COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
*Executive Session on the Restoring American Financial Stability Act*
Monday, March 22, 2010 5:00 pm, Dirksen 538

# STATEMENT FOR THE RECORD
# BY SENATOR JEFF MERKLEY

Thank you Mr. Chairman for all your laborious hard work on this bill and for American families. I associate myself with your comments. Without a doubt, we must move forward on financial reform.

It's a year and a half since reckless behavior – from defects in humble family mortgages to massive high-leveraged Wall Street gambling on mortgage-related instruments -- blew up our economy and cost Americans billions in taxpayer bailouts, lost jobs, foreclosed homes, and evaporated savings. The scariest part of all, though, is that the Wall Street landscape has actually gotten worse. Following last year's shakeup, we have fewer and larger banks concentrating risk. In addition, many banks have acquired high-risk investment houses, increasing the odds of a financial disaster. In 2008, Bank of America purchased the investment house Merrill Lynch and JPMorgan purchased Bear Stearns, dropping high-risk investing into the middle of banks that take deposits and make loans. As a result, if an investment house blows up now it can take a major lender down with it. This is the last thing we want. During an economic downturn that threatens an investment house, we want America's lenders to be strong and to be able to keep making loans to families and small businesses.

Tonight, we in the Senate Banking Committee will be voting to send the landmark financial reform bill we have been working on for over a year out of committee and to the floor. The bill makes many important changes to our financial rules, many of which have wide bipartisan agreement. On the few areas where significant disagreement exists, it is a step in the right direction as compared to earlier plans being discussed. While I believe certain of the financial rules in the bill need to be further strengthened, I support sending this bill out of committee – in part because I think those in favor of reform will have a better chance of fighting for reform on the floor of the Senate.

So in preparation for the floor debate, let me say a few words about where I think we need to take strong action to rein in Wall Street and make the financial system work for families and businesses. We would all be wise to remember that if we set the right traffic signals and lane markers for our financial system, we can provide the basis for a long economic expansion. If we get it wrong, stay prepared for more bubbles and busts.

To restore accountability and oversight to Wall Street and put an end to taxpayer bailouts for the bad bets of the big banks, I believe that we need to do three key things: get the high-risk investment gambling out of the banks that families and small business owners depend on for loans; protect consumers from deceptive tricks and traps; and make sure no financial institution is "too big" or "too interconnected" to fail.

*Investment Gambling Out of Banks*

The bill tonight does have a “Volcker Rule” section, named after the distinguished former Chairman of the Federal Reserve, Paul Volcker, and I am grateful to Chairman Dodd and my colleagues for working with me to include it. Specifically, it sets out a procedural pathway for regulators to consider limitations on high-risk investing within banks and systematically-significant financial institutions. While this is a big step in the right direction, I believe we should not stop when we’re already halfway there, because if we do, so will our regulators. As many of you know, Senator Carl Levin and I introduced a bill two weeks ago to implement the “Volcker Rule” to separate high-risk, hedge fund-style investing from the common depositing and lending services that Americans use every day. Our bill provides strong legislative direction and lays out clear boundaries, and I am hoping we can get this clearer, stronger approach incorporated into this bill on the floor.

In addition, we also need to take a very hard look at our system of rating bonds – in particular, bonds made up of loans packaged together by the very investment houses that trade in them. The willingness of for-hire rating agencies like Moody’s and S&P to give AAA ratings to packages of BBB bonds was a key part of the bubble and bust. This bill contains important improvements to the system of credit ratings, including a requirement that loan-level detail be provided for asset-backed securities so that investors do not have to rely blindly on the ratings agencies. Moreover, it includes provisions to strengthen accountability for rating agencies. However, we should carefully consider doing more, including providing investors greater choice about which rating they rely on – particularly in asset-backed offerings where only a limit number of issuers dominate the market.

A related concern is the conflicts of interest present in our securitization process. Some issuers of asset-backed securities were packaging toxic securities and then making massive bets against them. As some have noted, this is like building a car with no brakes and then buying life insurance on the driver. My bill with Senator Levin would address these conflicts of interest without impacting appropriate hedging activities. I would like to see these provisions included on the floor.

*Consumer Protection*

Consumer protection is incredibly important for two reasons.

First, our goal should be to help families build strong financial foundations, improving quality of life and building opportunity for our children. We should ban tricks and traps designed to strip wealth from working families. The rapid expansion of credit card debt, home equity lines of credit, and most recently subprime mortgages has been a direct and blatant effort by Wall Street to tap into the savings that families would otherwise accumulate through hard work, especially through the investment in their home. This is wrong and our financial regulatory system should be set up to check such attempts.

Second, good consumer protection greatly diminishes systemic risk. Elizabeth Warren, Professor of Law from Harvard Law School and Chair of the TARP Congressional Oversight Panel has observed that simply banning prepayment penalties on subprime mortgages would have done a lot to prevent the current bubble and bust. And she is right. These prepayment penalties were designed to lock families into sub-prime loans with exploding interest rates so that the loans could be sold for more on Wall Street. And because they were worth more, lenders started paying incentive payments to brokers to pose as financial advisors and talk families into signing these loans, corrupting the most important financial transaction most families ever make and placing those families at great financial risk.

Finally, these bad loans were packaged by Wall Street into bonds (and those bonds were sliced and diced into packages of bonds called Collateralized Debt Obligations, and those CDOs were sliced and diced into CDOs-squared, and insurance sold on these CDOs and CDO-2s were sliced and diced into "synthetic CDOs" because the insurance payments made regular payments like the underlying bonds and mimicked their performance) and sold to financial institutions all over the world, damaging or sinking those institutions when the bonds started to go bad.

In short, a transparent fair deal for consumers is not only better for consumers, it builds an economic house with much less systemic risk.

That is why I am very pleased that this bill contains an amendment for banning pre-payment penalties on all but the most plain vanilla of loans.

In addition, it contains two other amendments that I am proud to have put forward. The bill will double to coverage of the Truth-in-Lending Act on non-mortgage consumer loans from loans under $25,000 to all loans under $50,000. And, for the first time, that number will be indexed to inflation. When the Truth-in-Lending Act was enacted in 1968, a $25,000 loan was worth the equivalent of $150,000 today. I think there is no reason why any consumer loan can't be covered by the protections of TILA, but the improvements today are significant. In addition, the bill also doubles the amount of money that a consumer can withdraw against a newly deposited check from $100 to $200 and indexes for the first time those check-withdrawl amounts to inflation. This will help consumers get better access to their money, which means they don't have to rely on abusive loan sharks like payday and auto title lenders.

Most importantly, the bill features an improved plan for a Consumer Financial Protection Agency. The agency would set rules for the full-range of financial products and sets three levels of auditing depending on the size of the firms: audit teams for large systemically-significant firms, all mortgage lenders, and other large nonbank lenders; auditing through their regulators for medium-size firms like community banks and credit unions; and enforcement through state attorneys general for the smallest nonbank firms. In addition, the agency has independent funding, an independent director nominated by the President and independent rule-making authority. These are critical protections that must, at a minimum, remain – and hopefully be strengthened.

One area that continues to trouble me is the location for the CFPA. While I understand some of the rational for placing it in the Federal Reserve, we cannot ignore the fact that the Fed has had an abysmal record on consumer protection, failing to address any of the mortgage scams that drove this economic crisis. Certainly, these new structures will improve the situation, but again, I believe that following this crisis, half measures are not enough. Some groups want the CFPA in the Fed hoping that Wall Street aficionados will continue to water down consumer protection. I want it out of the Fed – for exactly the same reason.

To ensure that consumer protection doesn't remain at the bottom of the priority list, I'll continue to fight for an independent consumer protection authority because it is absolutely imperative that we have an agency whose sole purpose is protecting middle class families from financial tricks and traps. As Professor Warren has said so ably, we would never stand in this country for a toaster that had a one in five chance of blowing up. Why should we stand for a home mortgage that has those same chances of financially exploding on working families?

I also believe strongly in further restoring the power of the 50 states to protect their own citizens from financial chicanery. This bill moves in the right direction by reducing the range of national bank preemption, but I would like to see it go further. We should fully put the 50 cops on the beat so that they can police the tricks and traps in lending.

*Ban Big-Bank Bailouts*

In my lifetime the taxpayers have bailed out powerful financial institutions twice: First with the S&L scandal of the 1980s and again with Big Bank Bust of 2008-2009.

The goal of this financial reform should be to make sure this doesn't happen again in our lifetimes. The pattern works like this. 1) Congress and regulators deregulate. 2) Financial institutions take enormous leveraged risk. 3) The bets go bad. 4) The taxpayer is asked to clean up the mess because if we don't repair the damage, our entire economic ship will go down.

We need to make sure this doesn't happen again. We should be building a financial system where our critical financial institutions do not get themselves into the position of being close to failure. We can do this by keeping investment houses out of lending banks – as I've noted earlier. Good consumer protection will help so shaky consumer loans don't become shaky securities held by financial institutions.

But protecting against "too big to fail" requires more. I'd like to highlight two other key factors in decreasing the probability of failure: ensuring that financial institutions have adequate capital proportional to their risk and establishing a cap on size generally. This will help ensure that when a financial institution does get itself in trouble, it doesn't pose enormous systemic risk. These two provisions are in the bill today, but in the form of powers given to regulators. While that is a step forward, I believe that over the long term, our regulators need stronger legislative direction from Congress. Otherwise, it becomes too easy for regulators simply to accede to the wishes of powerful interests.

In addition, one area where the bill makes important steps forward is in the area of derivatives. Derivatives are essentially a combination of insurance contract and loan (bond) and can be written to guarantee or simulate just about any type of financial instrument. Given that 95 percent of the U.S. derivatives positions in the banking system are written by five mega-banks and that 90 percent of those positions are over-the counter, with millions of positions amongst and between themselves, those derivatives positions create a web of risk making the failure of any one of those banks nearly catastrophic for the other entities. Critically, we must cut the web of interconnectness arising from unregulated derivatives.

The bill we are voting on today takes a large leap forward in ending those interconnections. It places the vast majority of derivatives onto clearinghouses, which remove the linkages between firms, and requires many of them to be traded on exchange, providing transparency and price discovery to help the end user. It also provides requirements for capital and margin so that banks that write these exotic forms of insurance or loans have to keep reserves against them and provides regulators power to crack down on market manipulation.

In the weeks going forward, I will be paying particular attention to this complicated area, as it has been a major target of attack by Wall Street special interest. It needs to remain strong, and in some areas, I would hope we can make it stronger.

And finally, we need a system to "unwind" financial entities when they fail so the taxpayer isn't on the hook and they can be allowed to fail. This bill provides that infrastructure with powerful authority to wipe out shareholders, fire management, and break up failing firms. It also sets up "living wills" to provide a roadmap to wind down institutions.  While we need to do more to establish international resolution, having this type of authority for U.S. regulators will be a powerful tool in preventing bailouts.

*Conclusion*

This effort to reform our financial system has not been easy and it won't become simple as we move forward.  The Chairman and other members of this Committee have worked tirelessly to produce a bill that addresses complicated but critically important subjects, and I thank them.

There is more work yet to do, however and I am reserving judgment to see what the final product looks like on the floor. We have seen the destruction wrought by dismembering our regulatory system and taking cops off the beat. I will be looking to work with my colleagues in the coming weeks to create strong reforms so that our financial systems will once again be an agent of prosperity for our middle class families and small business.