Why Financial Institutions Must Have "Skin in the Game"

Remarks at the National Press Club in Washington, D.C.

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Thank you and in reference to my colleague, Michelle Bachmann, a reminder to those of you who cover the Financial Services Committee, might ask your editors for dual pay because you will also be covering the Republican presidential campaign.

Because I think for the first time in history, three declared Republican presidential candidates sit on the Financial Services Committee. Ron Paul, Thaddeus McCotter and Michelle Bachman. So talk to the Capitol Police. I hope people won't need to get by the Secret Service to get our committee business.

But I -- I don't think we've ever had three declared congressional presidential candidates in one congressional committee before. Anyway, on the Financial Reform Bill, and I wanted to do this because it is a year and we, I think are in a position to make some judgments about this.

I want to begin by saying that I believe that the year's study, examination, criticism, advocacy, et cetera leaves this legislation holding up very well. The Republicans have had a number of hearings and there have been very few calls for any substantial amendment on the part of the Financial Services Committee.

In fact, one of the things that I thought quite inappropriately, people were pointing as a criticism is, as we knew would be a strength and that is the fact that what the bill does in many cases, is to set forth some very important principles, but gives the regulators the ability to apply them in practice.

Now there were two reasons for that. First of all, you cannot in 2010 decide for the indefinite future what certain specific numbers ought to be, capital ratios et cetera. Secondly, to the extent when you legislate that you get very specific, you are inviting the people about whom you are legislating to evade what you did.

The more specific, the harder it is. As a matter of fact, you will remember for many years people in the financial community were telling us to be more like England where they did principles and not rules. We do think we need rules, but you cannot legislate some of these very important questions.

And, as people have come before the committee, they have talked about, for example with regard to taking into account international competitive factors with regard to imposing margin on end users, when we're talking about an American subsidiary based in a foreign country, dealing with a non-American customer.

The regulators have the flexibility to deal with that. The Volcker Rule, which many in the banking community didn't like, but they have acknowledged that the way it was written, the regulators have a flexibility to apply it in a way that we think does the good without doing the harm.

And that's true in a number of other areas. So I think that's a factor there. Its -- the only issue where I saw people on the whole in the financial community unhappy and the banks was the amendment sponsored by former Senator Lincoln to push derivatives out of the bank.

I always felt that it was more important to have rules for derivatives, wherever they were. But even that option, banks don't like it, some others do. But I am struck, at least in public at how little advocacy there has been for very substantial change.

I also think that things are moving well in the international front. When I was about to become chairman of this committee in 2006, we were being told that we had to cut back substantially on American regulation because everybody would go to more welcoming jurisdictions.

The Financial Service Authority with their quote, "light touch" end quote, regulation was advocated. About a year and a half later, Lord Adair Turner, who was the chairman of it, said the era of light touch regulation is over. And in fact, we no longer have that.

And I think America is in the lead in pushing for an international set of standards, which are better. And some of our friends in Europe understand that now because there were European countries, Germany for example, where people didn't make subprime loans at their financial institutions. They just went bankrupt because other people did, mainly in America. Because there is a degree of -- of -- of interconnection.

By the way an aside, not directly relevant to here except how we got here, we were told, obviously in 2008 by the Bush appointees, Ben Bernanke, Paulson and others that we were facing something as bad as The Great Depression. I think in many ways it could have been worse than The Great Depression.

Because 80 years ago, you had an -- there was a granularity to the economy. Things could be going very bad in one place, but they could be going well elsewhere. There was more of a localism -- a localism to it. By now, everything is interconnected and when things bog down one place, they bog down other. That's a powerful argument so you're not going to get the same -- and even over the last two years people have seen this.

Some of our European allies or friendly competitors underwent such turmoil themselves in the last few years and in many case they're worse off than we are today because we have dealt with this stuff more forth rightfully I think in some ways. You no longer have this, oh lets have people come over here.

As a matter of fact, many European institutions are complaining loudly to their regulators that America is nicer; for example, in compensation. And while there are some legitimate issues that have be addressed, as I said on imposing margin requirements on end users in -- in other countries some of the financial institutions, sometimes sound like the 14-year-old child of divorced parents, trying to play Mommy against Daddy.

And if you don't let me stay up late, I'm moving over there. And the regulators have been talking and I do not think we see at this point, any serious problems. And that includes a capital surcharge for systemically important financial institutions. And in fact, one of the things that's emerged, there's been this debate about did we end "too big to fail", it's not clear that we did.

And in fact, when the Republicans had the hearing on international competition, two industry witnesses, one representing a bank organization and one House God (ph) from Harvard who has been a supporter of a strong wealth of phantom industry and skeptical of some regulation in the committee on capital markets, both noted that there was a potential competitive disadvantage for large American financial institutions because we are so firm in not allowing bailouts.

And they noted that America has, by far, the strongest anti- public participation in bailout law and rules in the world and that this could be a problem for American institutions visa vi others. The argument, by the way, that being designated as a systemically important financial institutions somehow confers an advantage on you because you'll be able to borrow more cheaply, this -- is we've heard of the gift that keeps on giving, this is the gift the people keep on refusing.

Because unanimously any institution about which there is any discretion as to whether or not it is designated as systemically important, has vehemently asked not to be. Again the notion that this somehow gives you a benefit, apparently all these people have suddenly become very self sacrificing.

I was hoping we could get them to neutral, but now apparently they've given giveaway (ph). And the fact is that overwhelmingly people do not want to be designated because somebody carries (ph). I will say, and I've said this before, I -- I've pointed this out to Governor Tarullo of the Federal Reserve, he said that he talks about adding an element to the charge for systemically important financial institutions to offset any advantage they might get from being perceived as "too big to fail", he's mistaken.

He -- the way to deal with that is to help us get rid of that perception. And as you know, one of the rating agencies has already moved in that direction. But it is overwhelming and in fact a couple of the business have noted America at this point -- actually Lehman Brothers, not something that was done deliberately, but they say that's the only example of a major financial institution in a developed country being able to totally fail with -- with nothing.

So, that's -- that one, the evidence clearly puts to rest this notion that we didn't deal with "too big to fail." There are a couple of areas where I see the attack coming. First of all, it is interesting that my Republican colleagues, unlike climate change and health care, don't want to take this one on head-on because it is still too popular. This -- the -- the -- coming to the defense of unrestricted derivative trading is not a popular cause.

So they are coming at it sideways. One is to try to use the deficit as an excuse for underfunding the SEC and the CFTC. The CFTC is being denied the funds that it needs, that are a small percentage of what we're wasting trying to build infrastructure in Afghanistan.

The -- the notion that the CFTC, that the $80 or $90 million more than we need for the CFTC can't be done because of the deficit, when people were voting and set $147 million to subsidize Brazilian cotton farmers, so we can keep subsidizing American cotton farmers, is nonsense.

Similarly with the SEC, which they want to turn into a profit center. The SEC will bring in more money through its regulatory system than it will be given to run it. So, that's one negative effect. And in fact what you have running here is a catch-22. First, deny the SEC and the CFTC adequate funding. They in turn are not able to deal with the rulemaking requirements that they have.

And then because they haven't been able to move as quickly on the rules announcing clearly the rules have to be abolished. But that's something that they have imposed. Obviously you want the SEC and the CFTC to have very smart people and very good information technology. I have to say here, I do not see this coming from the financial institutions.

I think many of them recognize, as does for example the pharmaceutical industry, that while you may not like the rules in the first place, if you've got the rules you want them well run. And I have not see this -- this is coming from the ideologues in the Republican party who just believe, despite all the evidence to the contrary, that an unrelated free market works - and you saw this in Alan Greenspan's article in the Financial Times, it's as if the -- the last few years never happened.

The other problem we have and I have to be honest is, I have been disappointed at the pace of appointments from the Obama administration. We knew last August that a comptroller of the currency needed to be reappointed and they have only now come up with a good bipartisan appointment in Tom Curry.

I regret the failure still to appoint someone to the CFPB. On the other hand, there have been cases where they have made good appointments. Joe Smith from North Carolina, a bipartisan bank commissioner in North Carolina, brutally rejected. I mean brutally according to Joe Smith, treated like he was a disrespectable person by the Senate Republicans who announced that they will confirm nobody to the CFPB unless we undermine the very purpose of the CFPB.

The purpose of it was to give them independence in the bank regulators and now they want to subject them to the bank regulators before they will nominate anybody. And that is an absolute perversion of the Constitution. There is the legislative power, in which you make laws, and there is the confirmation power.

In announcing that you will not use the confirmation power until you get by that, extortion which you can't get through the legislative process is a perversion of the Constitution. And there is one final area that I am troubled by. And here I have to say some of my liberal friends are part of the problem.

The single biggest cause of all of this was the ability of people to make mortgage loans with neither regulation, nor risk. Now we have dealt with that in substantial part. And banks, particularly the community banks get unjustifiably unhappy when people talk about how the banks caused this problem.

Because if only those institutions technically known as banks, deposit taking institutions which get deposit insurance they are; therefore, subject to regulation -- if only they made mortgage loans, we would not have had the crisis we would -- we had. Part of the problem was that a couple of things grew up.

Great sources of liquidity outside of deposits and information technology revolution that allowed institutions that were essentially unregulated to make mortgage loans. And you have the worst of both worlds in some cases because what you had was some banks were able to set up subsidiaries that were not subject to the full regulation that banks are subjected to.

But because they were affiliates of national banks or because of what the control of the currency did in 2004, they weren't subject to state regulation either. You created a great kind of vacuum. And that, by the way, was a bipartisan mistake, because it was a Clinton appointee, Jerry Hawke, who was the holdover appointee -- he had a term as comptroller of the currency, who in 2004 greatly over preempted.

And we see the current control we're trying to maintain in direct contradiction to what the bill says. And that's one of these things that has to be corrected. But the problem was that people were able to make loans without regulation, as I said without risk. Now, we've solved part of that problem under the legislation.

The Consumer Financial Protection Bureau has jurisdiction now over activity. And that's one of the things we tried to do in the bill was to regulate activity, not institutions. Because if you regulate by institution, an institution can change its shirt and avoid regulations, go shopping for different regulators.

What you now have is a regulation by activity. Whether its derivatives or whether its mortgages. And the CFPB will now have rules for all mortgages. And it has some substantive rules for all mortgages. So we have dealt with that. But there was a second part of it. And I -- and I believe that will be well done. And they have the ability to put servicing requirements in going forward.

It's very hard to undo the mess we have now with servicing retroactively. But we can and I believe the CFPB will prevent that from happening again. But there was another aspect to it. With the best set of rules in the world, if people don't have an incentive only to make good mortgages, i.e. mortgages that can be repaid, you're going to have trouble.

That's why risk retention was so important. Now, I am troubled because there is an assault now on risk retention. And I agree that a 20 percent requirement for a qualified residential mortgage is higher than it has to be. But unfortunately, and some of my friends in the advocacy groups are involved in this.

There is a subtle shift here in which people have stopped objecting to what's involved in the qualified residential mortgage as an exception and instead try to claim it should be the rule. There is a general notion that risk retention in mortgages really is -- is too burdensome and that the combination of the rules and risk retention will -- will mean you can't get mortgages.

I just was re-reading (inaudible) testimony before the Senate in which this was created. (Inaudible) has been subsequently critical in the way in which some of this has happened. But his testimony in favor of legislation to allow securitization to go forward is in 1986. So if you listen to these people, you've got to wonder, how did we ever get any mortgages made before 1986?

If securitization is essential to mortgages and risk retention ruins securitization, what the hell were all these people living in before 1986? I will acknowledge, what we're trying to do with derivatives, putting them into clearinghouses and exchanges and requiring margins when the financial institutions deal with each other, when AIG and Goldman Sachs deal with each other. Yeah, we don't think they should be allowed to do it the way they did before.

Risk retention in mortgages, these things are disruptive. That's really what you're hearing. Well we haven't done it this way. It's going to be harder. It might cost us a little more. It's disruptive. Yes. It's disruptive because we had to disrupt a rotten system.

We had to disrupt a system which collapsed. And it collapsed because risk was made to appear to disappear. People were able to engage in activity in which they did not have any risk. But risk didn't go away. It just accumulated elsewhere and then it exploded and rained on all of us and caused a terrible problem.

Risk retention is a very important piece of this. I -- I was arguing with some of the people in the mortgage bankers and they showed me their view. And they say, yes we like risk retention. But if you read their paper, they really don't like risk retention very much. For example, they want to be able to sell securities that include some that meet the qualified residential mortgage test and some that don't and not have risk retention.

They want risk retention to last only five years on 30 year mortgage packages. This assault on risk retention is a terrible idea. And -- and here's the -- let me just read a summary of what people say about this. Here's -- no one disputes there were lending excesses during this decayed -- decades housing revels (ph).

But here's what people are complaining about; forbidding banks from signing up borrowers for overly expensive loans, requiring banks to make sure that the consumer has, quote "a reasonable ability to repay the loan." And the loans be and -- quote, overly expensive loans are banned. Also requiring banks that securitize mortgages be made explicitly liable for violations of the lending laws.

And here's what we're told about this set of regulations, which include risk retention requirements and specific bans on types of mortgages. For all the demonizing, about 80 percent of even subprime loans are being repaid on time and another 10 percent are only 30 days behind. Most of these are new home -- most of these new homeowners are low income families, often minorities who otherwise would not have qualified for a mortgage.

In the name of consumer protection, Mr. Frank's legislation ensures that far fewer of these loans are issued in the future. This would also hit banks when their shareholders are always being punished. The bill couldn't come at a worst time. It will shrink credit to marginal borrowers, which will mean fewer borrowers. This bill is a Sarbanes/Oxley for housing.

I'm reading to you from a Wall Street Journal editorial from November of 2007. They were talking about how wonderful the subprime loans were performing in November 2007. This is -- having the Wall Street Journal criticize others for allowing subprime loans is kind of like their sister publication, The News of the World, accusing people of not being respectful of other's privacy.

The -- the fact is that these criticisms the Wall Street Journal made back then, are unfortunately being repeated now. And there is an overwhelming consensus that securitization without risk retention, which will never go down with taxation without representation as a slogan, I understand that.

Even with people whose diction is better than mine, it ain't gonna work. But there's a consensus, it's -- read Michael Lewis in The Big Short and again it is very clear that it was the ability to make risk appear to disappear, to get it out of your site. Read Gillian Tett, it's Fools Gold.

The solution to that puzzle came by letting derivatives technology through a technique known as securitization. Michael Lewis, the same thing. The economists talking about the dangers that might be in exchange traded funds says, this has echoes of the subprime housing crisis in which financial innovation went out of control.

It had its origins in invention with a benign name. This was just a couple weeks ago. The packaging of mortgages for use as securities for bonds was intended to reduce borrowing costs and disperse risk. Eventually that translated in a complex collateralized debt obligation and lower lending standards.

And as I said, some of my liberal friends are joining in, so I want to make a few things clear. Qualified residential mortgages, mortgages not subject to risk retention are to be an exception, not the rule. The notion that you cannot have mortgages without securitization and you can't have securitization if you have risk retention, is clearly wrong.

First of all before 1986 we didn't have securitization, let's understand that and we had a pretty healthy housing market in America. But secondly, and I agree, securitization is a very important tool. But the notion that people who are making these loans should retain a five percent interest in the loan, has a guarantee against them making loans that don't have a chance to be repaid.

That that's an impediment, as the mortgage banker said. This would impede loans. If it is, then we have a serious problem with the kinds of loans we're making. I have been told by some, well it's a problem if you have two kinds of loans. A bifurcated market, some which are subject to risk retention and some that aren't, that'll be dead (ph).

Fine, if they really believe that, then let's do away with those without risk retention. The notion that holding five percent of the loans -- before 1986 you held 100 percent. And I remember again being told by some of those who made the riskiest loans, you'll drive us out of business, we can't do that.

Well I ask why is five percent so much of a problem? Well we don't have any capital. Well if you don't have any capital, don't lend it. Don't lend money you don't have. And I -- and again I -- I -- I -- in fact the Wall Street Journal editorial, here's the Wall Street Journal editorial again. These subprime loans are wonderful. You're going to drive low income people out of the market.

I run into again what I ran into for much of this decade and before, the notion that for many people in the lower income brackets, rental housing -- decent rental housing is preferable to putting them into a homeownership situation which is precarious. It's a hard one to overcome.

By the way on home ownership, and I acknowledge (ph) there's one area of the bill that need some work and I believe manufactured housing continues to be a very important thing that we -- we have begun improvements on that and I hope to continue them. But it's interesting, you have assaults on the bill now.

You have the funding ones. Well people understand those and I think the public will clearly fight back against those. You have this effort to undermine the rules on derivatives. My Republican colleagues have legislation that passed both the Agriculture and Financial Services Committee to postpone any new derivative regulation, including speculation until October of 2012.

Recently several publications noted the fear that American financial institutions have sold credit default swaps on Greek debt. And we have a degree in the tens of billions or hundreds of billions of liability nobody knows about. And we don't know how much that is because the bill hasn't yet gone into effect and people are still trying to postpone it even further.

And that uncertainty is in and of itself a problem. We have speculation. The spokesman for the Republicans on this has been Jack Kingston from the Appropriations Subcommittee on Agriculture. And he has clearly said on the floor of the House a couple of times, speculation has no impact on energy prices.

By the way, there was a big argument about that among economists and 20 years ago it was a tougher argument to make. What's happened is, information technology, greatly increased liquidity I think have transformed that. And there is now a consensus within the financial -- if you read the financial pages people talk about the impact of speculation, it's a given.

And the Republicans are trying to keep the CFTC from doing anything about speculation. Those are the head-on attacks we have. There is though this more subtle one, this attack on risk retention and I believe that risk retention is the single most important piece of this bill.

By the way, you know, of course the response when we used to say there was a problem, you know what was supposed to be the substitute for risk retention? The rating agencies. The rating agencies were the ones. You didn't need to have the lender worry about this because you could go ask the rating agencies.

The Oracle of Delphi. Now of course the rating agencies are trying to overdo it and the people who told us that subprime loans were good, are now telling us that the sovereign debt of Portugal backed by the European Union is not good. I think they were wrong both times.

But that's one of the things that I that -- I really wanted particularly to address now. And it does involve me in an argument again with my liberal friends. Yes 20 percent is too high. But if I -- I read the mortgage bankers, they don't like a down payment requirement. They are against a debt to income ratio and they are against the loan to value ratio.

But they say we should find out how much money the people are making to whom we make the loans. Why? If it doesn't -- if it's not relevant what the ratio of that income is to the debt, the value of the home isn't relevant, they don't have to put down any down payment and you're securitizing 100 percent of the risk, so what?

So, yeah it is important that we do substantive of what we did. I don't want to say that risk retention is the only thing. We made a substantive change. You know, we ignored the Wall Street Journal's editorial in 2007 because the bill that they were opposing then, which passed the House but not the Senate at that point, was incorporated into the bill.

And their fears that subprime mortgages won't be given, I hope they turn out to be accurate in that for once. But on the question of risk retention, you can give good -- we now have no unregulated mortgage lenders and we have banned a lot of the bad practices and they're going to be subjected to regulation.

But particularly those conservatives who point out correctly that regulation can never completely replace the market, shouldn't be advocating that we do away with the one market-based incentive that is so important here and that is, risk retention. Risk retention is a marked-based incentive.

It says to the person, put your money on the line and everything will be OK. And that's why I intend to talk more and more in disagreement with my liberal friends again. Not at 20 percent, but I do think there needs to be a down payment requirement and some of these other factors.

And risk retention -- loans made without risk retention should be an exception and not the rule. And if people are convinced that you can't have a bifurcated market, then I am for doing away with the exception, not the rule.

With that, I'll be glad to respond if there are any questions or comments.