Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

1-14-2010

FCIC Transcript of First Public Hearing of the Financial Crisis Inquiry Commission

Phillip Angelides

Bill Thomas

Brooksley Born

Byron Stephen Georgiou

Robert Graham

See next page for additional authors

https://elischolar.library.yale.edu/ypfs-documents/6425

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library. For more information, please contact ypfs@yale.edu.

Author/Creator
Phillip Angelides, Bill Thomas, Brooksley Born, Byron Stephen Georgiou, Robert Graham, Keith Hennessey, Douglas Holtz-Eakin, Heather Murren, John W. Thompson, Peter J. Wallison, Eric Holder, Lanny A. Breuer, Sheila Bair, Mary L. Schapiro, Lisa Madigan, John W. Suthers, Denise Voigt Crawford, and Glenn Theobald

This document is available at EliScholar – A Digital Platform for Scholarly Publishing at Yale:
https://elischolar.library.yale.edu/ypfs-documents/6425

The Official Transcript

First Public Hearing of the

Financial Crisis Inquiry Commission

Thursday, January 14, 2010
1100 Longworth House Office Building
Washington, District of Columbia
9:00AM

COMMISSIONERS

PHIL ANGELIDES, CHAIRMAN

BILL THOMAS, VICE CHAIRMAN

BROOKSLEY BORN

BYRON GEORGIOU

ROBERT GRAHAM

KEITH HENNESSEY

DOUGLAS HOLTZ-EAKIN

HEATHER MURREN

JOHN W. THOMPSON

PETER WALLISON

WITNESSES: PANEL ONE

HONORABLE ERIC HOLDER, UNITED STATES ATTORNEY GENERAL
HONORABLE LANNY A. BREUER, ASSISTANT US ATTORNEY GENERAL, CRIMINAL DIVISION
SHELIA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION
MARY L. SCHAPIRO, CHAIRMAN**,** UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WITNESSES: PANEL TWO

HONORABLE LISA MADIGAN, ILLINOIS ATTORNEY GENERAL
HONORABLE JOHN SUTHERS, COLORADO ATTORNEY GENERAL
DENISE CRAWFORD, COMMISSIONER, TEXAS SECURITIES BOARD AND PRESIDENT OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
CHIEF GLENN THEOBALD, CHAIRMAN, MAYOR CARLOS ALVAREZ MORTGAGE FRAUD TASK FORCE

CHAIRMAN ANGELIDES:

Good morning. The public hearing of the Financial Crisis Inquiry Commission will come to order. There is a quorum present. Welcome to our second day of public hearings on the causes of the financial economic crisis that is gripping this country. As I said and as the Vice Chairman also indicated yesterday, we are a panel that is going to do our level best on behalf of the American people to try to discern the facts and the causes of the current crisis, which has affected so many million Americans.

Yesterday we heard from a range of experts and folks from the private sector. Today we have a number of people with us who are at the federal, state and local level who have been involved in grappling with the consequences of this crisis. And I'm looking forward to today's testimony. I want to thank all the commissioners for all their hard work yesterday and what we'll do today. And I want to thank the folks in the audience and the people watching this hearing as well as all the witnesses who will provide testimony to us. Mr. Thomas, do you want to make any opening comments this morning?

VICE CHAIRMAN THOMAS:

No, thank you, Mr. Chairman, other than to say thank you very much for appearing before us. And we look forward to continued cooperation. Thank you.

CHAIRMAN ANGELIDES:

Excuse me -- on the first panel. And we have before us the Attorney General of the United States, Mr. Holder. We have before us Mr. Lanny Breuer, who is

the Assistant Attorney general in charge of the criminal division of the Department of Justice. We have Sheila Bair, who's the chair of the FDIC and Mary Schapiro, who's the chair of the SEC.

We're going to start as we are with all witnesses as will be -- as has been and will be our custom at this commission, we will swear all witnesses. So I'd like to ask all the witnesses to please stand and be sworn before us. Do you solemnly swear or affirm under

the penalty of perjury that the testimony you're about to provide the commission will be the truth, the whole truth and nothing but the truth, to the best of your knowledge?

ALL:

(OFF-MIKE) I do

CHAIRMAN ANGELIDES:

Thank you very, very much. We will now commence.

I will ask that each witness provide an opening statement. We do have written testimony from the witnesses. And I'd like to ask if each witness would provide up to 10 minutes of oral testimony. It's my understanding that Mr. Holder will provide the testimony for the Department of Justice. And I will also note that Mr. Holder rearranged his schedule to be here and will be with us for the opening statement and a couple of brief questions. And I know his schedule dictates that he has to depart. But let's start with Mr. Holder and then go to Ms. Bair and Ms. Schapiro.

HOLDER:

Thank you, Mr. Chairman. Chairman Angelides, Vice Chairman Thomas, thank you for inviting me to address you and the other distinguished members of this commission. These inaugural hearings, I believe, mark a critical step forward in better understanding the root causes of the financial crisis that has held our economy in its grip over the last two years. I appreciate the opportunity to participate in the commission's work and to assist in your inquiry.

This morning I am joined by Lanny Breuer, the assistant attorney general for the Justice Department's Criminal Division. Lanny spearheads many of our key efforts investigating, prosecuting and punishing financial crimes. He has submitted written testimony, which provides a comprehensive overview of the department's work in these areas.

And he'll be available to answer any additional questions that you might have.

We must be vigilant in our efforts to safeguard and to strengthen the American economy. Our efforts to fight economic crime are a vital component of our broader strategy, a strategy that seeks to foster confidence in our financial system, integrity in our markets and prosperity for the American people. Now, in carrying out the strategy, the Justice Department has long focused its efforts on combating financial fraud. Across numerous administrations, Democratic and Republican alike, the department has worked hard to combat fraud then to recover ill-gotten gains for the benefit of fraud victims.

Now, despite these efforts, however, we know that financial fraud persists. In fact, the Wall Street Journal reported earlier this month about that, quote, "Crisis and fraud in the securities and investment banking industries are at their highest level since records began," unquote.

The current economic crisis has brought these challenges to the forefront. Now, let me state at the outset what role the department plays and does not play in addressing these challenges. Put simply, the Department of Justice investigates and prosecutes federal crimes.

As I sit here today, prosecutors in Washington and in 94 U.S. attorneys' offices around the country are hard at work investigating a wide array of financial fraud cases from mortgage fraud to Medicare and health care fraud to securities fraud to corporate malfeasance. I'm proud we have put in place a law enforcement response to the financial crisis that is and will continue to be aggressive, comprehensive and well coordinated.

But while the reach of our investigative and prosecutorial function is broad, we do not purport to have all the answers. As a general matter, we do not have the expertise nor is it part of our mission to opine on the systemic causes of the financial crisis. Rather, the Justice Department's resources are focused on investigating and prosecuting crime. It is

within this context that I am pleased to offer my testimony and contribute to your vital review.

The department has a long history of prosecuting financial fraud. And we will continue to do so. Working in concert with our federal, state, local, tribal and territorial partners, the Justice Department is using every tool at our disposal, including new resources, advanced technologies and communications capabilities and the very best talent that we have to prevent, to prosecute and to punish these crimes. And by taking dramatic action, our goal is not just to hold accountable those who conduct -- whose conduct may have contributed to the last meltdown, but to deter such future conduct as well.

The cornerstone of our work in this area is a new interagency financial fraud enforcement task force, which was established in November by executive order of the president and is led by the Department of Justice. At the core of the task force's mission is a more robust and strategic law enforcement effort focused on combating four types of financial crime: number one, mortgage fraud from foreclosure rescue and loan modification frauds to systematic lending fraud in the nationwide housing market; number two, securities fraud from traditional insider trading to Ponzi schemes to accounting fraud to misrepresentations to investors; third, Recovery Act and rescue fraud, including the theft of federal stimulus funds and the illegal use of taxpayer dollars intended to shore up our financial institutions; and fourth, financial discrimination, including predatory lending practices in minority communities and the sale of financial products that exploit the elderly and the disadvantaged.

Now, in combating financial crimes, we will aggressively leverage the criminal and civil enforcement resources of the federal government. We will tackle every fraud case with the aim of recovering stolen funds for victims. And we will enhance coordination and cooperation among the federal, state, local, tribal and territorial authorities so that the perpetrators of these crimes are brought to justice.

Now, on this last point let me be very clear. When we find businesses or individuals whose disregard for the law has hurt the pocketbooks of average Americans, we will use every available measure to hold them accountable. Even before the launch of the task force, the department aggressively responded to the financial crisis by redoubling our fraud-fighting efforts.

In addition to convicting Bernard Madoff, who perpetrated the largest Ponzi scheme in our nation's history, last year we arrested the ringleaders of what has been described as the biggest hedge fund insider trading case in history. And we secured 30-year and 25-year sentences for two executives of National Century Financial Enterprises following their convictions on conspiracy, fraud and money laundering charges.

We've also devoted substantial attention to preventing and to prosecuting mortgage fraud. Right now the FBI is investigating more than 2,800 such cases, up almost 400 percent from five years ago. The recently enacted Federal Budget for 2010 will enhance these efforts as will the enhanced legislative authorities that Congress provided the department last year in the Fraud Enforcement and Recovery Act of 2009.

Now, I'm confident that with the new authorities, with the new resources, and a bold new plan of action, we can and we will make measurable, meaningful progress. And working together with our law enforcement and regulatory partners, we will succeed in restoring the integrity of our markets, preserving taxpayers' resources and protecting the vast majority of hard-working Americans, investors and businesses who play by the rules and who adhere to the law.

I thank you again for the opportunity to participate in today's hearing and to outline the department's ongoing efforts and to address financial fraud in the wake of our economic

crisis. I look forward to working with you and along with Assistant Attorney General Breuer, we'd be happy to answer any of your questions. Thank you.

CHAIRMAN ANGELIDES:

Thank you very much, Attorney General. Ms. Bair?

BAIR:

Chairman Angelides, Vice Chairman Thomas and commissioners, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation. My testimony will focus on the failure of market discipline and regulation that led to the financial crisis and suggest reforms to prevent a recurrence.

The last major financial crisis, the thrift and banking crisis of the 1980s, resulted in enactment of laws designed to improve the financial regulatory system. These laws significantly strengthened bank regulation and provided banks with strong incentives to operate at higher capital levels with less risk. But at the same time, they created unintended incentives for financial services to grow outside of the regulated sector in the so- called shadow banking system. In the 20 years following these reforms, the shadow banking system grew much more quickly than traditional banking.

At the onset of the crisis, it's estimated that half of all financial services were conducted by institutions not subject to potential regulation and supervision. Products and practices originated by the shadow banking system have proven particularly troublesome in this crisis. Many of these non-banks grew to be too large, too complex and too interconnected to resolve under existing bankruptcy laws. They also cannot be wound down under the FDIC's current receivership authorities.

We are now poised to make far-reaching changes that will affect how we regulate the entire financial system. Our approach must be holistic and give regulators the tools to address risks through the system, not just in the insured banks, where we have long recognized that heightened prudential supervision is necessary.

To be sure, we can improve oversight of insured institutions, but if reforms only layer more regulation upon traditional banks, it will just create more incentives for financial activity to move to less regulated venues. Such an outcome would only exacerbate the regulatory arbitrage that fed this crisis. If that occurs, reform efforts will once again be circumvented, as they were over the past two decades.

Numerous problems in our financial markets and regulatory system have been identified since the onset of the crisis. In 2002 and early 2003, encouraged by record low interest rates, there was a boom in the volume of mortgage origination. These originations were driven primarily by the refinancing of existing mortgages. Mortgage origination platforms grew to accommodate the surge in mortgage demand.

By 2004 house prices were rising at double-digit rates, setting the stage for dramatic changes in the structure and funding of mortgage loans. Because many prime borrowers had locked in their loans by 2003, the mortgage industry shifted its attention and its ample lending capacity toward less creditworthy borrowers and homebuyers struggling to cope with the high cost of housing. One result was a rapid increase in subprime loan originations, which more than doubled in 2004 and peaked at just over 20 percent of all originations by 2005.

Declining affordability and high-priced housing markets also contributed to a shift towards nontraditional mortgages, such as interest only and pay option mortgages. The limited reach of prudential supervision allowed risky practices to grow unchecked.

For example, subprime and nontraditional mortgages were originated and securitized primarily by brokers and mortgage companies and by non-bank affiliates of insured institutions. Securitization markets provided much of the funding for these loans.

Growth in private label mortgage-backed securities was enhanced by the development of the CDO and CDS markets. The size and complexity of the capital market activities that fueled the credit boom meant that only the largest financial firms could package and sell these securities.

Compensation schemes fueled the growth. Many compensation systems were not sufficiently linked to risk management. They allowed high, short-term profits to be translated into generous payments without regard to any long-term risks. Mortgages and many derivative products created long-dated risk, while compensation was weighted toward short-term results, creating perverse incentives for riskier behavior.

Another important cause of the crisis was a lack of strong consumer protections, especially in the non-bank sector. Increasingly, complex financial products, combined with opaque marketing and disclosure practices, proved toxic. As a result foreclosures are nearing three million per year, and more than 15 million households are saddled with underwater mortgages.

Finally, many financial firms grew to such size, complexity and interconnectedness that the market implicitly assumed that they were too big to fail. Credit rating agencies recognize this implicit guarantee, providing two ratings, one with and one without government support. As a result of their too big to fail status, these firms enjoyed funding at the low market rates for the risks they were taking. The financial crisis revealed that risk grew across the financial system unimpeded by a stovepipe financial regulatory framework, one framework for insured institutions and another less stringent one for non-bank entities. Differences in the regulation of capital, leverage and consumer protection among institutions in the shadow banking system and traditional banking sector and the

almost complete lack of regulation of OTC derivatives allowed rampant regulatory arbitrage.

The massive expenditure of taxpayer funds and the near collapse of the financial system demonstrate a need for major financial reforms that reduce moral hazard and improve the system's resiliency. These changes should include a resolution mechanism that makes it possible to break up and sell a large, complex, interconnected firm without taxpayer support. And I am very pleased that the bank CEOs who talked with you yesterday endorse this. We believe there should also be a pre-funded resolution reserve to provide working capital for this resolution process. We also support creation of a systemic risk council to provide macro prudential oversight and strengthen and harmonize capital, leverage and liquidity standards as necessary.

More effective oversight and improved transparency of derivatives markets is needed, and finally, a rulemaking authority to ensure uniform consumer protection throughout the financial system. These reforms would go a long way toward preventing another crisis.

But as the committee examines the causes of the financial crisis, I urge you to also consider other long-standing U.S. economic policies that may have played a role. This crisis is the culmination of a decades-long process where national policies have skewed economic activity away from savings and toward consumption, away from investment in our industrial base and public infrastructure and toward housing, and away from the real sectors of our economy and toward the financial sector.

Examples include federal tax and credit subsidies for housing, compensation practices that promote short-term profit without regard for the long-term risks, and implied -- now explicit -- government backstops for large financial firms. Such backstops subsidize excessive growth and risk-taking. No single policy is responsible for these economic distortions, and no one reform can restore balance to our economy. We need to examine

national policies from a long-term view and ask whether they create the incentives that will lead to better and sustainable standards of living.

Our financial sector has grown disproportionately in relation to the rest of our economy. Whereas the financial sector claimed less than 15 percent of total U.S. corporate profits in the 1950's and 1960s, its share grew to 25 percent in the 1990s and to 34 percent by 2008. Financial services are essential to our modern economy, but the excesses of the past decade were a costly diversion of resources from other sectors of the economy. We must avoid policies that encourage such economic distortions.

Fixing regulation can only accomplish so much. Longer term, we must develop a more strategic approach that utilizes all available policy tools -- fiscal, monetary and regulatory -- to lead us toward a more stable and more widely shared prosperity. Thank you.

CHAIRMAN ANGELIDES:

Thank you, Ms. Bair. Ms. Schapiro?

SCHAPIRO:

Thank you. Chairman Angelides, Vice Chairman Thomas, members of the commission, thank you for the invitation to share my insights as chairman of the Securities and Exchange Commission into the causes and lessons learned from the crisis.

The work of this commission is essential to helping policymakers and the public better understand the causes of the crisis and build a better regulatory structure. Many of the foundations of securities regulation, and indeed the SEC itself, resulted from the efforts of a similar investigation following the stock market crash of 1929.

When I became chairman of the SEC in late January of late 2009, the agency and financial markets were still reeling from the events of the fall of 2008. Since that time, the SEC has worked to review its policies, improve its operations, and address the legal and regulatory gaps that the crisis has laid bare. There were many interconnected factors

and mutually reinforcing the causes of the financial crisis. So I appreciate the enormous challenge facing the commission. My written statement discusses many of these causes in detail, but I'd like to use my time this morning to highlight just seven of the lesson

First, requirements around asset securitizations must be strengthened. I believe this is essential as one of the major factors in the financial crisis was the rise of subprime mortgage- backed securities. The securitization of mortgages led to an unintended facilitation of weaker underwriting standards by originators and excessive reliance on credit ratings by investors.

In short, the financial crisis exposed serious gaps in the asset- backed securities market. As a result, today, the SEC staff is engaged in a broad review of the way in which asset-backed securities are regulated. We are looking at disclosures, the offering process, and reporting by asset-backed issuers, and we're considering several proposed changes designed to enhance investor protection in this market. This is a vital market, and I believe the changes are critical to restore investor confidence and facilitate capital formation.

Our proposals will seek to align the interests of investors with those selling asset-backed securities. Among other things, the proposals will seek to provide significantly more time for investors to conduct a careful analysis before investing. The proposals will require that low-level data is provided in a format and manner that is accessible to investors. And the proposals will seek to create a mechanism for ongoing disclosure.

A second lesson growing out of the crisis is that investors and even regulators, in some cases, can over-rely on credit rating agencies. Throughout the crisis, credit rating agencies performed poorly by, among other things, providing high ratings to complex financial products made up of low-quality assets, including subprime mortgages. Nonetheless, many relied upon these ratings as indicia of quality, risk, and liquidity.

In response, the commission has undertaken a series of rule makings designed to improve ratings quality and reduce reliance by fostering accountability, transparency, and competition.

A third lesson is that standards are weakened and regulatory gaps emerge when the risks of deregulation are not adequately appreciated and when markets are considered to be almost always self-correcting. Indeed, it was quite recently when many viewed deregulation, particularly in financial services, as the key to fostering market growth and ensuring U.S. competitiveness. Unfortunately, this meant that main elements of the financial landscape, such as over-the-counter derivatives and hedge funds were subject to minimal or no regulation. And it meant that regulators lacked necessary information to identify, understand, and address risks in these areas. The result was a proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood.

One very significant gap in the regulatory structure is the inadequate regulation of OTC derivatives which were largely excluded from the regulatory framework in 2000 by the Commodity Futures Modernization Act. This gap leaves a very large and risk-laden market almost entirely out of public and regulatory view. To address these gaps and regulatory arbitrage dangers, we need greater transparency and oversight of OTC derivatives and major market participants and dealers. And such products should be subject to the greatest extent possible to central clearing and exchange trading. The current absence of regulation and transparency should not continue.

A fourth lesson from the crisis is that there can be a direct relationship between compensation arrangements and corporate risk taking. In fact, many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success. We know that some of these same decisions resulted in significant long-term losses or failure for shareholders and taxpayers.

In December, the SEC adopted new rules that will significantly improve disclosure in the key areas of risk, compensation, corporate governance, and director qualifications. The rules require companies to disclose their compensation policies and practices for all employees, not just executives, if these policies and practices create risks that are reasonably likely to have a material, adverse effect on the company.

Fifth, the financial crisis revealed that a siloed regulatory framework is unable to monitor and reduce risks flowing across entities in markets. For this reason, I support the establishment of a council of regulators empowered to evaluate risk across the financial sector to identify and address systemic issues. In addition, I believe large, interconnected institutions should be supervised on a consolidated basis. However, consolidated supervision is not a panacea, and policy makers should remain aware of the limits of such oversight and regulation. This is particularly the case for institutions with many subsidiaries engaging in different, often, unregulated businesses in multiple countries. Systemic risk management requires meaningful functional regulation, active enforcement, and transparent markets to be effective. And while a consolidated regulator of large, interconnected firms is an essential component to identifying and addressing systemic risk, other tools must also be employed. These include more effective capital requirements and leverage limitations, strong enforcement, functional regulation, and transparent markets that enable investors and counterparties to better understand the risks associated with particular investment decisions.

A sixth lesson of the crisis is that markets and market regulation should promote, not undermine, the investor confidence essential to the efficient flow of capital and the long-term success of markets and our economy. But since the financial crisis began, there has growing unease that markets are being stacked against investors. The roots of any deficiencies in market structure must be addressed head on to ensure that markets are transparent and investors are treated fairly. Accordingly, the SEC has taken a fresh look at market structure and trading activities to ensure they foster fair, orderly, and efficient

markets that are designed to protect investors. This includes activities such as high frequency trading; flash trading, and dark pools.

And, finally, the financial crisis has taught us that consistent and vigorous enforcement is a vital part of risk management and crisis avoidance, particularly in times of substantial financial innovation. Through aggressive and even-handed enforcement, we hold accountable those whose violations of the law caused severe loss and hardship, and we deter others from engaging in wrongdoing. We also help vindicate the principles fundamental to the fair and proper functioning of financial markets. The investors have a right to disclosure that complies with the federal securities laws, and that there should be a level playing field for all investors.

Over the past year, the SEC has taken steps to improve the speed and effectiveness of its enforcement efforts, from streamlining procedures and removing a layer of management to creating specialized investigative units. We also are currently investigating a significant number of matters growing out of the financial crisis, and we have brought more than a dozen cases recently against entities and activities associated with some of the worst practices.

There is still much work to do to ensure that we do not see these problems repeated in the future. For example, in light of the lessons learned from the crisis, broker-dealers with significant proprietary positions are now providing enhanced information about positions, and the commission has strengthened capital requirements by limiting the ability of large broker-dealers to use value-at-risk models for regulatory capital purposes.

Most importantly, we have established an internal task force to review all aspects of the agency's financial regulation of broker- dealers to determine how such regulations can be strengthened.

Where the SEC cannot act on its own, we are working with Congress to address the problem of too-big-to-fail, to ensure strong regulation of OTC derivatives, to close loopholes that allow hedge funds and their managers to avoid oversight, to impose the highest standards of conduct on those who provide financial advice, and to invest the resources required to keep up with new products, properly oversee the financial markets, and better deter and hold accountable entities that might be inclined to commit tomorrow's financial crimes.

In conclusion, there were many causes and lessons to be learned from the financial crisis. The enormity and worldwide scope of the crisis and the unprecedented government response required to stabilize the system demands a full and careful evaluation of every aspect of our financial system.

No one should hesitate to admit mistakes, learn from them, and make the changes needed to address the identified shortcomings and reduce the likelihood that such crises occur.

Thank you very much.

CHAIRMAN ANGELIDES:

Thank you very much, Ms. Schapiro.

We will now go to questions. And as I indicated at the beginning, the attorney general does have to depart, so what we'll do is maybe a couple of questions from me and the vice chair, at which point, we will go to questions to all the panelists.

So let me start. Very quickly, Mr. Attorney General, one thing I'd like to ask you today to look into -- and I don't know if you have already -- but if you haven't, I'd like you to look into a matter and report back to us, please. Which is, in September of 2004, the FBI warned -- or it was the head of the Criminal Division of the FBI -- the assistant director -- warned about a quote/unquote, "epidemic of mortgage fraud coursing across this country" and indicated that if it went unchecked, it could end up with a financial consequence as a crisis as large as the S&L crisis. And without saying that was the genesis solely of what's

occurred here, even though testimony indicates from many people, including Ms. Bair and other folks we've heard that mortgage fraud was potentially a significant contributor here, one thing I'd like to ask you to do, if the department has not already done this, is to evaluate what steps were taken in the wake of that 2004 FBI warning. And so let me just quickly ask, has anything been done in that regard, and if not, will you commit on our behalf to do a review of what was done in the wake of the 2004 warning?

HOLDER:

We are constantly in the process of reviewing that which we can do better. I'm not familiar myself with that statement, but we will look at that. I will certainly acquaint myself with the -- with that statement and what caused that statement to be made, and we will review what the Justice Department has done since that time and make the results of that search available to you.

CHAIRMAN ANGELIDES:

Great. What kind of time frame do you think -- maybe I'll ask you to get back to us with what you think is a reasonable time frame for some -- that kind of evaluation.

HOLDER:

Sure. I don't think it should take an awful long period of time. As I said, we are constantly in the process of trying to reevaluate what it is that we have done, how we can improve on what we have been doing. And so I think that getting that information to you shouldn't take an awful long period of time.

CHAIRMAN ANGELIDES:

As part of that, what I'd like to indicate to you is that I have been told by folks who served as assistant U.S. attorneys, in places where there was particularly high levels of potential mortgage fraud that it was an issue visited up the chain.

And so I'm very interested, given the consequence, and it's a question I asked the private sector yesterday, is when the information was made available, what kind of actions were taken. So I'm interested in both what happened on the public side, what happened on the private sector side. The additional question that I had for you was, do you have currently, in your opinion, or did statutory authority sufficient exist to prosecute financial crimes, specifically mortgage fraud crimes across this country? Did it exist as it exists today?

HOLDER:

Yes, I think that we certainly have had tools that were available to us to help us in the fight -- in combating mortgage fraud. And as I indicated in my opening statement, the number of cases that are under investigation by the FBI, there's over 2,800 of those now, but with the passage of the Fraud Enforcement and Recovery Act, FERA, in 2009, we were given, I think, additional enhancements that allow us to look into these cases I think to a greater degree and with more abilities.

FERA extended, I think very significantly, a number of criminal statutes, including the bank fraud statute that allows us to reach the conduct of private mortgage brokers. That's a tool that we did not have before. This will make it easier for our prosecutors to charge private mortgage brokers who engage in fraudulent conduct. So in addition to those tools, which did exist, we have had these enhancements from Congress as recently as 2009. Again, we are constantly in the process of trying to review what tools we have, where there are gaps in our abilities to prosecute these kinds of cases, investigate these kinds of cases, and we will not hesitate to interact with you and with Congress in requesting additional tools should we identify needs in that regard.

CHAIRMAN ANGELIDES:

Right. I have one more request for you in this regard. As part of your evaluation that I asked you to undertake, maybe a branch of it, is were there sufficient -- if there was knowledge about potential crimes across the country of the magnitude, was there at the time sufficient enforcement capability, as well as authority?

There have been reports in the wake of the terrorist attacks of September 11th, 2001, that there was a diversion of 500 white-collar crime investigators at the FBI away from white-collar crime to terrorist activities. So as part of that evaluation, what warnings were sent up the line, including the FBI warning, as well as what resources and authority existed, didn't exist, was deployed or was not deployed?

HOLDER:

Yes, I mean, I think it's a very good question. Certainly there has been a movement, I think fairly recently and understandably so, to move investigative resources to the national security front, given what happened in September of 2001.

I was just looking at some numbers. On the other hand, in our budget for 2010, we have made combating white collar crime a real priority and we -- the budget request that's been passed by Congress, and signed by the president, provides nearly $50 million in program increases to the department to pursue white collar crime, including both financial and mortgage fraud. And that has a very concrete impact. We will have 50 new FBI agents and about 155 new attorneys who will have the ability to work these kinds of cases.

Our resources, even given those additions, are relatively limited, and these cases are complex ones. They take time and money in order to bring to fruition. But we are determined, given the resources that we have and the enhancements that we are going to receive, to make this a priority area for this Justice Department.

CHAIRMAN ANGELIDES:

All right. Thank you. And I think now that I've asked you a little bit of a series of questions, I think what I'm really after, with the 2004 report from the FBI being one of the pieces, is an evaluation by you to the extent to which we may determine, may not determine, that mortgage fraud was a driving force here; the extent to which authority or resources or actions existed, were taken, were not taken. I think that would be very helpful to us to see if that's a hole that had it been plugged would have made a material difference.

All right. Mr. Vice Chairman?

VICE CHAIRMAN THOMAS:

Thank you very much, Mr. Chairman. Thank you all for coming.

Mr. Attorney General, on page six of your testimony you indicated that, based on your area of responsibility, law enforcement is putting in place from your structure a response to the -- quote, "a response to the financial crisis that is and will continue to be aggressive, comprehensive and well coordinated."

As you know, our charge from Congress is to put together an explanation for the financial crisis. And given the time frame in which we need to fulfill that statutory responsibility, we are forced to be aggressive, as comprehensive as we can be in the time frame. One of my concerns is that we probably aren't as well coordinated as we should be in the collection of the necessary information for us to fulfill that function. And if you'll allow me, I will ask briefly of both the SEC chairman and the FDIC chairman a question which should be easy to answer prior to my asking you in essence the same question.

On the 6th of January, the FCIC entered into a written agreement with the Federal Reserve signed by their chairman for access to and sharing of information.

As you might expect, the Federal Reserve deals with some very sensitive information. There was a period of negotiations to come up with an acceptable agreement on both sides. On the 11th of this month, the Office of the Controller of the Currency entered into an agreement with the FCIC, with the appropriate adjustments, given the responsibilities that they have.

Today, we're going to have an agreement signed by the Office of Thrift Supervision. My understanding -- and, Ms. Schapiro, you can correct me if I'm wrong -- that by the end of the day, the FCIC and the SEC will enter into essentially the same agreement that you will sign.

SCHAPIRO:

That's exactly right.

VICE CHAIRMAN THOMAS:

Thank you.

My understanding also -- and, Ms. Bair, you can correct me if I'm wrong -- the FDIC will reach the same written agreement, with the necessary modifications given the differences in the jurisdictions that you have. Is that correct?

BAIR:

Yes, sir, that's right.

VICE CHAIRMAN THOMAS:

Thank you.

I assume you know the question that I'm going to ask you, Mr. Attorney General.

HOLDER:

And you may know the answer.

(LAUGHTER)

VICE CHAIRMAN THOMAS:

Well, if it's yes, then we can move forward.

Although there has been cooperation, and clearly, given the focus of your law enforcement and the necessity for not divulging information in the pursuit of justice,

there are a number of areas that would be helpful to us, if the Department of Justice and the FCIC could reach a similar negotiated agreement.

I know we haven't felt that it was necessary to do so up to this point, but I hope you can appreciate as it takes a long time to get some of the cases that you investigate to conclusion. Our conclusion is pinned on the wall, and it's the middle of the last month of this year. So in anticipation of making sure that we continue to have a smooth working relationship, is it possible for you to give an affirmative answer to my question is it possible by the end of this month to reach an agreement similar to the others with probably even more necessary understandings of what type of information between the FCIC and the Department of Justice?

HOLDER:

Well, we'll certainly work to make such an agreement possible. And I would think that that would be a sufficient amount of time. I think we have to understand that the Department of Justice -- we have a series of rules that prohibit us from sharing information, federal rules of criminal procedure with regard to grand jury proceedings, for instance, the Privacy Act with regard to -- with regard to investigations. And then with regard to ongoing investigations, the ability to share information is difficult.

Having said all of that, it is certainly our desire to provide you with the information that you need. And we would endeavor to work with you to try to reach an agreement as quickly as we can.

VICE CHAIRMAN THOMAS:

OK. I don't interpret that as yes. In negotiating with the FDIC and others, they are also similarly constrained with statutes that does not allow them to share information. The one that would be most obvious is in dealing with private entities in terms of proprietary or, as the law is called, Trade Secrets Act. We were able to work our way through those difficulties as well.

My assumption is since we haven't placed a letter in front of you and you've indicated that you're more than willing to work to reach agreement and you indicated that the end of this month seemed reasonable and appropriate, let me say that I'll accept your answer as a probably. And by the end of the month, hopefully it will have become a certainty.

If it hasn't, you might be assured that we'll revisit you because we simply cannot conclude our job in the timeframe Congress has assigned us if we aren't able to get the appropriate, necessary and protectional structure in place to find out what the government did or didn't do as well as what the private sector did or didn't do. And I appreciate your willingness to go as far as probably today.

HOLDER:

OK.

VICE CHAIRMAN THOMAS:

Thanks. Let me -- do you have additional questions? Because I have a couple for the others. Thanks.

CHAIRMAN ANGELIDES:

Well, actually, what I was going to do, Mr. Vice Chairman...

VICE CHAIRMAN THOMAS:

Yes, absolutely.

CHAIRMAN ANGELIDES:

Yes -- is I do know that the attorney general's schedule requires that he depart. Mr. Breuer will stay with us. I want to thank you for coming today. I want to thank the department for being here. And I want to thank you in advance in helping us do what we need to do.

As Mr. Thomas said, let me reemphasize something. We are here, not just to examine what went wrong in the private sector. We have an obligation to as thoroughly and as vigorously examine what happened in the public sector, what happened in regulatory agencies, what happened in enforcement agencies in helping us understand the full record of what did or did not happen, actions, inactions -- is important to our inquiry. Thank you, Mr. Attorney General.

HOLDER:

Yes.

VICE CHAIRMAN THOMAS:

And, Attorney General, is it probably at the current time?

HOLDER:

Well, please, don't misunderstand. I mean, the -- there is a desire on the part of the department to cooperate. This is an important inquiry that you all are about. It is important for our nation going forward. It is important for historical purposes for us to understand why we are in the present situation that we have to confront.

The only concern I have are the rules and regulations that govern the dissemination of information the Department of Justice accumulates. And to the extent that we can work our way through those we will get the information to you.

It is our strong desire to cooperate with you in the effort that you are about. It is an important one. It is a vitally important one. The information that you develop, the reports that you issue will help us in our ongoing enforcement activities. So we want to cooperate with you.

VICE CHAIRMAN THOMAS:

Elevated to most probably.

CHAIRMAN ANGELIDES:

Thank you very much, Attorney General.

HOLDER:

I better get out before I get to yes.

CHAIRMAN ANGELIDES:

All right, let's now...

HOLDER:

Thank you very much.

CHAIRMAN ANGELIDES:

Thank you so much.

Now, I have a couple of minutes I'm going to take right now. And then the vice chairman probably has a couple of questions. And then we're going to go to commissioners. And I'm going to hit quickly here and ask a couple of questions.

Ms. Bair, I want to ask you very squarely. And that is that early on in your testimony you talk about the ability to curb subprime mortgage products, that the Fed had a report in 2000, didn't act on it. And -- and I know our hearings have just begun. But the more I listened yesterday, the more I read testimony, the extent, breadth, nature of these products in the marketplace seems to have been a very significant force here. And as you said in the end, they ended up being bundled and packaged by the largest institutions in the country. And I guess if there was a moment at which -- where was the primary responsibility for choking off the development of these subprime products that ended up polluting our financial marketplace?

BAIR:

Well, at that point in 2000, this really was a -- a perimeter-type of lending that -- that folks were doing. And really, at that stage it would have been much easier to choke off because not that many folks were doing it. It was really more the perimeter players in the mortgage market. So I -- and I think the only place to tackle that on a system- wide basis for both banks and non-banks was through the -- the HOPA rules, the consumer protection rules that did give the Fed the authority to apply rules against abusive lending across the board to both banks and non-banks. So, of course, hindsight's always 20/20. But, yes, looking back I think if we had had some good strong constraints at that time, just simple standards like you've got to make a loan, you've got to document income and make sure they can repay the loan, not just at the starter, right, but at the reset rate as well, we could have avoided a lot of this.

CHAIRMAN ANGELIDES:

So I think it's fair to say that was a critical point, critical decision point.

BAIR:

I think it was, yes. I do.

CHAIRMAN ANGELIDES:

And -- and absent that, we were left with a number of state -- we're going to hear from state authorities, others who had differing levels of authority...

BAIR:

That's right.

CHAIRMAN ANGELIDES:

... who had constraints and -- and at times were fighting preemption efforts.

BAIR:

That -- that's right. The states tried to tackle this one by one. And I do believe these efforts were thwarted in 2004 when the preemption of state consumer laws for national banks was significantly expanded just to how it existed before 2004. And, yes, this did make it more difficult for states to deal with these types of practices within their -- within their borders. And I'm sure the state representatives will be talking more about that.

CHAIRMAN ANGELIDES:

Right. I want to ask both you and Ms. Schapiro one other quick question before we move to commissioners and the vice chair and other commissioners. Rating agencies -- you -- you speak very clearly about their -- in a sense, the multiple impacts, not just their ratings themselves, but then the use of those ratings in capital standards.

And it seems that that was an enormous hole. But also as I look today, it seems to be a hole unplugged, no substantial reform, still a non-competitive environment, still, in a sense, deference and status given to those ratings. Isn't the whole system essentially broken? It was proved to be worthless, broken. And it remains so today. I'm going to ask. It's a little pejorative, but, please, respond, both of you.

SCHAPIRO:

I'm happy to do that. I think that, clearly, rating agencies bear a large share of responsibility for some of the products that got into investors' hands and -- and got their by virtue of the fact that they had high level -- high level of ratings. And Congress gave the SEC the authority in the Credit Rating Agency Act of 2006 to begin to -- to regulate these entities. Before that, the authority didn't exist. And the agency engaged in a series of rule makings over the next two years to try to do -- to try to bring more competition to this space, to try to bring more accountability to this space and to try to give investors a much better context within which to understand the quality of ratings. So, for example, rules that require the disclosure of the performance of ratings over a period of time so you could see how they performed, downgrades, upgrades, conflict of interest prohibitions, conflict of interest disclosures. And -- and most recently, we have proposed in a concept

release that rating agencies be subject to liability as experts and no longer receive that favored status under the federal securities laws.

But I don't disagree with you. The fundamental problem, to my way of thinking, is the business model. When the issuer pays for the rating, which is relied upon by the investor, the buyer of the issuer securities, we have a fundamental conflict of interest that is very, very difficult to square. So many of the rules we've done have been in an effort to move towards a realignment of the rating agencies' interests with that of the investor as opposed to the issuer repays.

There are a number of rating agencies that have a subscriber pays model. And that is helpful. But we've really been encouraging entities to come to us with a new business model. We are very open to approving that in the context of our existing authority, to see if we can break down the walls here and get some genuine competition into this space.

CHAIRMAN ANGELIDES:

All right. Ms. Bair?

BAIR:

Yes, thank you. What we do -- our approach to this -- our piece of this, I guess, is whether ratings can be used to set capital, and we have been relying on them in the past. Going forward, I believe the regulators on an interagency basis will be proposing new capital rules.

And one of the things that we will be doing is eliminating the ability of an institution for structured finance products to rely on a rating to set their capital unless they have actually identified -- can identify the assets ultimately underlying that structured product and do their own loan level analysis of the -- the credit quality of those -- of those assets.

And unless they can do their own due diligence and validate the risk associated with the securitization or the other structured product, they will not be able to rely on a rating.

We -- again, that's going to go out for comment, but I think this is -- that general approach has been agreed to by the Basel Committee, and this is one area where we do agree. And so I think this will help a lot, make sure that the assets that actually underlie the securitization, somebody's looked at them, somebody's identified them and looked at them. They just haven't used mathematical models and knows what the -- the quality -- the credit quality of those loans are. We're also trying to get our own house in order. Our large bank, our premiums for large banks right now, a component of that is their -- is their credit rating, their debt credit rating, their long-term debt credit rating. And so we will be eliminating that as a factor that we will be using going forward for setting premiums for large banks.

CHAIRMAN ANGELIDES:

Thank you.

SCHAPIRO:

Mr. Chairman, if I could add just one thing to that, the SEC has also in the last six months removed references to ratings in about -- about a half-a-dozen of our existing rules, again, to reduce our reliance on them. And we've made it clear, for example, in the context of money market funds that have quality restrictions on the paper that they can be that they cannot rely on a rating. They must do independent credit analysis.

CHAIRMAN ANGELIDES:

OK.

SCHAPIRO:

So I think it is important across the government that we start to move in this direction.

CHAIRMAN ANGELIDES:

Thank you. Mr. Vice Chairman?

VICE CHAIRMAN THOMAS:

Thank you. In regard to the rating agencies and the act, the act was signed into law in '06, did you say, Ms. Schapiro? And this is 2010. And I'm most familiar with having to get structures in place to oversee it, and I'm quite sure that the act as passed was prospective, although clearly the origins of a lot of the problems that we had precede 2006. Was there any action taken with the law, notwithstanding some structures in place, in '07?

SCHAPIRO:

Oh, absolutely. As you say, the law was passed in '06. The agency commenced rulemaking -- and, of course, I wasn't there -- but in 2007, and there have been no fewer than five separate rulemakings undertaken by the SEC under the credit rating agency act, that, as I say, go to much greater levels of disclosure about conflicts of interest that rating agencies face, including proposals to have them disclose revenues from the major issuers that they're rating, their performance histories, disclosure about how they do due diligence for structured deals.

A recent proposal is that we would require issuers to make available to all rating agencies information that would allow any rating agency -- not just the one they pay for the rating -- to do an unsolicited rating, so investors would have a point of comparison, and we've also proposed to require disclosure of rating shopping. So that if I'm an issuer and I've gone to three rating agencies and said, "What's your preliminary view of what this security will bear as a rating?" And two of you tell me, "You know, BB," and one of you tells me, "AAA," I'm going to hire the AAA rater, but I now have to disclose the two BB ratings, as well.

VICE CHAIRMAN THOMAS:

And that, obviously, is -- some of the information that will be most helpful to us in trying to analyze the pre-passage period with rating agencies, post-passage, and I want to thank you again for agreeing to share some of that information with the appropriate

safeguards in place, because that allows us to understand an environment that needed to be changed, but simply wasn't because what they were doing may not have been right under someone's understanding of what's right, but it wasn't illegal, because we didn't have a structure in place. Thank you. Ms. Bair, your comments were -- were very good, especially your willingness to go outside of your narrow area of responsibility. And I thought it was most appropriate in this particular hearing room, based upon the role of the Ways and Means Committee, in terms of being, frankly, the only committee in the House that -- under the Constitution and the ability of the purse springs originating -- purse strings originating in the House to deal with the tax code.

It's amazing to me that a lot of folks still haven't focused on the fact that, notwithstanding in the 1980s, we were able to remove the deduction of consumer interest as an itemized deduction. There's still an overwhelming financial windfall in the tax code for homeownership versus, for example, the same roof that you rent rather than own.

And that what might be helpful from an economic point of view for an individual was almost responsible for the collapse when that individual ability is collectively exercised, i.e., being able to literally, with some of the financial agreements, cash out every month the equity that you had in your home, which then could be deducted.

It's just a point of interest that we came very close in the mid- '80s to dealing with the deduction for consumer interest in the disguise of mortgage interest, same thing we do with individual retirement accounts. You get penalized in some way if you withdraw it for other than the purpose for which it was placed in a tax-preferred position, health savings accounts, any number of examples.

But yet we still haven't even talked about to any great extent penalizing people who utilize the mortgage interest deduction privilege for, in fact, funding consumer debt. And that is an example of how far we need to go, not even touching on tort reform or any other number of areas, to really get at the bottom of this.

Some of them shouldn't be that difficult, but obviously, all the focus is on the committees that have the jurisdiction for oversight and regulation of financial institutions, and why this particular commission, notwithstanding the time difficulties that we have, is truly unique, because we don't have boundaries, and I'm quite sure that the final report will comment on aspects of the tax code and other areas, which if you begin to lay out the scenarios and the consequences of decisions, which seem somewhat appropriate, if we hadn't allowed that kind of deduction, the equity in the homes that people have would have had a severe jolt to them, but many of them would have accumulated -- which was the concept over time -- sufficient equity not to be upside-down.

But when you push it to the limit for consumer use and you do get a downturn -- and as the panel we had in front of us yesterday, even those in extremely sensitive, difficult and technical areas indicated that they never thought home values would ever go down, that's why you were supposed to build up equity. Let me ask you some questions that I think are specifically in your jurisdiction so that somewhat the same phenomena could be illustrated, based upon your answers and your particular area. My understanding is that you did not -- not you personally, the agency which you oversee -- didn't collect insurance premiums for, oh, a decade before the crisis, in terms of the FEC's regulatory structure. I mean, do you think that you had an overly optimistic view of their -- or the agency had an overly optimistic view of the balance sheets of banks, many of which held a lot of the mortgage structure?

BAIR:

Well, actually, Congressman, as I understand it, in 1995, Congress eliminated the ability of the FDIC to charge premiums for well-capitalized banks, which was 98 percent of all banks during that -- that 10-year period that you were talking about. In 2001 -- I came to the FDIC in 2006. In 2001, the FDIC sought legislation from the Hill to start charging premiums from all banks, recognizing that insurance is a benefit for which you should pay and that there is some risk, even if you're well-capitalized. It took until late 2005 for that legislation to be passed. I came to the FDIC in June of 2006. Within two weeks I had proposed rules to start charging premiums on everyone. The staff had already been working on it. It was very much something the FDIC wanted to do, and it wanted to do for many years. So I do think Congress has some responsibility in that.

VICE CHAIRMAN THOMAS:

No, absolutely. But the term "well-capitalized banks" -- was that a very narrow, automatic, numerical decision?

BAIR:

That is. That is a supervisory...

VICE CHAIRMAN THOMAS:

There was no discretionary aspect to it?

BAIR:

No, there's -- there's not. If well capitalized were regulatory standards, then we -- we could not charge premiums. That's right.

VICE CHAIRMAN THOMAS:

Thank you.

CHAIRMAN ANGELIDES:

All right.

Ms. Born?

BORN:

Thank you, Chair Angelides.

And I want to thank the panel for all your very helpful testimony.

I wanted to start by asking Chair Bair about her testimony. I gather from your written testimony that you feel that the over-the- counter derivatives market played some role in the financial crisis, and I would like you to elaborate on that.

BAIR:

Well, I do. I think it factored in on the under pricing of risk. It created the illusion that people were hedged when they weren't really. They weren't really. I think the unregulated nature of it allowed large institutions to take some significant risks with compensation structures up front. They had quite a long tail to them, but there wasn't sufficient oversight of that. And then it also magnified the losses once, you know, the underlying losses on the mortgages actually going into default was one set of numbers, but that was exponentially multiplied by the losses on these derivative contracts, trades of dollars in derivatives contracts that were based on the performance of those underlying mortgages.

So it fed into the under pricing of risk by creating an illusion that people were hedged when they in reality weren't. And then when mortgages started to go bad, it -- it magnified the losses.

BORN:

Has it at all complicated your job and resolution of failed banks?

BAIR:

Right. Well, I think this is this empty creditor issued. And I know this is something that the -- the SEC is real concerned about as well. What kind of skewed incentives does the CDS market, the credit default swap market in particular, have in creditors of institutions when they start to get into trouble?

Traditionally, financial institutions start to get into trouble. Their creditors will work with them to restructure the debt to stabilize them to keep them out of bankruptcy, but if you have a large CDS position, even if you might have some debt exposure, if you make more on your CDS if the institution fails, it can create very skewed incentives.

And right now, there's -- there's very little transparency in that market. I -- as the chairman of the FDIC, I cannot access and use their information in this CDS information, which -- which is troubling. So, yes, I think this is an area where a lot more work needs to be done.

BORN:

Do you think the market still poses a systemic risk and that any regulatory reform is needed?

BAIR:

Yes, I do. I think it is absolutely -- it's probably the top of my list now in terms of things I believe we still -- and it's really that this more than anything requires congressional action, as you know, because of -- of laws that were passed before that -- that basically removed this market from regulation. So I think this should be very high priority for Congress. And there's only so much regulators can do until that legislation is enacted.

BORN:

Chair Schapiro, I wanted to know what your views of this issue are. Did OTC derivatives play a role in the financial crisis? And if so, what?

SCHAPIRO:

I agree very much with Chairman Bair with respect to -- to really all she said, and particularly with respect to the macroeconomic issues. But I also think on a more micro level they contributed in the sense that because the OTC derivatives market could become an end run around the regulated exchange traded financial instruments, the futures markets and the securities markets and the options markets, they allowed illegal conduct to some extent. And we've brought a couple of cases in this regard with respect to insider trading in CDS. It allowed those markets to -- to absorb illegal activity that then moved out of the sight of the regulators and -- and law enforcement. And I -- so I think on that level, as well as macro level, it's concerning.

I also think that with respect to issues like empty creditor, we've got to have transparency in this market. If people understood the size of the positions that were being taken -- not just regulators, but the public and counterparties and potential counterparties could understand the size of positions in these markets -- it would have an enormously positive effect on -- on market behavior, I believe.

BORN:

What regulatory reforms do you think are necessary?

SCHAPIRO:

Well, I think a lot of them have been discussed, obviously, to great extent in -- in the regulatory reform debate. I really do believe that we need both regulation of the products in the sense that they ought to be, to the maximum extent possible, cleared through central clearinghouses.

I think we all know that well-run and well-regulated central counterparties help to mitigate counterparty risks and potentially eliminate counterparty risks that exist in the

bilateral relationships -- exchange trading, price transparency, full oversight of -- of the clearinghouse and all that brings with it.

And I also think we need to regulate the dealers in the marketplace. And -- and while some of the legislation that's floating around takes a step in that direction, there are still some holes, obviously, with respect to end-user exemptions and the amount of dealer participation that would actually and up in central clearinghouses and on exchanges.

But regulation of the dealers so that we have sufficient capital, again transparency, risk management systems in place, internal controls within the dealers, and transparency again to the public and to the regulators I think would make these markets much -- much more comfortable, I think, for the regulatory community.

CHAIRMAN ANGELIDES:

All Right.

By the way, Ms. Born, we had originally allocated five minutes per questioner. Mr. Thomas and I have spoken, and given the ground we have to cover, we're going to allocate three more minutes to each commissioner, so why don't you proceed for another three?

BORN:

Thank you.

Chair Bair, do you agree that the regulatory reforms that Chair Schapiro mentioned are needed?

BAIR:

Oh, absolutely. I think this should be a very high priority for Congress. And again, make sure it -- it strengthens and gives the regulators enough flexibility and tools to deal with this market.

BORN:

I'd like to also ask Chair Schapiro about a program that the SEC had adopted in 2004 called the Consolidated Supervised Entity Program, which I think was intended to bring some prudential supervision to the large investment bank holding companies.

And I think it covered Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs and Morgan Stanley, some of which -- one of which failed, some of which had to be acquired, and the others became bank holding companies during the financial crisis.

Did the program fail in providing sufficient prudential supervision?

SCHAPIRO:

I think we have to conclude that that program was not successful in providing prudential supervision. The program, as I understand it, was developed as a result of changes in European law that really required that the five largest U.S. investment banks be subject to consolidated supervision by -- by some entity. And because they were investment banks and not commercial banks, they elected to be supervised by the SEC.

So the SEC created the CSE program. Prior to that -- the good news is prior to that investment bank holding companies were not subject to any supervision at all, so that was viewed to be a good thing to bring them under the umbrella of regulation. I think -- I have lots of concerns about the program and about many of the specifics in it, but let me say that generally I think there were several problems.

One is that it required the SEC to become a prudential regulator, which is traditionally not put the SEC had been. It had traditional net capital rules that were quite conservative with respect to broker- dealers and an enforcement orientation to a large extent deriving out of its examination program rather than the more prudential approach. I don't believe the program was ever adequately staffed. There were a handful of people who were responsible, not even necessarily on a full-time basis, for the large for those five largest investment banks in the -- in the world, frankly, not just in the United States.

And I think that the combination of really a very new way to approach regulation, inadequate resources, and then some of the specific changes that were made to the capital rules in order to get the holding company supervision, broker-dealers were allowed to use value at risk models rather than prescribed haircuts in calculating their capital requirements, which allowed for, frankly, lower levels of capital to support larger and larger positions, in combination, led to, you know, a program that clearly was not a success. It's one of the things we're looking at and really taking the lessons learned as we try to rethink entirely broker-dealer capital.

CHAIRMAN ANGELIDES:

All right.

BORN:

Thank you.

CHAIRMAN ANGELIDES:

Thank you, Ms. Born.

Back on my time for a quick question, Ms. Bair, picking up on this line of questioning -- and very briefly, you refer to the -- was it April 2004 decision in your testimony, the April 2004 decision on raising the -- kind of the lifting the cap on leverage for broker-dealers. But I want to ask both of you, did that affect the holding companies? In other words, when I look at the balance sheets of the investment banks -- and I talked to Mr. Blankfein about that yesterday -- there's a big bump up in leverage ratios going from 2003 to 2004. Was it the decision at the SEC that affected that? Some have said, no, that's just affected the broker-dealers.

SCHAPIRO:

My understanding is -- and Sheila should certainly jump in here -- is that the investment bank-holding companies weren't subject to any capital regulation prior to 2004. They did,

under the CSE program, calculate capital according to the Basel II standard, which I think clearly should be a subject of intense scrutiny here. The changes that the SEC made related to broker-dealer net capital calculation.

CHAIRMAN ANGELIDES:

Right. I think what I'm doing is referring to -- this is really, I think, your statement, Ms. Bair, page 31 of your testimony, where you say, for example, in 2005 -- I think it was 2004 -- but -- but you say the SEC allowed large broker-dealers to adopt lower capital standards in their consolidated supervisor entity capital rules. And I think you go on to say that, in 2008, two of the five institutions using the CSE capital rules collapsed. I just wanted your quick opinion, as to both of you, as to whether the raising of these capital standards, in fact, were seminal?

BAIR:

Well, I think what happened here -- Chairman Schapiro is right. The -- the CSE framework uses the Basel II advanced approaches to set capital. We -- the FDIC have been a very strong opponent of those rules, and we've blocked so far, frankly, them being used by the commercial banks and the bank-holding companies and where we continue to have dialogue with our fellow regulators on this, but we have basically said, if those approaches are to be used, they may not reduce capital, so they can -- if -- it's a models-based formula. It relies heavily on banks' own estimates about what the capital should be. And so we have said that they should not be used to lower capital, and we've resisted that so far, and so the bank -- the bank -- commercial bank and bank-holding companies were not using this at that time.

So there was -- but there was reduction and an -- in capital and increase in leverage for the investment banks, as compared to the commercial banks, because they were using that.

CHAIRMAN ANGELIDES:

All right. Let me move off -- well, I just want to know yes or no whether that 2004 SEC decision helped -- was one of the factors that led to the -- to the explosion in leverage and, therefore, the collapse of those institutions. Yes or no...

(CROSSTALK)

SCHAPIRO:

I would say yes, it contributed.

CHAIRMAN ANGELIDES:

OK, your opinion is yes?

SCHAPIRO:

And I think it's clearly a contributing factor. It's hard to say to what extent it is responsible, but clearly, within the broker-dealer, the ability to use models that generated smaller haircuts on -- on -- on positions allowed larger positions to be maintained on a smaller capital base.

CHAIRMAN ANGELIDES:

All right. And one other question I'd like to ask, before we go to the rest of the commissioners -- this'll probably be my last question, and that is, I asked yesterday of Mr. Blankfein -- and I will in writing ask of the other financial institutions before us --

whether in the wake of the calamity that's occurred, whether they had done an internal review, investigation audit of what broke down in their institutions. You know, given just the magnitude of what occurred, it would seem logical and prudent to do. And so made I that request of Mr. Blankfein, and intend to make that request of the other institutions, and also to ask for that report.

I would ask you, each of your entities, whether, in the wake of what appears to be as certainly a potential, a colossal failure of the regulatory oversight of this nation of our financial system, has the SEC done an internal review audit investigation of what came apart, number one? And if so, can we have that document?

SCHAPIRO:

I can tell you there have been multiple internal reviews of slices of the financial crisis, Bear Stearns, Lehman Brothers, the CSE program, credit-rating agencies, and others. So we're happy to share that information.

It's important to me, as well, because as the new leader of the SEC and having brought in new leadership across the agency, I want everybody informed by the things that didn't work out well so that we can make the appropriate changes going forward and we can build a much stronger regulatory program across the board and across all agencies.

CHAIRMAN ANGELIDES:

Thank you.

Ms. Bair?

BAIR:

Yes, we are -- have an ongoing self-examination. We've made a number of changes, and I'd be happy to give you a written document that describes that.

I would also say, when banks fail, there is always an investigation of why the bank failed and a review of the supervisory process. I think one piece of that that is missing is, because the large institutions were bailed out, they did not fail; the statutory provisions we have requiring what we call the material loss reviews of these investigations have not applied.

So I think it's very helpful to provide -- we do need to look better at what the supervisory issues were leading up to the -- those larger institutions becoming unstable and on the -- the precipice, as well. But, again, for the smallest...

CHAIRMAN ANGELIDES:

And you do have those documents?

BAIR:

We have -- for the smaller institutions, we have them.

CHAIRMAN ANGELIDES:

For the smaller, but not for the larger institutions?

BAIR:

But they're not required for the larger institutions, that's right.

CHAIRMAN ANGELIDES:

But both of you will provide us your internal reviews of what broke down, good.

BAIR:

Yes.

CHAIRMAN ANGELIDES:

Justice, I don't know if you have done this. I asked earlier today of the attorney general, but particularly with respect to mortgage fraud, we would like to see that report. Or have you done any other examinations of where enforcement might have broken down?

BREUER:

Mr. Chairman, I'm not aware of that. What I am aware of is that, of course, we have had now for the last few years quite a number of mortgage fraud task forces throughout the country that actually were prosecuting the cases.

And as the attorney general said, our mission, of course, is not that of the regulator. Our mission is to hold those who've broken the laws accountable. With respect to that, we've worked with our partners.

CHAIRMAN ANGELIDES:

All right. Well, do me a favor. I do want to follow up. I think that review of what was or what was not done at Justice would be very important to know in the -- in the wake of potential evidence of mortgage fraud across the country.

All right. Let's go to Mr. Wallison.

WALLISON:

Thank you, Mr. Chairman.

Chairman Bair, may I start with you? For banks, we rely on regulation to protect us, because there is much reduced market discipline because of the backing of banks by the government. And I want to congratulate you and thank you for what I thought was very candid testimony about the deficiencies of regulation in general. But there's one paragraph that caught my attention, in particular, I'd like to ask you about. You say here in your written testimony, "The traditional rules used by safety and soundness regulators, like peer institution analysis, did not detect individual institution excesses because many of the peer institutions also analyzed, engaged in the same risky activities. These activities were profitable until risky activities undertaken by all became unsustainable."

What that sounds like is that it's OK or was OK if everyone was doing it. Is that what you meant to say?

BAIR:

I think the supervisory process going into this crisis did rely a lot on -- on -- on peer review and peer comparisons. And that's absolutely right. It's -- because everyone was doing it and everybody was making money, there wasn't enough scrutiny, even within the insured institutions. I think it's absolutely true.

WALLISON:

So are you going to change that? Are regulators in general...

BAIR:

We are in the process of...

WALLISON:

... going to change these rules, so...

BAIR:

Well, in terms of the FDIC, yes, we -- we do full-scope exams now, much -- we drill down much more farther on individual loan quality. The loans performing now and making money, will it perform a year, two years from now, that kind of analysis, much less reliance on -- really, no reliance on the fact that the guy down the street might be doing the same thing.

I do think, though, that that feeds into the larger issue of having a systemic -- some type of systemic body to monitor -- even though something on an individual institution basis might look OK, if you look at the system as a whole, you might get a different picture.

So I do think this also relates to the need for a council that has a macro-prudential framework and mandate.

WALLISON:

There were a few other things that you said that I thought were quite interesting and should be in the record. In your written testimony, again, you said, "Record profitability within financial -- within the financial services industry also serve to shield it from some forms of regulatory second-guessing."

Another statement: "Often the potential risks associated with strategies that give rise to outsized profits are not obvious, especially when supervisors are examining new bank products or activities." And then, finally, "It proved difficult for regulators to rein in profitable legal financial activities without hard evidence that the activities were creating unwarranted risk."

Now, all of those things suggest that, when activities are profitable, it becomes very hard to regulators to stop them. What are the -- and you should know this by now -- what are the pressures that come upon regulators when profitable activities are going on and you might like to stop them?

BAIR:

Right. Well, I think we saw that in late 2006 and 2007 when the banks regulators -- the FDIC, working very diligently with our colleagues, to tighten up on subprime, to tighten up on Alt-A, and non-traditional mortgages, to tighten up on commercial real estate. A lot of industry push backs and -- I'll be honest -- some pushback from the Hill, too, on some of that. So it's -- you know, it's -- regulators -- somebody has to take away the punch bowl, and it can be very difficult to take away the punch bowl when, you know, people are making money at it now. But I think, going forward, this is a key lesson learned.

But, hopefully, you know, the leadership of this body, in saying that regulators need to be supported when they try to do that and not pilloried, I think, would be helpful.

WALLISON:

Do you think there's -- this lesson has been learned by Congress?

BAIR:

You know, I hope so. I think, yes. I think, you know, we have this -- I think there is still some pressure to forebear, you know, where, obviously, banks are being closed now by their chartering authority, and that's not always a popular thing to do.

And the more that occurs; there will be more bank failures this year. I think there will be more pressure to forebear and ease regulatory standards, perhaps. And we're trying to strike a good balance here, obviously. But as we learned from the S&L days, the longer you wait, it'll usually be more -- eventually they're going to have to be closed anyway, and it will be more expensive. So I do -- there are, fortunately, a lot of people on the Hill that still lived through the S&L days and remember that. But, yes, there is still a bit of that dynamic.

WALLISON:

Mr. Chairman, how much more time do I have?

CHAIRMAN ANGELIDES:

You have another three minutes and 11 seconds, but I'll yield you three seconds back for my answer.

WALLISON:

Oh, good. Thanks, I can use it. I just did.

(LAUGHTER)

I shouldn't have asked.

CHAIRMAN ANGELIDES:

I'll give you 20 seconds.

(LAUGHTER)

WALLISON:

In conclusion, you say -- and I want to just follow this up just a little bit and then ask a question of Chairman Schapiro. But in hindsight -- this is your testimony -- it is fair to say that regulators either did not have sufficient information to fully understand how

concentrated risk was becoming, or if regulators had access to the information -- and probably some regulators did -- they were unable to understand and identify the risks.

Now, why were they unable to understand the risks?

BAIR:

Well, I think we did -- there was, again, another reason why we think we need a systemic risk council is the information collection was stove piped as well. You know, we might have information on what's on the books of insured depositor institutions, but what's going on in their affiliates might be -- is opaque or has been opaque to us.

And then, of course, the non-bank sector and, you know, third parties -- mortgage originators or brokers that might be funded by banks -- their issues and the strength of their underwriting might be even less apparent to regulators. So I think this does -- the need for, again, a more holistic approach -- macro as well as micro mechanisms to collect and analyze information. I think that's another reason why you need a council -- is very important.

And, again, in terms of analyzing what we saw and not understanding it well enough, I think that gets back to the issue of not being enough forward-looking ourselves. OK this loan is currently performing but what’s going to happen six months or a year from now or what's going to happen if the market goes down ten points. Not enough of that analysis was done.

WALLISON:

So this isn't a question of the capacity of regulators to understand the complexity but rather the fact that your scope isn't broad enough?

BAIR:

I think the -- because we do have a stove piped regulatory structure, the ability to provide access system-wide information and analyze that is lacking. I absolutely do. But I would

also acknowledge, even with regard to the information we could have in access, we didn't -- none of us, I think, did as good a job as we might have in analyzing it.

WALLISON:

Thank you very much.

Chairman Schapiro, I really have one simple question for you. And that is, there was quite a lot of discussion at the time that we were going through the crisis in 2008, in the months of June, July, August, September and so forth, about manipulative short selling. Now, these things seem to come up every time we have this kind of market crisis, and the allegation is that the short sellers are creating rumors, and they drive down the stock prices, and they profit from that.

The SEC has investigated that quite a lot. Have you continued to investigate that? Have you found any indication that there is manipulative short selling going on?

SCHAPIRO:

It's a great question, and we do -- we do confront short selling issues virtually daily.

But I will say that we are still investigating it. It's an extremely complex kind of an investigation to conduct. So for example, with respect to rumormongering, to separate the rumors from the reality, if you're looking at Bear Stearns or Lehman Brothers, is not a simple thing to do. And the extent to which short selling has added real information to the marketplace about what the appropriate price ought to be for the stock of a particular company, that's a good thing. To the extent it's based on rumormongering or desire to drive down the price of a stock artificially, that's a terrible thing. And so our investigations are really trying to find the path through enormous amounts of data. You know, we're trading billions and billions of shares a day in this country. And understand, whether we have cases that could be brought for manipulative short selling.

VICE CHAIRMAN THOMAS:

Mr. Chairman, this is a very obviously interesting question to us and, obviously, a verbal answer in the time we have is not going to be sufficient. So if you'd allow us to frame some questions to you for response, we would appreciate that very much.

SCHAPIRO:

I'd be happy to do that.

VICE CHAIRMAN THOMAS:

All right. And that would -- I might as well make it a universal statement. We can't ask all the questions we'd like to ask and, frankly, after we ask them -- Ms. Bair, I've got some follow-ups to the one that we had -- we're learning as we go along, and we'd really appreciate the willingness to ask you questions and the context and then have you get back the answers to us. Is that appropriate?

SCHAPIRO:

Absolutely.

VICE CHAIRMAN THOMAS:

I understand you guys are not there yet. You're most probably willing to respond. I understand that.

(LAUGHTER)

BREUER:

I think that's fair, Mr. Vice Chairman. I'm sure, with respect to questions, we will be able to answers them.

VICE CHAIRMAN THOMAS:

That's probably most probably. We're making progress. Thanks.

WALLISON:

We got two yeses there, in any event.

CHAIRMAN ANGELIDES:

Mr. Hennessey?

HENNESSEY:

Thank you, Mr. Chairman.

Just one of those follow-up questions for you, Chairman Schapiro.

If we could get a memo from your economist on the uptick rule. I have heard lots of people argue passionately on both sides of the uptick rule question. I have yet to find an economist I respect who says that it matters one way or the other.

So just for later follow-up, I'd love to hear what the best thinking is from your economist.

SCHAPIRO:

We'd be happy to provide that. As you can imagine, we've spent many, many hours analyzing all the economic research that's available, soliciting that research and data quite broadly. And we'd be happy to provide that.

HENNESSEY:

I'm just not sure that we need to care about, but maybe you can tell me.

SCHAPIRO:

Many people care very deeply about it on both sides.

HENNESSEY:

Right. And I can't figure out why.

Chairman Bair, most of my questions are for you.

Someone said on CNBC last night that the financial crisis is over. You, possibly more than anyone, are having to deal with the, at a minimum, the ongoing effects of the financial crisis both with foreclosures and with dealing with failed depository institutions.

So I just want to ask you a couple of questions about that. One is, again, sort of one these request for follow-up. We had two witnesses yesterday who were pretty aggressive in criticizing the HAMP. And if you could just give us sort of your best thinking about here's the best case for the HAMP or I don't know what you're thinking in terms of modification and don't want to get into that now. In particular, just in terms of how effective you believe it's been in terms of number of foreclosures avoided, that would be very useful.

But what I'd like to focus on is you are still having to deal with failing depository institutions. And as I understand it, as you resolve those institutions, you've got to tap into the deposit insurance fund. You've got something like an $8 billion deficit in that now. One expert told me that to get back up to sort of your target reserve ratio, it's in the ballpark of $75 billion to $100 billion that you need.

As I understand it, you've got a proposed rule out there for a new fee to help close some of that gap tied to bankers pay. What we've got just today now is we've got a new proposal from the administration which is saying let's take $90 billion from large financial institutions -- and I want to ask some questions about that -- in particular, about how it effects your ability to have the funds you need in the deposit insurance fund to resolve these institutions.

One is, as I understand it, insured depositories are a part of the new administration proposal. Are you concerned that that conflicts with your ability to get the money that you need from them for the DIF?

BAIR:

Well, a couple of things...

VICE CHAIRMAN THOMAS:

Excuse me.

Prior to answering that -- Keith, one of the things we always try to do is if anybody's watching to try to keep them in the loop. And you mentioned HAMP.

HENNESSEY:

Sorry, the -- the mortgage foreclosure...

BAIR:

Right.

VICE CHAIRMAN THOMAS:

It's the Homeowners Assistance Modification Program under the president's...

BAIR:

Right. Yes. So...

VICE CHAIRMAN THOMAS:

It's just that as we carry on these discussions, there are a lot of folks who aren't...

HENNESSEY:

Absolutely.

BAIR:

Right.

VICE CHAIRMAN THOMAS:

... tapped into the jargon.

BAIR:

So -- so -- so on -- on...

VICE CHAIRMAN THOMAS:

Thank you.

BAIR:

Sure. Do you want me to start with the HAMP program, or did you want to...

HENNESSEY:

No -- no. Let's -- let's talk about -- about...

BAIR:

So I think a couple of things. There's been some misunderstanding about -- we put out an advance notice for proposed rule making asking the question of given there's a lot of evidence that front-loaded compensation structures encouraged risk taking and contributed to some of the problems we're having. So we have asked a question about whether that should be factored in our risk-based deposit insurance premiums.

This will be -- if we do this, it will be revenue-neutral. This is a question of should we reallocate so that those who ha these front-loader compensation systems should pay more and even those that have the claw backs and others would pay less. So that's -- that -- I think there's some confusion. They all came out at the same time, completely separate issues. I have not seen the administration's proposal. I've read about it in the paper. I understand that they are -- it's a liability-based fee and that they are taking deposits out so that there presumably would not be a double counting because obviously the insured depository institutions have been paying a lot in premiums.

I would also say that -- that we have tried to be very mindful of the balance between maintaining the integrity of our industry-based deposit insurance fund. I think it's very important to keep it industry funded and avoid -- I never say never, but try everything we can to avoid having to borrow from taxpayers. Everybody's had enough of that.

But we have tried to -- we did one special assessment, which immediately hit earnings. And we realized that the industry is still under stress now. So instead we did a prepayment of three years' worth of premiums, which brings us the cash and up-front, but they can expense over time so they don't have to immediately take the hit to capital.

So I think this is a good balance. We have about $67 billion in cash liquidity now, which I think will be -- based on our current projections, should be sufficient. You're right...

HENNESSEY:

And my understanding of their proposal is that deposits have been taken out, but insured depositories have not.

BAIR:

You know, I'm sorry. I have not seen it. I’ve read about it in the paper.

HENNESSEY:

OK.

BAIR:

And once I find out, I'd be happy to more thoroughly respond to your question.

HENNESSEY:

OK. More broadly, your testimony talked a lot about the too-big-to-fail question and about these large financial institutions, which I'm -- I'm very concerned about.

BAIR:

Right.

HENNESSEY:

And in particular, about regulatory arbitrage and firms that pose large financial risks just playing the system to avoid the regulation.

BAIR:

Right.

HENNESSEY:

Your system of deposit insurance is a -- as I understand it -- roughly a risk-based system and is designed to cover your entire universe of insured institutions. My understanding of this proposal is that there are significant large financial institutions, Fannie Mae and Freddie Mac, the auto finance companies, who we clearly have evidence have posed systemic risk but are exempt from the new tax. Does that concern you at all?

BAIR:

I would -- you know, I would like to respond in writing once I've actually seen -- written a proposal -- you know, I'm just operating on press reports.

HENNESSEY:

OK.

BAIR:

And I don't want to answer that.

HENNESSEY:

I don't -- I don't need your -- I don't need you to...

BAIR:

But I -- I'd be happy to respond to that in writing once I've actually seen the proposal.

HENNESSEY:

OK. And then just a further element of that...

BAIR:

Sure.

HENNESSEY:

... is they've got $90 billion, they think, coming in from that new proposal.

BAIR:

Right.

HENNESSEY:

You need somewhere in that ballpark for your deposit insurance fund.

BAIR:

Right. Right.

HENNESSEY:

You can't use the same money for two or three purposes.

BAIR:

Right.

HENNESSEY:

So if you've got money coming in, I understand possible uses of that funds can be to pay back taxpayers for losses from other firms in TARP. Two is to close the hole you've got in your deposit insurance fund. Three is to prefund liabilities from the possible future failure of some of these too-big-to-fail firms.

BAIR:

Right.

HENNESSEY:

I'd be interested, again, in writing for you to give us your views on to the extent that there is a new proposal to address too-big-to-fail and address the risks proposed by it should those funds be first targeted to address the ongoing programs that we know about -- sorry, problems that we know about with insured depositories.

BAIR:

Right. Right. OK, well, I think, yes, I'd be happy to respond in -- in writing. I think we have an estimate of $100 billion lost over a five-year period, 2008 on to 2013. We've already reserved -- or we've already incurred those losses or reserved about 66 of that already. So I think, you know, we -- we feel -- again, based on our stress scenarios, which are pretty stressed, we think unless the economy really gets into difficulty that we think

that the -- the collections we've made now should be sufficient. And so, there should be no additional needs for premium increases or additional assessments.

And again, I -- this is -- obviously has to be heavily qualified based on the economic conditions. I would say now that bank distress really is being driven by the economy. Early on we were dealing with the unaffordable mortgages and the -- and the antivirial lending and the residential construction development. There's still some of that. But more and more now it's being driven by the economy and just regular credit deterioration because people lose their jobs, get their hours cut back or whatever.

HENNESSEY:

Could I have 20 seconds to just pose one more question for follow-up?

CHAIRMAN ANGELIDES:

Twenty.

HENNESSEY:

It's short.

CHAIRMAN ANGELIDES:

Thank you.

HENNESSEY:

What would be great -- I've heard two different views on mark-to-market accounting.

BAIR:

All right.

HENNESSEY:

One is that it's an accounting problem.

BAIR:

Right.

HENNESSEY:

Two is that it is a regulatory capital problem.

BAIR:

Yes.

HENNESSEY:

It would be fascinating to see maybe even coordinated responses from the two of you as to your views, which is procyclicality. What is the most effective way to -- to address that on the accounting side or on the regulatory capital side. Thank you, Mr. Chairman.

BAIR:

We can do that.

CHAIRMAN ANGELIDES:

Thank you, Mr. Hennessey.

VICE CHAIRMAN THOMAS:

You can agree separate.

HENNESSEY:

Yes.

BAIR:

I think (OFF-MIKE)...

CHAIRMAN ANGELIDES:

Probably -- probably faster. How's that?

All right. Mr. Thompson?

THOMPSON:

Thank you, Mr. Chairman.

It would not be unusual in the aftermath of a crisis for the regulators to say we need more regulations or we need better regulations. I guess my question centers around beyond over-the- counter derivatives. Were there adequate regulations in place at the time of this crisis that could have prevented the crisis had we executed better within the regulatory agencies that we have in place today and the laws we have in place today?

Ms. Schapiro, we'll start with you.

SCHAPIRO:

I'd be happy to. And I'd love to be able to maybe supplement my answer because I can think of a lot of things that are worthy to talk about in this context in addition to over-the-counter derivatives, hedge funds, which while not generally thought to be a -- a central feature in the crisis, because we have almost no information, census-type information about hedge funds and how they operate in our markets, we don't really know.

But I would point to two things in particular. One, I talked about in my testimony the asset-backed securities market. And while there is -- was regulation in place, we think that we could do a lot better in terms of the quality of disclosure at the -- at the asset level for investors in -- in a way that doesn't just dump a lot of disclosure on them, but gives

them the tools to understand the quality of the assets in the pool, pool-level disclosure, ongoing disclosure after the first year, which has -- which has been a big issue, time to do due diligence, all of those things. So I think the asset-backed securities market -- and I know the FDIC is working on some things in this regard -- is one where we can do a much better job with regulation.

And then secondly, I would say supervision more generally. As I look back over the SEC's program for the consolidated supervised entities, we have a lot of lessons learned about whether models are reliable, whether stress testing was sufficiently robust and strong to really understand what was going to happen in very dire situations, whether putting assets off of the balance sheet into special purpose entities really meant they were off balance sheet or because of contingent liabilities or reputational risks they were going to have to come back on. I think there are a number of areas like that where -- where there's a -- perhaps a failure of supervision, perhaps a failure of vision to understand where some of these products and practices might take us, but also where there just weren't adequate rules and regulations in place.

THOMPSON:

So in short, would it be yes or no?

SCHAPIRO:

I've forgotten the original question.

THOMPSON:

In other words, could the existing regulations in place today, if well executed, have prevented this?

SCHAPIRO:

I think it's more the supervision, frankly, than -- than purely the regulations.

THOMPSON:

OK.

Ms. Bair?

BAIR:

I think there are -- there were two key missing elements. One was the lack of consumer protections that applied to both banks and non-banks. I think also there was no system-wide accountability with any -- any potential entity and which is why we think there needs to be a new body for consumer rules and also systemic risk counseling.

THOMPSON:

Yes. Well, if you were to look at some countries outside the U.S. -- the U.K., Germany, Japan -- they have one entity that regulates what goes on across these markets. Yet we have, for lack of a better term, a patchwork quilt of agencies that are involved here.

THOMPSON:

Would we not be better as a country to have a single agency doing this, as opposed to the multiplicity of entities we have today? And is that not what the council is trying to solve?

BAIR:

Well, I think that the council is a bit of a hybrid. Some of those mega-regulators proved to be very, frankly, captive and -- and not particularly robust, and so there are some problems there, which is why we think preserving some autonomy among the individual

regulatory agencies within our sphere of influence, but all of us kind of serving on a check on each other in the council, at least some prudential standards, like capital and liquidity, that, to me, is -- is the best model. You have some better checks and balances than a monolithic regulator, but that you do have some ability in ownership to look at the system and take accountability for the system.

THOMPSON:

Ms. Schapiro?

SCHAPIRO:

I'm very much in agreement with that. I think the single monolithic regulator model did not prove to be more resilient or more effective during the crisis or...

THOMPSON:

How about in recovery?

SCHAPIRO:

Did -- did not appear -- to -- to prove necessarily be much more effective than the -- than the U.S. system. We also very much support the concept of a council bringing diverse perspectives about different types of institutions, products and strategies to the broader group so that we can all have a better understanding of what the risks are that are flowing across the marketplace. That needs to be coupled with effective supervision, particularly of the largest consolidated entities by a systemic risk regulator.

THOMPSON:

So yesterday, when the bank presidents were here, several of them said that they created instruments that really had no value, hence, the SIVs, if you will. And these were off-balance-sheet items that we saw in the collapse of Enron, yet they were a part of the

amplification, if you will, of this crisis. How is it, Ms. Schapiro, that we could have off-balance-sheet items of the magnitude that we did in this crisis post-Enron?

SCHAPIRO:

That's really an excellent question. My understanding is that, after Enron, FASB -- that sets the accounting standards for U.S. public companies -- did revise their accounting for off-balance- sheet instruments and arrangements, but it was primarily directed at arrangements such as we saw in Enron, where there were non-financial assets that were being held off the balance sheet of the public company, and it did not affect the securitizations of mortgage loans off balance sheet, which is certainly central to what's happened -- happened in recent history.

In 2008, again, before I arrived at the SEC, the commission asked FASB to improve its reporting for off-balance-sheet treatment of -- of assets in securitizations. FASB went ahead and did that in the middle of last year, and we really do believe that the new standards will result in on-balance-sheet presentation for securitizations.

That said, very clever industry, and we have to be very watchful to ensure that, in fact, that does come back on the balance sheet and that we have full transparency.

THOMPSON:

Well, the -- the clever nature of the industry gets translated by them into "innovation," "financial innovation." So can the SEC and the FDIC and every other -- or any other regulatory body really keep up with the pace of innovation in the industry, the cleverness, if you will, of the innovators?

SCHAPIRO:

I think that's such a great question, because, frankly, there's innovation that's valuable and -- and moves us along as a society, and then there's innovation that generates additional fees for the innovator. This is a big focus that we've had in the past year at the SEC,

because I think, historically, we haven't been able to keep up. We created a new division of risk strategy and financial innovation in September. We've brought in some really cutting-edge experts on modern financial markets and the intersection of innovation and the law.

And it is our hope that this group of experts who are available not just to the SEC staff, but actually to other agencies, as well, if they're interested, will help us understand and dissect new products much more efficiently to understand where the risks may lay, so that we can either prevent that, those from going forward, or ensure that investors are well-informed and regulators have a good handle on the risks that they're creating.

THOMPSON:

Ms. Bair?

CHAIRMAN ANGELIDES:

And why don't we wrap up with this?

BAIR:

So, yes, we were highly supportive of FAS 166 and 167, which brought these -- these off-balance-sheet assets back on balance sheet. This was a big problem and concern for the FDIC. Because they were off balance sheet, they weren't holding capital against them, which meant that their capital levels were being overstated.

So we were highly supportive of that. And -- and I think, going forward, it is a lesson learned. And I think, in terms of innovation, yes, you don't want to discourage it, but you need the flexibility to deal with it when it -- when it takes a bad turn.

THOMPSON:

Thank you very much.

CHAIRMAN ANGELIDES:

Thank you, Mr. Thompson. A good line of questioning, and I will take just a couple minutes of -- a minute or so of my time to follow up, actually, on a question that Mr. Thompson asked.

So in the wake of Enron -- and I watched that very closely, because I sat on the board of our state pension funds. We took enormous losses from Enron and WorldCom. Those were, in a sense, that warning sign that much bigger things were on their way.

So -- so how, in the construction of the rules on SIVs, how on Earth were mortgage securities, which were already pretty substantial in the marketplace, how are they excluded? And whose -- whose decision was that? Who's culpable, responsible? Was it the SEC? Was it the public company -- public corporation accounting oversight board? Who missed that? Or was it a matter of lobbying? Did entities lobby to exclude?

SCHAPIRO:

I really don't know the answer to that, and I'd be happy to try to supplement the record. It obviously happened many years before I got to the SEC.

But my understanding is that it was focused on nonfinancial assets being brought back onto the balance sheet as opposed to mortgage assets having been securitized. That's not a satisfying answer; I understand that.

CHAIRMAN ANGELIDES:

Would you please...

SCHAPIRO:

And I'd have to supplement the record.

CHAIRMAN ANGELIDES:

Would you please look into -- and I'm asking you, was that an SEC decision? Or was it the public corporation accountability oversight board?

SCHAPIRO:

The accounting standards would have been set by FASB, the financial accounting standards.

CHAIRMAN ANGELIDES:

And by -- or by FASB.

SCHAPIRO:

Yes.

CHAIRMAN ANGELIDES:

All right.

SCHAPIRO:

But the SEC has oversight responsibility, and I just don't have any idea...

(CROSSTALK)

CHAIRMAN ANGELIDES:

All right. If you could get that to us -- and I'm particularly interested as to whether or not there was any active advocacy by folks to exclude asset-backed mortgage-related assets as somehow being different. And I'd love to know see the arguments made for their exclusion, if they were made.

SCHAPIRO:

We can certainly ask FASB about that.

CHAIRMAN ANGELIDES:

Or, relevant to Mr. Thompson's question, they just didn't get it enough to understand the different vehicles out there. Thank you.

Mr. Georgiou? Oh, Mr. Thomas. Yes, Mr. Thomas?

VICE CHAIRMAN THOMAS:

Thank you. I want to piggyback, as well.

To a certain extent, we had an earlier discussion, Chair Bair, in which you gave me an answer in terms of the well-capitalized banks and the lack of any real discretion to deal with the structure that was there. This is part of our ongoing process. I'm informed that you have provisions called prompt corrective action provisions in which regulators can lower a bank's rating below well capitalized on subjective grounds. And I guess it's back to the question about devices tied to real estate. I mean, if you were looking at the banks -- notwithstanding under the structure that was there, and they were well-capitalized -- did the FDIC look at -- do you think they should have looked at what I guess is the excess exposure by some of the institutions to what we now believe to be risky housing-related assets?

BAIR:

Well, I think there is -- it is absolutely true that the integrity of the capital ratio will depend on the honesty of reserving against projected loan losses. So the reserves are low, the capital level will be overstated. We don't have -- if you're talking about the period '95 to 2005, 2006, when we started charging premiums, I don't think, at least the -- I think that...

VICE CHAIRMAN THOMAS:

Well, let's just look at it...

BAIR:

Now, absolutely.

VICE CHAIRMAN THOMAS:

... in -- in the context of finding out that by '07 what you looked at in '02, '03, '04, '05...

BAIR:

Right.

VICE CHAIRMAN THOMAS:

... you had the ability, if you were discerning enough, to believe that the assets were riskier than would otherwise be required. And now, obviously, that makes you prescient and others weren't, so I guess I'm asking you, was the FDIC prescient?

BAIR:

Well, we -- I think we were earlier. Whether we were early enough is another question, but I think we were earlier. We started doing special exams on subprime very early. We only had -- we were the primary regulator of only one major subprime lender. We ordered them out of the business -- I believe it was in February of '07.

So I do think we were on top of this earlier perhaps than others. Whether it was early enough, I don't know. Again, hindsight's always 20/20.

VICE CHAIRMAN THOMAS:

Sure.

BAIR:

But we very much tell our examiners now to go in and dig down into those loan books and -- and make sure that reserves are adequate. And if they're not, they need to increase their reserves, and that can decrease their capital and result in an inadequate capitalized rating or below.

VICE CHAIRMAN THOMAS:

And I guess, given your area of jurisdiction, that's what I'm really kind of interested in. I mean, how many banks failed in 2008, roughly?

BAIR:

In 2008? It's probably about 25. And last year there were 140.

VICE CHAIRMAN THOMAS:

Well, and...

BAIR:

The**...**

VICE CHAIRMAN THOMAS:

And you have a watch list, obviously, so that you can look at the sick dogs.

BAIR:

Right, yes.

And if -- and I could back up just for a minute. I think it is important to understand that most of these toxic loans were not on bank balance sheets. They were -- they were outside banks.

VICE CHAIRMAN THOMAS:

I understand that, but to the degree they were...

BAIR:

Right.

VICE CHAIRMAN THOMAS:

That -- I mean I want to look at that collage.

BAIR:

Absolutely, absolutely.

VICE CHAIRMAN THOMAS:

How many -- how many banks are on the watch list now?

BAIR:

We have -- we're up to about 552 as at the end of the -- as -- at 552 as at the end of the first quarter.

VICE CHAIRMAN THOMAS:

And then you have a number that you can produce for me for '06, '07...

BAIR:

Absolutely. We'd be happy to do that.

VICE CHAIRMAN THOMAS:

... so that I could begin to look at that, because in retrospect, notwithstanding the limited involvement, how many of those failures were directly related, if we're able to make that judgment, to that aspect, which could have been available to you under the prompt corrective action provision, had you been fully aware of how -- somebody back there is shaking their head no, so I'll wait for it filter back up to.

BAIR:

Well, I think there are -- the PCA process is laid out in statute, and there are various steps in the process, so I think it's better to respond to this in writing. We'll be happy to.

VICE CHAIRMAN THOMAS:

Yes, because I just -- I mean everybody missed everything...

BAIR:

Right.

VICE CHAIRMAN THOMAS:

... to a certain extent, so I'm not trying to pin you down.

BAIR:

No, I understand.

VICE CHAIRMAN THOMAS:

It's just that I'm very concerned that we aren't looking at that on an ongoing basis. So if you'll give me the data, we'll go from there.

BAIR:

Sure. All right.

VICE CHAIRMAN THOMAS:

Thank you very much.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES:

All right.

Mr. Georgiou, on -- on my few minute or so remaining, I am going to ask one follow-up to this, because I think it's relevant.

Have you done any data collection on -- or can you give us a read here about how many of these failures are related to subprime toxic assets versus the collateral damage that resulted from the big meltdown?

BAIR:

Yes, I think we could get that to you, yes.

CHAIRMAN ANGELIDES:

I think that would be important.

All right. Mr. Georgiou?

GEORGIOU:

Thank you, Mr. Chairman.

Having spent the better part of the last decade investigating and prosecuting the financial fraud at Enron, I am tempted to go into the special investment off-balance sheet vehicles, but I'll temper my -- my desire to do that.

I would like to focus, though, on -- on follow-up on something that I approached the private sector people with yesterday. Really, the credit rating agencies issue is more serious than just investor pay, investor -- the issue is pay for it rather. It is that they actually pay as a percentage of the issue very frequently, and I think it's important for the public to understand what happens here.

Institutional investors for the most part, particularly pension funds, can only invest in securities that are rated AAA. And since the credit rating agencies only get paid if the issue gets sold, and get paid frequently as a percentage of the amount of money of these -- amount of the securities that are sold, and since they only get paid if they get bought, and can't be bought unless they're AAA rated, this is a conflict of interest of gigantic proportions. And it strikes me that the point I tried to make yesterday is the -- the credit rating agencies aren't the only ones who operate in this way. The auditors are paid by the issuer who audit the financials of the issuer, the lawyers who draw up the prospectuses, and obviously the investment bankers who charge in -- are paid in cash as a percentage of the issue when it's sold.

And customarily, they lack any financial consequences for the success or failure of the securities after they are sold. And we've been talking here about how financial innovation sometimes eludes the abilities of regulators to regulate, because it's so innovative.

Do you think there are any market mechanisms that either any of your agencies could put into place that would actually assist in enforcing accountability afterwards?

For example, one would be could they -- could some percentage of the fees be taken in the securities that were actually issued rather than in cash, so that if they go -- if they perform as -- as represented, then everybody does fine, including the people who were responsible for doing the due diligence to originate them? And if they fail, well, then, they suffer some of the consequence of the failure as well.

Ms. Schapiro?

SCHAPIRO:

I do think looking at risk retention is a very interesting concept with respect to the rating agencies. That eating their own cooking, so to speak, would -- would be interesting for us to explore. I will say there is one other difference, though, between credit rating agencies

and the other gatekeepers like auditors and lawyers, and that is the credit rating agencies have been shielded from liability, where is the auditors and the lawyers are -- are frequently sued or can be sued when -- when transactions go awry. So we've proposed and asked in a concept release whether credit rating agencies ought to be subject to experts liability just the way others are in the offering of securities and whether that might impose some additional discipline on how they conduct their business and -- and be an effective check on their enthusiasm for highly rating everything.

But I think one of the things we are quite interested in exploring is in -- with respect to our new securitization proposals, at least with -- and with respect to sponsors who would like to use the shelf registration process, which is a much faster way to get to market, that there be a risk retention requirement.

GEORGIOU:

Interesting.

And do you have any thoughts on that, Ms. Bair?

BAIR:

Yes. I think the idea of rating agencies being paid over time and -- and tying their -- their compensation somehow to whether the -- the securities that they rated AAA actually performed as AAA security, I agree with Mary. I think that -- that deserves a lot more thought. It has some -- some major advantages, obviously. I think on -- in terms of having some risk retention for the originator of these loans, too, when they go in I think is also helpful so that they keep more of the skin in the game in these assets once they're securitized. It would be another check on perhaps a bad rating to -- to make sure that we have better underwriting quality for securitized loans.

And then I also think, just back to the earlier point, transparency is key. If the market knows, if the public and other market analysts can access the assets that underlie the securitizations, independently evaluate them and second-guess the rating agencies, so to speak, I think that also will have a good disciplining effect on the ratings process.

GEORGIOU:

All right. Thank you.

SCHAPIRO:

If I could just add to that quickly, because I think it's so important. Investors relied on ratings in these complex structures, because they really didn't have a lot of choice in many instances. We would like to move forward with loan level disclosure that would give investors the ability to really second-guess what the ratings agencies are doing.

We want to do it, though, in such a way that provides standardized, formatted information so that investors aren't just dumped with massive amounts of loan level data. And -- and that's a project that we have well under way at the SEC.

GEORGIOU:

Yes, could you -- would you -- if you could report to us in writing on the progress of that -- that investigation, we'd certainly appreciate it.

SCHAPIRO:

I'd be happy to.

GEORGIOU:

I mean this -- this general concept of affixing accountability for the success or failure of these securities that became toxic and became illiquid and clogged up the system and contributed to the financial crisis is one that I think we're going to continue to explore as we -- as we move down the road here. And I wonder, to direct to Mr. Breuer, if you've had any experience or any discovery of really up the line involvement or conspiracies, if you will, to generate numbers of loans that are particularly juiced up, that are -- that are high -- have high interest rates that are able to be securitized into packages of mortgages and then ultimately sold, and to the extent -- the extent to which private sector providers of capital and accumulators of capital might have been involved in encouraging brokers

to provide loans -- to create loans that -- that could be, you know, could -- everyone could benefit from and earn money from all along this chain.

BREUER:

Well, Commissioner, what -- what we have done and what we continue to do is really look at the entire continuum -- entire continuum. So if you look at -- at what the Department of Justice has done over the years, and candidly what the agencies such as the FBI have done, at the very first level, of course, we've looked at, and there have been many, many prosecutions throughout the country of -- of mortgage...

CHAIRMAN ANGELIDES:

Mr. Breuer, can you pull the mike towards you?

BREUER:

... sure; I'm sorry -- of mortgage fraud by professionals at the first level, of course, mortgage fraud by agents and such, who defraud, really, the banks by coming up with false appraisals, coming up with straw buyers. But as the continuum continues, Commissioner, we do look at it. We then look at those who have been acting in a fraudulent matter with respect to misrepresentations of the underwriting process. So if a bank has those mortgages and they begin the process of some sort of a securitization or they want to sell to a securitizer, what do they say about their underwriting process?

And, of course, to that -- to the degree that that's occurred, we're looking at that, have looked at that, and will continue to, and when they break the criminal laws of course we prosecute it. And then, as we continue on the process, we absolutely are looking at the conduct of the securitizers themselves and what did they say to those who purchased the securitizations and what did they say about the underlying conduct.

There have been prosecutions, whether in seuritizations or others, of agents and others who have purported that the -- that the -- that the assets that they had were backed by perhaps in certain cases student loans, which were considered to be of a higher grade, when in reality, of course, they were supported by much riskier investments, mortgage-back securities.

And finally, if we go further, to the very end of the continuum, we look at the institutions who acquired the securitizations to see what of they -- what did they say to the investment public about what they had. So, of course, as the -- as the two chairs of course have said, there were incentives at every step, it appears, for some in profiting not to be candid about what they had. And we're looking at all of those, and, candidly, have been looking at that for a while and are looking at that right now in a very key manner.

GEORGIOU:

And of course the...

Thank you.

GEORGIOU:

Thank you. The statute that this commission...

CHAIRMAN ANGELIDES:

Mr. Georgiou, we're out of time.

GEORGIOU:

Well, let me just follow up...

(CROSSTALK)

CHAIRMAN ANGELIDES:

Real quick...

(CROSSTALK)

GEORGIOU:

The statute that this commission was created under provided -- the Financial Fraud Enforcement Act provided additional resources to each and every one of your agencies for the purpose, it seems to me, of investigating this particular area of fraud...

CHAIRMAN ANGELIDES:

Yes.

GEORGIOU:

... and I appreciate that...

(CROSSTALK)

CHAIRMAN ANGELIDES:

We got to move. Thank you.

All right. Mr. Holtz-Eakin?

HOLTZ-EAKIN:

Thank you, Mr. Chairman.

Thank you for coming today.

I want to start with you, Mr. Breuer. Obviously, mortgage fraud is a tragedy for those involved and harmed by it, but from the perspective of our job in determining the source of this enormous financial crisis, its magnitude is what's central.

And so my question to you is, do you or any of your affiliates on this task force have broad nationwide estimates of the fraction of mortgages, either by number or value, that are tainted by fraud versus simply performed poorly, from an economic point of view?

BREUER:

What I can say to you, Commissioner, is I can't give you an overall estimate. What I can tell you, though, is that we have enormous number of cases throughout the country.

Of course, the FBI itself has had now for a number of years regional task forces, mortgage fraud task forces, and as the attorney general himself said, right now there are 2,800 active investigations around the United States on the federal level just of mortgage fraud. So obviously we see a snapshot of it. We see it at the point when we have the investigation going.

I can tell you that we look at tens of thousands. I think last year there was perhaps somewhere in the range of 65,000 to 70,000 SARs, suspicious activity reports, just with respect to mortgage fraud, and often that's the very beginning of the investigation.

So it's obviously widespread, and all we can do -- what we do is we pursue those that are throughout the country. We pursue them either criminally or, if they're not criminal cases, we'll pursue them civilly as well.

HOLTZ-EAKIN:

But for purposes of this investigation it would be very useful to know things like, of those SARs, how many turn into prosecutions; of those prosecutions, how many mortgages are actually involved. By region we know what origination looked like.

If you could share with us information that you have available so that the magnitude of the problem is documented, that would be very useful.

BREUER:

I actually think we can do that and will do that.

HOLTZ-EAKIN:

I look forward to that.

With respect to the other members of the panel, this is the happiest day of my life. And I want to thank you for resolving forever whether the uptick rule matters, whether short sellers ruined the world, and how much mark-to-market accounting matters. I have been waiting for this day and look forward to your reports. It's going to be wonderful.

(LAUGHTER)

There are still a few mysteries left, though. So I am -- I want to go back to this issue of the rise in leverage at the big investment banks and the role of the supervisory regime. I didn't quite understand the answer. So I'm going to say something, I want you to tell me whether I'm wrong or not. The investment banks had no regulatory capital requirements.

HOLTZ-EAKIN:

Wrong.

SCHAPIRO:

The...

HOLTZ-EAKIN:

And then the -- the 2004 decision thus relaxed the...

SCHAPIRO:

No.

HOLTZ-EAKIN:

... in law relaxed the regulatory requirements.

SCHAPIRO:

The broker-dealers have always been subject to capital requirements, fairly conservative capital requirements under longstanding SEC rules.

HOLTZ-EAKIN:

Which were then relaxed.

SCHAPIRO:

The bank broker-dealer holding companies were not subject to capital requirements or any regulation at all prior to 2004.

In 2004 the Consolidated Supervised Entity program was created to bring those holding companies under supervision, and at the same time they were at the broker-dealer level allowed to take a different approach to calculating that capital that allowed them to use value risk models rather than our strict, "you must take a 1 percent haircut" for a short-term treasury bond, "you must take a 15 percent haircut" for an exchange-listed equity.

Instead, they were allowed to use the models under Basel. The result of that was that smaller amounts of capital were able to support larger positions.

HOLTZ-EAKIN:

OK. Thank you very much.

SCHAPIRO:

You're welcome.

HOLTZ-EAKIN:

I just didn't follow that the first time around.

So in looking back at the crisis -- and I'm about to do something which I hated when I was on that side of the witness table, which is you now own the SEC, congratulations,

and I'm going to blame you for everything that happened years ago. But if you look back at the key events in the crisis -- Bear Stearns, Lehman, the fallout thereafter -- the SEC is essentially missing in action and publicly silent.

And so my question to you is, given that it is now quite apparent that an enormous component of this crisis is the inability to assess counterparty risk, that central to that was -- is often asserted Lehman's interconnectedness and pervasive impacts when it failed, why as the prudential regulator was the SEC unable to say publicly something about the genuine financial condition of these large investment banks who were at the center of this crisis?

SCHAPIRO:

It's hard question to answer because I wasn't there, and I don't know the decisions that were made by my predecessor about what to speak to and what not to speak to.

It is my belief, having looked carefully at the programs that existed at the time -- and the Consolidated Supervised Entity program was also disbanded by my predecessor in the fall of last year, of 2008 -- that the agency never made a full commitment to what was a voluntary program. And I think that's one of the flaws of the program. The five entities that chose to be regulated as CSE firms under the SEC could also have chosen to go do other things and be regulated elsewhere and not subject to the SEC. I think voluntary regulation's a bad idea under almost any circumstances.

But secondarily, I don't think the resources were ever committed, either technologically or human resources, to become the kind of consolidated supervisor that was really called for under these circumstances.

I can understand very clearly how the changes in the capital rules impacted things, and we can fix those. We don't regulate on a consolidated basis any holding companies any longer. I can provide resources and we can support the program, we can rewrite the rules, but I can't really address for you all of the failures of the program historically.

HOLTZ-EAKIN:

And so it does seem clear in retrospect that there was an inadequate effort to assess the risks within these institutions and that...

SCHAPIRO:

I think there was reliance on models which turned out to be quite flawed in many ways. Some internal models, you know, relied on recent historical observation periods that turned out to be pretty irrelevant when we got into the financial crisis. I don't think the VaR measures fully captured all the risks that were appropriate to be captured. I think that there was not sufficient pressure on the firms to do really robust economic stress testing of their models under the sort of, you know, low probability/high stress scenario.

I think there was a fundamental misunderstanding, which was shared by many, many regulators, that secured funding would always be available, and it wasn't at the end of the day for Bear and for Lehman, secured funding wasn't a possibility. I don't think anybody envisioned, even in the backup liquidity pools that were required under the CSE program, it wasn't envisioned that secured funding would ever dry up completely. You know, there -- all of these things I think came together to render this program at this time ineffectual.

HOLTZ-EAKIN:

Was the SEC's mandate simply too broad for it to be effective at particular functions?

SCHAPIRO:

I don't -- I don't think so.

I mean, I think -- but I will say, I think it's quite a different thing...

VICE CHAIRMAN THOMAS:

Excuse me, Chair Schapiro. The gentleman should use an additional two minutes so he can continue to pursue this line. I think it's very useful.

HOLTZ-EAKIN:

Talk very, very fast. I'll do the same.

SCHAPIRO:

The SEC has very successfully for very many years successfully regulated broker-dealers. And broker-dealer capital and broker-dealer net capital and customer protections are designed to protect the assets of the customers at the broker-dealer, and that had worked extremely well for many years. I think it was a geometric difference in supervision and regulation to go from broker-dealer regulation to the regulation of heretofore unsupervised holding companies and multiple affiliates. And -- and I think that is not something that you do overnight. I think it's a program you build over time; you bring in tremendous resources and expertise. The SEC didn't have the budget to do that. The SEC to this day is smaller than it was in 2005. And the agency did not have at that time, in my view, a sufficient resource commitment to this kind of a regulatory program.

HOLTZ-EAKIN:

Last question for -- for both of you and Chair Bair. We heard testimony yesterday from a gentleman named Kyle Bass, who did extensive work identifying the fundamental weaknesses in a lot of securitized assets based on subprime mortgages.

He took that -- the evidence of the danger that it presented to Bear Stearns and -- and was told he -- it was rejected. He took it to the Federal Reserve Board, and it was rejected.

Did he bring that evidence to either the SEC, which would have had a clear prudential interest in the weakness of Bear Stearns, or to the FDIC? And if he didn't bring it directly, were you aware of this research?

SCHAPIRO:

I'm not aware of it. I'd be happy to find out and -- and provide that information.

HOLTZ-EAKIN:

Good. Thank you.

BAIR:

No, I'm not aware of it, though I -- since Bear Stearns had no significant depository institution, I don't know, it would -- he probably wouldn't have talked to us.

HOLTZ-EAKIN:

Thank you.

CHAIRMAN ANGELIDES:

Senator Graham?

GRAHAM:

Thank you, Mr. Chairman.

Earlier today, I was on a C-SPAN call-in program, and several of the callers raised the issue of the degree to which this crisis was a function of over-governmental regulation and intervention using, as the primary example, the Community Reinvestment Act.

Mr. Breuer, in your investigations, have you any opinion as to whether excessive government involvement or regulation has contributed to this? And if so, in what manner?

BREUER:

Well, Senator, from the perspective of the Department of Justice, we really do defer to Chair Bair and Chair Schapiro and other regulators about the regulations and -- and what needs to be. I mean, our -- our view remains that we continue to look throughout it in a very comprehensive approach with respect to -- with respect to the criminality. And where the criminality is, we're pursuing it. I just don't think that, given our perspective, we can opine on -- on the level of regulation one way or the other. What we are looking very hard at is, regardless of the level of regulation, where people made false statements or acted in a criminal manner, we're going to hold them accountable.

GRAHAM:

Let me ask the same question of Ms. Bair and Ms. Schapiro.

BAIR:

Yes, we -- we have looked at CRA's role in this, as have other banking regulators, and I think we've all concluded it was not any kind of a significant factor. CRA credit only -- again, only goes to insured depository institutions. The lion's share of these high- risk loans were made outside of insured depository institutions.

So, no, I know that people debate CRA, and there are other issues, but in terms of driving this, no, we have not found evidence of that.

SCHAPIRO:

We don't have responsibility for the administration of -- of the CRA, so I just -- I don't have a view about that.

GRAHAM:

Were there any other areas of government action or regulation that you have found to have contributed to the -- to the crisis?

BAIR:

I think, as I mentioned in my testimony, the role of the GSEs. I think that needs to be looked at. I think the GSEs also invested in a lot of private-label mortgage-backed securities, which has been a big loss -- big loss leader for them now.

And so I think that is something -- you know, I think there are pros and cons of having those types of entities, but I do think that -- that is an area of significant government involvement that I do think played a role here.

SCHAPIRO:

I would agree with that. I think it's incumbent upon us to look carefully at the role of the GSEs and to define a more effective role going forward.

GRAHAM:

Ms. Schapiro, you commented earlier about the fact that the rating agencies were not subject to private litigation and, to that degree, were less accountable.

Back in 1995, the Congress passed some legislation called the Private Securities Litigation Reform Act, which had the effect of making it more difficult for private investors to use the judicial system to hold alleged defrauding entities to account. What effect do you think that legislation has had in the -- the degree of fraud that we're now experiencing?

SCHAPIRO:

That's a really excellent question. And I guess I'd like to give it some more thought and provide you an answer in writing.

There's certainly data available -- Stanford University runs a center that tracks all of the litigation and does an analysis of it. And I guess I'd like to take a look at that and some other information before giving you a clear answer.

I do believe that holding parties accountable is a critical component of effective regulation and -- and effective discipline on our financial system. What I can't tell you is the extent to which that law in particular may have lessened the discipline that would be helpful here.

GRAHAM:

Thank you. And in your written response, if you could broaden it to include any recommendations that you might have as to the role of private litigation as an enforcer of fraudulent behavior within the financial arena.

SCHAPIRO:

I would be happy to. And -- as a general rule, I think the -- the view -- certainly my view, and I think the view of the commission historically has been that private rights of action are a very, very important adjunct to our civil enforcement and -- and the Justice Department's criminal enforcement capabilities and that it -- it instills an important discipline in the marketplace.

GRAHAM:

Thank you.

Ms. Bair, you've commented about the issue of compensation and setting some standards. I've been concerned that yesterday what we heard from the representatives of the major financial institutions seemed to be that all of the performance that was intended to be induced by different compensation packages was essentially internal to the financial institution, enhancing its profitability and success. As you are developing some compensation proposals, do you think there are some external factors that should also be included in the performance evaluation of the -- of executives and other officers of a

financial institution? As an example, the fundamental purpose of a financial institution is to be an intermediary and allocate resources in a way that advances the overall economic well being of society. Is that a consideration that should be a part of the performance evaluation of the executives of a financial institution?

BAIR:

Well, I think your answer would depend on whether I was speaking as a -- a board member, setting compensation, or a government regulator. I think as a government regulator -- or more specifically, a deposit insurer, our focus on this is financial risk to the deposit insurance fund, so we will be looking at structures that we think create incentives for riskier behavior that could put the institution in peril and cost us money. That -- that is our statutory authority.

I will say, though, I think, more generally, boards and the shareholders that they represent need to step up to the plate. And I know under Chairman Schapiro's leadership there have been efforts to -- to empower boards and shareholders to deal with this. But certainly, from that perspective, I would assume that they would want to look at what kind of corporate citizens of -- and leadership is being provided.

GRAHAM:

Ms. Schapiro, you've talked about regulatory change. The SEC has been a particular target for that regulatory change. In the middle of the presidential campaign, the fall of 2008, Senator McCain called for the firing of the chairman of the SEC. I think it was the only financial regulator who was specifically called out to be terminated. Are there any peculiar structural issues within the -- the SEC that -- that deserve specific attention as part of the general consideration of regulatory change within the financial agencies?

SCHAPIRO:

That's a very good question. You know, I've spent my nearly one year at the SEC really trying to take apart the agency and understand where -- where our strengths and weaknesses lay and then take action to try -- to bolster our programs wherever we can.

So we've created, for example, this new division of risk strategy and financial innovation to help us identify risks as they start to build in -- in -- in the markets that we regulate. We've brought in a lot of new leadership across the board. We've sought very different and new skill sets for the SEC in order to bolster our capability, and we've made some structural changes.

I don't think there's anything peculiar to our structure. And that leaves us more politically vulnerable, and I served as the SEC as a commissioner 20 years ago, and I had the same feeling then, that it is actually quite an independent agency that -- that seeks to do what it believes is right in every instance. That said, the one area where we have less independence than our fellow financial regulators, with the exception of the CFTC, is that we are subject to an appropriations process in Congress and -- and through the president's budget, while the other financial regulators are self-funded.

CHAIRMAN ANGELIDES:

OK. Would you like two more minutes? You can have two more.

GRAHAM:

Thank you. I am going to ask a question, but I'll first declare a potential conflict of interest. I am one of the public members on the American Institute of Certified Public Accountants. The word "accountant" has come up a few times.

Is there any you -- any suggestions to that specific profession that you would make as to how they could play a more effective role in suppressing fraud or other steps that would tend to mitigate the prospects of another crisis, as we're currently experiencing?

SCHAPIRO:

I think it's critically important -- and this was a debate in the regulatory reform context earlier this year -- that we continue to have independent standard-setters for accounting standards going forward and that those standard-setters focus on what the purpose of accounting standards is, which is to provide investors with all the information that they need in an unvarnished, honest and direct way to make rational capital allocation decisions. And -- and so I think it's particularly important for the profession to continue to remember that the investor is their audience at the end of the day and that they establish accounting standards that further the interests of investors in full disclosure.

BAIR:

I would just say that I think one area where bank regulators and the accountants continue to have robust dialogue is on the issue of provisioning against projected loan losses. I think all of the bank regulators agree that the current rules are too restrictive, that there basically has to be an event making a loss estimable and probable before a bank can reserve against it and that that, perhaps, led to banks being under-reserved going into this.

So I think we continue to have a constructive dialogue with the accountants about increasing flexibility for -- for banks to reserve more, have more flexibility to reserve more against loan losses.

CHAIRMAN ANGELIDES:

All right.

BREUER:

And, Senator, if I could...

CHAIRMAN ANGELIDES:

Thank you, Senator. Oh, go ahead. Go ahead.

BREUER:

I was just going to add -- and on the extreme, we at the Department of Justice are extremely interested in the role of the gatekeepers. Whether you're a lawyer, an accountant, or anyone else, and you are involved in fraud, we're going to go after you aggressively. And, obviously, if you're aware of fraud and you are a part of it, we encourage people to come in before we come knocking on your door.

CHAIRMAN ANGELIDES:

All right.

Ms. Murren?

MURREN:

Thank you, Mr. Chairman. And I am at the risk of making your day a little less bit happy, Commissioner. I'm going to go back to short selling. Sorry about this. I do want to talk a little bit about transparency as it relates to short-selling, because there's an awful lot of requirements either for filings or for disclosure that relate to long positions, in particular, ownership by mutual funds or the positions that investment analysts may have themselves or market commentators. And those types of disclosure requirements are not necessarily required on the short side.

And without a doubt, short selling is an important part of an efficient market. But I do think that it is worth noting that observers within the real economy, and perhaps on Main Street, have observed that the lack of requirements for transparency and disclosure on the short side may have exacerbated the financial crisis during it's course, in particular because if you look at some public companies, for example, who depend on investor confidence to access the capital markets, who at that time might have been renegotiating credit lines, as many companies were, and you have a stock that goes down 90 percent, 50 percent, there's a significant amount of confidence that's lost and an inability to tap the capital markets, to say nothing of employees who watch stock prices decline precipitously and, obviously, are frightened, and there are morale problems that are real

in companies that are actually part of the real economy, not necessarily part of the financial institutions. Could you please comment on whether you think there should be more transparency in this area?

SCHAPIRO:

Well, as a general matter, I am a huge fan of transparency across the board, because I think when people understand what all the issues are, what all the positions are, that we all are able to have real market discipline in -- in a way we don't when the markets are opaque.

I will say, new short-selling reporting requirements were put into place this fall, and I'd be happy to provide you with a full, for the record, description of those and what else we're contemplating in the short-sale area.

As you know, we have a number of proposals out for comment. There's tremendous interest in those, whether it's reinstatement of the uptick rule or a circuit breaker mechanism to stop the decline, as a result of short-selling, as opposed to long-selling of a stock after it's declined by 10 percent within a single day. And -- and the commission will be taking those issues up very soon.

MURREN:

And do you feel that you -- each of you have enough authority to be able to take a look at things that would be considered manipulative in that market?

SCHAPIRO:

It's extremely difficult. The amount of data to -- to sift through in these cases is -- is overwhelming. For us, it's an issue of being able to acquire or build the technology to do this kind of data analysis more efficiently than we do it now.

So when we were discussing earlier about the rumor investigations and the potential short-sale manipulations, those -- we -- we have to review millions and millions and

millions of trades in order to try to reconstruct what -- what has happened. And it is my hope that the agency will have sufficient resources to do a better job with technology.

Our -- our -- and I don't mean to make a pitch -- but our technology budget is 50 percent -- for -- for new development, is 50 percent below what it was just five years ago. So it's -- it's really incumbent upon us to have that capability.

MURREN:

Thank you. Separate question on shadow -- the shadow banking industry. Could you each comment a little bit on what you think the contribution might have been from the shadow banks to the financial crisis and its -- and its magnitude and perhaps what different authorities or regulatory environment you think might have prevented some of the exacerbation of what we saw?

BAIR:

Well, I think the -- the -- the really poorly underwritten loans, the payment shock loans, they -- it absolutely originated outside the traditional banking sector. I think it created downward -- as market share kept being pulled away from insured depository institutions, I think it created negative competitive pressure for the banks and thrifts to start following suit. And that's not to say all banks and thrifts were perfect, because they were not. Some of it was going on there, as well.

But I do think the lion's share of it -- it was started and the lion's share of it occurred in the non-bank sector, but that clearly created competitive pressures on banks. And back to my point earlier about consumer protections, I think nipping this in the bud in 2000 and 2001 with some strong consumer rules applying across the board that just simply said you've got to document a customer's income to make sure they can repay the loan, you've got to make sure the income is sufficient to pay the loan when the interest rate resets, just simple rules like that we have now, at least for high-cost loans, I think -- again, and retrospect is always 20/20 hindsight -- but I think that could have done a lot to stop this.

SCHAPIRO:

I think, to some extent, it depends on how you define the shadow banking system, I think, but -- so I would -- I would agree with everything that Chairman Bair has said. And I would just reiterate my concern about OTC derivatives markets, the role that they were playing, sort of shadow markets to the regulated securities options and futures markets, and the ability to do in those markets what -- what is clearly not permissible in the regulated markets or at least is invisible in those markets, even if it's not permissible.

MURREN:

Would it be possible to get a summary of what you believe to be the institutions that are part of the shadow banking system and also the ones that may be outside of your jurisdiction?

SCHAPIRO:

Sure. I mean there are questions. For example, are money market funds part of the shadow banking system? They're highly regulated entities, but they're -- they're not part of banks, although they are important parts of the financial system. So we could certainly try to divide the world up.

MURREN:

That would be terrific. Thanks.

Thank you.

CHAIRMAN ANGELIDES:

You have time.

MURREN:

I'm good.

CHAIRMAN ANGELIDES:

OK. Good.

Thank you very much. It's been -- you've been -- you've been asked to provide a lot of information. You've been given a lot of work to do, coming out of this meeting. I do want to add one additional request to this, following up on Mr. Holtz-Eakin's question.

I do think for the commission this impact of this April 2004 decision with respect to leverage limits of the broker-dealers and how that affected the bank holding companies -- the investment bank holding companies, I think a clear explication of that in writing would be very helpful, because I still think we want to see exactly how the -- the lifting of the limits on the broker-dealer -- what effect that had on the -- on the overall entity.

SCHAPIRO:

I would be happy to do that. And to be very clear, the actual leverage limitations weren't changed. It was really in how the net capital was ultimately calculated at the broker-dealer level versus the holding company level which, as we've discussed, was not subject to any regulation until 2004, or any capital requirements at all. But we'll be happy to provide a very straightforward description.

VICE CHAIRMAN THOMAS:

And -- and the difficulty partly, Mr. Chairman, is that when you have one that wasn't regulated and one that was, you put them together, they're under the same structure, they shift to Basel, in explaining all of that, how did we wind up with, I assume, good meaning people restructuring something for something positive was what we got.

SCHAPIRO:

Understood.

CHAIRMAN ANGELIDES:

And I think what we're really driving at is I think we want to get a sense of whether that was a critical decision and whether that in fact did increase the risk profile of those entities that subsequently collapsed or might have collapsed but for extraordinary government assistance.

Thank you very much for your testimony today. We will take a 10- minute break, and we will start promptly at 11:55.

(RECESS)

CHAIRMAN ANGELIDES:

Welcome back. We will now go to the second session of our public hearing today. And I want to welcome the individuals who have come here from around the country to talk to us as about the investigations and actions that are being taken around this country with respect to the financial crisis. As has been our custom as I announce at every session, we will be swearing all witnesses that come before us, and so consistent with that, I'd like all of you to please stand and be sworn.

CHAIRMAN ANGELIDES:

Do you solemnly swear or affirm, under penalty of perjury, that the testimony you are about to provide the commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

CHAIRMAN ANGELIDES:

Thank you very much.

And let me also announce, Commissioners, you may notice that Mr. Holtz-Eakin is now sitting to my right. There has not been a coup. What, in fact, has happened is Mr. Thomas has had literally a prior commitment that goes back one year, and he had already altered everything, but he -- to be able to be with us yesterday and today, but he has had to depart

for the West Coast. So Mr. Holtz-Eakin will be sitting in the vice chair's seat and working with me on the allocation of time for commissioners.

So let me start this by reminding witnesses, first of all, thank you for your written testimony. It was very well done, and we appreciate the effort you made. We'll ask each of you to give us a statement of up to 10 minutes, and then we'll go to commissioner questions. And we will start today with the attorney general of Illinois, Ms. Madigan. So if you would please begin your testimony, that'd be terrific.

MADIGAN:

Thank you, Mr. Chairman and members of the commission, for inviting me to testify before you today. My testimony is going to focus on my office's efforts to combat the predatory practices that grew rampant in the mortgage-lending industry over the last decade and are at the root of our country's financial crisis.

The state attorneys general who serve as first responders when problems in the marketplace emerge for our consumers were keenly aware of the wide-scale abuses in the mortgage lending market, and we were taking aggressive action to stop them many years before the housing bubble burst.

My testimony will also address what I see as the failure of federal regulatory oversight and the need for a robust state-federal enforcement regime to protect consumers in the future. I have served as the Illinois attorney general for seven years. And from day one, I have focused on protecting homeowners and borrowers from unfair and deceptive mortgage-lending practices.

Since the late 1990s, Illinois, often in conjunction with other states, has investigated some of the largest subprime lenders in the country: First Alliance Mortgage Company, Household Finance, Ameriquest, Countrywide, and Wells Fargo. And after uncovering and documenting their predatory lending practices, we sued these lenders for putting

homeowners into risky loans that they didn't understand, couldn't reasonably afford, and couldn't get out of.

Our investigations of these lenders and their brokers revealed a pattern of predatory lending practices that would eventually permeate and destroy much of the mortgage industry and our economy along with it. These predatory practices were driven largely by the rise of the mortgage securitization process, which allowed lenders to bundle and sell off home loans and to shed all liability for their soundness. Once lenders were freed from responsibility for a loan's failure, common-sense underwriting standards quickly deteriorated. Mortgage lending had been turned on its head. Lenders made more money selling high-cost risky loans than sound loans for the simple reason that Wall Street paid more for subprime loans and loans with expensive risky features.

So we see that, in 1999, subprime loans were only 3.8 percent of the market and Alt-A loans were only 1.7 percent. But by 2005, at the height of the lending frenzy, almost 50 percent of the loans originated were either subprime or Alt-A. To respond to Wall Street's growing demand, lenders created compensation structures that incentivized mortgage brokers and loan officers to add risky features to loans. In our investigations, we examined rate sheets lenders used to determine compensation for mortgage brokers and loan officers, and what we found was alarming. Lenders paid brokers and loan officers more for loans with low introductory teaser rates, which set borrowers up for payment shock and ultimately foreclosure when their rates reset upward.

Lenders also paid brokers more to place borrowers into no- documentation or low-documentation loans, which allowed brokers to simply state or inflate a borrower's income on the loan application without verification. This type of underwriting permitted lenders to place large numbers of borrowers into high-cost subprime loans without reviewing their ability to repay them. According to one report, by 2004, no-doc loans comprised 41 percent of the subprime market. Brokers were also paid more for putting

borrowers into loans for 100 percent of their home's value, leaving the borrowers with no equity in their homes. In fact, the percentage of nonprime loans that had an LTV over 100 percent increased dramatically from 2000 to 2006.

Additionally, lenders paid more for a number of other risky features such as higher interest rates, payment options that didn't even cover principal or the interest that accrued on the loan, and prepayment penalties that trapped borrowers in their loans. All of these risky features were common in the loans we reviewed during our investigations.

In addition to reviewing loans, we have talked to thousands of homeowners struggling to pay their mortgages. The stories we have heard from these homeowners adds to the picture of the lending industry's predatory practices. Time and again, we hear from borrowers who didn't understand the terms of their loans.

For example, many borrowers thought that they were being sold a loan with a fixed rate only to be presented at closing with papers for a loan with an adjustable rate. Worse, some borrowers didn't even know their mortgages had an adjustable rate until two or three years later when their interest rates reset. Borrowers have also told us that the most complex financial transactions of their lives took no more than 15 to 20 minutes to complete.

Additionally, based on a study of high-cost loans in the Chicago area and many of the borrowers that we have heard from, we have found that the lending industry's predatory practices were often concentrated in minority communities. I and other state attorneys general have been aggressively pursuing predatory lending practices for over a decade, and we continue to pursue them in the aftermath of this crisis. But there's a parallel story to the record of the states, one that is equally critical to a full understanding of this crisis.

In the years preceding the crisis, federal regulators often showed no interest in exercising their regulatory authority or, worse, actively hampered state authority. The Federal Reserve, for example, had the unquestionable authority to tighten underwriting standards

for all loan products and all lenders, but it chose not to exercise that authority until after the market collapsed. In 2006, the federal regulators finally addressed poor underwriting standards by putting out guidance on nontraditional mortgage products, but the bulk of the damage had already been done.

Even as the Fed was doing little to protect consumers and our financial system from the effects of predatory lending, the OCC and OTS were actively engaged in a campaign to thwart state efforts to avert the coming crisis. This culminated with the OCC's issuance in 2004 of sweeping preemption rules that purported to overturn the well- established legal principle that federally chartered banks are generally subject to state laws.

In the wake of the federal regulators' push to curtail state authority, many of the largest mortgage-lenders shed their state licenses and sought shelter behind the shield of a national charter. And I think that it is no consequence that the era of expanded federal preemption gave rise to the worst lending abuses in our nation's history.

A major lesson to be drawn from this crisis is that federal charters must not be mistakenly viewed as giving lenders a blanket exemption from state investigation and prosecution for violations of consumer protection laws.

In conclusion, some lessons to be learned are to preserve sound underwriting standards which evaluate the borrowers' ability to repay their loans and not to compensate mortgage originators more to place borrowers and loans with risky features.

There are signs that federal regulators recognize at least some of the lessons to be learned from this crisis. Last year, the Federal Reserve finally put in place stricter underwriting standards for higher cost loans. Unfortunately, those standards, while they would apply to subprime and Alt-A loans, won't apply to prime products, including pay-option ARMs, the riskiest and most complicated product we've seen and the one that will constitute the next wave of foreclosures. I believe common sense dictates that we need strong federal underwriting standards that apply to all home loans. In addition, the Federal Reserve has

recently proposed a rule that would ban forms of broker compensation that provide incentives to place borrowers in riskier loans. I, along with 17 other A.G.s, drafted and submitted comments strongly urging the Federal Reserve to adopt that rule.

This crisis resulted from a combined failure of the financial institutions, the regulatory system and government, and its resolution depends on the willingness of every participant -- federal and state, public and private -- to commit to common-sense reforms.

The state attorneys general and their ability to investigate and prosecute fraud in mortgage lending must be vigorously preserved. Our strong record of pursuing predator lending practices and responding to the problems of our consumers makes us a necessary part of any future solution. Thank you, and I'd be happy to answer any questions you have.

CHAIRMAN ANGELIDES:

Thank you very much, General.

Attorney General Suthers of Colorado?

SUTHERS:

Chairman Angelides and members of the commission, I appreciate the opportunity to appear before you today and describe the activities of my office, a much smaller office than General Madigan's, in the midst of and in response to our country's financial crisis. I've had the honor and privilege of serving as Colorado's attorney general since January of 2005. That means I came into office just as we were starting to hear rumblings about problems to come in the Colorado housing market.

In my view, which is largely hindsight, the states were not well- equipped with legal tools to deal with much of what has transpired over the ensuing five years. Like many states, Colorado had passed legislation in 2002 dealing with so-called predatory loans modeled

in part after the Federal Homeownership and Equity Protection Act of 1994. Unfortunately, like its federal counterpart at the time, Colorado's limits on balloon payments and prepayment penalties and its prohibition on negatively amortizing mortgage loans applied to such a small subset of the highest-cost loans that it proved to be very little deterrent to abusive lending practices.

Loan originators will able to push ever more exotic loan products whose introductory rates and low-minimum payment formulas with significant cost paid outside of closing took those products beyond the coverage of such laws. In 2005, Colorado was one of only two states that did not regulate mortgage loan originators. While we now have licensing of individual brokers, we are still one of the few states that does not regulate most of the mortgage lending activities of non-depository lenders. With respect to the laws we did have in place back in 2005, as General Madigan indicated, we were largely powerless to enforce those laws against national banks and their lending affiliates and subsidiaries due to the aggressive stance federal regulators took to preempt state law. Even with respect to discriminatory lending and deceptive advertising.

And I join General Madigan in encouraging you to carefully examine the advisability of federal preemption in financial industry regulation. As things began to unravel, my office joined a law enforcement task force and coordinated our enforcement efforts with Colorado's district attorneys and the United States attorney in Colorado to ensure various cases were pursued by the most effective means. Given our resource constraints and jurisdictional limitations, my office focused our enforcement efforts on deceptive advertising by local loan originators and on egregious cases of mortgage fraud affecting Colorado consumers.

In late 2005 and early 2006, we examined the advertising of dozens of local loan originators for Federal Truth in Lending Act violations. Cease and desist letters went to those advertisers who either were not disclosing an APR in their print advertising or who were disclosing an inaccurate APR. By late 2006, our newspapers were full of advertisements from local originators hocking option-payment-ARM loans. Most of these

advertisements emphasized low teaser rates and failed to disclose the negative amortization that borrowers would experience if they made only the minimum payments. Homeowners were led to believe that they were being -- buying a fixed-interest rate loan when, in fact, only the first monthly payment was at the advertised rate.

We issued subpoenas to all of these advertisers and conducted numerous depositions of loan originators. The witnesses told us the teaser rates really, quote, "made the phones light up," unquote. It was clear that thousands of Colorado borrowers got into these loans without knowing the true nature of the teaser rates, the significant negative amortization that they were adding to their principle balances, and the prepayment penalties that came with these loans. A number of these loan originators ultimately went out of business, and we eventually reached a settlement with seven companies that prohibited them from such advertising. Several companies refused to settle, and we successfully sued them for deceptive advertising.

We also brought a series of civil and criminal actions against lenders and loan originators engaged in deceptive or fraudulent transactions and against individuals engaged in fraudulent real estate schemes. We've summarized these in the written testimony. We joined with Illinois and other states in multi-state actions against Ameriquest and Countrywide. We've also aggressively pursued local companies in Colorado. And we aggressively pursued criminal cases. And I think the fact that we got sentences up to 30 years in mortgage fraud cases indicates how egregious judges felt this conduct was.

I want to turn to current trends. Over the past two years, my office has seen a dramatic shift in consumer complaints. We are receiving fewer complaints about mortgage originators, and we now have voluminous complaints about mortgage servicing and foreclosure relief scams. In addition to working with loan servicers on individual complaints on behalf of Colorado consumers, my office is participating in a multi-state effort to work with loan servicers to encourage loan modifications and other sustainable

long-term solutions. The State Foreclosure Prevention Working Group is comprised of 15 state attorneys general and the conference of state bank supervisors. Formed in the summer of 2007, this group met early on with representatives of the 20 largest loan servicers in the United States. Since that time, the working group has been collecting data from 13 of these companies in an effort to verify the performance of their foreclosure avoidance programs.

I'd indicate to you that the majority of the seven who are not disclosing the information are claiming federal preemption and no requirement to do so.

This data-collection effort has led to the publication of three reports during 2008 with a fourth report covering 2009 to be released shortly. Unfortunately, each of the first three reports revealed a wide gulf between the level of serious delinquent subprime borrowers and effective loss mitigation efforts with as many as seven or eight out of ten seriously delinquent borrowers are not in any loss mitigation process. While those numbers are believed to have improved over the last year, there are still far too many delinquent and seriously delinquent borrowers who either are not aware of loss mitigation alternatives to foreclosure or who are frustrated by the delays in working out a non-foreclosure solution.

Foreclosure relief scams are a very significant problem for the states. Shortly after I came into office, I was approached by a number of our local county officials handling foreclosures, called public trustees in Colorado, about a rapid increase in the number of individuals who were soliciting homeowners in foreclosure for a variety of foreclosure relief services ranging from refinances and loan modifications to investment schemes designed to, allegedly, save a home from foreclosure. I formed a task force of public and private parties to look at this problem and, in 2006, this task force was instrumental in drafting and securing passage of the Colorado Foreclosure Protection Act. The act prohibits foreclosure consultants from collecting up- front fees, from taking a financial interest in a homeowner's property, and requires that foreclosure-consulting contracts contain language designed to protect consumers.

Investors, referred to as "equity purchasers" under the act, are subject to strict written contracting procedures, a three-day cooling- off period during which no documents encumbering the property can be recorded and special unconscionability provisions relating to sale lease-back transactions. Not surprisingly, over the last two years, complaints about foreclosure relief scams have outstripped all other mortgage-related complaints into my office. Delinquent homeowners are besieged with solicitations arriving at their door, in their mailbox, over the telephone, and on the Internet.

We've now taken action against a total of 33 foreclosure rescue and loan modification firms. We also have investigations underway against dozens of additional companies that are aggressively advertising to Colorado homeowners facing foreclosure. Many of these complaints are located outside of Colorado -- many of these companies are located outside of Colorado. Seventeen of these actions were announced as part of two separate sweeps in July and November of 2009 that approximately 25 state attorney general offices coordinated with the Federal Trade Commission.

Let me briefly touch on other continuing concerns. As more Colorado consumers have fallen behind on their mortgage payments, we have seen an increase in the marketing of other services to those same consumers. In addition to the foreclosure relief solicitations, we've seen an increase in payday and other high-cost loans and an increase in debt settlement and credit repair frauds as well. Under Colorado law, payday loans are limited to an amount, finance charges, and duration. In 2002, the total loan amount reported by licensed payday lenders in Colorado was $245,900,000. By 2007, that number had increased 160 percent to $639,500,000. And these figure did not take into account unlicensed payday lenders operating primarily or exclusively on the Internet and attempting to avoid state licensing.

Let me say a word about debt management scams, are also very problematic. Since Colorado's version of the Uniform Debt- Management Services Act took effect in 2008, my office has investigated and taken disciplinary action against 26 debt-management

companies and has issued 22 additional cease-and-desist orders. Violations include failure to make mandatory disclosures and charging excessive fees. We've required debt-management companies to refund more than $1.3 million to Colorado consumers and assess fines and penalties of $135,000 against them.

Also a problem -- I'll wrap up just by saying we're seeing a lot of credit repair scams.

Let me conclude by suggesting the cause and effects of our current financial crisis, as you folks are finding out, are varied and complex. We in the states are dealing with the -- with the fallout, and that means the effects of record home foreclosures, spiraling credit card and other high-cost debts, and, unfortunately, the significant growth of other, perhaps less reputable industries to take advantage of the financial struggles of our good, honest citizens.

Thank you.

CHAIRMAN ANGELIDES:

Thank you, General.

Ms. Crawford?

CRAWFORD:

Good morning, Mr. Chairman, and members of the commission. I'm Denny Crawford, Texas securities commissioner and president of the North American Securities Administrators Association.

CHAIRMAN ANGELIDES:

Could you -- could you lean a little into that for us, Ms. Crawford?

CRAWFORD:

Sure. I'm Denny Crawford, and I'm the Texas securities commissioner, and I'm president of the North American Securities Administrators Association, also known as NASAA. I'm very honored to be here today.

In thinking about the role of state enforcement authorities, it's instructive to examine the regulatory responses to the major financial scandals over the past decade. From exposing securities, analyst conflicts, and market timing and mutual funds to the auction rate securities cases, state securities regulators have consistently been in the lead. Indeed, in some cases, at the time the states began their investigations, it was unclear whether the federal regulators intended to pursue any investigation at all.

The most recent example is with the auction rate securities, ARS. Billions of dollars of these securities were sold to investors by major brokerage houses as cash alternatives. In February of 2000, the market collapsed. Investors were left with illiquid securities.

In June of that year, state regulators in Massachusetts brought a civil against UBS Securities charging that the firm had sold ARS to customers with false representations. A month later, New York filed its own lawsuit against UBS. In July, a similar action was filed by Merrill Lynch -- against Merrill Lynch. And on August 7th, NASAA announced the first ARS settlement, which was with Citigroup, pursuant to an investigation led by the Texas State Securities Board, under which the company would fully reimburse its 40,000 customers who had been unable to sell their auction rate securities and pay civil penalties of $100 million.

Significantly, the SEC took no public action with respect to ARS until August 7, 2008, when they announced a preliminary settlement with Citigroup comparable to the agreements already reached with members of NASAA. Sadly, state investigations into corporate abuses that federal officials have missed through the years have resulted not in reform at the federal level, but in criticism of the states. Some federal agencies have responded by issuing regulations broadly preempting state law or even bringing suit

against state officials. States have found themselves engaged with a battle against certain federal agencies simply to retain the authority to protect the interests of investors.

The National Securities Markets Improvement Act of 1996, NSMIA, significantly impacted the role of state regulators. NSMIA preempted many state regulations and enforcement provisions. It also prohibited the states from taking preventative actions in areas that we now know have been substantial contributing factors to the current crisis.

The Congress, federal regulatory agencies, and the courts have created gaps in the securities laws and the entire investor protection regime. My written testimony provides several examples of problems with Regulation D Rule 506 offerings that have been investigated by the Texas State Securities Board.

In the final analysis, NSMIA obstructs the states' ability to investigate known securities law violators when they become participants in subsequent offerings.

By way of example, another recent enforcement -- enforcement case in Texas is worth mentioning. Investors in a company called National Life Settlements, NLS, recovered nearly $20 million, or 69 percent, of the amount they invested. Most of these investments were retirement funds. It's rare to have such a large recovery in a securities case. And in court, the receiver told the judge that the Texas State Securities Board had acted in this case before they even had a single complaint.

Investigations such as NLS are trademarks of state securities regulators. No lead is too small to warrant at least a cursory review. The failure at times is to see similarly swift action on the part of the federal regulators. State securities regulators' enforcement statistics show our effectiveness. From 2004 through 2008, we conducted more than 11,000 enforcement actions, which led to over $230 million in monetary fines and penalties and more than $3.7 billion ordered returned to investors. We are also responsible -- and this is significant -- for seeing that defendants in these cases were sentenced to more than 4,000 years in prison, 4,000 years. The calls for preemption or for

more SRO authority at the expense of state jurisdiction defy common sense, if only because the evidence clearly demonstrates that state securities regulators in their structure actually work.

Now I'd like to make a few recommendations for your consideration. First, state securities regulators have observed a steady and significant rise in the number of offerings made pursuant to this Rule 506 I referred to earlier that have later been determined to be fraudulent.

Although Congress preserved the state's authority to take enforcement actions after the fact in these cases, that power's no substitute for a state's ability to scrutinize these offerings in appropriate cases before they're actually made. The SEC does not review the Form D filings and rarely investigates the Rule 506 offerings with which they're connected.

The preemption of state regulation, therefore, has created a huge regulatory vacuum which is highly significant because these deals are often billion-dollar deals that have an effect on our economy. Today, no one regulates these offerings. NASAA believes that Congress should reinstate the regulatory authority of the states in all Rule 506 offerings.

Since the repeal of the Glass-Steagall Act through the enactment of Gramm-Leach-Bliley, we've seen -- we've seen excessive risk-taking emerge within institutions with federally insured deposits, which you examined yesterday. Key activities in investment banks are incompatible with the special character of commercial banking. These include underwriting and dealing in securities, derivatives of such securities, principal invested -- investing, and managing in-house hedge funds.

I believe that a non-bank financial intermediation industry would quickly emerge following Glass-Steagall-type re-regulation, but it would be one that was populated by transparent firms that lend themselves to straightforward oversight by regulators in tandem with a systemic risk regulator.

Third, as evidenced by the inspector general's report on the Madoff affair and the testimony of Chairman Schapiro and SEC staff before Congress, the bulk of federally covered investment advisers, I.A.s, are examined infrequently. A clear oversight gap has existed for some time and is now emerging into public view.

NASAA members are fully prepared to fill this gap by accepting responsibility for the oversight of investment advisers with up to $100 million in assets under management. NASAA members possess unique qualifications that ensure that permanent closure of this gap will be made or geographically near these folks it's more economical and easier for us go out and look at them. And this is the trend the industry is moving toward, investment advisers, and moving away from the broker-dealer business model.

Because I.A. regulation is complex and substantively different from the regulation of broker-dealers, the experience of NASAA members is all the more critical in this area.

Fourth, individual behavior is not reliably rational during just those times when systemic safety is in jeopardy. NASAA believes that ultimate -- optimal communication and associated systemic risk mitigation could best be accomplished by establishing an independent systemic risk council. Here both federal and state regulators need to be represented, and they need to undergo analyses, risk assessments and recommendations.

This would effectively establish a crisis management protocol with clear and regular lines of communication among all regulators. The complexity of the financial markets has exceeded the competency capacity of federal regulators, providing evidence for the need for state banking, insurance and securities regulators on the systemic risk council.

Fifth, the current levels of funding for state and federal law enforcement agencies is low. Increasing enforcement to more effectively deter fraud is much more cost effective than after-the- fact compensation of victims and economic damage repair.

In conclusion, the unique experiences of state securities regulators on the front lines of investor protection have provided the framework for my testimony. As the regulators closest to investors, we provide an indispensable layer of protection.

As you continue to examine the causes of our current financial crisis and develop recommendations to prevent a recurrence, I respectfully suggest that you strongly consider the restoration of state authority that was preempted over the last 14 years. Our presence did not contribute to the crisis. Rather, the fact that our regulatory and enforcement roles have been eroded was a significant factor in the severity of the financial meltdown. Thank you very much.

CHAIRMAN ANGELIDES:

Can you -- oh, OK. Thank you. Thank you for summing up.

Mr. Theobald?

THEOBALD:

Good afternoon, Mr. Chairman and members of the commission. I want to thank you for the opportunity to testify before you today about the Miami-Dade Police Department's effort to combat mortgage fraud.

Facing a wave of mortgage fraud investigations, Miami-Dade County Mayor Carlos Alvarez established a mayor's mortgage fraud task force in September of 2007. This public-private partnership uses a comprehensive approach that blends legislative change, prevention, enforcement, regulation and prosecution to reduce mortgage fraud and prevent victimization of individuals and businesses.

According to FinCEN, mortgage fraud is one of the fastest growing white-collar crimes in the United States. From '06 to '07, Florida held the dubious distinction of ranking first in the nation in mortgage fraud. According to the Mortgage Asset Research Institute, otherwise known as MARI, Miami-Dade County in particular leads the state in incidents of mortgage fraud and ranks in the top five major metropolitan areas hit by that crime.

The number of suspicious activity reports from financial institutions reported by FinCEN more than tripled from '04, when there was over 17,000, to over 64,000 in 2008, and it's closing in on 70,000 in 2009.

MARI estimates that 70 to 80 percent of all those foreclosures contain some type of mortgage fraud, so it seems clear that foreclosures and mortgage fraud are intertwined to some degree. In both '07 and '08, Florida ranks second in the nation in foreclosures, with Miami-Dade again being the hardest hit area in the state. Traditionally, the FBI and the -- and the HUD inspector general's office handled mortgage fraud investigations. In many areas, though, the FBI's threshold for handling these cases is set at certain dollar amounts, and cases that fall below these thresholds must be handled at a local level. The FBI Miami office, for instance, had a $1 million threshold that close to 98 percent of all the cases did not meet. So compounding that problem, that was the fact that no state statute existed to address mortgage fraud as a crime, and local law enforcement investigators and prosecutors did not have sufficient knowledge, experience or training in taking on mortgage fraud cases.

In addition, the combination of questionable mortgage industry professionals, the lack of appropriate resources for state regulators to accomplish the legal mandates of their office, and the relaxed lending requirements by lending institutions led to a rapid increase in mortgage fraud that has had a detrimental effect on Miami-Dade County, the state of Florida and the entire country.

Our response in Miami-Dade? Because local law enforcement had lacked the authority and the ability and the tools to investigate and charge subjects with mortgage fraud, the task force drafted and lobbied for the passage of a Florida state statute which allowed local law enforcement throughout the state to arrest perpetrators for the crime of mortgage fraud. This legislation formed the cornerstone of the task force. Nevertheless, a multifaceted approach was necessary, because the mortgage fraud crisis was not created

by one or two different components gone wrong, but an entire breakdown of the real estate industry.

To address the various strategies for reducing mortgage fraud, the Miami-Dade Police Department consulted key stakeholders, including county and state elected officials, leaders of local government, business executives, law enforcement professionals, prosecutors, and we formed five committees. The first committee was the Law Enforcement Committee that's responsible for detecting, investigating, apprehending and prosecuting mortgage fraud subjects and enterprises. The committee comprises largely investigators and supervisors from the Miami-Dade Police Department's Economic Crimes Bureau.

Our Economic Crime Bureau detectives work with other local, state and federal law enforcement to solve cases and apprehend subjects. The State Attorney General's Office, the U.S. Attorney's Office and the Miami-Dade State Attorney's Office prosecute the cases in the respective courts. The Legislative Committee, which enhances current laws, creates new laws and ordinances. Several of the task force members are state legislators, who have assisted in sponsoring and passing state laws to achieve the task force's goals.

The Regulatory Committee, which enhances and enforces state regulation on all parties involved in a mortgage transaction, the Business Partnership Committee, which creates and transmits effective business practices and an ethical code of conduct to enhance cooperation with law enforcement and different professions involved in a mortgage to attack the problem and stop fraudulent loans from actually being written; and an education component, which helps law enforcement prosecutors and industry professionals build awareness about mortgage fraud through extensive community visibility and guest speaking events, news conferences for major sweeps, arrests and new legislation..

To date, Mayor Alvarez's mortgage fraud task force is one of the few public-private task forces at the county level in the entire it United States, and it has a tremendous impact on the way mortgage fraud has been viewed in Florida. The Law Enforcement Committee has shouldered a number -- a lot of the burden in achieving this goal. To date, there have been several thousand reports and inquiries, and currently 682 investigations are active.

The Economic Crimes Bureau has made more than 189 felony arrests for mortgage fraud and related charges, which represent more than 60 million in losses. We have created a training manual and trained more than 400 investigators and prosecutors in the state of Florida.

As far as legislation goes, the Legislative Committee crafted new legislation and enhanced the current mortgage fraud statute, which was sponsored by our state representative, Carlos Lopez-Cantera, and our state senator, Gwen Margolis. These bills were signed into law by Governor Crist and effective July 1st of 2008. They enhanced the law enforcement ability to notify the county property appraiser's office when an affected property has shown mortgage fraud and where there is probable cause that a mortgage fraud occurred. And this is important, because the property appraiser's office is now required to reevaluate not only the affected property, but the properties around that particular home or that condominium. And this will reduce the taxes and has reduced the taxes of all the properties affected by the fraud -- not only the individual property, but everyone involved in the scheme. The bill also created a second-degree felony for the mortgage fraud that occurs over $100,000.

In 2008 at the federal level, House Resolution 6853, the Nationwide Mortgage Fraud Task Force Act of 2008 sponsored by Congressman Kendrick Meek, was passed in the House of Representatives, and it was amended as the Nationwide Mortgage Fraud Coordinator Act of 2008. And unfortunately, it ran out of time in the Senate, but it was filed again on January 14th 2009 as H.R. 529, the Nationwide Mortgage Fraud Task Act of 2009. The legislation sought to create a nationwide program modeled after Miami-Dade's mortgage fraud task force to address mortgage fraud in the United States. On May

20th of 2009, President Obama signed Public Law 111-22, a sense of Congress encouraging the creation of a Nationwide Mortgage Fraud Task Force Act. The act, which was Senate 896, was sponsored again by Congressman Meek and Senator Bill Nelson, both of Florida.

As far as regulation goes, following the recommendations of the task force's Regulatory Committee, the Florida Office of Financial Regulation and the Department of Business and Professional Regulation enacted regulations to expedite emergency hearings to suspend licenses of real estate agents and mortgage brokers involved and arrested for mortgage fraud or other related fraud. The immediate suspension will prevent the agent or broker from victimizing unsuspecting home purchasers. Regulations also required background checks and licensure for all loan originators. Additionally, a complete overhaul of the state statute regulating the mortgage industry was in this year's legislative package.

The Business Partnership Committee created real estate best practices manual to distribute to Miami-Dade County realtors. The committee also sought and received private funding from Florida bankers and other professions involved in a mortgage business to assist in financing the cost involved in investigating and prosecuting mortgage fraud.

The education committee has created a public complaint form with Web site access to report mortgage fraud, and it's on the mayor's Web site. There is also an established database of speakers available to appear at engagements and speak on behalf of the task force.

Additionally, an aggressive media campaign to educate the public and prevent victimization has been undertaken.

In conclusion, Mr. Chairman, the task force is committed to making a difference in the quality of life of the citizens of Miami-Dade County by reducing the number of incidents of mortgage fraud. Although, this is a tremendously large problem in the United States, the steps that have been taken in Miami-Dade can be duplicated elsewhere in Florida and throughout the country. The task force's comprehensive multi-disciplinary approach that has proven to be successful in Miami-Dade County is being sought as a model for attacking mortgage fraud in the United States. The Mortgage Fraud Task Force and its accomplishments can provide a solution to the national financial crisis.

With the task force model, hard work and perseverance by dedicated public servants and industry professionals can unravel the mess that was created by greedy lenders and fraudsters.

I look forward to working with you and other members of the committee on solving this serious threat to our nation's economy. Thank you for allowing me the opportunity to testify before you today, and I look forward to taking your questions.

CHAIRMAN ANGELIDES:

Thank you very much. We'll now start the questioning, and I'll lead off here.

Attorney General Madigan, I want to talk about what appear to be deep systemic failures at the federal level. So let me first visit this issue of the combined lack of federal enforcement coupled with then efforts to preempt.

Tell me just a little bit about your visits with, your talking with the federal regulators. You've been on the scene now for seven years. Did you see go to the Federal Reserve? Did you go to the OCC? Did you go to the other federal regulators and tell them about what was happening? Can you tell me what happened?

MADIGAN:

Sure, I have spoken with people -- and this would have been, you know, 2005, 2006, if memory serves me correctly, about the problems we were seeing, particularly with

subprime loans, particularly with low-doc, no-doc loans. You know, those are very specialized products, that until this crisis really got under way, were very rarely used.

They were used for people in general who had good credit but may not have an active stream of income. So let's use the example of a medical student. Recently graduated, secured a job, you know, wants to purchase a home but doesn't have any income at that point. But reasonably, you can look and see that that person will. You know, that was the intent of, say, a low-doc, no-doc loan.

When you look at what happened in the lending industry, those types of loans became almost standardized, in large part because there was a lot of money to be made by putting people in those loans because it would cost a little more to put somebody in that loan, so there would be a greater revenue stream and, therefore, more interest and more ability to sell that off to Wall Street. And, unfortunately, there was a lack of either appreciation or interest in the problems that were occurring on the ground, not just in the state of Illinois but throughout this country, with those types of risky loans. In addition...

CHAIRMAN ANGELIDES:

Can I ask you specifically, did the state attorney generals visit with OCC, Federal Reserve, and visit these issues?

MADIGAN:

I think in 2005, you might be aware there was an action brought against, at the time, Attorney General Spitzer, by the OCC. Attorney General Spitzer, at that time, had attempted to initiate a fair lending investigation of a number of national banks, and the issue of preemption arose then going all the way up to the United States Supreme Court. It was resolved earlier this year.

So the OCC was well aware, and we did, obviously, make the OCC aware that we were looking into not just fair-lending practices but other practices of the lenders in an effort to combat the erosion of underwriting standards. They just had a different agenda.

CHAIRMAN ANGELIDES:

Let me ask you about this notion of higher payments for riskier loans. That's because what mortgage brokers were being paid higher amounts to peddle these loans? Or was it that commissions were based on interest-rate structures, which by their nature over time, were higher? What was it...

MADIGAN:

It's both.

CHAIRMAN ANGELIDES:

Tell me the correlation between risky loans, higher payments, or making those more attractive for Wall Street. I want to understand that as best I can.

MADIGAN:

Ultimately, you're looking at what's the income stream out of that loan. And so the higher the interest rate is the higher the income stream should be, the higher those payments will be. And so brokers as well as loan officers -- so in-house lenders as well as -- originators as well as independent brokers who were selling loans were incentivized to put people into high-cost loans and then, to complicate the problem, add risky features to the loans. So the prepayment penalties, the balloon payments, things of that nature that would trap people, certainly, with the prepayment penalties, into those loans, again, ensuring an income stream in the case...

CHAIRMAN ANGELIDES:

So those were calculated into the income streams?

MADIGAN:

They would be. And they were -- well, here's what you're concerned about. They're calculated into what the payment is going to be to the broker or the loan officer, and so that was the incentive that we've seen. As I said, we have seen the rate sheets, so the amount that brokers and loan officers were paid based on the features of the loan, based on the interest rates of those loans.

CHAIRMAN ANGELIDES:

You can provide those to us?

MADIGAN:

It was part of our litigation with Countrywide. So I will see if I can.

CHAIRMAN ANGELIDES:

All right.

Ms. Crawford, you've been in your job for 28 years as the Texas Securities Regulator. What kind of grade would you give the federal regulators or the, specifically -- your greatest interaction was SEC?

CRAWFORD:

Yes.

CHAIRMAN ANGELIDES:

What kind of grade would you give them for the last decade?

CRAWFORD:

For the last decade, I would have to give a grade of approximately D minus. And the reason that the grade is D minus is because there have been some actions on the part of the SEC, but the problem is that they've missed the boat with regard to the most dramatic threats to the investing public.

There seems to have been a lot of activity there, but the activity has not been focused in a meaningful way in addressing these problems as they relate to individual investors and, really, large investors as well. So there has been a lack of leadership. Much has been said about the lack of resources, but the problem with that argument is that there are never enough resources. And what has to happen is that you have to have good people who will strategize to deploy the limited resources they have in the most effective way to protect investors. And that is the mission of the SEC and is at the forefront of what they're supposed to be doing.

We found on a number of occasions that they just weren't there. These major frauds that I mentioned before that turned out to be systemic and would have been exactly the kind of systemic national problem that the Securities and Exchange commission would have been expected to address was not addressed. And, therefore, the state securities regulators had to step up to the plate and fill that void. That is not the kind of thing that I want to be doing on a daily basis.

CHAIRMAN ANGELIDES:

Was there a collaborative -- let me -- has there ever been a collaborative relationship with the SEC? You know, you talk about limited resources. It would make sense organizationally -- if I was at the SEC, which I'm not -- to look at counterparties across the nation and talk -- on a regular basis talking about what they're seeing in the field and, in a sense, coordinating enforcement.

Has there ever been that kind of relationship?

CRAWFORD:

Mr. Chairman, that kind of relationship does exist at the regional offices of the SEC. The regional offices I would give probably an A plus grade to because they work very closely with their counterparts in the states. They work collaboratively with state and

federal prosecutors. It is really a beautiful business model for regulation on the regional level at the SEC.

It's only in Washington that we've had this problem. And it's not always been the case. Prior to about ten years ago, the SEC was, in our estimation, the crown jewel of federal agencies. They knew what they were doing. They knew what they were supposed to do. They knew how to work with all the other players to get the biggest bang for the buck.

So it's been very disheartening for all of us, state securities regulators and others, to see this occurring.

CHAIRMAN ANGELIDES:

OK.

Mr. Holtz-Eakin?

HOLTZ-EAKIN:

Thank you, Mr. Chairman. And thank you to the witnesses for taking the time to be with us today.

HOLTZ-EAKIN:

Let me begin with the standard admonition that we thank you very much for your answers to the questions we get to ask now, but we would ask your cooperation as well in answering questions that we would submit in writing after this hearing and look forward to working with you.

I have a couple of questions that are going to reveal that I know nothing about the kinds of things that you do. And -- and I guess the first one goes to you, Attorney General Madigan, which is, it seems to me very commonsensical that someone would pay more for a mortgage that's more valuable to them. So what's wrong with that?

MADIGAN:

Well, what was wrong with that is that, at the broker level, they were no longer looking to determine, as part of the underwriting practice, whether or not the borrower could actually afford to pay the loan.

HOLTZ-EAKIN:

So it's not so much the fact that you pay more for a mortgage that gives you greater income streams. That makes perfect sense. It's that underwriting standards again have -- had deteriorated?

MADIGAN:

Correct. So there was an incentive to put people into higher-cost, riskier loans when they were not appropriate to be in those loans because they ultimately may not be able to pay them off. And as we've seen, that was, in fact, the case.

HOLTZ-EAKIN:

OK. And can you -- I guess this would be a general request to everyone. If you have information, again, on the pervasiveness of fraud in mortgage origination that -- I think this is central to the investigation, you know, what fraction of mortgages, by value or number, were -- were affected by fraud over the period from, say, 2000 to -- to the present, getting a sense of -- of the magnitudes, I think, is -- is imperative.

SUTHERS:

I think it's essential when you ask that question to decide what you mean by fraud. I think you'll find, if you'll include deceptive advertising as fraud, you're going to have a very high percentage of the problem attributable to fraud.

If you actually get into, you know, fraudulent mortgage schemes, some of these complicated things, may not be a big percentage. But in terms of the number of borrowers that got into these things as a result of the teaser rates, as a result of not knowing what negative amortization was and all that sort of thing, I think you've got a very high percentage of the loans. We'll try to do our best job of analyzing that for you.

HOLTZ-EAKIN:

Well, I appreciate that very much. And I did want to ask you a little bit of a follow-up to the -- the issue of loan modification, because it wasn't clear from your testimony, at least to me, whether these were instances of illegal actions regarding loan modification or simply the failure to act in some way. So we're not asserting widespread fraud in loan modification?

SUTHERS:

No, Commissioner, we're not. What we're talking about is, all of a sudden pressure from all sorts of places -- the federal government, state governments, everybody, let's get into loan modification process. Our personal belief is the loan servicers were absolutely overwhelmed. They were not geared up for this. And I also believe that, despite our best efforts through foreclosure hotlines and everything like that, we have a very small percentage of all the people -- maybe it's our fault -- in terms of our ability to outreach actually trying to get into this modification process.

I'm not alleging any wrongdoing in that process. I'm just saying that our hoped -- our hoped-for situation with lots of people participating in the process, at least over -- up until recently -- and I haven't seen the latest report -- has not fared very well.

HOLTZ-EAKIN:

Thank you. Ms. Crawford, I want to go back to the auction rate securities, because that -- that was one of the really seminal moments in the financial crisis, both in its -- its sort of shocking magnitude and its duration. The market stayed frozen completely for a long time.

And I think I understand your complaint about the absence of, you know, after-the-fact action by the part of the federal-level officials. But was there something that you can identify that could have been done in advance to avoid the freezing of the auction rate securities market? Or was it going to be one of those pieces of the fallout of the crisis regardless?

CRAWFORD:

Well, one of the problems that has not been discussed is the privatization of governmental functions. And in the case of securities regulation, we do have an entity called FINRA that is a private entity that is responsible for actually looking at broker-dealer operations. And they tend to focus on the very large ones, because that's where the SEC emphasizes its regulatory authority. However, for whatever reason, FINRA failed to uncover these unsavory practices at all of the major Wall Street firms. And I think that if FINRA had done a better job -- or, better yet, if the SEC had assumed the responsibility and the accountability for looking at those firms and their practices -- perhaps we could have stemmed this early on.

HOLTZ-EAKIN:

Thank you.

Mr. Theobald, I guess the question I had for you, again, goes to these magnitude issues. The number you quoted in your testimony was that 70 percent to 80 percent of those mortgages that are in foreclosure show evidence of fraud. I think this is from the MARI folks. Does that mean the foreclosure process is fraudulent? Or does that mean that somewhere in the chain -- from origination all the way through -- there was some evidence of fraud?

THEOBALD:

What we found is that somewhere in the chain, and the number was quoted by MARI, because what they're talking about is either fraud for profit or fraud for housing.

And, again, you're talking about two different animals. Somebody might fudge the numbers to get into a property that they really can't afford. So that, in essence, is a fraud. However, it's not something that we are really going after. We're going after the fraud for profit and the criminal conspiracies that are involved in that.

HOLTZ-EAKIN:

I see. OK, thank you. That's all right now.

CHAIRMAN ANGELIDES:

Well, let me on my time ask just a follow-up to this, which is, let me understand it. The 70 percent to 80 percent number does include both the -- the -- the fraud for profit, the conspiracy for profit, as well as the fraudulent documentation?

THEOBALD:

That's correct. And -- but what's happened is the -- the fraud for property has actually hurt the market and hurt the economy, as well, because now you're looking at all the foreclosures that have occurred because of that.

CHAIRMAN ANGELIDES:

Well -- and I do want to emphasize. I think whatever data you can provide us on the pervasiveness of fraud -- and I want to direct our staff to make this a work item.

And I think one of the other things, I'd -- there's a term. I think it's controlled fraud, which is sometimes you have entities the very nature of which is, from start to finish, what they're moving into the marketplace is something that's fraudulent, non-sustainable.

I'd be interested in, particularly, I think, the non-financial institution, mortgage originators, you know, these monoline originators -- I would be interested in some stats from our staff on the extent to which there was, you know, kind of widespread failure of mortgages. That's really directed to the staffs, to look at some entities to see, were there certain entities in the marketplace the very product of which was unsustainable?

All right. Let's go to questions from commissioners.

Ms. Born?

BORN:

Thank you very much. I am concerned by your testimony relating to preemption of state law in areas of financial regulation and regulation of market participants.

During the last two days, we've been hearing testimony about weaknesses in federal regulation, for example, the failure of the Federal Reserve system to institute effective predatory lending bans, problems with the SEC's oversight of asset-backed securities, problems with the SEC's oversight of credit-rating agencies.

And now we hear that, in addition to the problems on the federal level, there's been federal action, either by Congress or by federal regulators, to prevent states from stepping in where the federal government has not been successfully regulating.

I would like to ask, for example, Attorney General Madigan what the motivation for preempting the states has been, if -- if you know?

MADIGAN:

I'm probably not the best advocate for preemption, so I don't know if I'm going to give you a satisfactory answer. Certainly, from our perspective, clearly over the last decade -- and this financial crisis has demonstrated it -- there needs to be -- and I think everybody on the panel spoke to this -- there needs to be a strong system that includes federal regulators and state regulators in large part because we are the front lines, we get those consumer complaints.

However, there are arguments that are made by the OCC and others at the federal level that -- and banks, in particular -- that they don't want to have to contend with 50 different state laws. We would counter and say, in many areas, they deal with 50 different state laws, but if there was one strong standard that the states could enforce, there wouldn't be a need for different state laws.

And so Attorney General Suthers testified to it, and it was the experience in Illinois that we went in, in Illinois, to our legislature and said, "We have to change the law to require a fiduciary duty of brokers to ensure that, you know, they are, in fact, putting borrowers into loans that they can afford to repay and that is the best possible loan for them."

However, very difficult for us at the state level to pass those laws when the brokers and -- and other lenders can look and say, "Well, if they're not doing it at the federal level, it doesn't need to be done here. There isn't a problem." So we have some real significant problems, obviously, when there is not coordination with federal regulators in the federal government.

Preemption has -- as I said in my comments -- it just paralleled with the rise in high-cost, risky loans. And in large part, we think, because there was not an ability for us to -- and limited resources at times -- to go after all of the participants, if the Feds weren't doing their job, you know, we could put our finger, you know, in the crack in the wall, but we couldn't prevent the wall from falling down eventually.

BORN:

Commissioner Crawford, would you comment?

CRAWFORD:

Yes, Commissioner Born. I think that it varies from entity to entity. For example, in the case of the OCC, I believe that it's a regulatory turf battle. I believe that the OCC wants to capture all of that space.

With regard to the SEC inside the Beltway, I think there's a little bit of fear. Sometimes fear can be a good thing; it can be a motivator. I do believe in regulatory competition to the extent that it results in better protection of our nation's investors. However, for the SEC, that is a significant problem, so Washington worries about that.

On the other hand, the regional offices that I mentioned before don't worry about it at all, seemingly. They just want to work collaboratively to get the job done. So there's a bit of politics there.

The last thing that I want to mention that is really rather insidious is that, from time to time, federal agencies do suffer from regulatory capture. And what I mean by that is they've become so close to the entities that they are sworn to regulate and there's so much moving back and forth between those entities and the regulators -- sort of a revolving door system -- that I believe that their mission gets lost in the process. And some of that has occurred at the SEC, in my view.

CHAIRMAN ANGELIDES:

All right. Commissioner Born, would you want another couple of minutes?

BORN:

I would like to be able to let Attorney General Suthers respond, if he would like to.

CHAIRMAN ANGELIDES:

Sure.

SUTHERS:

Thank you, Commissioner. I've watched the arguments about federal preemption for many years now. And typically the proponents tell Congress that subjecting our industry to 50 different state regulatory schemes will interfere with interstate commerce. And commerce -- and Congress bases that preemption on their powers over interstate commerce.

I think what's bothered me, just as we tend to have somewhat of a knee-jerk reaction to fight preemption, a lot of the lobbyists and industries that come to Congress have a very knee-jerk opposition to any kind of state regulation and seek preemption. And nobody really takes the time to decide the extent to which any state regulation would really interfere with interstate commerce, for example, keeping us out of pursuing these companies for their deceptive advertising.

At the front end of this whole thing, I think, would have been very beneficial for us to be able to not just pursue those entities we had jurisdiction over, but as -- as you know, the OCC was very, very aggressive in stopping any efforts by the states to get into some of these areas.

BORN:

Just to clarify one thing, are you suggesting that the major arguments and pressure for preemption are coming from the regulated industries, either their advocacy before Congress or their advocacy before, for example, the OCC?

SUTHERS:

I certainly am.

BORN:

Thank you.

CHAIRMAN ANGELIDES:

All right. Commissioner Wallison?

WALLISON:

Thanks very much. I've looked through your testimony, all of your testimony, and you make very strong cases that there is very substantial abusive mortgage-lending going on in your states. And that's probably true if we had 50 of your counterparts here. I do want to stress, however, that our job is to report to Congress and to the American people about what caused a worldwide financial crisis. And that's why it is so important for you, if you can, to be able to provide us with information that would allow us to assess the dimensions of the fraud problem in relation to the entire subprime-lending problem.

There are probably 26 million subprime and Alt-A loans. That's a huge number. It probably is well over a trillion dollars that we're talking about here, in terms of potential losses throughout the world financial system, so we have to, to the extent possible, get

that information. The chairman has asked our staff to look for it, and I'm sure they will, because they are skilled, and they are good investigators, and they will find this data, where it exists.

But if you have that data anywhere within your jurisdictions, that would be exceedingly helpful to us. And in particular, Ms. Crawford, I would like to ask you, in your role with the North American securities commissioners, to see what they might have

within their jurisdiction, because, of course, they cover all of North America. And if there's something in their files, if studies have been done, that might give us a sense of the dimensions of this, we'd very much appreciate it.

Now, I'd like to give you each the opportunity to tell me if there is anything you know of or anything that you think -- any place you think we should go to find this information, please tell us now. We'll be asking you -- as the chairman and others have suggested, we'll be asking you in writing for this material, so you'll have a chance to go back to your offices and think about it, but if there's anything you can think of now, it would be very helpful.

MADIGAN:

Well, let me direct the commissioners, as well as your staff, there is a GAO report that came out on July 28 of 2009 regarding the characteristics and performance of nonprime mortgages. And there's a lot of information that I think would be very useful to the commission enclosed in there.

It may not cover, however, pay-option arms, which were categorized as prime mortgages, which are the ones that are now defaulting in record numbers. And so they'll have to find additional studies, but we're happy to look for that information and provide it to you.

WALLISON:

Anyone else? OK. Let me -- I actually only have one other question, and that is for Commissioner Madigan. I think you mentioned in your statement that pay-option ARMs were part of the predatory or otherwise abusive loans that were bought by Wall Street. Is that -- is that correct?

MADIGAN:

What I reference is the fact that pay-option ARMs are the most complicated and risky loan product that we've ever seen. Often, they include -- we've been talking about low introductory teaser rates. The low introductory teaser rates on pay-option ARMs can be as low as 1 percent, but that teaser rate only lasts for 30 to 90 days, at which point the borrower then has the opportunity to pay four different ways.

Either you can make a minimum monthly payment that doesn't cover your principal and doesn't cover all of the interest. You have an option of paying what would be a 30-year amortized payment, a 15-year amortized payment. And there's one option I'm forgetting, but another one that -- that exists.

We have seen that the vast majority of people who took out these loans that were, again, originally intended only for very sophisticated investors, unfortunately, the majority of people who took out these loans didn't fall into that category, and they are treating their home mortgage loan the same way they would treat their credit card payment. So they're making only a minimum monthly payment, and the real concern about that is that, within three to four years, those loans then will be larger than the actual value of the home.

So people end up upside down. And when that happens, the borrower has to make a fully amortized payment. So it's incredible shock. I believe that, in the Countrywide complaint

that we filed, there's actually quotes from Angelo Mozilo basically indicating that he was unsure how borrowers were ever going to be able to pay these loans himself.

WALLISON:

Commissioner, an additional three minutes to finish up?

CHAIRMAN ANGELIDES:

Yes.

WALLISON:

Well, actually, that was a good answer, but I had a much more specific question...

MADIGAN:

Oh, I'm sorry.

WALLISON:

That's OK. That's OK. It's useful.

The question I had is: Were those loans sold to Wall Street?

MADIGAN:

To the best of my knowledge, they were. I'd have to look at what percentages. I think that when you look at, for instance, subprime, I can tell you that subprime loans, three-fourths of them were eventually securitized and, allegedly, the quarter that weren't probably

had different values, may have been better loans. They weren't as concerned about shedding the risk on those. I'd have to find numbers for pay-option-ARMs and prime loans.

WALLISON:

Well, my question was really this. And that is, in the normal securitization that Wall Street did, of course, they were assuming that interest was going to be paid on these loans. And one of the reasons they were paying up for subprime mortgages, as you suggested in answer to Commissioner Holtz-Eakin's question, is that they were looking for that stream of revenue to pay through these securitizations. The pay-option ARMs, any of the negative amortization loans wouldn't support that idea. So I'm just trying to find out whether, in fact, that was part of what Wall Street was buying.

MADIGAN:

Well, if you want to look at -- much of this is sort of an equity-stripping scheme. As long as -- and with many of these loans, both the pay-option-ARMs as well as the subprime Alt-A loans -- a lot of the promotion of them to borrowers was that if you do have a problem, we'll refi you. And so as long as people still had equity when they got into trouble, they were able to refi into another loan product which would then give the originators more money, more fees, and continue to feed the beast essentially.

And so I think that's another one of those situations that you would find with putting people into pay-option-ARMs. Incredibly low teaser rates, people making minimum payments, and if they got into a problem, presumably, until credit was no longer available and home values were no longer going up, they could refi.

WALLISON:

Right. Let me just respond to that, Mr. Chairman. I know my time is up.

CHAIRMAN ANGELIDES:

You actually have 43 seconds, take your time.

WALLISON:

43? Now I have 40. I'll go right at it.

The question I had really assumed what you were talking about, but when one of these loans is refinanced, it disappears from the securitized pool so that it's actually a problem for the securitizer to have these loans refinanced. They preferred loans that wouldn't refinance quickly. So that's one of the issues that we have to be looking at.

MADIGAN:

And you need to look at the securitization contracts because there were provisions in them, and I don't at all want to say I'm an expert on this. But there were provisions in terms of the representations and warranties that, in times, if there was a loan that was defaulted on, it could be swapped out for a new loan.

But you'd have to look at those individual contracts to determine what was allowed, what wasn't allowed.

WALLISON:

Thank you.

CHAIRMAN ANGELIDES:

Good. Thank you.

Mr. Hennessey?

HENNESSEY:

Thank you.

Peter, to a certain extent, stole my question, but I want to see if I can -- if I can give may version of it as well. This is both for the staff and then if you all can help us at all think about something quite close to what he was thinking about.

I look at this -- at the universe of foreclosures that we have, and there's always -- there's sort of a baseline level of foreclosures that naturally occurs in normal times and then, obviously, we clearly saw a dramatic increase and are seeing a dramatic increase in foreclosures.

I'm interested in both the components of the baseline level of foreclosures and the increase in foreclosures. And if you look at those people, I, in my simplistic way, divide them up into four groups of people. The first group are victims, people who were suckered by some bad lender, mortgage broker, someone who fooled them into taking a mortgage that they never should have taken. Right. These are people we clearly feel sorry for, especially on the back end now when their property is being foreclosed on, they're being hit in all sorts of ways.

The second are knowing but unlucky people; people who understood that they were taking a risk. They basically understood what they were doing. They wanted to get into the home. The mortgage was available to them. They knew they were taking a risk, and the economy tanked or they lost their job or whatever happened. And so they're about to lose their home.

The third are gamblers; people who were knowing and were intentionally speculating on home prices continuing to appreciate. Maybe there were more of those in certain areas of the country than others. I don't really know.

And then the fourth category are the fraudulent individuals; the people who were doing the fraud from the borrower side rather than the fraudulent behavior on the lender side. These were people who were lying in terms of the information they were providing.

I'm trying to think about it from the standpoint -- not of the universe of mortgages that were out there -- but if you look at a universe of a hundred people who are facing foreclosure, kind of what's the breakdown? Because if this is 80 percent victims, that says one very significant thing about how we should be thinking about the foreclosures. If it's 80 percent knowing people, what can you tell us about what you see and how that might influence our understanding of the relative components of the universe of people who face foreclosure? Mr. Theobald, anything? Sorry if it's too complex of a question.

THEOBALD:

That's quite all right.

HENNESSEY:

Can I add two more categories? No, just kidding.

(LAUGHTER)

CHAIRMAN ANGELIDES

It's actually a very good question. It is a very good question.

THEOBALD:

It is a very good question. And what we have seen -- the different scams that are involved with the foreclosures, folks that were knowing got into these properties knowing that they couldn't afford them in the first place. However, they fudged the numbers to get into them. Now, you put them in one of your other categories as opposed to being a fraudster.

Technically, they did commit fraud because they gave false information on their application.

HENNESSEY:

Yeah. I have that person in Category 4 where, if they're being foreclosed on, I have no sympathy for them because they lied in getting their mortgage.

THEOBALD:

Right. But what had happened is the phenomenon of the artificial increase in the property valuations. And folks got into properties and paid far too much money than what they were actually worth. And then when the bubble burst and all of those properties went down to what they were actually worth, folks are holding half a million dollar mortgages on a $200,000 property. Their best move is to go into foreclosure.

HENNESSEY:

Right.

THEOBALD:

Not to pay that half a million dollars.

Now, that's bringing us to the next wave of fraud because now they're identifying a party to sell that short sale to at the lower rate and then quit claiming the property back over. So, in essence, stealing $300,000 from the lender.

HENNESSEY:

OK. So let me just focus then in the universe of fraud that you're dealing with, to what -- what's the relative balance of fraudulent lenders -- I'm thinking of these as firms that are using these deceptive advertising practices and basically fooling borrowers versus individuals who are trying to take advantage of either other individuals or of the lenders.

THEOBALD:

Right. And there are a number of folks that are part of the industry that work in different various aspects of the mortgage industry that have been involved in this, maybe knowing

or unknowingly by the lending institution. And those people are the ones that probably caused the most damage because they were able to approve or, you know, allow those fraudulent loans to go through.

So what we have seen is it’s a myriad of folks that are involved in this, whether it's folks that are real estate agents, mortgage brokers, appraisers. Everyone involved in the process had something to do with it. Title attorneys, closing agents -- everyone that's involved in there.

HENNESSEY:

OK. But all of those people are, in my simple model, they're on the industry side.

THEOBALD:

Correct.

HENNESSEY:

It's bad behavior by people in the industry rather than a guy who wants to get into the half million-dollar house and so he fudges the numbers. He's looking to live in it. It sounds like you're saying that universe of individuals who are lying to get into homes is a small proportion of the total amount of fraud. Is that...

THEOBALD:

Commissioner, that is...

HENNESSEY:

One minute. That's all I need.

THEOBALD:

That is actually a significant portion because of the market and what had happened to the market. As the market went -- artificially inflated where folks couldn't even afford to live in Florida anymore due to the increase in taxes, due to the increase in insurance.

So they had to fudge the numbers in order to get a mortgage to be able to get that property.

HENNESSEY:

All right, to repeat it back to make sure I understand it, in Florida, in particular, there were, in fact, a significant number of individuals who were not affiliated with the -- with this industry who were in a position that they felt they had to behave fraudulently, because it was the only way they could get into a -- into a home?

THEOBALD:

Exactly. There was -- there was nothing else that increased the valuation of the properties. We didn't have an increase in industry, jobs, high-paying jobs, salaries that went up. It's just that the speculation on the properties and the condominiums and single-family homes went up and -- and to a point where folks could not afford to live, so they have to do something in order to get into a property. And that's where you saw the option ARMs and the sub primes and everything else. And the numbers...

HENNESSEY:

So the housing price bubble encouraged bad behavior by some people who wanted to own homes?

THEOBALD:

Right, it exacerbated it. It exacerbated the problem.

HENNESSEY:

That's surprising. Thanks.

CHAIRMAN ANGELIDES:

Mr. Thompson?

THOMPSON:

Thank you, Mr. Commissioner. I think you all brought some texture and color to the shape and nature of the problem, not just in 2006 and 2007, but the problem that lives today, lives on in our communities around this country.

You also represent what we all know of as first responders. And in many respects, we think of first responders as firefighters and policemen and what have you. But in fact, in this particular fight, you are the first responders for -- for us.

I'm struck by the preemption problem, because I think it represents a real conundrum for us, because here we sit in a time when, quite frankly, funding for state and local governments is under enormous, enormous stress.

And so even if we were to say, yes, let's clear away the conflicts and perhaps put more authority back into the states, how are we assured that there will, in fact, be funding to support what has become a massive, massive national crime problem, not just a problem in Illinois or a problem in Colorado?

So I guess what I'd like for you to describe for me is, what are the conditions under which we can have a more cooperative relationship between state and local government and the federal regulators that you interact with, recognizing that there's not going to be infinite funding, there's not going to be, perhaps, significant changes in law that would shift these

things about, but we've got to fix what appears to be a broken interaction between the states and the federal regulatory process?

So, General Madigan, we start with you.

MADIGAN:

Commissioner, I appreciate the question. And -- and one of the things that has occurred, I would say, during this past year has been an increase in the level of cooperation, in particular, with the federal government and state attorneys general.

And so a number of meetings have been had at Treasury to discuss some of these very issues, as well as what General Suthers talked about, which is the concern we have about the mortgage foreclosure rescue fraud. And as we speak, there are a number of task force working groups that have been put together to contend with mortgage fraud in a whole series of different areas, whether it is the origination end or if it's the back end or if it looks at discrimination.

And so we have been working with Attorney General Holder. We have been working with Secretary Geithner. We have been working with the HUD secretary, as well, when we look at the modification programs and how they are working or need to be improved.

We have been working with the FTC, which is a longstanding relationship, but one that I think has been invigorated over the past year, to look at a lot of the fraud that's taken place.

And so that is -- from what I have been told -- I've been A.G. for seven years. My counterpart in Iowa has been the attorney general for upwards of 28 years. And what he has said is that it is unprecedented to have this type of dialogue, this type of relationship with federal regulators.

And so, again, we're heartened, I think, by the change, but obviously, as proposals are made to Congress about what do we do to prevent this crisis from happening in the future, we know that right now, certainly in terms of putting in place a Consumer Financial Protection Agency, a large part of the argument is whether or not state-level enforcement will not just remain, but actually be expanded to where we believe it should be, in part recognition for the work we've done and in part for recognition that the resources are limited, and more cops on the beat, hopefully, should deal with these problems.

THOMPSON:

Commissioner Crawford, can I hear from you?

CRAWFORD:

Yes, sir. Commissioner, I think that you've raised a very important question. And right now, there is a higher level of cooperation, because there's a great deal of fear. This is a huge, huge problem, and it's beyond the ability of either the federal regulators operating alone or the state regulators operating alone to address.

So the fear factor has caused for greater communication and collaboration. The problem is going to be, on a going-forward basis, where perhaps the fear level is not quite as high, how do you ensure that there are mechanisms in place that won't allow for this same sort of situation to develop?

And I think that the systemic risk council holds out great opportunities for us in that regard. As long as we have both federal and state regulators represented on that council, and it's written into law and it's mandated that those folks speak to each other and that we work together going forward, I think that we lessen the probability of a major systemic crisis.

THOMPSON:

OK, thank you very much.

CHAIRMAN ANGELIDES:

Would you like more time?

THOMPSON:

No, that's fine.

CHAIRMAN ANGELIDES:

All right.

Mr. Georgiou?

GEORGIOU:

Isn't it -- isn't it the case that the push for extensive securitization of these mortgages enabled, in a certain sense, the proliferation of mortgages that -- some of which were motivated by fraud and others of which simply never looked to be able to be paid back?

And let -- let me try and be a little bit more precise, if I can. Once you buy a whole pool of mortgages and you securitize them, everybody involved in that process gets paid when the security is sold, the lawyers who write the prospectuses, the auditors who audit the financials, the -- the underwriting investment bank, the -- the ratings agencies that -- that issue them.

And none of those parties retain the risk that ultimately the failure of the underlying mortgages will -- will imperil the securities themselves. That risk falls exclusively on the

purchasers who are customarily pension funds and other investment vehicles that have accumulated the potential retirement benefits of others.

So I guess my -- my -- my question really is -- is, when you talk about the option-pay ARMs and, you know, these pick-your-payment -- we call them pick-your-payment -- mortgages, at the end of the day, who, if anybody, has undertaken responsibility to pick up the pieces of those lost -- those lost opportunities?

And once they're purchased, I don't really know even what the assumptions are made as to what the amount of interest that'll be generated by those particular loans, what assumptions are necessarily made in the securities. You know, will they pay 1 percent? Will they only pay 1 percent for three months? Well, then they move to 12 percent. I just don't know the answer.

And could you speak to what the accountability question -- how the ultimate accountability question may have motivated the underlying fraud?

MADIGAN:

Commissioner, I think that you do a very good job of really explaining the problem. And so, at the end of the day, the people who had the risk were on the very front end, the borrower, and on the very back end, the investor.

All the other market participants were paid along the way, and they didn't hold on to any of that risk, and so the previous panel, there was some conversation about risk retention. And on Capitol Hill, there has been conversation about requiring a certain amount of risk retention such that you don't incentivize this lack of underwriting standards and you don't incentivize just kind of volume sales so as making money along the way, when ultimately you don't bear any responsibility if that is going to be a sound loan that is ultimately able to be paid on.

So what we have seen is that that's the breakdown, right? The securitization process allowed everybody along the chain to make money and none of them to have to deal with the consequences of the risk, except, as I mentioned, on the front end and the back end.

SUTHERS:

Commissioner, when Commissioner Hennessey gave his breakdown of categories of victim, knowing but unlucky, that's exactly what occurred to me. I do think there's a large knowing but unlucky category here, people who knew what they were getting into, but still shouldn't have been getting into it, and no one had the incentive to keep them out of it.

I really do believe that, that this is a big part of the problem, which goes to exactly what -- what you're describing, the lack of risk for the people who are putting them at -- putting them in this.

GEORGIOU:

Commissioner Crawford?

CRAWFORD:

I think that you've done a superb job in articulating the nature of the problem. And the thing that's very disturbing is that almost any product can be securitized, so it's very possible that down the road, or even as we speak, the great minds of Wall Street are figuring out new products that could be securitized in a similar fashion. So as long as we have a situation where you can offload 100 percent of your risk at each stage, we face the possibility of another financial meltdown. So this is a serious problem, and it does to be -- it does need to be addressed.

GEORGIOU:

I don't -- yes, I...

CHAIRMAN ANGELIDES:

More time?

GEORGIOU:

Just very, very briefly.

CHAIRMAN ANGELIDES:

Well -- well, then take two more minutes.

GEORGIOU:

Thank you.

I mean, just -- I just want to say that -- that, you know, I appreciate your commending me for my questions, and I guess I would return the compliment in that I know that the National Association of Attorneys General, with whom I've worked extensively, and the North American Securities Administrators Association are on top of this and a whole variety of other things.

And I guess I would remind all of us as commissioners how important it is to empower the front line and the local officials. I don't mean to not include you, Mr. Theobald, but to empower people who actually are the closest to the problems, because you are the early warning systems, in many respects, for these issues, which ultimately may come to federal attention at some point.

But abuses are more quickly identified to you, and that problems are brought to you at the local and state levels and in securities and attorneys general and law enforcement authorities. And I guess I think that we -- you know, we need to examine the extent to

which we've, you know, we've reduced the authority of the locals to the point where we -- we create a greater systemic risk as a result.

Thank you, Mr. Commissioner.

CHAIRMAN ANGELIDES:

Thank you.

Ms. Murren?

MURREN:

Thank you, Mr. Chairman.

I have a question for Commissioner Crawford. If you could talk a little bit about whether you believe that there were any specific actions that might have been taken over the course of the last several years, that would lead diminishment in what you characterize as being regulatory capture.

CRAWFORD:

Yes, I do. I think that it's a problem that when you go to work for federal agencies, particularly the SEC, there are no revolving door prohibitions whatsoever. And if you work for the SEC, you can immediately leave and go represent Wall Street firms, work on Wall Street. And what I think that that does is it tends to have a chilling effect on the zeal with which you regulate those people across the table from you.

In addition, I think that there are some -- some systemic issues that need to be looked at by all the federal regulatory agencies. One of the problems with Washington, and you hear this over and over again, is that they're too removed from what's actually happening on a day-to-day basis. And it makes a big difference if you're a regulator and somebody literally walks in off the street and sits down and gives you their documents and says, "I think I've been defrauded." You have to deal with them.

That doesn't happen as often in Washington, D.C., because people don't ordinarily get on a plane and fly to Washington and lay out their problems before representatives of federal agencies.

Now, that's probably always the way it's going to be, but I think a recognition of that fact is so important in terms of trying to keep financial meltdowns from occurring in the future. And that's why I really do hold out great hope that the systemic risk council will enable local first responders to interact with their federal counterparts in a way that creates a sense of urgency and humanizes issues that we all need to be addressing.

MURREN:

Thank you.

Attorney General Madigan, you had mentioned in your testimony that it is your belief that consumers require and need to have more protection. And certainly, I think all of you have described a lot of reasons why that's the case. But do you believe that if we were to fully maximize the effectiveness of the regulators that we currently have, that that would give consumers the protections that they need? Or do you feel like we need to do something different?

MADIGAN:

Excuse me. I think that the current proposals that are being talked about in Congress are -- are very important. I also -- the other panel earlier today had different views on what the model should be. Should it be one consolidated regulator? Should it be a panel of people who work together?

The concern that I think we as state attorneys general, who are really the front lines of enforcing consumer protection laws in our states, have is that there has to be somebody whose primary or sole responsibility is consumer protection, because we have seen that when that is not a component, we've seen what happens.

And we have a -- a flood of foreclosures across this country. And so it depends what the ultimate structure is going to be, whether or not it would be sufficient. I think at this point it is safe to say that there is no federal regulator who was involved, whose primary responsibility was consumer protection -- OCC, OTS, Federal Reserve. All of them could do work on consumer protection, but that is not their primary or sole responsibility. So there has to be consideration not just given, but responsibility given and -- and prioritization of consumer protection. So we'll see how that plays itself out.

MURREN:

Thank you.

And just one remaining question.

Mr. Theobald...

CHAIRMAN ANGELIDES:

Take -- take a couple of minutes.

MURREN:

... could you talk a little bit about perhaps anything that is lingering that you might be seeing, since you are on the front line. You've obviously done a terrific job of being able to pull together your task force for mortgage fraud, and all of you have identified the fact that there were some early warning signs about the -- the problems inherent in that.

I'm wondering if there's anything that you're seeing today that continues to concern you as we look at our financial system going forward.

THEOBALD:

Actually, there -- there are a lot of concerns. And one of the most particular concerns is the state and local folks working with our federal partners. Pushing the work down to the

state and locals is the only way that we're really going to get on top of this mortgage fraud.

There's far too many cases to handle for the FBI or HUD inspector general themselves. They have to push this down. And in order for us to move forward, we need training for local law enforcement. We need to do these things. And we are accomplishing that through the Department of Justice and the Bureau of Justice Assistance by pushing down the training.

But as far as trends that we're seeing right now, we're seeing a lot of loan modification fraud. And that is coming from businesses that are opening up shop, and these are people that are behind on their mortgages, and they can ill afford to pay $1,500 or $2,000 to hire someone to help them modify their loan, and all they're doing is taking that money and -- and doing nothing.

So that's the next wave that we're seeing, these short sale frauds, which I described before, as far as folks that got into their property back when they paid too much for the property and now are trying to unload it at a short sale price, but then sign it over and quick claim it over to a friend or a relative and then have it back again.

MURREN:

Great. Thank you.

CHAIRMAN ANGELIDES:

Senator Graham?

GRAHAM:

Thank you very much.

Ms. Crawford, a couple of questions. First, your organization starts out North American Securities. Does that indicate that Canada is also part of your association?

CRAWFORD:

Yes, sir, it does. All the Canadian provinces and territories, Mexico, Guam, Puerto Rico and the Virgin Islands our members of NASAA.

GRAHAM:

Among the economies of the world, the Canadians are stated to have been one of the least affected by the financial crisis. Has that all -- have they done anything in this particular area of mitigating housing fraud that may have some lessons for the United States?

CRAWFORD:

I think there are a number of lessons from the Canadian experience, and this commission may want to even explore that. Of course, they have had problems in Canada, but not nearly as severe as what we've had in the United States. And I don't consider myself an expert with regard to their regulatory regime, how they do things in Canada, but it might be worthy of exploration.

GRAHAM:

I'd like to ask if you would -- if it wouldn't overburden you -- if you could develop some lessons that we might learn from our neighbors to the north.

CRAWFORD:

Absolutely. Yes, sir.

GRAHAM:

Let me ask a second question, which I asked of the earlier panel. Back in 1995, Congress passed legislation on litigation relative to the securities industry, which was intended to raise the bar, make it more difficult for a private litigant to bring a case of securities fraud.

In your written testimony, you allude to this. What's been the effect now, some 15 years later, of this legislation? And would you have any thoughts as to whether it should be modified, repealed, or otherwise changed?

CRAWFORD:

I am thrilled that you asked me that question, because we have very strong opinions on that. It's impossible for regulators, either federal or state, to address every single fraud.

Private enforcement of the securities laws is absolutely essential, and it's pretty clear that the legislation that you refer to has had such an overwhelming chilling effect on the ability of people to bring really good cases, but they're -- they're stymied because of their requirements to get into the courthouse. That is detrimental to all of us. We can't be there all the time. Taxpayers cannot fund every effort to bring about justice. And these cases are mightily important, and I'm hoping that this will be revisited by Congress.

GRAHAM:

Mr. Theobald, as someone who was born in and still lives in Miami-Dade County, I was particularly interested in -- in your commentary and -- and would look forward to discussing this with you privately further.

The legislation that was passed states that the -- those -- a person -- law enforcement official who comes into contact with some fraudulent activity is to report that to the county property appraiser's office. Do you know how many cases of fraud were, in fact, reported to the county property appraiser's office?

THEOBALD:

Yes, senator. And -- and if I could for a second -- and I don't know if you remember -- about 16 years ago, you were doing jump-outs with me in one of the roughest neighborhoods in Miami-Dade, and this is a lot more...

GRAHAM:

Thank you for covering my back...

(CROSSTALK)

THEOBALD:

Yes, sir. But so far to date, we've delivered over 100 cases to our property appraiser's office. And the significance of that is, with the fraud that occurs in neighborhoods, the -- the fraudsters were having to have two comparables in a particular neighborhood. And those two comparables raise the valuation of the properties in that entire grid that the property appraiser uses.

So all the other folks that were not involved in the fraud, their taxes went up, because their homes were artificially inflated by the fraudsters, and especially in condominiums in Miami-Dade County -- and you know better than anyone, down in the -- in the corridor just south of the city of Miami, in the Brickell Avenue corridor -- there are 25 percent, 30 percent foreclosures and buildings in that neighborhood, and attributed from these fraudsters.

GRAHAM:

This is to all the panel. Many of the people who are involved in these activities are licensed professionals, realtors. In most states, mortgage brokers are required to have a state license, et cetera. How effective have the professional regulatory agencies been in effectively prosecuting cases of license removal or other form of sanction against these professionals?

THEOBALD:

In Florida, the statute was on the books to have these hearings. However, the -- the personnel that is assigned to these regulatory agencies is very minimal at best, and they don't have the resources or the personnel to do it.

However, since the heightened awareness and the mortgage fraud crisis that we've had in the state of Florida, the increase in the licensure removals and suspensions has increased, because we are now constantly communicating with those agencies, and they

are having these hearings now to pull folks' licenses and, again, prevent them from victimizing other people.

SUTHERS:

Senator, we were one of the states that until recently did not license mortgage brokers. And interestingly enough, when the Department of Regulatory Agencies looked around the country, foreclosure rates and other problems associated where there was full licensing and in our state, where there wasn't, there wasn't a whole lot of difference.

But one of the things that we have noticed is that there's an amazing number of felons who are now unable to get -- at least when people were applying for mortgage licenses -- were being disqualified as a result of having criminal records. So at least there was a subset of this group that actually had criminal records and is -- is now being excluded.

I will tell you that, since this occurred, this collapse, one of the things that's gone on in Colorado is an incredible increase in the scrutiny of appraisers. We have greatly tightened our laws. And as a result of a problem with what -- with the fraudulent appraisal of conservation easements, we are now suspending high numbers of appraisers in Colorado.

GRAHAM:

Thank you, Mr. Chairman.

HOLTZ-EAKIN:

If I could take the last little bit of my time, I just want to go back to that last question and make I understand it. A characterization often given of the -- the mortgage crisis is that it occurred in certain states, the California, Nevada, Arizona, Florida, bubble states, and that it was the state-specific licensing and oversight of the mortgage brokers that has -- that is the -- should be the focus of attention, that it -- that really wasn't anything to do with federal policy or the -- it was the states.

And so what I want to be real clear about is the licensing clearly was within the state's domain, but were there preemptions from either the '96 law or the -- the comptroller of the currency 2004 action that -- that inhibited your ability to prosecute and generally oversee mortgage brokers' conduct in your states?

MADIGAN:

In terms -- let me do two things. Let me give you some statistics and then let me also respond maybe more directly, because we obviously hear this all the time, the contention from Chairman Dugan at the OCC, that this wasn't a problem with the national banks.

And, in fact, national banks funded 21 -- or of the 25 largest subprime issuers that were doing business in the lead-up to the crisis, and it was national banks and federal thrifts and other of their subsidiaries that were responsible for almost 32 percent of subprime mortgage loans, 41 percent of the Alt-A loans, and 51 percent of the pay-option and interest-only ARMs that were sold, and that's for 2006. And I believe that information comes from -- I'll find where it comes from for you.

And so it's been recognized that, yes, some states have very few resources. And so while enforcement actions are taking place, again, they're a drop in the bucket in terms of the entire problem, but that doesn't mean that enforcement actions weren't taking place.

And when I look across the country, we see that enforcement actions were taking place against every single participant in the chain, that this was taking place at a state level and, again, not being supported by the federal regulators and, in fact, oftentimes being challenged by.

And so to the extent that this problem existed and -- and was funded by national banks and thrifts, and then just went down the chain, very hard for states to go after that problem when, arguably, we had to decide, are we going to spend our limited resources on fighting a preemption battle or are we going to go after the lenders that are operating in our state?

CRAWFORD:

I would agree with the -- with General Madigan.

HOLTZ-EAKIN:

Great. Thank you.

CHAIRMAN ANGELIDES:

I want to ask a follow-up, though, on the percentage. You said 32 percent of the subprime loans -- is that a national figure?

MADIGAN:

I believe that is a national figure.

CHAIRMAN ANGELIDES:

And that was 32 percent of the subprime loans were originated by -- say it again?

MADIGAN:

National banks, federal thrifts, or their subsidiaries.

CHAIRMAN ANGELIDES:

All right. So the balance, the other 68 percent...

MADIGAN:

Non-depository lenders, most likely.

CHAIRMAN ANGELIDES:

Non-depository lenders.

MADIGAN:

That had state charters.

CHAIRMAN ANGELIDES:

OK.

GRAHAM:

Mr. Chairman, can I...

CHAIRMAN ANGELIDES:

Yes. And then -- yes -- yes, absolutely. We've got eight minutes and 38, seven seconds. Let's use it all up. No.

GRAHAM:

Another follow-up question. When you encountered these cases involving federal institutions and where preemption was -- was lodged, did you hand the file over to the

federal agency that was asserting preemption? And if so, what action did the federal agencies take with those files?

MADIGAN:

What I can tell you again is that when -- these cases initially tend to come to states the way it was described in Texas. So every year we take in -- the Illinois attorney general's office -- approximately 30,000 consumer fraud complaints, a whole variety of them. A subsection of them are going to be related to consumer debt.

So when somebody comes to us with their stack of mortgage documents and we review those and then we start to see patterns, that's when we start our investigations. And so, what we do is make a determination is this somebody, is this, you know, an organization that we have the legal authority to do something about. When we do, those tend to be the ones that we decided to pursue versus the ones where arguably we were preempted.

Yes, there are times when that information has been given to federal regulators across the country. And we can probably work to try to get you examples of that and report that back to the commission because I think it would be valuable for you to have.

GRAHAM:

And particularly, what did the federal agencies do when they were so alerted?

MADIGAN:

Well, we can include that. I can tell you that in -- in one report I have read that between, I believe it is, 1995 to 2007, I believe it's the OCC initiated 13 consumer protection actions publicly, 13 over that time period.

GRAHAM:

As a -- editorially, it seems to me, that the corollary of preemption is the assumption of responsibility. It's not just to abdicate to the bad people and give them a free firing range to operate upon. And it'd be interesting -- what was the response of the federal agencies when they were given the opportunity to carry out the other side of preemption, which is responsibility.

HOLTZ-EAKIN:

Commissioner Wallison, an additional two minutes?

WALLISON:

I don't know that I need two minutes. But I just wanted to clarify something, if I understood it. You said that 68 percent of the mortgage fraud was -- or subprime lending or Alt-A lending came up through non...

CHAIRMAN ANGELIDES:

Subprime lending, correct?

WALLISON:

Was it subprime lending?

CHAIRMAN ANGELIDES:

Yes, I think it was 68 percent of subprime lending was -- well, 32 percent was national banks and thrifts, which means 68 percent would have been other.

WALLISON:

OK. So for the 68 percent you do have authority, it was the -- the preemption occurred as to the 32 percent. There's no -- there -- let me just check to make sure that everyone at the -- on the panel here has jurisdiction over non-preempted organizations such as mortgage brokers non-bank, non-federally regulated bank institutions. Is that -- is that correct?

CRAWFORD:

I actually do not have that authority over that particular group because we are restricted to securities. But I can tell you in my state there isn't an entity that does.

WALLISON:

OK. So there is -- at least in your states, mortgage brokers are regulated? Yes, Attorney General?

MADIGAN:

Commissioner, and those are the entities that we went after as state attorneys general. We went after the largest of the subprime lenders. So at the time we were investigating Household, Ameriquest, Countrywide, they were the largest subprime lenders in this country. And we directed our resources toward them.

What's also interesting to note is that when we started doing these investigations, particularly out of Illinois with Countrywide, almost immediately they changed their originations. They were no longer originated under their state charter and moved to find the protection under the federal charter. And so, there are very few, if any, state chartered entities left out there doing mortgage originations.

WALLISON:

Thank you.

CHAIRMAN ANGELIDES:

I just have a couple of wrap-up questions.

You mentioned in your testimony, Commissioner Crawford, the National Securities Market Improvement Act of 1996. They always have such nice names -- Commodities Future Modernization Act. But you talk about how some of the authority with -- oversight authority over the rating agencies were pulled away from states, no longer registered investment advisers. Was there any practical affect to that? I mean, pre and post, was there a different real level of scrutiny in terms of rating agencies? Were states bringing actions or...

CRAWFORD:

Quite honestly, no.

CHAIRMAN ANGELIDES:

OK.

CRAWFORD:

But if you remember back in 1996, it was just before things started going downhill in terms of there being very obvious conflicts being pointed out. People were becoming generally aware that it was an inherent conflict to pay for your rating. And I won't say what we would have done had we had the chance, but the fact that there was no backstop there in the states is not a good thing.

CHAIRMAN ANGELIDES:

So maybe the only observation is no backstop versus practical or measurable affect.

CRAWFORD:

I think that's fair.

CHAIRMAN ANGELIDES:

Attorney General Madigan, I want to just clarify one more time. When you were talking about more payment for the riskier loans, I can understand obviously maybe the desire to have, quote, unquote, "higher paying loans." As it turns out, they weren't. You know, I mean, they turned out not to be at the end of the day.

MADIGAN:

Right.

CHAIRMAN ANGELIDES:

But were you also saying that mortgage brokers -- the fees paid to mortgage brokers, that that was the rate sheet you were talking about? So if I'm a mortgage broker, the non-depository financial institution's telling me if you originate A, B and C here, you get paid more. We're incenting you because this is the stuff we want.

MADIGAN:

Exactly.

CHAIRMAN ANGELIDES:

OK. But that doesn't necessarily apply to the no-doc loans?

MADIGAN:

No, that -- no doc -- essentially you're looking at somebody who probably has good credit. You as the borrower will end up paying slightly more because there's no documentation. So they finance you at a higher rate. So...

CHAIRMAN ANGELIDES:

No, that's...

MADIGAN:

... ultimately, yes, you as the broker will get paid more if you're in one of these no-doc loans.

CHAIRMAN ANGELIDES:

Because there's -- there's the compensation for the no doc? All right. Which is -- yes. I won't observe on the fact that it wasn't to cover the additional cost of no documentation. All right.

CHAIRMAN ANGELIDES:

And then -- I don't know if the commissioners have any other questions.

Do you have -- I have one last one. I guess I have an observation, which is as much for the commission as for all of you -- is that sitting here today one of the things that strikes me -- and it's actually been striking me more as I've -- as I myself learned about the FBI warning in 2004 is one of the things, I think, that as a commission we look at is as we look at the causes, to also look at the early warning signs that were out there. I mean, we know that there were many in many places. But I do think you've been very helpful in that respect today.

Witnesses, thank you very much for coming all the way here. Thank you for your time, your testimony. It was extraordinarily valuable.

And with that, the public hearing of the Financial Crisis Inquiry Commission is adjourned. Thank you all very much.

END