BETTER MARKETS

15th Anniversary Lehman Collapse Conference

Wednesday, September 13, 2023, 9:30am – 5pm

KEYNOTE: Too-Big-To-Fail from a Financial Consumer's Point of View

Dennis Kelleher, Better Markets

Now it's my honor to introduce the Consumer Financial Protection Bureau Director Rohit Chopra. He was confirmed by the Senate on September 30, 2021, almost exactly two years ago. As Director, he also serves as a member of the Financial Stability Oversight Council, FSOC, and as a member of the FDIC board. As a result, he has a 360-degree view of all the key consumer banking and financial stability issues facing the country. Uniquely, his purview is not siloed by the type of form or financial institution or activity. It spans banks and non-banks alike. His job is to protect financial consumers regardless of where threats, dangerous or illegal conduct come from. Prior to becoming the CFPB Director, he served as the Commissioner of the Federal Trade Commission or FTC for almost three years, where among other things, he focused on repeat offenders, protecting small businesses and promoting competition. And before that, he was an Assistant Director at the CFPB, where he worked to actually stand up the Bureau during its first five years from about 2010 to 2015. And he served as the agency's student loan ombudsman. Few people have arrived at their job with as much experience or better prepared than Director Chopra, and the result has been that I doubt anybody has accomplished as much in two years, as he has with the fantastic team he has put together. Director Chopra is going to discuss Too Big To Fail from a financial consumer protection point of view, then we're going to ask them a few questions. And now I'd like to welcome Director Chopra.

CFPB Director Rohit Chopra

Fifteen years ago, in mid-September, Lehman Brothers collapsed, and the financial system crashed. Troubles in the United States mortgage market infected the entire globe, and American families and businesses lost trillions of dollars and experienced an incalculable level of pain. The story is not just one of an out-of-control financial industry, but it is also a story about a series of the worst failures by regulators in modern history.

This anniversary is not a celebration, but a moment to reflect. In my remarks today, I want to first dive a bit deeper into the collapse of Lehman Brothers. I then want to share a few details on post-crisis reforms, including the establishment of the Consumer Financial Protection Bureau, and how consumer protection is more than its name suggests – it is, in fact, a pillar of ensuring stability in the entire financial system. I will highlight that fact by discussing how the consumer protection reforms now in place may have been able to prevent much of what tipped the globe into the Great Recession. I'll then move into some unfinished business from the post-crisis reforms. I will conclude by discussing an impending threat, including the upcoming Supreme Court case involving the CFPB.

The views I express today reflect the views of the CFPB, and do not necessarily reflect those of any other part of the Federal Reserve System.

The story of Lehman Brothers often sounds complicated, but at its core, it's a story about one of the financial products that literally is closest to home: residential mortgages.

For a long time, Lehman Brothers, like other Wall Street firms, had a profitable business in buying up mortgages and reselling them on the secondary market. In 1997, the company became one of the first Wall Street firms to move from just buying and selling mortgages to originating them. And they moved into the subprime origination market with their purchase of BNC Mortgage – a nonbank lender – in 2000.

Lehman Brothers blew up in spectacular fashion for many reasons, but I'll highlight a few of them. First, it relied heavily on short-term, often overnight, funding that looked a lot like the deposits that banks fund themselves with. But these deposits did not have insurance, access to the Federal Reserve's Fed-to-bank lending system, nor the safeguards that come with being a chartered bank. Instead, Lehman Brothers operated like this – imagine taking a mortgage out on your house every morning, with the expectation you would pay it off by midnight – every single day. That's what Lehman Brothers was doing to stay afloat.

Second, the firm relied excessively on borrowed money and didn't have enough of its own skin in the game. In November 2007, for every $1 of its own money available to absorb losses, it had borrowed $30.

Finally, it originated, packaged, distributed, and held high-risk subprime mortgages that inevitably nose-dived in value.

Within Lehman Brother's origination business, there was little concern given to homeowners' ability to repay, no concern given to the day those homeowners could no longer meet monthly payments, and little concern given to the pensioners and retirees who had been led to believe had their money safely invested in securitized and bundled mortgages.

As one of Lehman Brothers's own lawyers put it, we simply "expected the Fed to save Lehman."[1] And as Lehman Brothers' CEO, at the time of the collapse, Dick Fuld, said, "Until the day they put me in the ground, I will wonder" why the federal government didn't bail us out.[2] Under such a belief system, there was no need to seriously worry about risk management nor to take the "voluntary regulation" system that existed at the time.[3]

The bankruptcy of Lehman Brothers marked a watershed moment in the 2008 financial crisis, as public confidence evaporated, markets plunged, and other firms fell like dominos.

One key lesson learned from the crisis was how consumer protection is foundational for the stability of the financial system. It is safe to say that it was the failure of consumer protection safeguards that led to the collapse of the U.S. financial system and global economy.

It was that lack of a consumer protection focus that enabled Wall Street's shadow firms, banks, and independent lenders to undermine the mortgage system. Consumer abuses played a starring role, and there was no agency truly accountable for it.

Lenders were able to approve mortgages for families that they either knew could not repay or they could just take mortgage brokers' word that homeowners could repay. Those actions are the base of the 2008 crisis.

From there, financial institutions were able to make, buy, and sell mortgage securities they never examined for quality or ability to repay. Oftentimes they knew they were trading in junk securities, but they knew investors would just blindly listen to credit rating agencies that also were not concerned about actual calculations of risk.

It can be easy to fall into the trap of thinking the Consumer Financial Protection Bureau only matters for the family that could lose their home or the person getting their car repossessed or the student taking out a loan to finance their education. However, the consumer financial protection laws enforced by the CFPB serve as catalysts for long-term economic growth, and defend against the buildup of systemic risk – just like the buildup of risky subprime loans.

That's why the CFPB is not just looking out for consumers, but it is ensuring that risks to consumers do not spread and infect entire markets or economies.

Back to Lehman Brothers. A Lehman Brothers of today would face the series of safeguards mandated by Congress and implemented by the CFPB. Importantly, its nonbank mortgage subsidiaries would need to operate under the exact same strengthened mortgage rules as chartered banks and credit unions.

One of those reforms was a ban on mortgages where the lender did not assess a borrower's ability to repay. The CFPB implemented a set of standards that mortgage lenders follow to stay in compliance with this prohibition. Given that some lenders used to be able to profit even when setting borrowers up to fail, this would reduce defaults in the system.

A CFPB assessment of the qualified mortgage and ability-to-repay rule found approximately 50 to 60 percent of mortgages originated between 2005 and 2007 that experienced foreclosure in the first two years after origination were mortgage loans with features that the rule would have generally eliminated, restricted, or otherwise excluded from the definition of a "qualified mortgage." In other words, most of the mortgages that comprised the basis of the 2008 crisis would never have been approved.

In addition, banks and nonbanks today that acted like Lehman Brothers would be subject to state action. Many state regulators and attorneys general had been sounding the alarm for years and years before the 2008 financial crisis, but were consistently rebuffed by the federal Office of the Comptroller of the Currency. Not only did the leadership of the OCC fail to take appropriate action at the federal level to check egregious risk-taking and predatory lending behavior, it went so far as to hit delete on state laws designed to protect families from dangerous mortgages by using its abusive preemption policy.

The Financial Crisis Inquiry Commission revealed how another federal regulator, the Office of Thrift Supervision, engaged in race-to-the-bottom regulation, marketing its lax oversight as a feature to attract more fees. This "clientele" theory of regulation didn't end well. By November 2008, the FDIC would seize three banks supervised by OTS and three other supervised banks would sell themselves to avoid failure.4

Post-mortems of the crisis also revealed how the Federal Reserve Board of Governors failed to use its own tools to stem the flow of toxic mortgages.5 It acted too little and too late.

All this was allowed to happen because consumer protection was not considered a necessary pillar of financial stability. And the results of that choice are stark: more than 2.3 million properties went into foreclosure in each year between 2008 and 2010.6 The Great Recession ended up costing every single American $70,000 in lifetime present-value income.7

Better Markets' own aggregate analysis found that four years removed from the 2008 crisis, there was an excess of 12.5 million people out of work and there were 46.2 million people in poverty – the highest number from the previous 50 years.8

Many of us know that if the CFPB existed two decades ago, the factors that led to the Great Recession would have been mitigated early on.

I have discussed how the CFPB has changed the regulatory system, but I also want to mention a couple of areas where more must be done to make those words in the statute a reality.

First, open banking and personal financial data rights. A key priority for the CFPB is to help accelerate the shift to open banking and payments in our increasingly digital world. Over time, this can help people get paid faster, access more attractive rates on deposits and loans, switch more easily, avoid intrusive surveillance, and minimize the consequences of inaccurate credit reporting. This can also create a more resilient and dynamic financial system. We will be proposing rules next month to implement a dormant authority under Section 1033 of the Consumer Financial Protection Act to advance these goals.

Second, amid yet another series of emergency bank mergers, the biggest financial institutions have only become bigger. JPMorgan Chase's acquisition of First Republic has led to significant frustration within the industry.

An important part of the financial crisis response was the 2010 amendment to the Bank Merger Act that added a new financial stability analysis to the agencies' bank merger review process. After collecting comment and assessing current practices by the agencies and the Department of Justice, it is clear that the merger review process is a double whammy of dysfunction: failing on analytical rigor and failing on process. Expect more on this front so that we can ensure merger review respects the law and is grounded in market reality.

Third, we need to ensure that the so-called "living wills" of large financial firms are not just fairy tales. After the experience with Silicon Valley, Signature, and First Republic – banks that are a fraction of the size of Wall Street giants – many experts continue to question whether the largest financial firms can go through the bankruptcy process without creating chaos in markets or requiring a string of bailouts. The experience with the government-facilitated Credit Suisse-UBS megamerger unfortunately provides even more evidence of this concern.

Fourth, too-big-to-fail shadow banks did not magically disappear after the collapse of Lehman Brothers. Yet there is not a single shadow bank today that faces the enhanced financial stability safeguards envisioned by financial reforms, which are supposed to be complementary to the stronger consumer rules put in place. The Financial Stability Oversight Council is taking initial steps to restore its credibility.

Congress did not want his body to be a book report club, but instead serve as a strong bulwark against threats to the financial system from firms and activities operating outside of the traditional banking system. The FSOC is currently reviewing comments on a proposal to reinvigorate this systemically important shadow bank designation authority.

Fifth, uninsured short-term funding instruments outside the core banking system – that look and feel like deposits – often fuel shadow banks and make them risky to consumers. The law provides the authority to place stronger protections on risky payment, clearing, and settlement activities. Regulators must carefully review whether this is an appropriate tool to address the risks posed by new forms of money, like uninsured balances on popular nonbank payment apps, coins minted by Big Tech and other firms, and other pockets of short-term funding.

And there's a whole lot more.

Right now, families are facing an uncertain future. As many of you are aware, the CFPB is facing a challenge to its constitutionality, and in a few weeks the Supreme Court will hear a case reviewing a decision from Fifth Circuit Court of Appeals.

Vacating or calling into question the CFPB's past actions and rulemaking could be destabilizing, as the agency has issued more than 200 changes to the rules, many of them required by Congress, implementing laws such as the Truth in Lending Act, the Fair Credit Reporting Act, and the Electronic Fund Transfer Act. These rules affect the way millions of people borrow and send trillions of dollars every year, and uncertainty could have real consequences.

The rules administered by the CFPB, and other financial regulators, are crucial for the stability of the financial markets and of household finances, and questions about those rules and the ability of markets to adapt to future challenges would raise significant concerns for the stability of the nation's financial system.

If the past fifteen years have taught us anything, it is that the stakes for our financial system, economy, and society are too high for consumer financial protection to recede into the background.

The recent bank failures, likewise, demonstrated that financial executives continue to place bad bets, and the public has to clean up the mess.

Consumer financial markets need enforceable bright lines, and consumers need to know there is someone looking out for them. Despite threats to the CFPB, we are going to continue doing our work, and ensuring markets work for families, consumers, and law-abiding businesses.

Thank you.

Dennis Kelleher
Great! Thank you for those remarks. Really interesting, especially spelling out how financial or consumer protection is foundational for financial stability. I think a lot of people don't really understand that. And

for talking about the reforms, the CFPB and others have put in place that strengthened consumer protection, and at the same time, financial stability.

You know, one of the things that's clear to me evidencing the change from before the CFPB to after the CFPB is the interactions with the states. And one of the signal achievements, I think that has happened is the partnership developed with the states. So, before the crash, the federal regulators stomped on the states prevented them from enforcing their own laws, and then didn't enforce the laws themselves. And yet, I find it really interesting how often you, a federal regulator, work with the states. In fact, just earlier this week, I saw that the CFPB and 41 states in the District of Columbia took action against a company called Tempoe, a leasing company that was ripping off customers when they were seeking just to finance their purchases at Sears and Kmart. And I think it's noteworthy that action, like so many others include so called red states like Texas, West Virginia, and North Dakota, as well as blue states like Massachusetts, Minnesota, in New York. And I think that highlights a sea change in the way federal consumer protection regulation works with the states. And I wondered if you would talk a little bit about your work with the states and protecting consumers and why that's important.

CFPB Director Rohit Chopra
Well, really, when it comes to state regulators, State Banking commissioners state AGs, I really see this as an all hands-on deck approach, and that no one has a monopoly on consumer protection. And let me explain to you why Dennis, it's especially important. I think some of the lessons from the financial crisis, many states did actually put into place some restrictions on the worst abuses when it came to mortgage lending. And they found themselves hearing from the Office of the Comptroller of the Currency, a regulator that was basically saying that many banks didn't have to follow that those law. Congress essentially banned that practice. And now preemption, or hitting delete on those state laws is much narrower. But the other part, Dennis, that's so important, is that states actually can enforce the Consumer Financial Protection Act. It gives them the ability to directly go to court to stop some of these abuses. So that means if the CFPB is asleep at the switch, it won't be catastrophic, because there will be others who can fill in those gaps. It also sends a message to financial firms that even if they are able to convince the CFPB, to turn a blind eye, that there will be others who may go and make sure they're held accountable.

Dennis Kelleher
Yeah, that's incredibly important, and I think overlooked the limitations that were put in the Dodd Frank Act on the Feds to use preemption to stop the states from protecting their own people. And the Secretary of State of Massachusetts Bill Galvin, just used some of those authorities in connection with the fiduciary duty. Was upheld by the Massachusetts Supreme Court and a perfect example of how you show working with the state's works, but when the Feds don't work, the states can still step in and protect their citizens.

I wanted to talk about the CFPB’s record and enforcement priorities for a minute. You know, by my count in the last three years, the Bureau has ordered almost $3 billion in redress or restitution for millions ripped off American consumers. And that's make us you know, making companies put money back into consumers, pocketbooks and wallets on top of the $2 billion in civil fines the Bureau has imposed. And you know, that's been for everything from, you know, abusive debt collection practices, fraudulent auto loans, mortgage rip off, student lending, and much more. And you know, I think it's interesting, they're not just small and fly by night operators that the CFPB is dealing with here. It's some of the biggest corporations in the country like Nissan Motors and Hyundai, as well as Bank of America Regents Bank, Wells Fargo and others. So, would you talk a little bit about the Bureau's enforcement program and its priorities, including in particular the importance of restitution, dealing with repeat offenders and holding executives accountable?

CFPB Director Rohit Chopra
Well, this is important because I think we are now at the moment where we know that there are so many billions of dollars that would otherwise not be in individual families hands. We are sending checks or getting account credits on so many different cases, but also through our other work examining those institutions that leads to redress and more.

Now, I want to spend a minute just on the issue of repeat offenders. I think a lot of Americans are getting numb to the fact that they keep hearing about the settlements, settlements, settlements with the same firm over and over and over again. And I think the recipe for addressing those repeat offenses just isn't working. So we are starting to move in different directions. And we've set up a repeat offenders unit. And you're right, we got to look at what is really some of those incentives about whether they're going to break the law, again. Growth restrictions, bans on certain business practices, and importantly, individual accountability. In some of our cases, we have named top level executives, including of some of the most well-known players in the industry. We've received some favorable court rulings on that front, but often litigation continues on and on. But I do think that we've got to identify the specific folks sometimes that call the shots and expect to see more of that on our side. I'll also say, you know, we also want a world where things don't have to go to law enforcement. That they follow the law in the first place. But of course, we know that the temptations, and the big money can often lead to breaking the law. And that's what that's what we're there for.

Dennis Kelleher
Yeah, that's great to hear. I mean, I know you're not limited to banks. But I've been saying for years that the banks and buildings don't break the law, bankers, and people do. And until bankers and people are meaningfully and personally punished, you're not going to get banks or non-banks to follow the law. And so not only is it important that individual executives and officers get punished, or repeat offenders get punished, most importantly of all, or we're just never going to get there.

I wanted to turn for a minute to Too Big to Fail. And I see Too Big to Fail in bailouts for the biggest financial firms in the US is kind of a deeply unfair and anti-competitive practice. And when those firms fail, like Lehman and the rest of them did in 2008, they don't go bankrupt, like any other company in the United States. Instead, they get bailed out by the government and taxpayers. And I see this fundamentally unfair. You know, as a director at the FDIC, you recently voted in favor of proposing a rule that, among other things, would require resolution plans for banks that are so large, that they're systemically significant. And that means that their failure could threaten the financial system and economy, which, you know, people don't realize we've got about 4700 banks in the United States, but only about 30 of them are so big that their systemically significant. But the proposal and resolution plans often called Living Wills, are supposed to enable them to be resolved in an orderly way, ideally, in bankruptcy. And you touched you mentioned this in passing earlier. But I wondered if you talk for a minute about why you think Living Wills for those handful of giant banks are so important.

CFPB Director Rohit Chopra
Well, I think you raise this, this, there is this unjust piece of this? Which is why is it that when a small firm goes down, you know, they face a lot of consequences. And frankly, when a small company in general breaks the law, I feel like federal regulators are really quick to lay the hammer on them. It just appears that there's a different set of rules for the largest ones. And we have to make sure that there really is a level competitive playing field on that. So, here's really what we're proposing. What we're proposing is that those firms, and we had a number of them just this past March that most members of the public had never heard of them before. But it led to emergency interventions to stop it from infecting the financial system. We now have a bunch of those. And so, what we want to do is to make sure that there's some plans that if they go down, is there an alternative and what are the alternatives of dealing with them, rather than just being forced to bail them out or to sell them to one of the largest Wall Street giants. Are there are ways that we can prevent their failure? And if they do fail, what is the ways to stop the catastrophe and the consequences? So, we're going through that process we've seen firsthand, six months ago, of them failing and dominoes toppling. And that's exactly what we want to stop.

Dennis Kelleher
Yeah, I see resolution plans or Living Wills as anti-bailout plans. So, let's hope with it that gets to a speedy resolution like in the rules get in place.

I know we don't have much time left. But I would really be remiss not to return to a subject that you mentioned, and that is the existential threat to the CFPB with the pending Supreme Court case. I don't think a lot of people have any understanding, of course, legal cases are complex, and the Supreme Court is difficult to understand for most people, but this is a case that may wreak havoc not just with the CFPB. But it's going to take the consumer cop the CFPB off the beat, and it may well wreak havoc in the mortgage markets in the financial markets and other parts of our economy. So, I'd like to end with asking you talk a little bit more about that, so that people have a better understanding of exactly what kind of a threat that this particular legal case poses. And it's going to happen soon. I think the arguments on October 5, and it's expected that in the months thereafter, the Supreme Court will rule.

CFPB Director Rohit Chopra
Yeah, A Payday Loan Coalition has alleged that the CFPB's funding which is the same as the Federal Reserve's funding is unconstitutional. And so, the Solicitor General is representing the CFPB in this matter. We've put forth our brief to the Supreme Court, I won't really comment in detail on the case. But, you know, we know that it's already inviting questions, especially from the mortgage industry, on what happens if all these rules that the entire housing finance system relies on, are somehow called into question. Will there be years and years of uncertainty and litigation. And Dennis, I think you're also hearing others who are saying, we've had a system Congress has designed the banking regulators, financial regulators to have independent funding, and Congress spells it out. That's happened since just around the time of the Civil War. So, what are the implications for not just the CFPB, but all of these financial regulators and the Federal Reserve Board when it comes to these types of attacks? So, we're still doing our job. We're still delivering results. But I don't think a lot of financial executives are really wondering whether this gambit to kind of tear down the CFPB is really what's good for business, or what's good for the economy.

Dennis Kelleher

Yeah, well, that's a good point. Because not only isn't it good for consumers, it's not good for business, the financial system of the economy, and you probably didn't get a chance to see it with everything you've got to do. But several of the experts earlier in the conference talked quite passionately about this case and the importance of the CFPB winning this case. Because that's not a win for the CFPB, it's a win for the American people. And they are lucky to have such an effective consumer cop on the beat. And they're lucky to have you as director. We appreciate your time. We appreciate your thoughts. Thanks for coming on. We really enjoyed it.

CFPB Director Rohit Chopra

Well, thanks so much, Dennis, and thanks to all of you as we really reflect 15 years later, and what we do to make sure something like that never happens again.