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STATEMENT OF

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on

IMPROVING FEDERAL CONSUMER PROTECTION IN FINANCIAL SERVICES

before the

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Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding ways to improve federal consumer protection in financial services. The examination by the Committee of existing federal consumer protection safeguards is timely in light of recent regulatory and judicial decisions that have preempted state consumer protection laws for federally chartered financial institutions and their non-bank subsidiaries, as well as for out-of-state branches of state chartered banks through the operation of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

In recent years, the U.S. financial system has been the source of extraordinary economic innovation. New products and processes ranging from credit cards, to internet banking, to securitization have substantially altered the choices and opportunities available to consumers. In turn, these new financial tools have helped to support generally strong and stable U.S. economic growth over the past two decades.

While the impact of innovation in the financial system has generally been positive, not all consumers have benefited. Many of these changes have been accompanied by pitfalls for the financially unwary or unsophisticated. This has resulted in financial distress for a number of consumers and has highlighted the importance of having a state and federal legal framework that provides consumers with the information and tools necessary to protect against unfair or exploitive products and practices.

My testimony will discuss some of the broad changes to the financial system and the challenges they are creating for consumers. It also will discuss the current legal tools available to regulators and how they are used to protect consumers. Finally, my testimony will discuss reforms that would improve the ability of consumer protections to keep pace with innovation in the financial marketplace.

Developments in the Financial System

Advances in technology and changes in lending organization structure have resulted in financial products that are increasingly complex and marketed through increasingly sophisticated methods. The pace and complexity of these advances heighten the potential risk for consumer harm. Consumers today often face a bewildering array of choices, especially in the credit options available to them. For example, there are seemingly unlimited types of credit cards, each with its own particular terms and conditions. Consumers now have choices beyond the traditional fixed-rate mortgage that include adjustable rate or nontraditional products that are tied to a variety of amortization schedules and arcane index rates. In many cases, it is difficult even for sophisticated consumers to fully understand the costs associated with particular credit options or to compare alternative products.

Another significant development in banking has been the increasing impact of fees on the overall cost of financial products. For example, typical credit cards now include higher and more complex fees than they did in the past. As noted in a recent study by the Government Accountability Office, "Controversy surrounds whether higher fees and other charges are commensurate with the risks that issuers face."[1] The application of over-limit fees illustrates this problem. While issuers typically do not reject cardholders' purchases during a sale authorization even if the transaction will put a cardholder over the card's credit limit, they will likely later assess the same cardholder with an over-limit fee and also may impose a higher interest rate.

Similarly, while depository institutions have paid overdrafts on a discretionary basis for many years, a substantial number of institutions now routinely provide fee-based overdraft protection programs to their customers rather than offering traditional overdraft programs, such as lines of credit or linked accounts. Fee-based overdraft protection programs typically charge customers at least \$20 - \$35 for each overdraft. Depending on the size of the overdraft and length of time for repayment, the effective annual percentage rate (APR) can exceed 1000 percent. When used to cover the occasional overdraft, these programs can be beneficial. However when used repeatedly as a source of credit, they are extremely high priced.

Although we do not have pure fee statistics available, trends in the growth of noninterest revenue[2] underscore the banking industry's increasing reliance on fee-based sources of income. Last year, insured institutions obtained 42.2 percent of their net operating revenue (net interest income plus total noninterest income) from noninterest income. Ten years ago, the share was 34.3 percent. Twenty years ago, it was 29.4

[1] U.S. Government Accountability Office (GAO), "Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," Report 06-929, October 11, 2006, p.30.
[2] In addition to fees, total noninterest income also contains gains on asset sales, as well as market-sensitive revenues such as trading gains and venture capital income.

percent. During the past 20 years, the average annual rate of growth in noninterest income for the industry has been 8.4 percent. During that same period, the average annual growth rate in net operating revenue has been 6.4 percent. The growth of fee income is not per se harmful and has helped keep banks strong in an era of narrow net interest margins. However, as noted below, fee structures are problematic if they are poorly disclosed or so complex that consumers are unable to understand them.

Another significant change in the financial system has been the increased participation by providers other than banks and thrift institutions. For example, one estimate shows that some 52 percent of subprime mortgage originations in 2005 were carried out by companies that were not subject to examinations by a federal supervisor.[3] There also has been dramatic growth in both transactions services and small denomination consumer loans outside of the banking system by firms commonly called "alternative financial services providers." These firms, which include pawn shops, rent-to-own-stores, check cashing firms, and payday lenders, tend to provide relatively high-cost financial services to people of modest means. While estimates vary, some place the transaction volume of alternative financial services providers at $250 billion annually.[4] These firms are regulated at the state level and are subject nationwide to widely varying degrees of regulation, supervision, and enforcement.

In addition, the proliferation of securitization as a funding method has moved large volumes of assets off of the balance sheets of federally-insured financial

[3] Lending Oversight: Regulators Scrutinized in Mortgage Meltdown – States, Federal Agencies Clashed on Subprimes as Market Ballooned." *The Wall Street Journal*, March 22, 2007.
[4] Brian Grow and Keith Epstein, "The Poverty Business: Inside U.S. Companies' Ambitious Drive to Extract More Profits From the Nation's Working Poor," Business Week. May 21, 2007. This article cited data from investment bank, Stephens, Inc.

institutions. Federally-insured financial institutions held only about 31 percent of 1-4 family mortgage loans outstanding as of first quarter 2007, with more than 57 percent of 1-4 family mortgage loans outstanding held by mortgage pools or other asset backed securities issuers.[5] Securitized asset pools also have become significant holders of non-mortgage consumer credit. Though their share was insignificant prior to the 1990's, pools of securitized assets held 27 percent of outstanding consumer credit at the end of 2006. The share of consumer credit outstanding held by federally-insured financial institutions peaked at about 70 percent in 1985, and steadily declined to about 44 percent by 2006. This change in the market landscape has created competitive challenges for banks and thrifts and supervisory challenges for financial regulators.

Innovation in the financial system also has been accompanied by an increase in debt loads among consumers. Over the last 20 years, the ratio of total household debt to disposable personal income has more than doubled, climbing to more than 125 percent. Much of the rise in household debt is due to mortgage obligations. Credit card lines also have been part of a trend of rising household debt in recent decades. Credit card debt grew from 2.7 percent of annual personal disposable income in 1980 to 9.2 percent in 2006. In recent years, many consumers may have been using home equity loans or cash-out mortgage refinancing to pay credit card balances. Mortgage debt grew from 66 percent of total household debt at the beginning of 1992 to 75 percent by the end of 2006. Although there is no available data showing the proportion of household debt outstanding that represents money owed to alternative financial services providers, transaction level data suggests that interest and fees paid to these firms are substantial.

[5] Flow of Funds, Federal Reserve Board of Governors.

The significant growth in debt loads for lower income consumers and for young people has been especially troubling. Many of these borrowers have accumulated debt obligations, often as a result of student loans or credit cards, that put their financial health at risk even though the economy as a whole has experienced years of positive economic growth. In addition, subprime borrowers spend nearly 37 percent of their after-tax income on mortgage payments and other costs of housing -- roughly 20 percentage points more than prime borrowers spend, and 10 percentage points more than subprime borrowers paid in 2000.[6] Data show that young adults today are more indebted than previous generations were at the same ages and appear less likely to make timely debt payments than other age groups. The average credit card debt held by young adults ages 18 to 24 and 25 to 34 grew by 22 percent and 47 percent, respectively, between 1989 and 2004.[7]

Developing Problems

As financial products and services become more varied and complex, disclosures do not always provide adequate consumer protection from confusion or abuse. In addition, increased use of fees and tiered or variable pricing by financial service providers make it more difficult for consumers to shop and compare the costs of financial products. Moreover, given that disclosures are sometimes written more to guard against liability rather than to inform, they may even do more to obscure important information

[6] Eduardo Porter and Vikas Bajaj, "Mortgage Trouble Clouds Homeownership Dream," *New York Times*, March 17, 2007.
[7] Demos, "Generation Debt: Student Loans, Credit Cards, and Their Consequences," Winter 2007.

rather than clarify it. A recent GAO Report found that credit card disclosures, "... were too complicated for many consumers to understand."[8] Features and requirements that produce frequent and excessive fees and penalties are not always apparent to borrowers.

In addition to the complexity of the underlying product, aggressive or misleading marketing can have a negative impact on the ability of borrowers to make informed credit decisions. Without complete and balanced information, consumers may not realize that they may be unlikely to afford the required monthly payments of credit products -- particularly when a loan includes an initial teaser interest rate that will expire.

While improvements in the ability of lenders to price for risk have permitted financial institutions to extend credit to borrowers who have not previously been able to access credit, such improvements also have created problems. The extension of credit to unsophisticated borrowers has created greater opportunities for abuse. These vulnerable consumers are more susceptible to sophisticated marketing that directs them to products that may not be the best for their needs -- or affordable in the long run. Risk-based pricing is not a substitute for appropriate underwriting that ensures borrowers receive products that they understand and can afford.

The growing reliance by consumers on non-bank providers also has generated problems by creating a non-level playing field between bank and non-bank providers. Many financial service providers operate outside the traditional regulated banking and financial systems, at times to the detriment of consumers.

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[8] GAO, Credit Cards: Increased Complexity in Rates and Fees, p. 6.

For example, the recent guidance issued by the federal banking agencies establishing standards for non-traditional mortgages[9] does not apply to non-bank lenders, often leaving them free to continue to make loans that are not underwritten to the fully indexed rate or with appropriate disclosures. This creates a competitive disadvantage for banks that are subject to more stringent regulation and provides less protection for consumers.

Finally, recent judicial and regulatory decisions on the preemption of state consumer protection laws have frustrated state consumer protection efforts. In addition to the preemption of state laws as they apply to national banks, state law restrictions on interest rates and fees are generally preempted for state banks to the same extent that they are for national banks. With regard to other consumer protection laws, if the particular host state's laws do not apply to the interstate branches of national banks, then they also do not apply to the interstate branches of state banks.

Many states have proven to be innovative laboratories for the development of consumer protections in recent years. They have been especially active in efforts to address predatory mortgage lending, including provisions addressing loan flipping, prepayment penalties, the fiduciary obligations of mortgage brokers, and many other areas. Yet, other states, eager to attract or retain financial service providers, have an incentive to permit such providers to operate with fewer, if any, constraints. In addition, multi-state banks wanting to avoid variations in state requirements have an incentive to

[9] See *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006).

choose a national charter, thereby preempting many state requirements. Most significantly, the general provisions governing federal preemption do not require the preempting authority or jurisdiction to substitute comparable standards. In the worst case, strong state standards may be preempted even if no alternative federal or state standards are substituted.

Current Legal Authorities, Supervision, Enforcement and Other Activities

The FDIC ensures that the institutions it supervises comply with all major federal consumer protection laws. Some of the major statutes include the following:

- The Truth in Lending Act (TILA), which ensures that credit terms for both credit card and mortgage transactions are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably;
- The Home Ownership and Equity Protection Act (HOEPA), which amended TILA to provide additional protections for mortgage lending;
- The Federal Trade Commission Act (FTC Act),which prohibits unfair and deceptive acts or practices affecting commerce;
- The Equal Credit Opportunity Act (ECOA), which prohibits discrimination in any aspect of a credit transaction; and
- The Real Estate Settlement Procedures Act (RESPA), which governs information disclosures for the home buying process.

In addition, the FDIC ensures that banks under its supervision comply with other statutes such as those related to flood insurance, privacy, fair housing, community reinvestment, credit reporting, electronic funds transfers, and disclosures for saving accounts.

While the FDIC has authority to enforce all of these laws, its rulemaking authority under them varies. For example, the FDIC has rulemaking authority with respect to the entities it supervises and many of their subsidiaries under the privacy provisions of the Gramm-Leach-Bliley-Act, although the agencies must "consult and coordinate" with one another.[10] On the other hand, under the FTC Act, the Federal Reserve Board (FRB) has sole authority to issue regulations applicable to banks regarding unfair or deceptive acts or practices, while the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) have sole authority with regard to the institutions they supervise. As discussed in more detail later, the FTC Act does not give the FDIC authority to write rules that apply to the 5200 entities it supervises -- state nonmember banks – nor does it grant that authority to the OCC for their 1700 national banks..

Activities that are harmful to consumers also can raise safety and soundness concerns. In these cases, the FDIC and other banking agencies have broad statutory authority to issue rules and guidance to address safety and soundness issues that also protect consumers. For example, the federal banking agencies recently issued interagency guidance for the safe and sound underwriting of subprime and nontraditional mortgages that directed banks to underwrite these loans to the fully indexed rate to ensure that banks are not making loans with no real prospect of repayment. This addresses an issue of poor underwriting practices by banks while also protecting borrowers from receiving loans they cannot realistically afford. Similarly, the account management guidance issued by the federal banking agencies[11] was designed to ensure credit card accounts were managed in ways that protected banks from excessive levels of default

[10] 15 USC 6804(a).
[11] See FDIC Financial Institution Letter 2-2003, "Account Management and Loss Allowance Guidance for Credit Card Lending" issued on January 8, 2003

while at the same time establishing minimum payments at levels that avoid creating a risk of negative amortization for credit card debtors.

Supervisory Activities

With a cadre of specialized compliance examiners, the FDIC regularly examines institutions to determine whether they are operating in compliance with consumer protection laws and regulations. Institutions that effectively manage their compliance responsibilities are examined less frequently than those that fail to do so. As part of this process, the FDIC reviews the degree to which an institution's board and management oversee compliance, and whether they have implemented effective policies and procedures, employee training programs, consumer complaint response programs, and audit processes. The depth of the review of compliance with specific consumer protection laws and regulations is tailored to the risk profile of the institution. As consumer protection risks increase, the focus of the FDIC's review expands. Compliance examinations also provide information regarding management's performance in addressing regulatory responsibilities, which can provide insight into safety and soundness concerns as well.

When FDIC examiners find either violations of law or other weaknesses in how institutions manage their consumer protection and compliance responsibilities, the next step is to require corrective action. Such action may require changes in the way that an institution does business as well as require restitution or reimbursement for consumers.

Moreover, the FDIC may require that an institution document its commitment to take remedial action through either informal or formal enforcement actions. Evidence of discrimination or other illegal credit practices also adversely affect the evaluation of an institution's performance under the Community Reinvestment Act.

Informal enforcement actions may include a resolution issued by the institution's board of directors or a Memorandum of Understanding (i.e., a written agreement with the FDIC). Since January 2002, the FDIC has required institutions to issue 259 board resolutions and sign 138 Memoranda of Understanding to address consumer protection issues.

In more serious situations, the FDIC takes formal enforcement actions against financial institutions and individuals. In addition to ordering compliance with consumer protection laws, these actions may seek restitution on behalf of consumers, assess civil money penalties, remove individuals from office, or prohibit individuals from participating in the affairs of any financial institution. Since January 2002, the FDIC has issued six "cease and desist" orders and 213 civil money penalties against institutions for violating consumer protection laws.

Complaint Resolution

The FDIC Consumer Response Center (CRC) provides a single point of contact for consumer complaints against institutions supervised by the FDIC. The FDIC website provides a toll-free phone number for consumer complaints, as well as an online complaint form. The table below shows the volume of complaints about FDIC-supervised banks that the CRC has received over the past five years. Approximately 40 percent of complaints received about supervised institutions involve credit cards. The top issues involved in these complaints include billing disputes and error resolution, terms and conditions, and fees and service charges.

Consumer Complaints Addressed by the FDIC, 2002 - 2006						
Complaints:	**2002**	**2003**	**2004**	**2005**	**2006**	**Total**
FDIC Supervised Banks - Total	4,008	4,057	3,950	3,618	3,831	19,464
Referred Outside the FDIC	3,809	3,770	4,473	5,059	5,604	22,715
% of Total Referred Outside the FDIC	45%	47%	51%	57%	58%	52%
Credit Cards – FDIC Supervised Banks	2,184	2,073	1,608	1,241	1,318	8,424
Credit Card Complaints as % of Total for FDIC Supervised Banks	54%	51%	41%	34%	34%	43%
Residential Real Estate Loans	235	255	279	207	245	1,221
Residential RE Loans as % of Total for FDIC Supervised Banks	6%	6%	7%	6%	6%	6%
Installment Loans	173	184	252	209	166	984
Installment Loans as % of Total for FDIC Supervised Banks	4%	5%	6%	6%	4%	5%
Other	830	895	1,077	1,139	1,211	5,152
Total	8,408	8,026	8,802	8,904	9,648	43,788

When the FDIC receives a consumer complaint, specialists evaluate the complaint, log it, and track the complaint case on an automated system to ensure appropriate follow up. The FDIC investigates each complaint with the financial institution involved and provides appropriate information to the consumer to respond to the problem.

Almost 60 percent of the complaints received by the FDIC in 2006 relate to institutions supervised by other federal and state regulators. When concerns are expressed about institutions beyond the FDIC's jurisdiction, the complaint is referred promptly and directly to the agency that has the authority to help. In an effort to further enhance the process, the FDIC is working with the other federal and state banking agencies to develop a common consumer complaint form. The form would ensure that each agency is collecting the same data in the same format and increase the effectiveness of interagency complaint communications and referrals.

In addition, consumer complaints and inquiries play an important role in the development of strong public policy. Resolving these matters helps the FDIC:

- Identify trends or problems that may affect consumer rights;
- Understand the public perception of consumer protection issues;
- Formulate policy that aids consumers; and
- Foster confidence in the banking system by educating consumers about the protection that they receive under law.

Consumer complaints also may signal management or structural deficiencies in financial institutions that are indicative of more systemic problems within an institution. For this reason, every FDIC compliance examination of a financial institution includes a review of complaints against the institution and their resolution.

Encouraging Alternatives to High Cost Small Dollar Credit

In addition to supervisory tools, the FDIC also has the power to create regulatory incentives for increased competition for underserved markets and products. One example is responsibly priced small dollar lending. Loans in small dollar amounts are in strong demand. The payday lending industry now generates more than $42 billion in loans per year.[12] Moreover, a substantial number of institutions now routinely provide fee-based overdraft protection programs to their customers.[13]

In response to this growth, the FDIC has issued guidance on both payday lending[14] and fee based overdraft protection programs,[15] two sources of small dollar lending, and is in the midst of gathering empirical data about the nature of overdraft protection programs and how they are used by customers. However, the larger issue is the lack of low cost alternatives for consumers. To address this concern, the FDIC is working closely with the industry and consumer groups to identify the best ways to expand the availability of affordable small dollar credit to customers. Over the past two

[12] See Stephens Inc., Payday Industry Report, March 27, 2007. The Stephens Inc. report also estimates that another $5.65B in payday loans were advanced by internet payday lenders.

[13] See "Banks: 'Protection' Racket," BusinessWeek Online, May 2, 2005, http://www.businessweek.com/magazine/content/05_18/b3931085_mz020.htm (30% of institutions provide overdraft protection); "Sizing NSF-Related Fees," by Bill Stoneman, *Banking Strategies*, January/February 2005 (2500 institutions, i.e., about 28%, provide overdraft protection) http://www.bai.org/bankingstrategies/2005-jan-feb/sizing/ Laura K. Thompson, "Lending Rule Won't Apply to Overdrafts," *American Banker*, May 28, 2004. (3000 institutions, i.e., about 33% provide overdraft protection) http://americanbanker.com/article.html?id=200405271P3U4RUD&from=washregu

[14] Guidelines for Payday Lending, Federal Deposit Insurance Corporation, March 2, 2005.

[15] Joint Guidance on Overdraft Protection Programs, 70 FR 9127, February 24, 2005. Among other things, the guidance explains "best practices" for marketing these programs, monitoring customer usage, and communicating with consumers about overdraft protection. The guidance encourages institutions to monitor excessive usage and offer recurrent customers more affordable products.

years, the FDIC has held two conferences to discuss both the need for such products and ways that insured institutions can meet this need and achieve positive business benefits.

Institutions offering reasonably priced small dollar credit products that meet consumer needs can receive positive consideration under the Community Reinvestment Act. Next week, the FDIC will issue final guidelines that will further explain how affordable small dollar credit can be offered in a streamlined way that benefits both borrowers and financial institutions. In addition, the FDIC Board will consider a proposal to launch a two-year small dollar lending pilot project. This proposed project will evaluate the effectiveness of business models used by up to 40 banks that currently offer small dollar loans to their customers. Working with the bank trade associations, we have initially identified 28 banks interested in participating in this proposed project and the FDIC will be recruiting others over the next several months. Consistent with our guidelines, the FDIC anticipates that loan programs selected to participate in this proposed project will include reasonable interest rates below 36 percent APR, low origination fees and repayment periods longer than a single payroll cycle. The goal of this proposed project is to assist bankers by identifying and disseminating information on the most effective ways to offer affordable small-dollar loans to consumers. Not only will a successful small-dollar loan program achieve positive outcomes for banks, it will also encourage wealth-development through savings and reduce consumers' reliance on high-cost, non-bank service providers. It is my hope that, over the next few years, responsibly priced small dollar loans will become a staple offering among our nation's banks.

Needed Reforms

I support the operation of market forces; however, regulators need to set rules for market participation. Moreover, price competition does not work if consumers do not understand the true cost of financial products. Through appropriate rulemaking, regulators can establish consumer protections against abuses that are strong and consistent across industry and regulatory lines. In addition, there should be meaningful enforcement authority and sufficient resources devoted to that authority. To achieve these goals, I would recommend that Congress consider the following reforms:

- The creation of national standards for subprime mortgage lending by all lenders which could be done by statute or through HOEPA rulemaking;
- Expand rulemaking authority to all federal banking regulators to address unfair and deceptive practices;
- Permit state Attorneys General and supervisory authorities to enforce TILA and the FTC Act against non-bank financial providers; and
- Provide funding for "Teach the Teacher" programs to provide for more financial education in the public schools.

Creating National Standards for Mortgage Lending

In light of the existing patchwork of state laws, consistency in consumer protection standards applied for mortgage loans at the federal level has the potential to raise the bar for many institutions and reduce the incentives for regulatory arbitrage. In a recent speech to the Greenlining Institute, Chuck Prince of Citigroup noted that:

> This balkanization, this patchwork of regulatory framework, . . . creates the opportunity for regulatory arbitrage, . . . people will find out how to game the system, they find out how to get the capital, get to that prize of

> funding in the capital markets through the least possible regulatory oversight.[16]

National standards would address these concerns with regard to mortgage lending and can be achieved through rulemaking under HOEPA or, alternatively, passage of new statutory standards.

<u>HOEPA Rulemaking</u>

HOEPA was an amendment to TILA enacted in response to abusive lending practices in the home equity lending market. HOEPA contains specific statutory prohibitions that apply only to “high cost” home equity loans and refinance transactions, and not to purchase money loans. HOEPA defines these “high cost” loans in terms of threshold levels for interest rate, points, and fees. For these “high cost” loans, HOEPA bans some practices -- balloon payments, prepayment penalties and the extension of credit without consideration of a borrower’s ability to repay.

In addition, HOEPA requires the FRB to promulgate rules prohibiting acts or practices with respect to any mortgage loan that it finds to be unfair, deceptive, or designed to evade the provisions of HOEPA, and acts or practices with respect to mortgage refinancings that it finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower. These provisions apply to all mortgage lenders, not just banks. The FRB has sole rulemaking authority with respect to HOEPA.

[16] Speech by Chuck Prince, Chairman and CEO, Citigroup, to the Greenlining Institute, April 23, 2006.

A regulation under HOEPA would have several advantages over a statutory approach. Rulemaking can usually be completed faster than passage of legislation and can be changed more easily, making it potentially more flexible and more precisely targeted to specific practices. It also can benefit from the public comment process to assure technical fine tuning and the identification of unintended consequences. Many abuses might be more effectively addressed by regulation rather than statute, especially in areas such as misleading marketing, in which the manner and types of abuse frequently change.

By using its broader rulemaking authority, the FRB could address a wider range of transactions. A HOEPA rulemaking establishing national standards for mortgage lending should include the following elements:

- Underwriting at the fully indexed rate -- Standards should require underwriting based on the borrower's ability to repay the true cost of the loan, not payments based on an artificially low introductory rate. This requirement would go a long way toward helping borrowers avoid loans they cannot repay, and would improve the quality of lender portfolios and mortgage backed securities. It also would help balance the role of mortgage brokers by curtailing the incentives to steer customers to high cost products that they cannot afford;

- A presumption against affordability if the loan, including taxes and insurance, exceeds a debt to income ratio of 50 percent;

- A prohibition on stated income loans in the absence of strong mitigating factors;

- Restrictions on prepayment penalties beyond two years or three months before reset, whichever is earlier;

- Mandatory escrow of insurance and taxes;

- No advertising of a teaser rate without a fully indexed rate and 30-year baseline comparison in the marketing materials -- Standards should address misleading or confusing marketing that prevents borrowers from properly evaluating loan products. The standards should require that marketing information for adjustable rate mortgages include a benchmark comparison of the rate and payment being offered by the same lender for a traditional 30-year fixed rate mortgage. The standards also should require that all rate and payment disclosure information include full disclosure of the borrower's monthly payment at the fully amortized, fully indexed rate, not just the teaser rate -- consistent with the approach of the guidance that the FDIC and other agencies have issued;[17] and

- A prohibition on the use of the term "fixed" for anything but permanent fixed rate loans.

A HOEPA regulation that includes these elements would establish strong national anti-predatory lending standards that would provide significantly enhanced protections for consumers. In addition, the rule under HOEPA could make clear that the standard for secondary market liability attaches only where the violation is apparent on the face of the loan documents.

The regulation also should address activities by entities that operate outside the supervision of the federal banking regulators or on a multi-state or nationwide basis. For example, mortgage brokers have been identified as playing a significant role in predatory mortgage lending problems.[18] Mortgage brokers are increasingly operating on a multistate or nationwide basis, making it difficult for any one state to effectively regulate the actions of a particular broker. A HOEPA rule could set standards that, as a practical matter, would be applicable to mortgage brokers. For example, it could require lenders to only do business with mortgage brokers that are licensed by a state. Such a rule would complement the efforts of the Conference of State Bank Supervisors to establish a

[17] Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609 (October 4, 2006); Proposed Statement on Subprime Mortgage Lending, 72 FR 10533, March 8, 2007.
[18] Mortgage Loan Fraud, Financial Crimes Enforcement Network (November 2006) at 6, http://www.fincen.gov/MortgageLoanFraud.pdf; Predatory Lending Report, Department of Housing and Urban Development, Department of the Treasury (Report 3076, July 15, 2000), at 76, http://www.treas.gov/press/releases/reports/treasrpt.pdf

nationwide database identifying all licensed mortgage brokers -- a project which the FDIC supports -- and would provide an incentive for states to license individual brokers.

The FRB will hold a public hearing tomorrow on HOEPA. The FDIC supports the FRB's efforts and would welcome new rules against abusive subprime or predatory lending practices.

Statutory Standards

Although rulemaking under HOEPA has a number of advantages over a statutory approach to the establishment of anti-predatory mortgage lending standards, Congress alternatively could consider enacting federal legislation to set standards. A statutory approach could establish whatever legal standard Congress wants to set for mortgage lending and could apply it to any parties in the lending process that Congress feels should be covered. However, it is very difficult to legislate underwriting and it would probably take longer to pass a statute than to establish standards by regulation.

Similar to HOEPA rulemaking, a statutory approach to establishing national anti-predatory mortgage lending standards could draw from the 36 state anti-predatory mortgage laws currently in effect. This menu of state laws includes provisions addressing loan flipping, prepayment penalties, escrow of taxes and insurance, the fiduciary obligations of mortgage brokers, and many other areas. At its core, however, a statutory framework should address two important areas: (1) the ability of the borrower to repay the loan; and (2) misleading marketing and disclosures that make it unnecessarily difficult for borrowers to fully understanding the terms of loan products.

Expand FTC Act Rulemaking Authority to Address Unfair and Deceptive Practices

Section 5 of the Federal Trade Commission Act (FTC Act) prohibits "unfair or deceptive acts or practices in or affecting commerce." It applies to all persons engaged in commerce, whether banks or non-banks, including mortgage lenders and credit card issuers. While the standards for deceptive and unfair are independent of each other,[19] the prohibition against these practices applies to all types of consumer lending, including mortgages and credit cards, and to every stage and activity, including product development, marketing, servicing, collections and the termination of the customer relationship.

<u>Deception</u>: A three-part test is used to determine whether a representation, omission, or practice is "deceptive."[20] First, the representation, omission, or practice must mislead or be likely to mislead the consumer. The entire advertisement, transaction, or course of dealing must be considered in determining whether a practice is misleading. Second, the consumer's interpretation of the representation, omission, or practice must be reasonable under the circumstances. The totality of the circumstances and the net impression that is made by the representation is evaluated in making this determination. If the representation or practice affects or is directed at a particular group, reasonableness

[19] Joint Federal Reserve Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004, http://www.fdic.gov/news/news/financial/2004/fil2604a.html
[20] Id.

is examined from the perspective of that group. Finally, the representation, omission, or practice must be material. The basic question is whether the act or practice is likely to affect the consumer's conduct or decision with regard to a product or service. If so, the practice is material, and consumer injury is likely because consumers are likely to have chosen differently but for the deception.

Unfairness: Under the FTC Act, an act or practice is "unfair" where it: (1) causes or is likely to cause substantial injury to consumers; (2) cannot be reasonably avoided by consumers; and (3) is not outweighed by countervailing benefits to consumers or to competition.[21] Where information is "minimally" disclosed to consumers, some courts have held that consumers can avoid injury by choosing another product or service.[22] This makes the second element hard to prove. With respect to the third element, lenders argue that providing credit is a benefit -- even if questions can be raised about a borrower's long term ability to repay it. Finally, it is generally accepted that public policy may be considered in the analysis of whether a particular act or practice is unfair, but public policy may not serve as the principal basis for an unfairness finding.[23] Taken together, these high thresholds mean that situations that meet the statutory definition of "unfair" are rare and, therefore, enforcement actions by all relevant agencies are also rare.

The FTC has express authority to issue regulations that define and ban unfair or deceptive acts or practices with respect to entities other than banks, savings and loan

[21] 15 USC §45(n).
[22] For example, *Orkin Exterminating Co., Inc. v. FTC*, 849 F.2d 1354, 1365 (11th Cir. 1988) (observing that "[c]onsumers may act to avoid injury before it occurs if they have reason to anticipate the impending harm and the means to avoid it, or they may seek to mitigate the damage afterward if they are aware of potential avenues toward that end").
[23] 15 USC § 45(n); FTC Policy Statement on Unfairness (December 17, 1980).

institutions, and federal credit unions.[24] Currently, the FRB has sole authority to issue regulations that prohibit banks from engaging in specific unfair or deceptive acts or practices.[25] The OTS and the NCUA have such rulemaking authority with regard to savings and loan institutions and federal credit unions, respectively.[26]

In order to further strengthen the use of the FTC Act's rulemaking provisions, the FDIC recommends that Congress consider granting Section 5 rulemaking authority to all federal banking regulators. By limiting FTC rulemaking authority to the FRB, OTS and NCUA, current law excludes participation by the primary federal supervisors of about 7,000 banks. Including the perspectives of the supervisor of some of the nation's largest banks and the perspectives of the supervisor of the largest number of banks, as well as the deposit insurer, would provide valuable input and expertise to the rulemaking process. As a practical matter, these rulemakings would be done on an interagency basis and would benefit from the input of all interested parties.

State Enforcement of Federal Consumer Protection Standards

While strengthening the authority of the FDIC and its sister agencies provides tools necessary to deal with federally insured financial institutions and some related entities, non-bank financial service providers are now a significant portion of the lending market. Currently, state Attorneys General may bring actions to enforce violations of the prohibitions against certain high cost mortgages under HOEPA. To enhance enforcement

[24] 15 USC § 57(a).
[25] Id. at § 57(f).
[26] Id.

of federal consumer protection laws, Congress could consider expanding TILA as well as the FTC Act to allow state Attorneys General, state banking regulators, and other appropriate state authorities to bring actions against non-bank financial service providers under these laws. In general, state authorities currently operate under their own statutes that prohibit unfair and deceptive acts or practices, but may not have the full ability to enforce the federal standards. Expanding TILA and the FTC Act for non-bank financial service providers would give additional tools to state authorities, assist in maintaining minimum standards that apply to all financial service providers, and help provide a more level playing field for consumers and all lenders.

Financial Literacy

In addition to resolving consumer problems once they occur, the FDIC is committed to improving consumer knowledge and understanding of financial products. The FDIC considers financial education to be an essential component of our activities on vital issues facing consumers, markets and communities today. Not only is financial literacy essential to evaluate the multitude of choices available to consumers, but this knowledge serves to protect informed consumers from bad products and scams. A consumer who knows the right questions to ask, understands economic fundamentals and has the confidence to challenge products and practices that seem “too good to be true” is a regulator’s best weapon in consumer protection.

While innovations in financial services have dramatically improved access to credit, this improved access has not always resulted in improvements in household welfare. Lack of adequate financial knowledge can lead consumers to make poor financial choices. Financially unsophisticated individuals may easily become targets of abusive lending practices. In addition to arming consumers with the ability to recognize the tradeoffs presented by products that may seem appealing at first glance, educating consumers about basic financial services helps them accumulate wealth, keep transaction costs down, comparison shop and secure access to credit.

As many on this committee know, the FDIC introduced a financial literacy program in 2001 called *Money Smart*. Over the past six years, this program has been used by 864,000 low- and moderate-income adults to enhance their money management skills. Available in six languages, large print and Braille, the program also helps these consumers understand basic financial services, avoid pitfalls, and build the confidence to use banking services effectively. To augment the *Money Smart* program, the FDIC has worked to establish partnerships with community and banker coalitions to blend a strong financial curriculum with service programs and proven asset building strategies.

Responsible and prudent financial practices should start early to teach good habits to young consumers. To this end, Congress may want to consider continued funding for programs that integrate financial literacy into school curricula such as the Excellence in Economic Education Program, authorized as part of the No Child Left Behind Act of

2001. This program is designed to provide resources for school systems to create curricula and provide teacher training for financial literacy programs.

The public schools are the best venue for reaching students of all income levels. Integrating financial education into core requirements such as math reduces the cost of providing separate financial education classes, which may be less effective, and assure students will be exposed to basic financial principles year after year. There are a number of excellent Teach the Teacher programs being provided by a growing number of education departments at major universities, but they could benefit greatly from federal financial support.

Conclusion

In conclusion, the U.S. financial system has undergone significant change and innovation in recent years. Although these new products and processes have increased the choices and opportunities available to consumers, they have also created financial pitfalls for the financially unsophisticated or the unwary. This has resulted in financial distress for a number of consumers and has highlighted the importance of having a state and federal legal framework that provides consumers with the information and tools necessary to protect against unfair or exploitive products and practices.

The FDIC considers consumer protection as an integral part of its mission. Working with our state counterparts, the FDIC regularly examines state-chartered financial institutions for compliance with consumer protection laws and regulations. In addition, opportunities exist to improve and expand the ability of the federal banking agencies to protect consumers through the regulatory and legislative process. The recent judicial and regulatory decisions on preemption provide an opportunity for policymakers to reexamine the existing supervisory framework for consumer protection at the federal level. The FDIC stands willing to assist Congress and to join with our fellow regulators in exploring options to supervise a financial industry that is profitable for the institutions and fair to its customers.

This concludes my testimony. I would be happy to respond to any questions from the Committee.