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15) [R-1814]

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Your comment: Fifteen years ago, in mid-September, Lehman Brothers collapsed, and the financial system crashed. Troubles in the United States mortgage market infected the entire globe, and American families and businesses lost trillions of dollars and experienced an incalculable level of pain. The story is not just one of an out-of-control financial industry, but it is also a story about a series of the worst failures by regulators in modern history. This anniversary is not a celebration, but a moment to reflect. In my remarks today, I want to first dive a bit deeper into the collapse of Lehman Brothers. I then want to share a few details on post-crisis reforms, including the establishment of the Consumer

Financial Protection Bureau, and how consumer protection is more than its name suggests; it is, in fact, a pillar of ensuring stability in the entire financial system. I will highlight that fact by discussing how the consumer protection reforms now in place may have been able to prevent much of what tipped the globe into the Great Recession. I'll then move into some unfinished business from the post-crisis reforms. I will conclude by discussing an impending threat, including the upcoming Supreme Court case involving the CFPB. The views I express today reflect the views of the CFPB, and do not necessarily reflect those of any other part of the Federal Reserve System. The Collapse of Lehman Brothers The story of Lehman Brothers often sounds complicated, but at its core, it's a story about one of the financial products that literally is closest to home: residential mortgages. For a long time, Lehman Brothers, like other Wall Street firms, had a profitable business in buying up mortgages and reselling them on the secondary market. In 1997, the company became one of the first Wall Street firms to move from just buying and selling mortgages to originating them. And they moved into the subprime origination market with their purchase of BNC Mortgage; a nonbank lender; in 2000. Lehman Brothers blew up in spectacular fashion for many reasons, but I'll highlight a few of them. First, it relied heavily on short-term, often overnight, funding that looked a lot like the deposits that banks fund themselves with. But these deposits did not have insurance, access to the Federal Reserve's Fed-to-bank lending system, nor the safeguards that come with being a chartered bank. Instead, Lehman Brothers operated like this; imagine taking a mortgage out on your house every morning, with the expectation you would pay it off by midnight; every single day. That's what Lehman Brothers was doing to stay afloat. Second, the firm relied excessively on borrowed money and didn't have enough of its own skin in the game. In November 2007, for every $1 of its own money available to absorb losses, it had borrowed $30. Finally, it originated, packaged, distributed, and held high-risk subprime mortgages that inevitably nose-dived in value. Within Lehman Brother's origination business, there was little concern given to homeowners' ability to repay, no concern given to the day those homeowners could no longer meet monthly payments, and little concern given to the pensioners and retirees who had been led to believe had their money safely invested in securitized and bundled mortgages. As one of Lehman Brothers's own lawyers put it, we simply "expected the Fed to save Lehman."1 And as Lehman Brothers' CEO, at the time of the collapse, Dick Fuld, said, "Until the day they put me in the ground, I will wonder" why the federal government didn't bail us out.2 Under such a belief system, there was no need to seriously worry about risk management nor to take the "voluntary regulation" system that existed at the time.3 The bankruptcy of Lehman Brothers marked a watershed moment in the 2008 financial crisis, as public confidence evaporated, markets plunged, and other firms fell like dominos. Lessons Learned from the 2008 Financial Crisis One key lesson learned from the crisis was how consumer protection is foundational for the stability of the financial system. It is safe to say that it was the failure of consumer protection safeguards that led to the collapse of the U.S. financial system and global economy. It was that lack of a consumer protection focus that enabled Wall Street's shadow firms, banks, and independent lenders to undermine the mortgage system. Consumer abuses played a starring role, and there was no agency truly accountable for it. Lenders were able to approve mortgages for families that they either knew could not repay or they could just take mortgage brokers' word that homeowners could repay. Those actions are the base of the 2008 crisis. From there, financial institutions were able to make, buy, and sell mortgage securities they never examined for quality or ability to repay. Oftentimes they knew they were trading in junk securities, but they knew investors would just blindly listen to credit rating agencies that also were not concerned about actual calculations of risk. It can be easy to fall into the trap of thinking the Consumer Financial Protection Bureau only matters for the family that could lose their home or the person getting their car repossessed or the student taking out a loan to finance their education. However, the consumer financial protection laws enforced by the CFPB serve as catalysts for long-term economic growth, and defend against the buildup of systemic risk; just like the buildup of risky subprime loans. That's why the CFPB is not just looking out for consumers, but it is ensuring that risks to consumers do not spread and infect entire markets or economies. Preventing Lawbreaking Behavior and Providing Financial Stability Back to Lehman Brothers. A Lehman Brothers of today would face the series of safeguards mandated by Congress and implemented by the CFPB. Importantly, its nonbank mortgage subsidiaries would need to operate under the exact same strengthened mortgage rules as chartered banks and credit unions. One of those reforms was a ban on mortgages where the lender did not assess a borrower's ability to repay. The CFPB implemented a set of standards that mortgage lenders follow to stay in compliance with this prohibition. Given that some lenders used to be able to profit even when setting borrowers up to fail, this would reduce defaults in

the system. A CFPB assessment of the qualified mortgage and ability-to-repay rule found approximately 50 to 60 percent of mortgages originated between 2005 and 2007 that experienced foreclosure in the first two years after origination were mortgage loans with features that the rule would have generally eliminated, restricted, or otherwise excluded from the definition of a "qualified mortgage." In other words, most of the mortgages that comprised the basis of the 2008 crisis would never have been approved. In addition, banks and nonbanks today that acted like Lehman Brothers would be subject to state action. Many state regulators and attorneys general had been sounding the alarm for years and years before the 2008 financial crisis, but were consistently rebuffed by the federal Office of the Comptroller of the Currency. Not only did the leadership of the OCC fail to take appropriate action at the federal level to check egregious risk-taking and predatory lending behavior, it went so far as to hit delete on state laws designed to protect families from dangerous mortgages by using its abusive preemption policy. The Financial Crisis Inquiry Commission revealed how another federal regulator, the Office of Thrift Supervision, engaged in race-to-the-bottom regulation, marketing its lax oversight as a feature to attract more fees. This "clientele" theory of regulation didn't end well. By November 2008, the FDIC would seize three banks supervised by OTS and three other supervised banks would sell themselves to avoid failure.4 Post-mortems of the crisis also revealed how the Federal Reserve Board of Governors failed to use its own tools to stem the flow of toxic mortgages.5 It acted too little and too late. All this was allowed to happen because consumer protection was not considered a necessary pillar of financial stability. And the results of that choice are stark: more than 2.3 million properties went into foreclosure in each year between 2008 and 2010.6 The Great Recession ended up costing every single American $70,000 in lifetime present-value income.7 Better Markets' own aggregate analysis found that four years removed from the 2008 crisis, there was an excess of 12.5 million people out of work and there were 46.2 million people in poverty; the highest number from the previous 50 years.8 Many of us know that if the CFPB existed two decades ago, the factors that led to the Great Recession would have been mitigated early on. Looking Forward I have discussed how the CFPB has changed the regulatory system, but I also want to mention a couple of areas where more must be done to make those words in the statute a reality. First, open banking and personal financial data rights. A key priority for the CFPB is to help accelerate the shift to open banking and payments in our increasingly digital world. Over time, this can help people get paid faster, access more attractive rates on deposits and loans, switch more easily, avoid intrusive surveillance, and minimize the consequences of inaccurate credit reporting. This can also create a more resilient and dynamic financial system. We will be proposing rules next month to implement a dormant authority under Section 1033 of the Consumer Financial Protection Act to advance these goals. Second, amid yet another series of emergency bank mergers, the biggest financial institutions have only become bigger. JPMorgan Chase's acquisition of First Republic has led to significant frustration within the industry. An important part of the financial crisis response was the 2010 amendment to the Bank Merger Act that added a new financial stability analysis to the agencies' bank merger review process. After collecting comment and assessing current practices by the agencies and the Department of Justice, it is clear that the merger review process is a double whammy of dysfunction: failing on analytical rigor and failing on process. Expect more on this front so that we can ensure merger review respects the law and is grounded in market reality. Third, we need to ensure that the so-called "living wills" of large financial firms are not just fairy tales. After the experience with Silicon Valley, Signature, and First Republic; banks that are a fraction of the size of Wall Street giants; many experts continue to question whether the largest financial firms can go through the bankruptcy process without creating chaos in markets or requiring a string of bailouts. The experience with the government-facilitated Credit Suisse-UBS megamerger unfortunately provides even more evidence of this concern. Fourth, too-big-to-fail shadow banks did not magically disappear after the collapse of Lehman Brothers. Yet there is not a single shadow bank today that faces the enhanced financial stability safeguards envisioned by financial reforms, which are supposed to be complementary to the stronger consumer rules put in place. The Financial Stability Oversight Council is taking initial steps to restore its credibility. Congress did not want his body to be a book report club, but instead serve as a strong bulwark against threats to the financial system from firms and activities operating outside of the traditional banking system. The FSOC is currently reviewing comments on a proposal to reinvigorate this systemically important shadow bank designation authority. Fifth, uninsured short-term funding instruments outside the core banking system; that look and feel like deposits; often fuel shadow banks and make them risky to consumers. The law provides the authority to place stronger protections on risky payment, clearing,

and settlement activities. Regulators must carefully review whether this is an appropriate tool to address the risks posed by new forms of money, like uninsured balances on popular nonbank payment apps, coins minted by Big Tech and other firms, and other pockets of short-term funding. And there's a whole lot more. Upcoming Supreme Court Case Right now, families are facing an uncertain future. As many of you are aware, the CFPB is facing a challenge to its constitutionality, and in a few weeks the Supreme Court will hear a case reviewing a decision from Fifth Circuit Court of Appeals. Vacating or calling into question the CFPB's past actions and rulemaking could be destabilizing, as the agency has issued more than 200 changes to the rules, many of them required by Congress, implementing laws such as the Truth in Lending Act, the Fair Credit Reporting Act, and the Electronic Fund Transfer Act. These rules affect the way millions of people borrow and send trillions of dollars every year, and uncertainty could have real consequences. The rules administered by the CFPB, and other financial regulators, are crucial for the stability of the financial markets and of household finances, and questions about those rules and the ability of markets to adapt to future challenges would raise significant concerns for the stability of the nation's financial system. Conclusion If the past fifteen years have taught us anything, it is that the stakes for our financial system, economy, and society are too high for consumer financial protection to recede into the background. The recent bank failures, likewise, demonstrated that financial executives continue to place bad bets, and the public has to clean up the mess. Consumer financial markets need enforceable bright lines, and consumers need to know there is someone looking out for them. Despite threats to the CFPB, we are going to continue doing our work, and ensuring markets work for families, consumers, and law-abiding businesses. Thank you. Footnotes The Financial Crisis Inquiry Report , Financial Crisis Inquiry Commission, January 2011. Lehman Brothers Boss Defends $484 Million in Salary, Bonus , ABC News, October 6, 2008. Chairman Cox Announces End of Consolidated Supervised Entities Program , Securities and Exchange Commission, September 26, 2008. IndyMac Exposes Rift Between Regulators , ProPublica, March 2, 2009. The Financial Crisis Inquiry Report , Financial Crisis Inquiry Commission, January 2011. Home foreclosure and risk of psychiatric morbidity during the recent financial crisis , National Institutes of Health, July 2012. Ten years later; the financial crisis cost ever American $70,000 in lifetime income , U.S. Bureau of Labor Statistics, October 2018. How Much Did the Financial Crisis Cost? , Frontline, May 31, 2012.