TRANSCRIPT OF THE
FEDERAL RESERVE SYSTEM
CONSUMER ADVISORY COUNCIL MEETING

THURSDAY, JUNE 21, 2007

The Consumer Advisory Council met at the offices of the Board of Governors of the Federal Reserve System, in Dining Room E, Terrace Level in the Martin Building at 20th and C Streets, N.W., Washington, D.C., at 9:00 a.m., Lisa Sodeika, Chair, presiding.

Members present:
Lisa Sodeika, Chair
Tony Brown, Vice Chair
Stella Adams
Faith Anderson
Dorothy Bridges
Carolyn Carter
Kurt Eggert
Jason Engel
Joseph Falk
Louise Gissendaner
Patricia Hasson
Thomas James
Sarah Ludwig
Joshua Peirez
Anna Rentschler
Edna Sawady
Faith Schwartz
Edward Sivak
Cooke Sunoo
Stergios Theologides
Linda Tinney
Luz Urrutia
Alan White
Marva Williams

Others present:
Randall Kroszner, member, Board of Governors
Frederic Mishkin, member, Board of Governors
Sandra Braunstein, Director, Division of Consumer and Community Affairs

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P-R-O-C-E-E-D-I-N-G-S

(9:11 a.m.)

CHAIR SODEIKA: If everyone could take their seats, we're ready to get started. Well, good morning, everyone. I would like to just start the morning by welcoming you all. Before we begin, I would like to take a moment to acknowledge the Governors here in attendance.

First, our Oversight Committee Chair Governor Kroszner and also Governor Mishkin. Thank you very much for joining us today.

We will begin the meeting by discussing the proposed amendments to Regulation Z, which implements the Truth in Lending Act, or TILA as it is known. The amendments would revise the disclosure requirements for open-end, revolving plans that are not home-secured, including credit card accounts. The goals of the proposed revisions to credit card disclosures are to aid consumer decisionmaking and increase competition.

To achieve these goals, the Board's proposal seeks to ensure that consumers receive key information about the costs of their credit card transactions in ways that they can understand, in ways they can formulate and use, and at times when it is most helpful.

Yesterday, members of the Consumer Credit and the Depository and Delivery Systems Subcommittees discussed this topic during their committee meetings. And at this point, I would like to turn the discussion over to Kurt Eggert, who will lead the discussion, along with Faith Anderson. Kurt?

MR. EGGERT: Thank you. In talking about the regulation of consumer finances, we are always running into the same major issue, which is how do you protect the finances of consumers while protecting their autonomy as well? How do you keep them free from sharp practices while also keeping them free to make decisions that they need to make as consumers?

We depend on consumers to know their own preferences, but we also have to arrange the system, so that they can express those preferences and decide what is best for them. Now, this dilemma -- how do you protect autonomy and consumers? -- one way out of it is by having disclosures, is by looking at the disclosure system as a system of regulation that allows consumers to be protected by empowering them.

The problem with this, though, is that disclosures have their own sets of problems. The problems include how do you disclose things that are essentially very complicated? And how much can you rely on disclosures to save consumers if they don't perhaps understand the product

itself?

So what we are looking at now is how to improve these disclosures and for -- to look at that, we would like to, first, turn to Faith Anderson, who will lead this part of the discussion.

MS. ANDERSON: Good morning. I will be leading the discussions regarding direct mail solicitation and applications, also known as the Schumer box, account-opening disclosures, and convenience checks for accessing the account. But before we begin, we would just like to get the committee's comments on the overview of the general format of the solicitation and application disclosures. Josh?

MR. PEIREZ: First, I would really like to commend the Board and staff for what is a very, very lengthy and quality effort here. I joked yesterday, I can't remember the last time I read 800 pages, let alone wrote that much. It also represents a substantial overhaul of the Regulation Z requirements, and many have referred to it as solely being focused on disclosures, but I think it will have a significant impact on practices as well.

I would emphasize that, I think, there is probably consensus on sort of if you wanted to go with the normal business "80/20 Rule." I think you will find consensus around 80 percent of it and 20 percent we'll be debating. I think that ultimately there will be a lot of time spent by industry complying with many aspects of this, and there will be lots of benefits to consumers, but also significant costs to industry participants.

And we need to make sure that the changes and the costs that they end up imposing on the consumers are ultimately warranted by the benefits they bring to consumers. And I think that that will be the case with much of what is proposed, but not necessarily with all of it and we'll talk about some of the specifics later.

I also think that in the effort for simplicity, the tabular format is wonderful. For the various disclosures enhancing the disclosure box, the Schumer box is also very helpful, and providing clarity to lenders on what is to be disclosed is always welcomed. However, there is a risk that the simplicity can come at the expense of accuracy. And so you could end up with a dual disclosure regime where you have the account opening, for example, the very simple, straightforward proposed disclosures from the Board followed by 10 pages of the actual real disclosures that a consumer would have to read and understand explaining the one to two pages that they got up front if, in fact, simplicity and straightforwardness is chosen over accuracy.

So there may be the need to provide some flexibility or to also recognize the fact

that in those very simple tabular formats, some of these things are more complicated to disclose than others and will require substantial backup, particularly to comply with some state laws and other things where a lender could have liability if they fail to do so. And I'll save my other comments for the specific areas.

MS. ANDERSON: Carolyn?

MS. CARTER: Thank you. I also want to congratulate the Board on making huge -- proposing huge improvements in the application and solicitation disclosures. One thing that is particularly important that the Board has done is you have mandated or you are proposing to mandate format and mandate uniformity. Many of the credit card disclosures have, up until now, allowed lenders, issuers to really decide on the format, decide on the order, decide on the emphasis for themselves and that freedom has a certain nice ring to it, but I think it has been really counterproductive, because we have ended up with a regime where, except for the Schumer box, and I'm now talking about account-opening disclosures, for example, and even there to some extent, there has been -- everyone has invented it on their own.

And there has been an enormous amount of variation, and consumers can't compare head to head what the terms of the transaction are. I think that the proposal by making it uniform, you are going to save issuers a whole lot of money and expense, because they are not all going to have to sit down and puzzle through the rule and figure out how to comply with it. You have set it out exactly how they should do it, and you have tested it with consumers to see that consumers actually understand it this way and understand it better this way than it had been in the past.

So the uniformity and the standard format, I think, are just an enormous improvement, both at the application stage and then carrying that same format and the same terms and the same order throughout the life of the credit card. At the same time, disclosure alone is not enough, in my opinion, to deal with credit -- with abusive practices in the credit card industry.

And one perfect example is the balance calculation method. Up until now, the creditor has had to disclose in the Schumer box the balance calculation method, and there are some shorthand terms that the Fed has created for the balance calculation method, two-cycle, one-cycle, average daily balance, all of these. I don't think in your consumer testing any one consumer ever understood any of those terms.

So what can you do about that? Disclosure is clearly not enough. But a term like

the balance calculation method is a way of increasing the cost of the credit in a very subtle, invisible way that should -- that requires substantive regulation. You do have some substantive regulation authority under various statutes, and I urge you to not just stop at disclosure, but to go beyond that and see where you can address those sort of abuses in the marketplace through measures that go beyond disclosure.

MS. ANDERSON: Before we move on to the solicitation disclosure, I would just like to add that I would like to also commend the Board and the staff. We know that this has been a very lengthy process. My concern is just that currently the example that was given is a legal size, and I know a lot of financial institutions prefer the letter size. And then another question that we have is, because we have to list certain fees and penalties, would it be possible to have the Schumer box continue on the second page?

And so that's just a minor comment, but I just wanted to put that out there, especially with the increase in postage, it just would be a concern for smaller financial institutions.

Now, let's move on to the solicitation disclosures, specifically where the proposed changes highlight penalty rates and triggers, if anyone has comments on those issues, or if the right fees are highlighted and also does the proposal adequately address concerns about comments, are we receiving offers for subprime cards. Would anyone like to start?

MR. SUNOO: I would like to make a comment just with regards to solicitation. We're living in an era now where there are a lot of new citizens to the United States, new residents that are non-English speaking and that's fine. Regardless of how we might feel about it, we know that the industry is well ahead of us in terms of approaching these new Americans in their own native languages to the point that there is a significant solicitation, significant negotiations for these types of things where the Schumer box becomes important as a disclosure.

And where the solicitation is done in the language, other than English, just a recommendation and thought that shouldn't the Schumer box also be developed in the language of the solicitation? This is law in California in a number of different instances, and I think that something along those lines is really important. If you get a solicitation letter in Spanish or Korean or Chinese or Thai, then the disclosures ought to also follow that.

MS. ANDERSON: I would like -- oh, well, you --

MS. CARTER: Go ahead.

MS. ANDERSON: You go ahead.

MS. CARTER: Okay. So turning to the specifics of the applications and solicitation disclosures, first, I think it's great that you have put the fees, or at least many of the fees, into the application and solicitation disclosures, into the Schumer box. It used to be that interest was the primary cost of credit card credit and perhaps partly because the APR has to be disclosed and has always had to be disclosed prominently.

It has shrunk and shrunk and shrunk so that now it's not the primary or it's a much less prominent part of the cost of credit, and fees are a much larger part of the cost of credit. And so by highlighting the fees in the Schumer box, you are alerting consumers to more of the components of the cost of credit.

Related to that, though, is the fee-inclusive APR, the effective APR, which actually -- and I have two comments about that. First, the fee-inclusive or all-inclusive. First, I would rather see it be an all-inclusive APR. Second, I would rather see it on the application and solicitation disclosures too. And let me explain a little bit about what I mean.

The all-inclusive APR would be a calculation that took into account all of the costs of credit: the annual fee, the over-limit fees, the cash advance fees, the balance transfer fees, and the interest rate. And that -- and what we would like to see is first, that all-inclusive APR disclosed on the periodic statement, which we will get to later. But also, we would really like to see that converted to a typical APR and disclosed on the Schumer box itself.

So that, I know that the Board has taken some steps to address subprime credit cards. There is an abusive type of subprime credit card which is really just a means of generating over-limit fees, which we may talk about a little bit more later. You have taken the disclosure approach to it, and I commend you for taking that problem seriously and trying to address it.

A typical APR would really capture all the costs of that abusive product and give it to the consumer at the time of application. And I submit would do -- would be a better approach to alerting consumers to the costs of those products and enabling people to avoid them.

MS. ANDERSON: Josh?

MR. PEIREZ: Thanks, Faith. I think Carolyn raises an interesting point on the fee-inclusive APR, and I do want to comment on it. And I think her premise up front is correct, which is we have seen a large percentage of cards never revolve. And so, therefore, these people are effectively getting interest-free loans every month for whatever they choose to spend, and the banks are bearing those costs.

What we have seen is that credit cards have more and more become not just a loan extension. They have become vehicles for many other things. They have become vehicles for getting money when you travel. They have become vehicles for accessing other forms of protection. They have become many other things. And many of the fees that Carolyn alludes to are, in fact, fees for services that you can access using your credit card that are not really the extension of credit in a traditional sense.

And that's why those fees are flat fees, rather than interest rate-based fees. And I think to include those in an APR calculation is inherently misleading to the consumer, because it is not, in fact, interest. It is in fact a fee they are paying for a particular service, which is not to say it shouldn't be clearly disclosed. It should be, and I think the efforts here to include them in the Schumer box are excellent and we support those.

And also one of the examples provides for a disclosure of a year-to-date interest paid and a year-to-date fees paid as two separate line items right next to each other, and I think that gets to the issue of what the fully loaded cost of the product is. But the interest part is the fully loaded cost of the credit extension, the borrowing. And to include in that fees that are not, in fact, interest is misleading the consumer. And then when they try to compare that to other forms of credit they may be able to obtain, that's not a card that provides these other opportunities, they actually can't make an apples-to-apples comparison.

So, in fact, it becomes more misleading and not more clear. And so I would encourage the Board to take its second option of not including the historical APR calculation as a required fee -- required disclosure anymore. However, clearly, the interest rate that applies should be disclosed. It should be disclosed in the account-opening documentation, and it should be disclosed as arranged in the solicitation as proposed.

But I do think that, you know, year-to-date fee disclosure is excellent and should be there and should give consumers full information. I think the tabular format of it, the location of it makes a lot of sense. But to include it as part of an APR is, frankly, just misleading and provides sticker shock that's not real in terms of what the cost of, you know, using the card to revolve balances would be, which is what a consumer should be evaluating when they look at interest rates.

MS. ANDERSON: Lisa?

CHAIR SODEIKA: Yes, I would just add to what Josh is saying in terms of, as a consumer, I don't want to get an application or a statement that says what a typical APR is, what a

typical fee is. Actually, I would read that and say ah-ha, that means my fee is going to be a lot higher. What does that mean? I'm not sure I understand that.

I do want to know what interest rate I'm going to be charged. I do want to know exactly what fees I'm going to be charged for. I would like to see a list of what those fees are. And to me, just showing what those -- what the topics are, the issues, and what the typical fees are or what the fees are for those services, that's clear to me. It would be very unclear to me to see a typical rate.

If I ever received an application or solicitation that stated that, I would rip it up immediately, because I wouldn't trust it. I wouldn't believe it. I wouldn't understand it. That's my input as a consumer.

MS. ANDERSON: Stella?

MS. ADAMS: Well, as a consumer who is confused, but does not own a credit card, so it's okay, because I'm too confused. But in terms of the calculation of the fees, do you not charge interest on the fees when they are -- I mean, it would be fine to separate the fees and just have the fees over there and not calculated into the APR if you charged the fee the one time and it's not included in the interest payment, calculated in the interest.

But if it is calculated in the interest, I really ought to know that if I were a credit card holder. But again, because it's so confusing, that's why I don't have one.

MS. ANDERSON: I would just like to add that the staff tried to make it easier for consumers to understand if there is an introductory rate and if balance transfers are paid first, but a lot of institutions have the lowest APRs paid first and so we would just like the flexibility to add that language in one of the boxes, so that it really mirrors what the actual practices are.

And also, in the fee section, on the penalty fees, which I know is highlighted a lot so that consumers understand what their penalties are if they are late or they don't -- miss quite a few payments. But in the penalty fees box section, three times in the same box it states "Your APRs may also increase. See penalty APR section above." And it is three lines right in a row.

And if we really wanted to highlight that, maybe just list it once at the top of the box in all bold, so they will see that. I mean, it's redundant and it makes you think is that a typo, because they just said it again and they just said it just below also. And getting to the typical APR, I also agree with the comments made by Lisa and some of the others that really a typical APR doesn't have any meaning to a particular consumer, because they know that would not apply to them.

And is a typical APR one where those who are constantly late or are those who are paying on time and so it just won't have any meaning like a minimum payment where we were required to give that minimum generic requirement. I mean, a lot of people, I think, would just, like Lisa said, throw it away and believe that would not apply to them. Kurt?

MR. EGGERT: We have to recognize that in the effective APR there are two aspects, and there is the solicitation aspect where you are telling people sort of what the industry average for this card is and then later we'll be talking about the personal effective APR. But I think if we're talking about the industry aspect, I mean, we have to concentrate on what the purpose of this disclosure is.

The purpose is to allow people to shop between cards and to see, generally, what the price differential between cards is. If we don't give people -- so to do that, given that a lot of the cost of cards has shifted to fees, the question is how do you best disclose to people what the typical or average fees on a card will be?

I don't think that you can do that easily just by saying oh, your fee for this is this. Your fee for this is that, because a consumer, it would be hard for them to go through a list of fees and know on average which ones a typical consumer will rack up. And so I think we need to give them some overall number, and it strikes me that the effective, typical effective APR is a good way to do that.

But to some extent, you don't have to take my word for it or you don't have to take the word of anyone around here. I mean, I think the great thing about what the Fed has done in this round is to do consumer testing. And so you guys should know if consumers have any idea what the effective APR is or can at least use it. Even if they can't tell exactly what it is, can they at least use it to judge which cards are more expensive or less expensive based on fees? Because that is a crucial piece of information. And if they can get that from this piece of information, then I think we should disclose it to them in the solicitations.

MS. ANDERSON: Carolyn?

MS. CARTER: I wanted to, on the typical APR question -- Mike Cook, who isn't here today because he is in Ireland, said at an earlier meeting that from a retailer's point of view, he thought the typical APR would -- made a lot of sense and would make sense to consumers, because it's like the EPA mileage rating, which everyone knows doesn't apply to their usage of the car. They may be city driving, lots of stops. But people know that it's there for comparison purposes. So I

think that we should -- that the fact that it wouldn't be what the particular consumer's rate would be is not a reason not to make this disclosure.

I would like to address one other topic. Going back to the balance calculation method, as I said, I agree with the idea of moving the balance calculation method out of the Schumer box, because no one -- no consumer of all the ones you tested ever understood it. Another approach to consumer understanding would be to rate a sort of an Energy Star type of approach to rate the balance calculation methods on how consumer friendly they were, and then put that rate on the Schumer box.

And I know that some of the balance calculation methods are clearly very unfriendly to consumers. Mathematically, I haven't worked it out whether you could put them all on a continuum, but you could, that might actually give consumers the ability to take that factor into consideration. At the moment, because of Congressional pressure, I think that a lot of the credit card issuers are retreating from the worst balance calculation methods.

So I think there is already some movement in the industry here, and highlighting it in a way that consumers could understand might actually succeed in completing the job of wiping out this particular practice that I consider abusive.

MS. ANDERSON: Josh?

MR. PEIREZ: Just to respond to a couple of the points that have been made and encourage the Board to consider a few. I think Faith's points on the page size, it's not expressed as a clear mandate, but the lack of examples on 8.5 x 11 paper will likely lead examiners to be looking for that 8.5 x 14, so we should just put one with an 8.5 x 11 and then people can use it.

Also, I think Faith's point is quite good in terms of the -- where payments are going to go. I think that as a general matter, the practice in the industry is generally to apply them based on the interest rate applicable to particular balances, not based on whether it was a purchase or a balance transfer or the like. So, in fact, I think providing that flexibility is actually a requirement to mirror what happens in practice.

On Stella's point, we're going to get you to get a credit card someday, but in the meantime, I think that your point about whether the fees are part of the interest question, I think that ultimately, the consumer, you know, pays the fee. If they end up paying it, then no, it won't be part of the interest. If they end up not paying it and choosing to revolve that fee, then, yes, it will be part of the interest, but no differently than any purchase.

So that would be like saying that we should disclose that if you buy a $100 TV, that's going to lead to this change in interest rate. It doesn't really make sense, because they are buying a different service or paying for a different activity than the pure interest. And so you certainly can disclose to them you're going to incur these fees. You should certainly say if you fail to pay these fees with your next payment, it will then accrue interest at the following rate. That makes perfect sense; that's an accurate disclosure.

But to then try to fully load that, as people are calling it, to come up with an interest calculation that, frankly, you know, exists only to provide sticker shock, not to actually give an accurate depiction to a consumer of what their interest rates are, is not something that we think is particularly useful.

And I think Kurt's point is an excellent one, and I think we are mixing a few things up with the discussion of APR. We are confusing the solicitation, and I'll address Carolyn's or Mike Cook's previous miles per gallon example. The APR that would appear on the solicitation versus the APR that would appear in account-opening documentation, first, versus a historical APR for the actual consumer that allows them to see what their actual card has cost them over time.

And I think that you have to look at those three things as separate things. And certainly, disclosing in the solicitation document to a consumer the range of interest rates that could apply to the card that they are applying for makes sense. I think certainly in the account-opening documentation, telling the consumer exactly what interest rate they are getting is necessary; otherwise, you know, you wouldn't have a contract. You have to tell them what interest they are paying. It's an absolute requirement.

Giving them a typical one, at that point, would make no sense. You have to tell them what they are actually getting. And I think that the real discussion of the fully loaded APR can only be based on that consumer's actual experience with the product and that's where my concern is. It could be particularly misleading, especially in the first year, where a consumer may well have a card with rewards or an annual fee and that would be fully loaded in the first or second month and show up as like ridiculous interest rate, you know, calculations if they don't pay that right away.

So I think that, you know, you do need to separate those three periods of time and understand what you are doing. I think on the typical APR issue and the comparison to miles per gallon on a car, you know, again, the example I'm making of the three distinct characteristics are important there, because, you know, even though people may use a Jeep to do more off-road driving,

when they disclose the miles per gallon, they are not doing it based on that off-road driving or if people may use a Jeep to go up hill more, they don't do that.

There is a standard process for saying what it is going to be. And, you know, if you wanted to say we're going to have a standard process that says you take whatever interest rate you, you know, give to the mean or the median of people that apply for this card and call that your typical on the card, you know, lenders could do that. I don't think it provides consumers any accurate information, but I guess it would allow them to benchmark where in that range cards generally fall and it would not be a particularly hard thing for someone to calculate.

But if you're trying to tell a lender that they should look across that portfolio over the entire history it has existed, come up with a calculation of what the average APR based on some number of fees that have been included in the APR, based on consumers who did or didn't pay it off at the moment it came, and how long they carried it for and whether it compounded interest, you are asking for a very complicated calculation that is not disclosing anything typical at all and doesn't allow a comparison between products, because the products have different fee structures and you are trying to calculate them all as interest rates, when, in fact, they were different things.

So I would encourage the Board, you know, if you do go down a typical APR route, which is, I think a third category between what we have now, which is, you know, an effective APR that is based on the interest fees versus other -- finance charges versus other fees distinction that has been drawn in the past, the fully loaded APR that you are proposing here and then a typical APR, which is almost a third category, I think, then you really think long and hard about what you would actually want to express as a typical APR that would allow comparisons across products throughout the industry over time.

MS. ANDERSON: Kurt?

MR. EGGERT: I like this metaphor of the mileage thing. One of the differences between credit card companies, if you want to carry this metaphor further, is different credit card companies may charge different amounts for late fees, but also may have different rules for when people incur late fees. So it would be misleading to some extent if you said we're going to have a hypothetical consumer, who will incur the following fees and here is what their APR would be if they incurred those fees, because you could have the same consumer with two different cards and one card they would incur the fee, the other card they would not incur the fees.

So using the mileage thing, it would be like saying your Jeep not only can be used

for off-roading, but your Jeep will occasionally swerve off the road on its own and you will have different mileage, because you will be driving through the ditch. So I think when we are deciding on how to give people before they take a card a view of how expensive it will be, I think it's clearly you have to give them some view of how much the fees will typically be or likely be.

But I think if you do that, you can't do it just by creating a hypothetical consumer with set fees. You have to give them some sort of idea. If I get this card, how likely am I to be dinged as well as when I'm dinged how much will the dings be? If that makes sense.

MS. ANDERSON: Carolyn?

MS. CARTER: I wanted to address two other issues in the account-opening disclosures. First are the disclosures that relate to subprime credit cards and I really want to commend the Board and staff for tackling the problem of subprime credit cards. A type of subprime credit card is designed mainly to be a generator of over-limit fees. The consumer will get an advertisement saying credit limit $250 to $10,000 and 0 percent interest, applies for the card and then the issuer charges up front $210 in activation fees, annual fees, account opening fees, fees, fees, fees.

So the consumer has a $40 actual credit limit, which the consumer may not even be aware of until the first bill arrives. The consumer starts using the card and is over limit maybe 10 times in the first 10 transactions and then it just goes downhill from there. The 0 percent goes to 20 percent and so on and so on.

So I really commend the Board for tackling this. Your proposal is to notify -- put a notice on the -- in the Schumer box in applications and solicitations telling consumers in any event where 25 percent of the credit limit is going to be consumed by the up-front fees.

My only concern about this proposal is that you don't count optional fees in determining whether that 25 percent threshold has been met. And optional fees have been a big part of this particular subprime credit marketing. And it's mostly been done through telemarketing, very skillful telemarketers who are skillful at selling consumers a whole bunch of so-called optional products without really making it clear that it is optional.

In addition, the consumer may not know, probably will not know at the time of getting the card, where within the range of $250 to $10,000 their credit limit is going to be. And since most human beings are optimists, consumers will probably think well, gee, I'll probably be in the middle or maybe a little above average. A $60 account, a $60 credit protection fee may not be

much to a consumer who is thinking, oh, I'm going to have a $7,000 account limit, but then when it turns out to be the $250 account limit, then that fee looms much larger. So I encourage you to take a look at that optional fee loophole.

And that raises a second issue with the Schumer box, and that is allowing the disclosure of ranges. From the language of the rule and the commentary in the examples, this -- it appears that issuers are allowed to include in the Schumer box not the interest rate that will apply to the card for which the consumer is being asked to apply, but at 6 percent to 22 percent and a credit limit of $250 to $10,000.

And I understand that there are some -- I have heard the reasons why, from the industry, they want to be able to do that, but it really does open the door for bait-and-switch tactics, and the subprime credit cards are probably the best example of that, but it's not just been a subprime credit card issue.

MS. ANDERSON: Patty?

MS. HASSON: I guess two points. Going back to the effective APR versus the typical APR, if you truly want consumers to understand what they are paying for a service, take a simple example of a $10,000 balance transfer with a 5 percent transfer fee and a two-month average balance that it is computed on. The effective APR is going to be very different for somebody who gets a $10,000 balance transfer with no fee, hard to find today, but with no balance transfer fee and a one-month average balance.

If you show that example to a consumer of what that will cost them, an effective APR, they will get it. Doing it this way and hiding the fees and I think it's really important that balance transfer fees and cash advance fees, which are the cost of actually taking that credit, really need to be computed in so that consumers understand what they are paying for that.

I think we all here could calculate it on our own. And when I have people ask me, I can explain to them and show them how to calculate it, but the average consumer cannot. So if you're going to give disclosures, you need to be sure that they can understand the difference between all of those costs.

The second point which I agree with Carolyn on is the disclosures around subprime credit cards is critical, and I commend you for the work you did on that, because the other practice that we often see is that the individual gets that card and the example that you give is ultimately they get a $250 line and they may end up with $68 in credit after they pay all the fees.

And on the same day they get that card, they get another solicitation from the same creditor giving them another offer of a $500 card.

So that practice is going on. Consumers need to know up front that they are -- you know, $68 is all they are getting, because when it comes down to it, they get another card. They only have $68. They are like well, yes, I need another card. I mean, it's logical. So they take this second card. So I think it's important that that even be more prominent that consumers understand before they get a card that's all of the money they may possibly get out of this card.

MS. ANDERSON: Well, switching topics. The proposal also provides that certain fees may be disclosed orally at the time that the consumer actually will incur the fee versus giving that fee notice at account opening. For example, the expedited card fee or a duplicate card fee. I would like to commend the Board for putting that in the proposal, because I know it's different from always giving the certain disclosures up front, but it really is much more practical for the consumer to know five years later that yes, when they want an expedited card, that you will incur a $10 fee or a $15 fee, because they will be able to remember it versus trying to find that account-opening agreement and disclosure where it lists the fees from years ago.

And also, getting to Carolyn's point about the ranges in the solicitation Schumer box, for a lot of financial institutions, we give the ranges that we offer to our consumers, and unless you are able to pull credit or pull or verify their income and look at their credit report, it is very difficult to let that particular consumer know in a solicitation that this is what your APR will be. And it will then become meaningless.

And also, I just wanted to again thank you for making it easy for the consumer when they compare the account opening and the solicitation box, because then a consumer can verify that, yes, what I received on my account-opening disclosure matches up with what was given to me at solicitation. And that's really very easy, and I just have to say that not having a lot of the dense prose, because I know I write dense prose and I'm sure nobody else reads it, but it just makes it easier to just look at and read and the format and all the white space, I think, is very helpful to a lot of consumers.

Anything else that anyone would like to add on the application, solicitation, account-opening disclosures format? Josh?

MR. PEIREZ: Yes, I would just mirror, I think, some of Carolyn and other comments regarding the subprime proposal. The only thing I would say is it's very tricky to say that

an optional fee is not optional and therefore should be included in the calculations up front of what the actual credit that a consumer is going to get. And if the reason why we're doing that is that we're afraid that certain marketers are going to misrepresent to consumers whether this is truly an optional fee or mislead them, I would encourage us to enforce existing laws that would probably cover that.

And these people are probably, you know, violating any number of laws at that point in time, and I think that, you know, we would be providing a disclosure that is probably misleading to many consumers who are not fooled by those people who are violating the law, rather than just dealing with the clear fact that there are these fees.

So I would encourage us to make very clear which fees are optional on the solicitation and perhaps even in the account-opening statement to make clear to a consumer which fees they incurred via a phone call that was optional and even maybe give them the ability to, you know, change their mind on that for a short period of time after they receive it and say, you know, I didn't mean to get that. I didn't realize it was optional whatever it was. But I wouldn't go so far as to make the initial disclosure in the solicitation inaccurate by including things that truly are optional services they may or may not buy.

MS. ANDERSON: Ed?

MR. SIVAK: Just one of the things that I thought was really good about some proposals was defining what a fixed rate is. As someone who once had a fixed rate at 6.99 percent, which I can tell you is no longer 6.99 percent, I think that that's a critical improvement. And so I just wanted to make sure that that feedback was out there, because I think that's an important thing.

MS. ANDERSON: Carolyn?

MS. CARTER: I wanted to say a few things about the account-opening disclosures. First, I wanted to echo what others have said that it is really, really good to have the Schumer box at account opening. That's going to be -- that's such a -- that's night and day. I am sure you have seen account-opening disclosures that you need a microscope to actually perceive the print on, which has really been the standard account-opening disclosures up until now.

I am concerned about the fees that are not in the Schumer box at account opening, in the account-opening disclosures. You have a list of fees that have to be included in the Schumer box, and then all the other fees don't have to be in the Schumer box. And I'm not arguing that all of the fees should be in the Schumer box, because then it would have to be -- you would have to have a scroll that you could unroll.

And I also think that the oral disclosure before the consumer becomes -- actually incurs the fee is a good idea. But I urge the Board to require creditors to include all the fees, a list of all the fees somewhere in the account-opening disclosures. Not in the Schumer box, but somewhere in the account-opening disclosures there should be a list of all the fees.

For one thing, consumers can then look at the list and they may -- it may help them decide whether to do things that would incur the fees. Like there may be fees for certain payment methods, it would be helpful to consumers to have a list that included all those fees.

Second, I don't think it really helps industry to encourage industry not to have all the fees in writing. An oral contract is worth the paper it's printed on and by allowing only -- by encouraging only oral disclosure, I think that that would encourage misunderstanding, dispute, all sorts of problems.

So I encourage the Board to -- and a final point is that the Board in its -- in your description of the rule, you point out that most issuers include that list in their account-opening disclosures for contract reasons. So it wouldn't be all that much of a burden on industry to say, yes, include it in the account-opening disclosures and include it in the form of a list that consumers can readily refer to.

MS. ANDERSON: I would like to add on to that point before I get to Josh. You're right, a lot of institutions in their account-opening agreements would put the fees in there. So I think that's just because of contract law, so I don't think it's necessary for the Fed to mandate that, because we would already do that and provide that also, because we know that with our consumers we want to be up front with them. And that we don't want to charge them some fee that has never existed before. Josh?

MR. PEIREZ: Yes, I would just -- first, I'm very encouraged to hear that Carolyn is not promoting the scroll method of disclosure, because I can't imagine the postal costs that would be involved. But I think on the fee point, you know, whether you require people to disclose them all or not, I think, base point is it's happening, so it's kind of hard to make a vigorous case either way.

I think though that to the extent that disclosing them in the back of the account-opening documentation then triggers obligations to include them in some fictitious APR calculation as we were discussing earlier that leads to a totally, you know, now even more beefed-up and misleading APR. I would have concerns there, so I think, you know, just looking at the linkage between what you are putting in those documents and how that triggers any obligations under

interest rate or APR calculations you are forced to make based on hypotheticals, I think, to Kurt's point that are particularly not useful as opposed to actual real experience may be, you know, across your portfolio or across all portfolios, is something I would encourage us to be quite careful about.

And I also would encourage the Board that things that are disclosed there not be considered change of terms later. And I know we will get into more of a discussion around this shortly, so I won't go into too much depth, but there is a seeming requirement that even if something is disclosed in the account-opening documentation, there may still be an obligation to disclose that exact same thing as a change in terms and to provide 45 days, which we think is more like 70. So let's, you know, get to that shortly.

MS. ANDERSON: Before we segue to Kurt, I would just like to add that on the discussion regarding typical effective APRs, that in the consumer study that the Board had conducted that it was found that consumers understand dollars better than percentages when they saw the year-to-date totals, so I would like to just remind you that that's what consumers found comparable.

And then you did put that in the periodic statement also. I'll turn it over to Kurt.

MR. EGGERT: Did you cover convenience checks yet?

MS. ANDERSON: I don't know. Does anybody have any comments on convenience checks? We didn't really have any comments yesterday. We just would need to now disclose the APR if a consumer decides to use a convenience check and I don't think anyone had an issue with that.

MR. EGGERT: All right. Okay. Well, I'm going to lead the discussion on the next group of topics involving the proposed amendments to Reg Z. And starting out with a nice segue by Joshua on the question of change-in-terms notice. The new rules require and it would require an additional time period, and probably the most controversial application of that time period would be to the change in the interest rate due to a default interest rate.

And so, first, I would like to turn it over to Alan for comment on that.

MR. WHITE: All right. Well, let me start by joining with the other members of the Council in commending the Board, generally, for the excellent work on these proposed rules and for using some good empirical consumer testing to develop the forms and to sort out what is important to consumers and what is not important.

On the issue of default interest rates, let me start my comments by saying the

disclosure approach is certainly helpful. On the other hand, I think there are some serious limitations to dealing with the problem of default charges and default interest rates with disclosure. Basically, the limits to disclosure approaches come from the fact that the problems with this type of complex pricing are not just information problems. They are also, basically, consumer bias problems.

Consumers when they shop for credit are going to shop based on salient terms, and this has been fairly well-studied in the marketing and psychology literature. And in addition to looking only at salient terms, so that no matter how much information you provide them about non-salient terms, it's just not going to matter, consumers also have biases. And one of their biases is called the over-confidence bias. They are systematically persuaded that they are not the typical consumer who is occasionally going to be late and who is going to incur any of these price -- contingent price elements.

So most consumers are going to discount to zero any information and certainly an account opening about default interest rates and about default penalties. So in light of all this, I think, you know, disclosure has its limitations. Certainly, I think it is a huge improvement to give the disclosure of default penalties and particularly of changes in interest rates at the point where the consumer is going to incur them.

And to do it before the status quo has changed, because there's also a status quo bias, such that, you know, if you tell a consumer after they have already started incurring charges of a higher rate that their rate has changed because of their past behavior, they are somewhat less likely to do something about it than if you tell them in advance, you know, your 12 percent rate is going to become 30 percent in 45 days.

So I think as far as it goes, the notification provision is an excellent one. I think it's really splitting semantic hairs to say it's not a change in terms, because the original contract allowed the issuer to change your rate if you were late and now you are late and therefore we're not changing your contract.

I mean, if there is any term that you can call the term of a credit card agreement, it's the interest rate. And when you are changing the interest rate, you are changing the contract terms, in the lay person's understanding of that. So I think providing the notification as proposed in the regulation, sufficiently prior to the change, so the consumer has an opportunity to react and maybe to make some decisions, such as paying off their balance or getting a different card or engaging in some other behavior, to avoid this is clearly an improvement.

But I do want to step back a little and suggest that the Board ought to look apart from disclosure approaches at the question of default interest rates and default-related price elements. I know, for example, in the United Kingdom the Office of Fair Trade, I think it's called, the equivalent of the FTC more or less, has done some good empirical research on what it actually costs credit card issuers, what the marginal costs that they incur are that relate to late payments.

And they have looked at late fees and found, not surprisingly, that the fees are considerably more than the marginal costs that they are supposed to compensate for and they have issued substantive regulations limiting those fees. I realize that's not an approach that's very popular on our side of the pond, but on the other hand historically, in contract law the notion has been that when you have a penalty that's related to an event of default, that penalty should be compensatory and should be related to the cost that's being incurred.

I think that element has been completely lost in this effort by card issuers to get price out of the interest rate and into -- to recover more revenue from people who are essentially sometimes captive or at least psychologically captive customers and to make the least well-off and the people the most distressed bear costs that really aren't the costs that they are producing.

So I would suggest in addition to focusing on disclosures that it would be worthwhile maybe to have the payment card center in Philadelphia take a look at default interest rates and penalty rates and see if they have any relationship to cost. They are clearly not competitive. I certainly don't get solicitations from card issuers saying, go with us because we have a lower default interest rate than our competitors. They are pretty uniform, and so I think there needs to be -- this issue needs to be looked at more. I think certainly the step that is being proposed is a good one.

MR. EGGERT: All right. Josh?

MR. PEIREZ: Let me just say I'm really looking forward to the HOEPA discussion this afternoon. I think, you know, first of all, I don't think it's a contractual semantic discussion to say that the terms disclosed up front are the form of a contract. And one of the terms that is standard for many cards these days is a term that basically says I'm giving you a lower interest rate than I might other on the condition that I'm expecting you to pay your balance at the end of the month or pay the minimum payment that's required, which is, you know, usually not a substantial amount relative to the whole balance that could be there, to pay on time.

I'm floating you free money, you know, for that period of time if you do pay in

full or otherwise I'm still bearing certain costs up to the point of that minimum payment. I have certain costs that I incur when people are not making payments at all month to month where I have to then deal with that from a safety-and-soundness perspective in looking at what my portfolio looks like, etcetera, and to say that, you know, should one of those behaviors occur, I then need to change your rate to something higher.

And to disclose exactly what that rate is going to be up front to a consumer, is a very clear disclosure. That being said, I certainly don't object to telling the consumer before that rate kicks in that it is going to kick in. I just really don't think that the 45 days we're proposing here, which by the way I also don't think is unreasonable for true changes in terms that have not previously been disclosed to a consumer.

For example, saying to a consumer your account-opening documentation, you have a late fee of $9 and then saying, you know what, we have decided to change that to $29, that clearly -- giving the consumer the 45 days to know that and to decide whether they want to shop for a different product, to me, is a very different scenario than something that has already been told to the consumer and is based very much on the consumer's behavior.

And I'm not saying it's always their fault or that there aren't circumstances that lead to a consumer not being able to make those payments, but it's still a loan and it's still terms that they had that they ended up not meeting. And I think consumers know, at this point in time, that when they have a credit card, on a monthly basis they owe a certain payment.

And to say that they don't know that and that it's unfair for a card issuer to be repricing based on consumers' failure to meet that obligation that they have incurred as part of the contract, to me, is also something that ignores reality.

I also would take issue with the concept that this movement of fees from being in the form of interest to behavioral-based fees is something that has been issuer-driven. I would suggest actually, to the contrary, it has been very much consumer-driven, as many fees are. And consumer behavior on cards, the Fed studies show and depending on which study and which numbers you want to believe, anywhere between 45 and 55 percent of accounts never revolve, means that, you know, roughly half the cards our industry puts out there are effectively free loan instruments providing free-flow travel benefits, rewards, many other features to consumers half the time.

Which is not to say the other half aren't incurring interest-based fees, but, frankly,

you know, we're not providing a social utility here. We are a business. It is fair to make money. And I think that, you know, it is fair to charge reasonable fees. And so in looking at fees, issuers and looking at consumer behaviors, consumer behavior has driven fees away from interest in many cases towards other behavioral-based things, which often are optional and can be avoided.

You know, most of them, in fact, are that way. And so people talk about a cash advance fee. Let's remember, credit cards were developed not so much to allow people to access cash, as they were developed to allow people to make purchases. That was their primary purpose and remains their primary purpose for most consumers. So the ability of a consumer to take that unsecured loan, use it at an ATM to withdraw cash is a great feature, and charging a different rate for that is also not a problem.

And I wouldn't mix, you know, to the prior discussion the interest rate that applies there with the interest rate that applies on purchases, which is the primary reason for which the card was developed. There is also a less risky, by history, default-type scenario and a scenario where consumers are also less likely to be involved in fraud.

MR. EGGERT: Faith?

MS. ANDERSON: On the penalty APR, I would like to commend the Board on using the term “penalty” instead of “default” APR, because I think a lot of consumers don't understand what a default is, because that's a legal term. But I would like to point out that there are certain financial institutions like federal credit unions where we are capped at 18 percent, whether it is a penalty, and it's for all loans.

So, for example, I was looking at our solicitation that we had and the rates that we ranged from were 12.24 percent to 17.99 percent. So for us to give another 45 days’ notice for an increase of $1/100^{th}$ of a percent does not make sense. So maybe you would tailor it so that if the purchase APR, whatever the APR increase is by so many points before -- I mean, we will never get to the 29 percent APR -- that it's just not practical to give another 45 days’ notice when we have given the penalty APR in the solicitation.

We have given it in the account agreement, and we have given it also in the account-opening solicitation. And so to give another 45 days’ notice does not make sense for federal credit unions where we are capped at the 18 percent. Which probably is a great deal for them, because if they have defaulted with us or -- I mean, they probably won't find anything better than the 18 percent anyway. So I just wanted to point that out.

MR. EGGERT: Stella?

MS. ADAMS: I want to address a couple of things that why I think the 45-day notice is important, especially on the change in trigger, because of late pay. Many people are triggered into that fee by the fact that the accounting on the bills is done by 10:00 a.m. in the morning and if your payment gets in at 12:00 in the afternoon, then that is a late pay and that triggers the fee.

The other thing is that a lot of consumers write their bills once a month, but the bill -- the behavior of the billing is on 25 days. So that puts them into the thing. The third thing is that the 45 percent who can afford to make their total payment and have that interest-free rope, shouldn't -- we should not -- those of us who can't make the total payment every month on the credit card should not be supplementing through fees the losses that you make on the other folks.

Perhaps you should then charge interest to those folks in another way. But you should not be feeing the other folks to death to compensate for that. So if we are going to say that people who have thought they paid their payments on time, should have the 45 days to find out that they hit a late fee and they are like what are you talking about? I mailed it in on time. I've got where it was paid on this day. And then they would learn oh, well, if you didn't pay it by -- because they didn't read the disclosure where it says it's by 10:00 a.m. in the morning of that day, when the mail actually arrives at 2:00 in the afternoon in that office. So there is some trickery in the way these penalties are used and so there should be some notice that you have actually triggered it.

MR. EGGERT: Alan?

MR. WHITE: First of all, on the issue of cards providing free credit to 45 percent of their users, I'm certainly one of those users. I think Josh neglected to mention the interchange fee, which is a source of considerable revenue for the card issuers. It's the money the merchants pay, not the consumers, but it's nevertheless revenue that is generated by people who use cards as a payment device and as a source of, I guess, short-term credit, but, you know, not very long-term credit.

I do think though that Stella's point is correct -- that there is to some extent a cross subsidy, a very unfortunate cross subsidy between, you know, the most -- people in the most dire straits who are providing, you know, more than their share of the revenue. And there has been a very interesting article written about that that just characterizes it as the sweat box, you know, the way the card issuers can make the most money and this relates somewhat to bankruptcy reform as well, because to get people into default, but not push them so far that they just stop paying

altogether, but just keep running up those so-called behavior-related fees.

And, you know, that particular article takes a somewhat cynical view of the approach that card issuers are taking to their pricing and I'm not sure I completely endorse it, but, you know, I think that there is a reason that consumers and commentators are cynical about the pricing of credit cards. I think that's unfortunate, and I want to repeat my suggestion that the Board ought to at least do some research and investigation on this cross-subsidy issue and on the degree to which penalty fees and behavioral-related fees in credit cards are cost-related, or are they, in fact, cross-subsidizing the free riders like me?

MR. EGGERT: Patty?

MS. HASSON: I just wanted to comment, I guess, to first agree with Josh that I believe financial institutions are in business to make a profit. And I also believe that they were originally started so that people could make purchases. But I don't think it was the consumer who one day said I would love my credit card to give me a cash advance. I think that the industry developed them as a profitability model, and there is nothing -- I don't have -- I think that's great. But I think that's why it's even more critical that when people get that cash advance, they truly know what they are paying for, so that the all-inclusive APR is critical, so that people can shop around and understand the difference between the cards first.

And on the 45-day notice, I think in bankruptcy today in bankruptcy reform, whether you agree whether it's working or not, six months prior you have to go for credit counseling and a lot of people are saying it's too late. Perhaps with the 45-day notice, we could have an impact where people may take that time to truly seek out credit counseling prior to it being too late. So I just think that's an important consideration to take into account, and those 45 days would give the consumer that opportunity to really step back and look at their finances.

MR. EGGERT: Okay. Before I get to Josh, I would like to make one point though. And to build on something that Alan said, you know, the purpose of these disclosures is to encourage competition based on price. And that's what we want to do. We want credit card companies to be fighting it out based on price, and that includes all types of price, not just interest rates, but also default interest rates.

I think having the 45-day wait does a lot to encourage that kind of competition in that it gives consumers a time to say what do I do now and how can I fix things? I have this default interest rate coming at me. There is something called the sticky default in that people tend to stay

where they are rather than move, and I think not having a delay encourages that.

If somebody says I'm already mired in this default interest rate, you know, maybe I'll do something in the next couple of weeks, maybe I won't. But if they say I have now only 30 days to do something and now I have 20 days to do something, it encourages them to take action, and that encouragement, I think, will stimulate competition between cards based on default rates.

I think if you are a credit union and can only charge 18 percent default rate, I would be advertising that. And I think that we want to encourage that kind of competition. Josh?

MR. PEIREZ: First, let me agree wholeheartedly with Stella's point on the time-of-payment issues. I just don't think they should link to the default or penalty payment rate issue. I think that there should be a separate issue to address time of payment, day of payment, whatever the clear rule is, clear disclosure of it, so consumers understand, because the person who gets the check in on the day it's due and missed by an hour or two should not, frankly, have a late fee for that, should not be penalized for that. There should be some clear standard, and we certainly don't oppose that.

So let me just start by saying I just don't see those two issues as being linked, and I don't think it should be a situation where people can be fooled into the default interest rate as opposed to the people who actually go there because they didn't make their payment or because they, you know, didn't make their payment for two or three months or whatever the trigger is for that default, because it's not always one time.

You know, some issuers have it for two or three cycles, and I think that when you extend the time, the law of unintended consequences has to be considered here, because issuers are going to look at what that extension of time means to them. And they are going to make a couple of calculations. One, can I really continue to afford to provide this lower initial rate on the condition that people are not going to default when I now have this 45 day, which based on cycles and billing cycles and timing could equal 70, 75 days, whatever the number is.

We heard pretty consistently from industry it's longer than the 45 by the time they are actually able to get the notice out and trigger the rate change.

Secondly, I think you would look at issuers saying, okay, well, you know, do I need to make the higher rate go higher to make up for the window of time where I'm not able to recover the increase based on this behavior that has taken place? That's the second, you know, thing that sort of, obviously, would have to figure into an issuer's calculation.

And I think the third thing that's going to have to figure into an issuer's calculation at that point in time is what the triggering events that they are going to look at are going to be. So for those issuers today who say if you miss two straight months or if you're late twice in a six-month period, and there are plenty of those, those people are going to have to look at that and say well, now, that I'm providing a 45-day window, should I shrink the trigger, so that I can, you know, get my 45-day notice out there based on a consumer, I think, is going to incur the kinds of behavior they have incurred in the past and, you know, make those types of calculations.

And I think I'm not objecting to some notice there, and I'm certainly saying it should be in the account-opening documentation. And I think if it's not in the account-opening documentation, 45 days is fine. But otherwise, I really do wonder why you would have the exact same period of time for a change that has been previously disclosed as a condition of the credit as for changes that are true changes that were never disclosed and are just changes.

And I think that, you know, here we're just drawing the assumption that if 45 days is good for one, it should be good for the other when, in fact, the circumstances are quite different in the two. And I really think that that is something that should be considered, because there is a reason why issuers are disclosing up front the default rate calculation change, because they are saying we are going to change it. This is not something we are considering in the future or thinking about. This is a condition of the loan.

And the last point, I think just to go back to a couple of things that have been said, you know, I think it's very important to remember that these are unsecured portable loan products. And there are not that many of them in the world in terms of the types of them. There are lots of cards, obviously, and types of card products and, you know, there is significant risk with them.

But there are also tremendous benefits with them. And I think that, you know, again, I believe that consumer desire to be able to have an unsecured loan mechanism at their hands, that they did not need to apply for at the time they wanted cash, is one of the driving factors that led issuers to provide cash advances to the point that Patty was making.

And so I think that it's important to note that yes, issuers obviously recognize that that was something that could be demanded from their products and could be a feature that would be attractive to consumers, but allowing somebody to take an unsecured extension of cash on a card that has been out for a number of years, has a very different risk profile than other things. And to include, you know, that in an APR that applies to purchases and other standard things up front

becomes misleading.

You should disclose both and they should be clear. But, you know, the percentage of consumers who use their cards to make purchases far dwarfs the percentage of consumers who use their cards for cash advances. You know, other than the people who never use their cards and just have them, because they like having them. People use their cards to make purchases. Almost all people who have -- you know, who get them, that's why they want to use them. So I just, you know, think we have to draw those characterizations.

MR. EGGERT: Faith?

MS. ANDERSON: I just wanted to add that when it's required that 45 days' notice be given before there can be a change in terms, that really for less sophisticated financial institutions that rely on third parties, we're actually giving more than 45 days. It can be up to 90 days. Because, for example, when we send out statements for a credit card, they don't all go out on January 1, because of the number. Some go out the first week, the second week, the third week, and the fourth week of the month, or sometimes even it falls into the first week of the following month -- the week of February 1.

And we don't have the sophistication to say, okay, those consumers who receive their 45 days' notice so that the new fee or whatever the changes can be effective on March 15 or, I mean, February 15. You know, those fees will go into effect as of February 15th for those consumers who didn't receive a change-in-terms notice -- it wasn't mailed out until the beginning of February 1, and so really their fees wouldn't be effective until, let's say, March 15 or March 16. Those fees will then go into effect on March 15 or 16.

What we would do is we would say all change in terms are effective on April 1, just because it's just easier to explain to our call centers when they get calls from consumers. You know, what is or why is there a change in terms and what is the new effective date. And even if it went down to 30 days' notice, I was calculating that we would still probably not have the new change in terms effective until April 1, just because of the timing of when all of the various change-in-terms notices would be given out on the periodic statement.

So, please, keep that in mind too -- that when you say 45 days, that's just the minimum. It's really going to be 75 days or 90 days, depending on how the institution sends out their statements on the change in terms.

MR. EGGERT: Patty?

MS. HASSON: Just on the point where the disclosure is being sent out with the original application. I think I happened to pull out my American Express, because I know it says the date I got the card, it was 1990. So in 1990 they told me that my APR may get jacked-up if I forget to make a payment or two, because I'm, you know, traveling in France, because I wouldn't do it otherwise doing what I do.

You know, I think it's important that people keep that in mind. Some of these cards people have in their wallets they have had for a long time and mishaps happen, illnesses happen, you know, we know the story. So I think that's important.

And the second point is that as a small non-profit who works with credit card companies, we have been forced to automate from the point that I came there to today where we're told you need to do everything electronically. We figured it out, folks. It wasn't easy. It cost us money. Those of us who even have less money, but we figured it out.

So I have to push back on the industry here and say, well, I understand your concerns around 45 days. I do think that there are ways within your system that may cost you a little bit, and you may have to think differently about how you do it, but you can get those notices out and change your system. So, you know, if I could do it on my budget, I believe others can.

MR. EGGERT: Okay. The next subtopic that we are going to address is going back to that favorite topic of the effective APR, only this time focusing not on the solicitation overall typical APR for the credit card supplier, but rather the specific effective APR for the individual credit card user. And so I would like to turn to oh, let's say, Josh, for example, on this issue.

MR. PEIREZ: I just want to say I didn't actually ask to lead this one off, I was appointed. I think that --

MR. EGGERT: Anointed.

MR. PEIREZ: Anointed, yes. We discussed, I think, many aspects of this already, so what I would really say is that for a consumer, I think, the proposed disclosure that has a year-to-date interest paid and year-to-date fees paid is an excellent format, that I think very usefully provides to the consumer on a year-to-date basis exactly what they are paying for their card.

And I think it doesn't mislead them into thinking it's interest when it's not interest or it's fees when it is not fees or it's optional when it is not optional. It very clearly says here is what you paid in interest, here is what you paid in fees. Obviously, they will also have received disclosures as time has gone on of exactly what fee they paid what for, so it's just a year-to-date

calculation that they can use over time. I would encourage the Board to keep that format.

I think that trying to come up with an APR calculation that moves away from the traditional finance charge and other fees calculations to a fully loaded or inclusive APR, as I have stated earlier, really provides ultimately very misleading information, particularly in the initial days or initial part of the year to a consumer where fees may be incurred.

I think a lot of it will become a timing question more than an actual percentage rate question. I would just encourage, you know, the Board to think about, you know, what really is understandable and meaningful here and, you know, the interest paid makes a lot of sense. The fees paid makes a lot of sense. The interest applicable to certain balances makes a lot of sense and should be disclosed.

But trying to then jumble all those things together to come up with a single interest rate that you can say, well, that is the real measure of the cost of this credit -- I think is misleading, because it's not the cost of the credit. It's the cost of many other things in addition to the extension of the credit. And for most consumers, it will be a very misleading number, in fact, probably for all. So I would just encourage the Board to go with the interest paid, fees paid, and applicable APRs to different balance mechanisms.

MR. EGGERT: Faith?

MS. ANDERSON: I would just like to echo some of Josh's statements. I would like to also commend the Board on how they grouped various purchases and the balance transfers and the fees and the interest, you know -- they have given it in summary form in dollars, which I believe, in consumer testing, they found to be very helpful. And I still would like to echo that. However, even though you call an effective APR a fee-inclusive APR, I still believe that a lot of consumers won't understand that.

And especially since they already are receiving great information on the new format of the periodic statement, I just think it would be redundant and add more confusion, because maybe they -- if they even did see the effective APR before, you know, we're calling it a much friendlier term that would be easier to understand, but I still think we would get questions where they would think, oh, you've increased my rate and why did you increase my rate.

And really when we would really like them to focus on, look at the dollars that you have been spending on fees and on your balance transfers and look how much interest you have paid to date. I mean I think all that information is already very helpful to consumers.

MR. EGGERT: Carolyn?

MS. CARTER: Yes. There are many things that the Board has done with the periodic statement that the Board is proposing to do that I think are very good. The formatting is a great improvement. I'm very, very concerned about the approach to the effective rate, interest rate or the fee-inclusive interest rate. To me, the effective or fee-inclusive interest APR is about the most important disclosure that consumers get in their -- with their credit cards.

Credit card pricing has been over the past couple of decades like a 1,000 pound pillow where you squeeze at one end and then it bulges out at another end. Interest, there has been competition on the periodic rate and we see a lot of zero percent APR credit cards, really low APR credit cards, but then fees balloon. If you start squeezing the fees too, something else will balloon.

The fee-inclusive -- or better yet, all-inclusive APR -- is the way to capture the true costs of credit, rather than just one or two components of the cost of credit. And the recent history has shown that if you capture one cost, then the cost just moves to a portion of the pricing that isn't captured. So there are two things that I'm very concerned about with the Board's proposal.

First is that the Board is proposing that if it retains -- well, first, let me say one thing I really, really like, and that is terming it the fee-inclusive APR. Your testing showed that no one, no consumer understood effective APR or the terms that were being used. When you switched in the fourth round of testing to the term fee-inclusive APR, then a majority of your consumers tested understood that. That's what your report said, and I believe it was 50 percent, 51 percent type majority.

But that was the first time you had ever used a term like fee-inclusive APR. And in terms of the terminology, you're on the right track. Keep going. And even 50 percent, I submit, is a good high number when you look at how many people understand decimals, that may be about 50 percent too. 50 percent is good. You can probably even do better, and I think you have solved the problem of consumers not understanding this disclosure, or at least you're on your way to solve it.

So my concerns are, first, that the proposal would confine the fees and charges that are included in the fee-inclusive APR to a closed list. And that just asks for the 1,000 pound pillow problem, because that just means that we will see movement from fees that are included in the closed list to fees that aren't included in the closed list, and it will once again stop capturing the true cost of credit.

And there are many types of fees that I think are not optional. They are not

contingent, they are truly, clearly -- no one would disagree they are finance charges. They are a part of the cost of credit that should be included in the fee-inclusive APR.

And then second, of even greater concern, is the alternate proposal to abolish the fee-inclusive APR. This is a critical disclosure for consumers that you should retain. And the example that I would like to give is a payday loan product that has been -- that was developed in Pennsylvania about three months after the FDIC finally stopped its rent-a-bank arrangement, which had allowed payday lenders in Pennsylvania to issue closed-end, the standard closed-end payday loan.

When that was shut down, within several months, a large payday lender in Pennsylvania rolled out an open-end payday loan product where the consumer gets a $500 line of credit at 6 percent interest, sounds good. There is also a monthly maintenance fee of $149. So if the consumer has the full $500 -- has taken advantage of the full $500 extension of credit, the consumer is paying an actual annual percentage rate of 432 percent.

If the consumer has only taken $250, then it is double that. And right now under the disclosure regime, since even now the definition of fees that are included in the effective annual percentage rate doesn't include all components that we would recognize as finance charge, that payday lender is disclosing on its periodic statement 6 percent as well as advertising 6 percent, so that is so deceptive.

So for -- the full cost of credit should be -- can be captured and should be captured by a fee-inclusive APR, and I encourage the Board to move away from the idea of a closed list of fees and to retain the fee-inclusive APR.

MR. EGGERT: Anna?

MS. RENTSCHLER: I want to address Patty's comment with regard to the change. It brings the element of time into my mind, in that when the Board finally does come about with the definitive changes they are going to put in there, that you need to keep in mind that we need a substantial period of time to change our systems. Many of us, and I don't know the size of Patty's organization, but I don't want to compare her definitely, but many of us are on a ski-doo or a jet ski and then there are others that are an aircraft carrier and it takes time to turn that aircraft carrier around.

And so we have many things on our plate, because many of us are not just credit card issuers. We are financial institutions with many products. And once you get in the

programming requests and all the changes we need to make, this will take a large period of time, because it is a substantial change.

MR. EGGERT: Marva?

MS. WILLIAMS: I just would like to make a general comment about credit card use, in fact, consumer loan products. And I, first of all, want to say thank you to all of you who are looking at very specific disclosure and other kinds of proposals to protect consumers. And I'm reflecting back on Kurt's statement when he opened this topic about the fine balance between consumer choice and consumer protections.

And as I reflect on this conversation, I am -- it makes me think about the whole sort of economic context for credit card and other consumer loans. And we all know that consumers are experiencing stagnating wages and home prices are increasing, that medical costs are increasing. And although there are these stories that people are using their credit cards to buy wide-screen televisions, the truth of it is that 7 out of 10 consumers are using their credit cards for medical expenses and for basic living expenses.

And it's not just credit cards. It's other kinds of consumer loan products like payday loans, auto title loans and increasingly using the equity on their homes to pay their credit cards. And I think that the strategy that we have developed, which, you know, may be sort of a default strategy of consumers using short-term credit to support and to increase their income and the use of these products to fuel our economy are extremely short-sighted and not sustainable and seem to me to be built on a house of cards.

And I just wonder how much longer we're going to continue to facilitate this kind of consumer debt and negative savings and what the long-term effect will be on our economy.

MR. EGGERT: I would like to make a point. Just going back to the over-arching autonomy versus protection, you know, one of the things that people who study disclosures think about is how do you do effective disclosures? It's a very difficult task. And I think it's even more difficult when you have a fairly complex financial product. Disclosing the cost of fees and credit cards is one of the more complicated things that an agency has tried to figure out how to disclose.

And I think what your testing has shown is, lo and behold, this thing that we thought was too complex to do, you have succeeded in doing. To have a 50 percent rate of consumers understanding fee-inclusive APR is an amazing achievement. I didn't think -- I thought we could -- if we could get 20 or 30 percent, we could pat ourselves on the back and go home and

have a beer. To get to 50 percent is amazing.

A lot of scholars look at, you know, what drives the market. And they say a small number of people who really understand products can drive competition. I think 50 percent is a great achievement. And so I think you -- maybe there is room for improvement, but even if it doesn't improve at all, I think that that's a wonderful thing and that it should be included and that you should be congratulated.

Faith and then Joe.

MS. ANDERSON: I would like to echo Anna's comments regarding when this does finally get finalized and we have to get our statements in a certain order. A lot of us rely also on third-party vendors. And so we don't really even have control over them to make sure that they follow everything, so we would just appreciate much lead time, because I know that in the minimum payment section, I know a lot of financial institutions would like to avoid giving the warning that if you -- that if the consumer only makes the minimum payments, that they would pay more interest and that it would extend their payments.

We would like to avoid giving the hypothetical example when minimum payments are made, because it's hypothetical and it won't mean anything to anybody. And we also would like to avoid having another toll-free number. So if our third-party processor can give our consumer the actual amount, the actual -- how long it would take for them to pay off their balance with the actual minimum payment, based on their actual APR, I think all of us would just love that.

And so we would really push our third-party vendors to at least have that in the statement, plus everything else that's required in the new formatting. But we think that would be great, because then consumers can receive accurate information. There is no chance for error. So thank you.

MR. EGGERT: Joe?

MR. FALK: I am very depressed over this discussion. And the reason is that the last time I checked, we were consumer-driven, capitalist system. It doesn't really talk about redistribution of wealth and redistribution across different product lines and consumers within an individual privately owned industry.

But what really makes me very, very frustrated is that we're very proud of the fact that 50 percent of the people understand what a percentage is. There's something wrong with that. And to the degree that at least one voice here today should say we need a commitment to financial

literacy, there has to be a way to get into the high schools and into the colleges to give consumers, new consumers of credit whatever their product, whether it is home mortgage, (I'm up next for the hit parade), whether it's payday loans or any of these other products, unless consumers ultimately, you know, we individuals, you know, either teach our kids or ultimately train the next generation of consumers as to the effective use of credit, what it means, how to read the forms.

Until such time as we can get to 90 percent of the people who can understand what a percentage rate is, you know, we shouldn't be too proud of ourselves, is my view.

MR. EGGERT: I think that's a good point. I didn't quite understand the percentages you were using, but I thought it was a great point. Carolyn?

MS. CARTER: I was going to first applaud Faith Anderson's approach to the minimum payment length of time disclosure. I think it would -- I just hope that other credit card issuers do exactly what Faith is proposing to do, which is give the actual time it would take to pay at the minimum payment, rather than the extremely complex set of 800 numbers and charts and matrices and generic disclosures that are in the Bankruptcy Act. That is so much the way we should be going.

MR. EGGERT: Which is -- oh, Ed?

MR. SIVAK: Thanks, Kurt. I just wanted to also highlight, I think, that the late payment warning inclusion on the periodic statement is an excellent addition. They should put it on the front. The notice about minimum payments is a very important addition. I really like the way that transactions were grouped in categories and the years -- the totals for year-to-date.

I actually think that year-to-date total would facilitate financial management discussions in my home. I'll check it out and let you all know. I also want to put a plug in on the fee-inclusive APR, just from the standpoint of people who I interact with every day in the Mississippi Delta. We are a community development finance institution so, you know, we're in the business of making small business loans. We do low-income home loans. We do consumer loans.

The very first question that people ask regardless of how much financial sophistication is theirs, what's the interest rate. People understand what the interest rate is. They don't ask what's the origination fee on that small business loan. They don't ask, you know, those types of things. They recognize that if it's a 10 percent interest rate or it's a 5 percent interest rate or it's 15 percent, higher means I'm going to pay more.

And so I think that I agree that 50 percent is a floor. Let's keep testing and see

what we can do to make that point, how we can get more understanding of what that means, because I think that's what consumers understand.

MR. EGGERT: Josh?

DIRECTOR BRAUNSTEIN: Can I ask Ed a question? I have to admit, I was a little surprised to hear you say that the first question people have is what is the interest rate, because what we have heard in other venues is, for any kind of loan, the first question people usually ask is what's my monthly payment.

MR. SIVAK: That's just -- again, that's anecdotal. That's a lot of -- people will ask or even like a conversation I had in the store. Again, we're a community development finance institution and often have higher rates, and they are saying, oh, you guys have big interest rates, don't you? You know, so that notice, recognition that high interest rates have higher payments, so that's how --

MR. EGGERT: Is your mike on?

MR. SIVAK: Pretty much. It's green.

MR. EGGERT: Josh?

MR. PEIREZ: Yes, I would just -- I think Ed's point is a good one I would like to latch on to, which is to say, you know, if someone is asking what the interest rate is, what they are trying to ask is what am I paying as a percent on what you are lending me. And that's different from well, what's the origination fee or what are the other fees.

And so I think I support that view, which is, you know, having a very clear disclosure, it says this is what you pay on what I lend you and this is what you pay for certain other services and I think that's very much the point, you know, I have been making. And I think that it's not a fee-inclusive APR. That's a -- this is your interest rate. And I think that's a much more straightforward thing.

I think to Joe's point, I would hope we have far higher than 50 percent of people who understand this is the percent you pay on what you carry as a balance with me. I would hope we're in the 80s. I have no idea. But I really understand -- I really do also think I personally don't know that I understand what the data from the studies, you know, in the focus groups shows in terms of what understanding means in an interest -- in a fully loaded APR context, you know, a fee-inclusive APR context.

I mean, do they understand that that is, in fact, not really what they are paying on

the extension of a loan? That instead that is what they are paying in fees included that may or may not be carried as a loan, and it's not really a reflection of what the cost of that card might be to them, because it would depend on their behavior and which services they choose to take or not take advantage of and in which things behaviorally they choose to do or not do.

So I'm not sure I understand what the 50 percent think they are understanding in that context, because I think the fee-inclusive APR is actually an extremely complicated calculation that I think is extremely hard to understand if you really mean understand in a fulsome way in that regard. So I just would encourage us to understand, you know, to really look at what it is consumers think they are understanding in that context.

MR. EGGERT: Stella?

MS. ADAMS: I want to thank the Board and the staff for doing the consumer studies and getting information from actual consumers about what they do and don't understand and how they do -- and their behavior in trying to craft disclosures that are assistive to consumers. Because getting back to the original issue about the balance between consumer choice and consumer protection, if you don't understand, you don't make a choice, and so you then need protection.

But to the extent that you can get the consumer to understand the decisions that they are making, then they are making a choice. To the extent that they don't understand what's going on, then you need to find a way to protect them from abuse. And that's where the balance is. And I think that you have done a good job of finding some of that balance in these new disclosures.

MR. EGGERT: Okay. We're taking a break in a couple of minutes, but we'll turn to Edna.

MS. SAWADY: Thank you. In many of our comments today we have -- people have applauded the consumer testing, which I definitely agree with. I just wanted to alert us all and bring to our awareness the difference between qualitative testing and quantitative testing. Quite a few of us talked about focus groups. Focus groups are a way of qualitative testing, which have their role and are very useful in many circumstances. But it's very hard or actually impossible to generalize from qualitative testing and say whether it is 50 percent, 80 percent, or 20 percent of the population that is affected.

We need to compare it with some sort of quantitative testing and a very carefully designed study. And I'm not suggesting it wasn't that. I'm just alerting us that focus groups not always can represent what the true understanding is. Their role is more to bring up ideas, to figure

out what issues need to be tested quantitatively, but are still this other step of quantitative testing before we can say whether we do or do not -- whether most of the population or a portion of the population does or does not understand something.

DIRECTOR BRAUNSTEIN: Just to address that, our next phase of this project is going to include quantitative testing. So we are planning to do that with these forms, because we agree with what you're saying.

MS. SAWADY: And I'm sure that all the researchers, that our staff already know that. I just wanted to alert us, as somebody who is reading the reports, not to put too much emphasis on results of qualitative before we have the quantitative endorsement of it.

MR. EGGERT: Okay. Faith, and then I'll give Patty the last word.

MS. SCHWARTZ: I'll hold mine for the HOEPA disclosure discussion.

MR. EGGERT: All right. And we're looking forward to it. Patty?

MS. HASSON: And I'll be brief. I can't let the mortgage broker end on financial education, come on, Joe. As an agency and an entity that does financial education, lives it, breathes it, I agree with you, Joe. I think the one thing I want to caution everybody, I didn't grow up learning financial education in high school. I think it was a much simpler world. I think there was a lot more consumer protections out there. There were caps on interest rates. There were a lot of different things.

So assuming that we can educate people and I spend my days and nights doing that, I can tell you folks we still need consumer protections. We still need the disclosures that are in this and these alone will not work.

MR. FALK: But my comment was not one to the exclusion of the other. My comment was --

MS. HASSON: Yes, I --

MR. FALK: -- more addressing the question, is there a role for the Fed? Is there a role for government? Whether it is congressional or otherwise, agency-driven, for increasing the expenditure either through private or through public means to fund appropriate outreach for financial literacy, no matter what the product. Because if all we do is end up squeezing, changing, working on the technical details of what a piece of paper means and says and at the end of the day the consumer doesn't open the envelope, doesn't care enough to actually look at the piece of paper or if they look at the blizzard of numbers, they ultimately don't get anything out of those numbers.

Then all of this is interesting, but won't solve the problem, which is the effective, rational, appropriate use of credit by consumers. And so if we don't try at least to do something about financial literacy, either in the schools or the question of parental guidance or in the colleges, somewhere, then we just throw up our hands and say we're not going to arm -- we're not even going to give consumers a chance to understand these things until such time as they are in trouble.

So I would prefer at least to spend a little bit of time on preventive medicine. Let's spend a little more time than we are spending now, rather than just reacting to a problem. And I haven't seen a commitment on that. I've testified in Congress on it. Others have said it. There have been bills that have been proffered in Congress to fund additional money towards financial literacy in the high schools and college and, at this point, I don't see any result of those efforts.

MS. WILLIAMS: I'm sorry to beg the point, but I think there has been a significant commitment to financial literacy education over the past several years. Whether it is bank regulatory agencies like the Federal Reserve or non-profit organizations, schools, there are many, many efforts and initiatives out there to increase financial literacy.

However, it has its limitations, and I think careful evaluation of those programs is really important. But as you mentioned before, you know, this consumer education in and of itself is not sufficient -- that regulations and the development of affordable alternative products is also a very important part of this.

MR. EGGERT: I would like to thank you all for an interesting discussion.

CHAIR SODEIKA: Thank you, everyone. A very robust discussion this morning. We will take a 10-minute break and start on HOEPA promptly at 11:00.

(Whereupon, at 10:53 a.m. a recess until 11:09 a.m.)

CHAIR SODEIKA: Okay. We'll continue our meeting by discussing a topic that was the subject of the Board's June 14th public hearing under the Home Ownership and Equity Protection Act, otherwise known as HOEPA. The purpose of the hearing was to gather information on whether and, if so, how the Board might craft rules to stop fraud and abusive practices in the home mortgage market.

Yesterday, members of the Community Affairs and Housing and the Consumer Credit Subcommittees discussed various issues related to the Board's HOEPA authority. We all discussed various practices as well as the differences and pros and cons between establishing rules versus guidelines on these topics. And so I would like to call upon Stella Adams to start and lead the

Council's discussion on this topic. Stella?

MS. ADAMS: Thank you, Lisa. We had yesterday a very spirited discussion amongst the members, because this was an issue -- the HOEPA is such an issue of importance to all of our communities that we were all very invested in this topic, so much so that we worked through lunch to try to iron out and give perspectives. And so I guess we would, too, the 80/20 rule. There was 80 percent of it that we really did have real agreement and consensus on, and then there is that 20 percent that we will be discussing here today.

There is a lot of passion around this from all sides and we're going to try our best, I'm going to try our best to make sure that the Board gets a flavor of the issues and concerns of the members of the CAC and our best recommendations on how to fix the problem, because the problem is overwhelming on the ground. It may not be a macroeconomic crisis, but on the micro level, we're drowning and we need the help of the Board.

I'm going to ask Kurt to talk about kind of one of the key pieces of the 20 percent problematic, and that's the issue about rule-making versus guidance and so we want to talk about that and I'll have him tee that up.

MR. EGGERT: Okay. One of the primary or first issues that needs to be resolved in deciding what to do about this is should the Board be acting in its rule-making capacity or merely issue guidances, which it has already done? And so we, as a committee, have tried to educate ourselves on the differences between the two, both in terms of what they mean, but also in terms of the effect that they would have on the industry.

And so I would like to start by asking Faith to discuss this.

MS. SCHWARTZ: Good morning. Thank you, Kurt. We had -- as Stella said, had a robust discussion and actually on many of the terms and issues on how it could be corrected, I think there was quite a bit of agreement -- it was just well, where do they fall. Do you put underwriting in guidance? Do you put it in rule-making? Do you put prepays in rule-making or guidance, etcetera?

And what I would like to ask is that people step back and look at what you just issued in the non-traditional guidance, which is on interest-only mortgages and option ARMs. I think you had a little help from market conditions in addition to rating agencies and others who have already repriced interest-only going into your final guidance.

But with that said, when you issued your non-traditional guidance, that covered

quote the banks and some of the other institutions, but not the brokers or mortgage bankers, hedge funds, whomever, I would suggest it was very powerful and transformational in the market. When you requested that interest-only ARMs be underwritten at fully indexed rates, which were probably not being done so across the whole market, no matter where you got some of these loans, that has changed.

You have seen a market -- change in the market based on guidance and because the states have adopted it -- not all of them, by the way, but some companies like ours have adopted it in all 50 states. So my only point on guidance versus rule-making is it's our recommendation when you go to your rule-making, if they are bright, clear lines, that's easy. That's easy to have a prepayment penalty with clear terms, clear choice on how to market it, etcetera.

If you want to curb them, restrict them, bright red lines are good, because lenders can program systems for that on the front end -- someone else selling it, it doesn't matter, you can't get it through the system.

On underwriting and other issues, we will get to them. That's more dynamic and changes the dynamics of the rates, higher, lower, all over the place and the marketplace has been there. And I just would suggest the market already has adopted your guidance largely. Thanks.

MR. EGGERT: Alan?

MR. WHITE: Let me step back a little and, for the purposes of this discussion, talk about the approach to regulating the subprime market and some of the premises that underlie it. I, obviously, am an advocate for some strong, clear, substantive regulation of the terms and conditions of subprime mortgages. Most of the Federal Reserve Board's public statements on either the subprime market or its HOEPA regulatory authority seem to start with a formula which consists of, I would say, three premises.

First, that the subprime mortgage market is working well and improving consumer welfare. Secondly, that regulation could have unintended consequences, presumably, that would reduce consumer welfare. And third, that disclosure is the best way to protect consumers. And my view is illustrative of something that has come to be known in the academy as autistic economics. I think if you start with these kind of counterfactual premises, you are going to develop regulations that are not going to be either effective or useful.

I think if you look at the empirical evidence on how this market, the deregulated mortgage market has functioned for the last 10 or 15 years, I would say that this market has caused

considerable harm or disutility, to use the economist's term, to consumers, and that regulation, at least at the state level, has been proven to be very beneficial and to improve consumer welfare. And I'm going to refer to a couple of the studies that were discussed at the Fed's, the Consumer Affairs Research Conference back in March, that I think were very illuminating on some of these questions.

First of all, as to the benefits of the subprime mortgage market, one of them that is referred to reflexively and really with no evidence is the suggestion that homeownership rates have been increased because of subprime lending. There really is no data to support that contention. And the one study I know of that has looked at the net effect of subprime lending on homeownership has found it to be negative, simply because of the fact that a small percentage of subprime mortgages are purchase loans. And even a smaller percentage are to first-time homebuyers adding, you know, net new homeowners.

And the overall foreclosure rate has reached a point where there are more foreclosures every year than there are new homes being purchased as a result of subprime lending. In addition, I think if you look at the way subprime mortgage lending has displaced the market share of FHA lending, it's not clear that had subprime lending been significantly curtailed for the last 10 or 15 years, that there would have been a lower homeownership rate.

I don't pretend to know the answer to that question, but I think to assume that homeownership has been promoted by subprime lending is to assume something that's never been proven.

Secondly, what subprime loans are mostly used for -- not to buy houses, but to get cash out -- to that extent, they have stimulated consumer spending, certainly. I saw that Chairman Greenspan had just written a paper that suggested that a fairly significant percentage of overall consumer spending came from cash-out refinancings.

The problem with that as a consumer benefit is that it also has resulted in stripping wealth that -- the function of liquidating home equity to facilitate consumer spending also means that wealth accumulation has been significantly impaired. And the transaction costs of home equity borrowing are very high, especially in the subprime market. And that wealth-stripping effect has fallen particularly hard on black and Latino families.

So to say that, overall, making all this cash available to consumers has been a positive is also a premise, I think, that has to be looked at a lot more closely to see whether on the whole there has been a benefit or a harm caused by this deregulated market.

The third notion is that somehow access to credit has been improved. That people who otherwise couldn't get credit now have access to credit. And I think that's also not something that has been empirically demonstrated. In my experience, most of the homeowner clients I have who have access to subprime credit had access to other forms of credit before, if they were already existing homeowners.

And to a large extent, the first home mortgage refinancing has displaced second mortgage lending, home equity lines of credit, other kinds of credit, sometimes perhaps much more expensive, at least on the interest rate side, but it's not clear to me that it has been demonstrated that there has been a useful and beneficial effect of making credit available to people who didn't have it before. It's just simply an assertion that is accepted on faith.

And finally, I think, it's also important to keep in mind the price discrimination that has been clearly demonstrated exists in this market. Price discrimination with a small d and a capital D. The fact is that the market has resulted in what we could call a black tax. That African-American, Latino homeowners are paying considerably more for credit, and we're not successful in controlling for cost-based justifications for that differential.

So the market has driven a wedge in the black/white wealth gap, which I think is something that we do not want to encourage with our social policy.

And finally, with regard to regulation, there was an excellent paper that Patricia McCoy presented at the conference in March that looked very closely at the states that have regulated subprime lending, including things like just banning prepayment penalties and various other restrictions, and it found that the stronger the regulation, the higher were the level of both applications and approvals for subprime credit.

And there have been a number of other empirical studies, some of them focused specifically on North Carolina, because it was the first state to adopt fairly strict regulations, but I have never seen an empirical study that convincingly demonstrated that strict regulation of subprime lending hurt the economy or hurt consumers or dried up access to credit.

So I think to continually restate the premise that regulation is going to have all these dangerous, unintended consequences is really to ignore the experience we have had over the last 10 years. So, I think, you know, a much better introductory statement to a discussion about the subprime mortgage market and the role of the Fed in regulating it is to say the following:

That we deregulated mortgage interest rates in the 1980s. That led to a huge

increase in subprime lending. That the result has been there have been significant harmful effects on the consumers who took out these loans, and there is a need for reasonable regulation, directed not only at consumer information, but at the structure and the risk that these products have created for consumers.

I'm certainly not advocating that the subprime market be abolished, but it clearly needs to be regulated and we now have the experience to see the problems that it has created. It's clear also to me that because of the structures that securitization has created, that the market is not going to correct these problems by itself, that there will continue to be cycles and there will continue to be an over-supply of lending capital trying to create products that benefit investors and don't necessarily benefit consumers.

And so I think if you rethink the premises of regulating this market, the outcome and the regulation you're going to write, it's going to look a lot different.

MR. EGGERT: Sarah?

MS. LUDWIG: Good morning. I'm going to talk a little bit about guidance versus regulation in the context of a borrower’s ability to repay, but before I get into that, I just want to sort of reiterate something that Alan was pointing out, which is a real problem we have seen in thinking about sound policymaking, which is that there are these sort of oft-uttered myths or statements or rhetoric around this whole issue or set of issues that have gotten to the point where you are sort of taught that if you're going to be an effective messenger, just keep saying the same thing over and over again. But it doesn't make it true.

It doesn't make it true to say it over and over again that if we regulate, it's going to dry up credit. Well, what are the adjectives there? Is it going to dry up abusive credit? We hope so. You know, to say over and over again that, you know, some of the myths around borrowers using loans like ATMs, you know, things like that. And we had mentioned that, of course, all of that gets a little bit distressing after a time.

On the borrower's ability to repay, whether there should be guidance or a rule, we had a discussion about it yesterday. I guess it came as no surprise that the lenders or those who represent lending institutions on the Council were pretty consistent in strenuously arguing that we need guidance not a rule. And part of that argument was that they, as member banks or as reputable financial institutions, voluntarily comply with guidance.

What we have seen, however, is that although the Federal Reserve has issued

guidance regarding the borrower's ability to repay, both in 1999 and 2001, it just look -- when we just look around at the world, it hasn't been effective in ensuring that loans are made that are affordable or verifiably affordable to borrowers.

And whether, you know, we're talking about the refinancing scams of the '90s, the property flipping that came after that, or the newer array of subprime and non-traditional mortgages, the hallmark of all of these in the abusive context is that they are unaffordable to borrowers. And many of us, in our daily work, for years now have seen borrowers -- young, old, from one neighborhood or another -- but what they all had in common, you know, no matter what specific product they had, is that they couldn't afford to repay their loan.

And it's something that in most cases, any responsible broker or lender would have been able to ascertain at the outset. Either they couldn't afford the loan when the loan was made, or it was clear they weren't going to be able to afford the loan when it reset. So obviously, this is really core. And, you know, the HOEPA statute granting the Fed jurisdiction is so critically important because -- and here's another reason why we need a rule and not just guidance -- it grants you the jurisdiction over not just your regulatees, but the whole field.

And I can't underscore enough how important that is and why a rule will make requirements that just all these efforts we know won't voluntarily comply within the guidance context. On top of which, the way I read the legislation, you are required to promulgate a rule. And I know that in the context of ability, borrower's ability to repay, there is concern that in the underwriting context, as Faith said earlier, it's not as concrete as prepayment penalties or some of the other provisions that you are looking at.

But I do think that we can achieve through a rule the specificity that gives the secondary market the measurable and quantifiable risk it seeks. And, you know, we had discussion yesterday that, I think, was intriguing that the principle of a borrower's ability to repay would be in the rule and perhaps a guidance could cover what some of those standards would be -- what it means to verify income and things like that.

I guess a few points to keep in mind also that are very important to me are that in thinking about policymaking, it's very easy for any of us to come up with all sorts of exceptions, right, all sorts of kind of well, what about that person who, and then fill in the blank, would be denied credit under this formulation, because they have this exceptional circumstance. And I think that in a lot of these debates that I've been part of for the last decade plus, those sometimes get into

the front of the room and can drive the policy decisions.

And I think it's really important that we not be driven by the exceptions and those sort of convoluted examples that we can all come up with, but really follow a basic principle that most people, if you would ask them, you know, are lenders held to a standard in which borrowers are able to repay their loans, would say, of course, why would a lender ever make a loan that a borrower couldn't afford to repay? What's going on?

I think also the ability to repay is integrally linked with the escrow issue, which we're going to talk about, and the stated-income issue, and there are ways that those could flow together well. I think just as an added accountability standard, and this gets to some of the oft-repeated myths that I have been reading about in the paper, in thinking about this rulemaking and the requirement for lenders, it's really important that lenders bear responsibility, and that's just for making sure that the borrower can repay, but to bear some responsibility for the broker actions.

So many of the loans are, in the subprime market, as we all know, are brokered and, you know, it's the lender who underwrites the loan. It's not the borrower. It's the lender who originates the loan, makes the loan. And some of us are working at the state level to create a duty for brokers, a legal duty to require them to put the best interest of the borrower first. And it's the same thing. I mean, we work in terms of the popular understanding of what goes on.

We do, at our organization in New York, extensive community education. Sometimes there are 20 people in the room, sometimes there are 200. And it's usually a mix of prospective homeowners. Sometimes it's existing homeowners who are thinking about refinancing, and often times it's people who are in foreclosure trying to figure out what their options are.

And we have started in the last six months to ask these rooms full of people just kind of, you know, impressionistically, true or false, the broker has a duty to represent your interests in making the loan? Is it true? And virtually every hand goes up, except sometimes the skeptical person in the back of the room thinking they are being tricked and they come -- I don't know. But it's just what everyone understands in their engagement with the broker.

The same thing, do lenders have an obligation to ensure that you can afford to repay your loan? True or false? True. All the hands go up. It's just understood as a basic principle.

So, you know, we think this is a matter of the -- you know, complying with the HOEPA statute, but also a matter of great urgency to make sure that not only borrowers, but entire neighborhoods are treated justly and equitably and protected.

MR. EGGERT: Okay. Before I hand it back over to Stella -- I would like to add one more thing on the rule versus guidance. There are two major effects, one which has been pointed out as if you do it as a rule, it affects a lot more financial entities. You reach all the ones who are not federally regulated. But the other big difference is who can enforce this? If you do it as a guidance and you have a consumer who says, you know, my lender did not follow this guidance, what really can they do?

Whereas, if it's a rule, it gives individual consumers a lot more power to assert that in any claim. Carolyn?

MS. CARTER: I would like to first commend the Board for this initiative. I'm really glad that the Board is looking at exercising its authority under HOEPA to adopt rules that would address unfair and deceptive practices in the mortgage lending market. On the question of a rule versus guidance, I agree completely with what Sarah said. I just wanted to add one other thing.

HOEPA itself, on the question of whether ability to repay is appropriate as part of -- could be appropriate as part of a rule -- HOEPA itself, the statute, already has a prohibition against lending without regard to ability to repay. Yes, it's only outlawed if it's done as a pattern or practice, so it's a little bit different than the guidance, but that's already incorporated into a statute.

And in the Board's comments when it adopted the amendments to the HOEPA rules back in 2001, effective in 2002, the Board made it clear that scientifically designed survey evidence is not necessary to show a pattern or practice. So that just tells me that the Board should not be afraid of incorporating an ability-to-pay requirement into something binding like a regulation.

MR. EGGERT: Sarah, and then I'll hand it back to Stella.

MS. LUDWIG: I want to say something really quick, which I forgot to say, which is that the knowing making of an affordable loan to a borrower is both an unfair and a deceptive practice.

MS. ADAMS: Okay. As you can see, we have a lot of discussion on -- that's just on rule-making versus guidance. Wait until we get into the meat. And the first part, I guess, we're just going to follow on Reg. Z and talk a little bit about disclosures from this perspective. And I'm going to ask Faith if she will make a comment, and then after that and then Tom, I'm going to ask you to follow that. And then we're going to move to prepay, escrow. We're going to talk a whole lot about ability to pay and stated income. And anybody else feel free, just, you know, raise your hand. I will be looking around. Thank you.

MS. SCHWARTZ: Okay. Thanks, Stella. Well, disclosures. We spent about a minute on it yesterday, because the thought about disclosures is, they're just not effective in theory and certainly in the way they are constructed now across the whole market. And so I do want, for the record, and I think I'm fairly informed by the previous discussion, that if they can help, we urge the Board to make plain language disclosures across the market for every lender, broker, banker out there, on high-risk terms and mortgage terms.

And I would even add, a little out there, but do a DVD. If I'm hearing no one reads them, they don't care, put it on a media form where borrowers might look at it if they're not reading it. But to think that the plain language disclosures on the most complex financial decision of your life is not a good idea is simply not acceptable to me. I think that we all should have those to look at. I'm a consumer as well. And I urge the Board to act on that.

DIRECTOR BRAUNSTEIN: For the record, we are engaged in a project to do the same type of rigorous consumer testing that we did with credit card disclosures we are doing.

MS. SCHWARTZ: Excellent. And by the way, congratulations on your mortgage calculator, because it informs again the consumer. That's fantastic.

MS. ADAMS: Tom?

MR. JAMES: Well, I guess I want to talk about disclosures in the context of the kind of product mix that has emerged in the marketplace. And what we see with the interest-only and the option payment and the hybrid mortgages are really products that function in many ways like securities. And they involve placing complex bets on events that -- on market change events that may or may not occur in the future.

And I was telling the Council yesterday that I took an option purchase disclosure, one of the biggest in the marketplace or most used in the marketplace, and gave it to 12 of our lawyers, 15 of our lawyers, gave them half an hour and said tell me all about this product when I get back. I came back and half an hour later, no one -- everyone was confused. No one understood how that product worked.

You know, a whole group of lawyers who could talk about it among themselves and try to figure it out couldn't put it together in that time. So now that we have these products that are out there, that to me look very much like securities and function very much like securities, and are very much as dangerous in the hands of an unwitting consumer as securities can be. We have to really change our assessment of whether or not we want to try protecting consumers by making

extraordinarily complex disclosures or changing the nature of how consumers are dealt with by the people who are vending these products.

MS. ADAMS: I saw Lisa?

CHAIR SODEIKA: I just want to add to what Faith and Tom have said. I think it calls for simplified disclosures for sure. When we talk about plain language, we don't necessarily mean more or layered on top of the complicated. But, you know, I sense that every time we bring up financial literacy or disclosure, there is kind of a big, quiet, polite yawn in the audience and yet it's so important.

And I think if we have simplified disclosures and plain language disclosures that, for instance, say this is your rate. This is your payment. You have a prepayment penalty on this loan. It's in existence for the next three years. If you paid your loan off tomorrow, it would cost you $4,000. Those are very simple. Those are very straightforward things to understand, and that in and of itself is another form of financial education or financial literacy.

And there are for every -- for the hundreds, for the thousands of consumers that are sitting in a legal aid office today, because they have a bad loan, because they have an abusive product, because they are in financial dire straits, there are hundreds, thousands of consumers, and we need to give them credit, sitting out there in an educational workshop trying to figure out what their credit score means, how to read their own credit bureau, how to start up a savings account, learning about IDAs.

They are out there. They are learning. They want to learn. And so we need to give them the credit. And I think we do that through the simplified disclosures as well.

MS. ADAMS: Joe?

MR. FALK: Let's debunk the myth about the simplified disclosure with all due respect to my chairman. Hybrid option ARMs are not a simple product. Option ARMs and some of the more exotic products that are in the market today will not be able to be disclosed on one piece of paper. It's just never going to happen. The ability to show all the terms and the conditions, how the modified portion of it works, how interest rates can cycle, what is the maximum payment, the minimum payment, depending upon which way you choose Mr. Consumer to pick amongst those four payment coupons.

That's not something that's suited for one piece of paper. So while I am fully in favor of fixed rates, more simplified products, you know, the standard 30-year, fixed-rate type of

thing. I think that can be simplified. We have been working on that here in Washington, at least for 10 years that I know of, on mortgage simplification issues. But on the exotic products, the pay option ARMs, the hybrid pay option ARMs, my sense is that we won't get there with one piece of paper, one simplified method.

I think yes, Sandy, that we do need to move forward rapidly on the effort that you have spending the same effort and the time and the focus on closed-end real estate loans, TIL. It's a long time in coming. We need to do it. We obviously need to do the consumer testing. But if we think we're going to explain to a consumer, the average consumer, I'm not going to test the 50 people here in this room. I'm not going to give them a test today to explain how a hybrid option ARM works.

Lord knows I wouldn't give the people at this table a test, myself maybe, on a pay option ARM hybrid. So at the end of the day, let's acknowledge that these are complicated products, and ultimately they will need a higher level or a different level of disclosure than the traditional 30-year product.

CHAIR SODEIKA: Just if I may just quickly, but you can say, first of all, thank goodness most customers aren't looking at those kinds of disclosures. But you can say to a customer, this loan allows you to make basically any payment you want. It's negatively amortizing, which means you may not pay it off in your lifetime. That's a very simple disclosure, and maybe that's a bit harsh and that's a bit of an exaggeration, but that is what that loan can do.

And you can't put that kind of Surgeon General's warning on a loan that basically tells the customer what kind of loan they are getting into, without getting into all of the detail that we know sometimes folks don't understand or read. But thank goodness, I think, the plain disclosure can impact the great majority of fixed-rate loans out there.

MR. FALK: Not to forget the risk-based pricing notice that we're still waiting for, and I know the Fed is working hard on it -- something also that could be used if introduced quickly.

MS. ADAMS: Okay. I am going to go Kurt, Tony, and then Louise.

MR. EGGERT: I want to go on with what Joe was saying. I think some of these products are so incredibly complex that to think that we can accurately disclose even their -- you know, how they function is a little misleading. For example, the Fed has a great book, it's called the CHARM, on how to -- and it's something like 30 pages long, 27, something like that. And if you look at it, there's not a wasted page. If you want to understand that product, you need to understand

every darn page in that book. It's a great book. I recommend that we all read it, and I think we should have a group reading at lunch, but I don't think that many consumers will read that.

So I think when it comes to simplified disclosures, I mean, I think we have to have disclosures that give consumers basic information, and a crucial piece of information is what can your maximum payment be? How high can your payments go if you take out this loan? And that should be a piece of information that's right in front of them when they are solicited with the loan, when they are signing with the loan, because that's one of the most important things that they can find out is if I get out -- take out this loan, will I lose my house because the payment goes too high?

And so when you are thinking about what disclosures to give, that, I think, has to be at the top of the list.

MS. ADAMS: Tony?

VICE CHAIR BROWN: My comments might be outside of the authority of the Fed, I'm not sure, but as I was listening to the comments and the issue of disclosure rule-making, I think in mortgage lending, we have a system problem. I think the issue is at the point of sale. That as a consumer, I'm going to perhaps make the most significant purchase in my life, and that's a home. And I'm either going to rely on the originator or that mortgage broker to tell me what is the mortgage product that is best for me.

And typically, who I'm working with or who I think is working for me does not have that fiduciary responsibility to put me in the best product based on my lifestyle, based on my income. And so I think that the issue, I don't know if you're going to fix it with disclosure, you're not going to totally fix it with financial literacy. I think we have a point-of-sale issue when 60 plus percent of mortgages are originated by a mortgage broker, and in many states they are unlicensed and unregulated.

MS. ADAMS: Louise?

MS. GISSENDANER: Actually, my point, that was going to be my point, but I'll just take that just a little bit further in the sense that even if you have the disclosures for whatever reason, people have a tendency still not to read if they have someone there to assist them. They will say sign here, sign here, and sign here. Here are the pages that you need to sign.

But the previous point to at least having the very specific information about the cost of that loan and what that loan actually means, at least on the first page in some kind of box, in

some way, that shows that information without them having to dig in the document for it has got to be the effort that we make in terms of that. I mean, I don't care how complicated they are, at the end of the day, like you are saying it has to be some bullet there that says here is what this is going to cost you if you have a prepayment penalty, just like you said.

So again, it is a lot of reliability on the person at the point of sale, and those people that you think mean you well in the long run. So I don't know. Again, that is a whole other subject about licensing and all those other kinds of good things, but those are very important pieces, too.

MS. ADAMS: Okay. We're going to go Tom, Joshua, Joe, and Faith. Did I skip you? Terry is next. Did I skip you?

MR. THEOLOGIDES: No, you didn't get me.

MS. ADAMS: I'm sorry.

MR. THEOLOGIDES: Thanks. No, I was -- I'm a little less negative than Joe was. And while I certainly wouldn't want to overestimate the utility of disclosures and recognize their limitations, I do think some of the areas that have been common sources of misunderstanding or abuse in subprime are ripe for enhanced disclosures. And they are some of the very ones that the Fed has asked for comment on.

I think the prepayment penalties, you could explain in a sentence or two quite clearly. I think that informing folks of the fact that they are applying for a more expensive limited or stated doc program and may be able to get a cheaper loan if they are able and willing to fully document their loan, is not nearly as intimidating as explaining a pay option ARM, which I would agree with Joe, you know, is a complex product by any standard.

And so I, you know, don't want to be overly negative about the -- as part of a general enhancement of protections and regulation. Let's not be overly dismissive about the utility, at least on some of these key terms, of trying to elevate the level of disclosure.

MS. ADAMS: Tom?

MR. JAMES: Another concern that I would just like to get out there is the timing of the disclosures. Certainly, when we were taking apart the Ameriquest model for push marketing hybrid products, it became clear that the initial phone call by, you know, the cold caller, the response to the mailer, that initial phone call set up in the consumer's mind the entire deal. And that was generally done with an oral pitch.

After that moment, the consumer's conceptualization of the deal never changed even though the deal did. So there is tremendous need to look at the initial communication and weigh that in more heavily than any subsequent interaction with the consumer.

MS. ADAMS: Joshua?

MR. PEIREZ: Thanks, Stella. Listening to this discussion, first, I think there's probably a lot of issues in the mortgage broker area, but I also think they can be quite good and useful and I certainly, as a consumer, have used a few that have been very good in spending hours with me helping me understand things and avoid things and in some cases take a, I keep forgetting the word that Faith uses, but one of these -- I'll call it sophisticated loan products, that made sense for me at a certain point in time, which having tried to explain it to my wife numerous times, I can assure you that there are many people who will never understand what the product is.

So I do think the Surgeon General warning concept is actually a very intriguing one, sort of saying like, you know, you're getting a very complicated product. You should make sure you understand all the terms, and some sort of, you know, effort like that might at least signal that there is not going to be a plain language disclosure of this product. You're going to have a complicated product, and you may want to seek counsel on it.

And that raises, I think, a timing issue that Tom was touching on, but I would touch on a little bit more, which is you don't actually get your real disclosure until you are sitting at a closing. And a lot of times you don't really have a choice but to sign those documents at that point in time, because you're going to forfeit a contract deposit or other things in many instances, at least that's been my experience.

Where I happen to know the lender I'm getting the deal with and know I can fix it afterwards with a couple of phone calls, but another consumer wouldn't be able to do that. And I would never sign the changes they have made since the disclosure they gave me 10 days earlier and the one they are giving me when I'm sitting there at the table, including rate changes or margin changes.

And I think that, you know, apropos of our 45-day discussion earlier today, I don't know why you don't get some period of time in advance of the actual closing to have your, you know, 5-foot-long stack of documents to review and actually go to an attorney and review them. Because I sat there, I'm an attorney, my wife is an attorney, my father is a real estate attorney, who sat there at the closing and the advice was well, just sign them all, because we've got to get out of

here and it doesn't matter what they say, because you have no choice but to sign them, because you're going to lose your contract deposit.

So I really think there is a whole timing-of-disclosure question that is -- I haven't heard it really as part of the debate in that regard, but why you get your final documents at the closing, to me, I have never understood.

MS. ADAMS: Joe and then Faith and then Alan and then Kurt and then we'll move on to the next topic.

MR. FALK: There is a great debate going on around the country on the issue of the role of the mortgage broker, the role of the originator, what is the relationship with the consumer, etcetera. And our position is really very clear. There is tremendous channel confusion going on as it relates to consumers. I believe that when a consumer walks into a mortgage company, they don't understand whether they are going into a mortgage broker, mortgage banker, mortgage lender.

They might be going into the affiliated mortgage company with the real estate agency. It might be the affiliated mortgage company in touch with the mortgage -- the builder or the developer. And so to the degree that consumers ultimately -- an individual who walks into a mortgage company, there are no signs with bright lights and little bouncing balls that says, warning, you're going into a mortgage broker and this is sort of a unique channel of distribution.

There are multiple channels. There are brokers that act as bankers. Bankers that act as brokers. There are community banks that are acting as mortgage brokers in individual transactions. They open up a kiosk in their lobby where they are distributing somebody else's products. And to the degree that you have an originator, banker, broker, lender, candlestick maker who is using somebody else's underwriting guidelines, my contention would be they are a mortgage broker.

So there is great channel confusion and ultimately, in our view, it's all irrelevant. Because when you look at the process of the consumer walking into a mortgage company, no matter who they go into, they should be treated the same way with the same disclosures and the same documents.

Brokers ultimately act in different capacities. Lenders act in different capacities. So if I was walking into a community bank and they were acting as a mortgage broker in that transaction, do they have this duty, fiduciary agency, quasi agency? If a consumer walks into a mortgage company in Florida, where I'm from, and they start off with a loan that is a qualifying loan,

right, where they do have a warehouse line, they're going to close the loan in their own name, and then for whatever reason the loan changes and it becomes a broker transaction, because they don't have the subprime product and therefore they now transition to a broker transaction.

All of a sudden does their duty or their responsibility change in that regard? And because there is such a competitive marketplace, people acting in so many different capacities, it's all irrelevant, in my view. Treat everybody the same. Have the same disclosures no matter what company they go into, and ultimately that will, in my view, give a consumer an ability to shop and compare and choose the choice that they desire.

Now, let's talk about the role of the originator. Since 1998, my group has urged HUD to adopt a role-of-the-originator disclosure. 1998, that was 9 years ago. In 2001-2002, at the beginning of RESPA reform, with the then HUD Secretary Martinez, we have urged a disclosure of the role of the originator. We reiterated that desire, a mandated form across all channels, role of the originator, so there would be a clear, concise form that they would sign, that they would understand, consumers understand. Again, in 2005, this relates to RESPA reform.

I'm sorry to tell you that nothing has happened in that regard, and we have urged that that be a standard of excellence that should, in fact, be imposed upon all originators. Let's talk about state standards for a moment. The mortgage brokers are the ones in most state capitals that have been pushing for licensing, criminal background checks, and educational requirements for all originators.

And my friends in the lending community have been stalwarts in opposing that legislative initiative in most state capitals across the country. And I'm pleased to tell you that Alaska, in my view, is the last one that finally passed a law over the objection of most of the lending community. And when I talked to the lending community, they say to me our model state statute initiative, which was originally done not last year, last month in reaction to subprime, back in 2001-2002, well, it's too expensive to have licensing.

It's hard to keep track of all those licenses and educate our loan officers on all these different products. You know, we really have a hard time doing that, because ultimately that's a burden that we don't want to bear. And my answer in public testimony has been the cost of fraud, the cost of those loan officers going from bankers to lenders to brokers back to bankers again and then becoming account reps of the wholesalers, that cost is much greater than the cost of the simple license, the criminal background check, a bar to employment.

Give a loan officer, no matter who they work for, something that you can take away for bad behavior. It's not perfect. It's not the only thing we recommend, but it's certainly part of it. I agree wholeheartedly, Josh, with your question of the timing of the disclosures. RESPA reform started, I'll remind everybody, back in 1998 under the -- and then we started again in 2001-2002. RESPA is the governing statute that talks about advance disclosure.

We talked about the problems of the good faith estimate and the bait-and-switch people that I abhor. We talked about the people that ultimately need to get a definition of good faith, rather than a whim at the beginning and a final disclosure when you are at the table and the kids are out front and ultimately everything is in the car and you are forced and urged to close the transaction, because it's too late.

So I think the proper venue to talk about advance disclosure and the nature of those disclosures, here, yes, we need to do the work under TIL, but we also need to get to HUD. Maybe we can do it together. Let's get cracking on RESPA reform, so that we can start to talk about what is the definition of good faith. Let's make sure that we ultimately have advance disclosure of all the documents, so that we can ultimately protect consumers.

So despite the fact, Kurt, I thought we would get at least five minutes that we could agree with each other, right? We were almost there, but ultimately we, as mortgage brokers, embrace higher standards. We're not running away from it. And we just wish that our lender brethren would embrace them as well.

MS. ADAMS: Faith, Alan, Tony, I'll have to catch you all.

MS. SCHWARTZ: I would just like to say it's interesting the channel conflict is out there, and I certainly understand some of the strife with the broker community as well as lenders and retail lenders. But whoever is at the point of sale, you know, that is where it starts. And as a wholesale lender who is not at the point of sale and buys from good brokers, but, you know, we don't know what has been said at the table, we immediately, upon application, send out five or six plain language one- or two-paragraph disclosures. I submitted to the Fed last week on stated income, if it's stated income, on yield spread premium, on prepaid, that's simple, but very direct and very -- written to the 8th grade understanding, it's not perfect.

But we want to know what the borrower knows, because we're not at the point of sale. And that type of responsible communicating with the consumer, whether it's with the wholesaler or retailer or whoever is making those phone calls, if it's direct, I mean, I think we have

to get to that and not dismiss it. It's a big deal. And I think the market would be transformed.

MS. ADAMS: Alan?

MR. WHITE: I think the topic at hand is the role of disclosures and combatting unfair trade practices in the mortgage market, particularly the subprime market. And I want to make it clear that those of us who are skeptical about that role are not skeptical about disclosures in general. I think at another place and time we will discuss closed-end disclosures, and there are certainly a lot of improvements that can and should be made in timing and format and everything else.

The point is that even after that exercise is concluded, it will be helpful in reducing some of the abuse in this market, but it's not even 10 percent of the solution. And to put disclosures at the top of the list rather than substantive regulation of the abusive practices in this market is a serious mistake. And one other comment about disclosures is that I think disclosures are much more useful on disclosing price than they are on disclosing risk. And that's because of some classic consumer bias and saliency problems.

And Lauren Willis has written a couple of excellent articles about this. So that, you know, I just don't see that the Surgeon General warning saying this is a dangerous product is going to help you, because you can tell the consumers as much information as you want about risk, they are still going to take risks that are harmful to their welfare if you have a completely deregulated market and you don't deal with risk.

And I think every one of the terms we are talking about that should be substantively regulated -- no doc loans, prepayment penalties -- those all have to do with contingencies and risks, and those are the kinds of things where disclosure is just not very helpful.

MS. ADAMS: Tony gets the last word on this subject for this day.

VICE CHAIR BROWN: That makes it tough. That means I've got to try to be profound or something. But not to try to get into debate with my good friend, Joe, you know, I will say that the industry, the mortgage brokering industry takes on a great deal of responsibility and has shown a great deal of credibility. But the problem is whether -- regardless as to which channel, whether it's a broker or originator, is that if I don't put you in the loan, I will not get paid.

And that the system works if the information is accurate, if I put you in the loan, and if there has been fraud or misinformation, that the system works, if the actuarial risk is predictive and if it's predictive with a set of accurate facts. In that case, when there is fraud and misinformation

or the consumer is put in the wrong product, then the actuarial risk is not predictive, and that's the problem we begin to have today. So I say it starts at the point of sales, because mortgage origination is very, very decentralized.

MS. ADAMS: We're now going to switch to the subject of prepays, because this is not even the big -- this is the little topic. The big topic is yet to come -- the ability to repay and stated income. Those are where we're having the fights. We're not even close, so we've got to move on to the prepay.

MR. EGGERT: Well, we have managed to fight a little bit on every topic, so the prepayment penalty topic comes up, because, again, the question is do we just disclose prepayment penalties or do we regulate them somehow? And so to tee off that issue, I would like to turn to Alan.

MR. WHITE: Thank you. There are now, I think, about 10 states where prepayment penalties are either prohibited or prohibited from certain classes of loans. And the market seems to have handled that situation reasonably well. The demand for prepayment penalties, in my view, is not a consumer demand at all. It's an investor demand. I think prepayment penalties are an excellent example as they operate in the subprime mortgage market today of an unfair and deceptive practice, which should simply be banned.

The Federal Trade Commission developed, in its 1986 credit practice rule, a set of fairly good rigorous criteria for determining when a uniform practice, not just an individual case but an industry-wide practice, was an unfair and deceptive practice. And that standard required looking at significant consumer harm caused by the particular practice, whether there was a countervailing benefit to consumers or to competition and whether consumers could reasonably avoid the harmful term. Those are the three essential components of the test.

If you look at prepayment penalties in the subprime market, I think that they meet all of those criteria. First of all, as they operate, empirical research has demonstrated they harm consumers. Many, many subprime mortgage consumers are paying the penalty. Now, the penalty -- ordinarily you would expect consumers to agree to prepayment penalty if they are reasonably protecting that they are not going to pay it.

The penalties are typically six months of interest, which represents 300 to 400 basis points. Fifty to 75 percent of subprime loans are prepaying within the prepayment penalty, and 75 percent of them have penalties. So you have at least a third of subprime consumers who are paying on the back end, essentially, 3 or 4 points, 300 or 400 basis point additional loan fee, which

they probably never intended to pay. They are making the wrong bet.

Secondly, the evidence is very clear that there is no price trade-off at the retail level. There are two studies that I think that have been done that are really good on this. One was done by the Center for Responsible Lending, which found using a very large database, the Loan Performance Database, that at the retail level controlling for all other factors and doing a pretty serious regression analysis, a prepayment penalty was not resulting in any reduction of the interest rate across the market for subprime borrowers.

The other study that was presented at the March research conference was the one by Mike Staten and Greg Ellihausen and a number of other authors, and they found a small discount for ARMs. They found a 13 basis point interest rate savings for consumers who accepted a prepayment penalty. Now, I think if you compare that 13 basis point savings to a one-third chance of paying 300 or 400 basis points as a penalty, you will see that's not a rational economic choice, at least in the aggregate.

So the savings is just not happening. I think the savings is clearly happening at the wholesale level, and it is being captured by brokers, essentially, and retailers. I don't mean to pick on the brokers. It is being captured between the wholesale and the retail level, and it's allowing for rent seeking opportunities, essentially.

There are two other problems that have been empirically demonstrated with prepayment penalties in the subprime market. One is that they clearly increase foreclosure risk. And the mechanism for that is pretty clear, that if the homeowner has the opportunity to sell their home or refinance to avoid a foreclosure, that opportunity is reduced if they have to pay a 300 or 400 basis point add-on to the balance of their loan. It reduces the likelihood that they are going to be able to avoid foreclosure.

In my own practice, I have had to try and get those penalties waived in many instances in order to avoid a foreclosure.

And the fourth problem is that they clearly fall disproportionately on black and Latino homeowners. And there's a specific study the Coalition for Responsible Lending did on that and found that this particular price component is being sold, essentially, in a discriminatory manner separate and apart from the interest rate problem that we also see in this market.

So I think the case is pretty strong for banning them in the subprime market. I don't think the sky will fall if prepayment penalties are banned. I don't think capital will dry up. I

think the investment community will be a little unhappy, because they like the prepayment penalties. But I think that this segment of the market will thrive and continue without prepayment penalties.

MR. EGGERT: Stella?

MS. ADAMS: Prepayment penalties are in the subprime market. I think this is something that you can absolutely ban. Your own findings and studies by Glenn Canner and Bob Avery showed that a consumer's credit -- that their credit score improves enough if they make on-time payments in their subprime loan, that their credit would improve enough within a year, a year of on-time payments would get them into the prime market.

So the prepayment penalty locks them in the subprime market when they would have financially proven that they are able for reentry into the prime market. The purpose of the subprime market when it originally was there was to reform people and give them a second opportunity to enter into the prime market. But the prepayment penalty locks people out of the opportunity that they have earned by performing well within the market.

And so there is no reason to allow a prepay penalty in the subprime market when the purpose of the subprime market was to reeducate people for entry into the prime market. It serves as a barrier to entry back into the prime market. And further, it serves as a way to create a permanent second-class borrower.

MR. EGGERT: Faith?

MS. SCHWARTZ: Yes. Well, I've spent a lot of time on prepayment penalties starting with my years at Freddie Mac when looking at how the markets were operating in the mid-90s. And when there is just a double-digit interest rate environment finance company and when you did not get a GSE loan, you fell off a cliff and you did get 7 points on the front end. I think in the old days maybe 7 would get yield spread on the back end, and there was less prevalent of the prepayment penalties and securitization.

I don't know if we're going to talk about securitization, but that's kind of coupled with kind of the growth of prepayment penalties. In the investor side, I would say that's true that it has been driven and the pricing through -- from wholesale lenders into the broker community is passed through. As Alan said, you can see the rate sheets, so that's a pretty significant discount in rate with a loan that an investor thinks may stay on at least for two years, three years.

And I think the use of prepayment penalties has been very variable across the market for years. I think that causes some of this. You know, well, some people had a five-year

prepayment penalty on loans. And for years that happened until Fannie and Freddie and others said, you know, we're just not going to invest in securities unless they have two or three years maximum on the duration of the prepay penalty.

I share all that with you, because I remember seeing evidence last year where the subprime market not only no longer had 600 and 700 basis point rate spreads that were not risk-based priced with the tools of the market, but they were 140 basis points over Fannie and Freddie pricing, and a lot of that is the construct of having the existence of prepayment penalties in the market.

I do concede, I think that it's not working as well as it should. I recommend the Federal Reserve put in tough regulation the use of a prepay where the borrower gets the benefit, which is given to the retail level, of the price differential. I recommend they get notice of what exactly a prepayment penalty is. And I recommend they get a choice. I have heard there are people who don't offer choices. I don't know, you know, if that's the truth, that is just not a great product.

But to eliminate and ban a tool from the market that has clear -- can have clear benefits, but it could be abused, I think there is a way for the Fed to make use of a tool that could be appropriate for all those people who may have paid. There are a lot of people who did get lower rates and our own numbers do dispute the numbers cited both on the pricing differential and, you know, benefit. But again, I'm sure it's not all passed through, and I think there is a way to make that a much better use of a tool in the market.

MR. EGGERT: Okay. Ed and then I'm going to say something and then I think we should move on to the next topic.

MR. SIVAK: This is going to build on a couple of comments that were made and also harking back to the discussion we had in the first session. We have to get back to the notion that a home is a tool to build wealth. I think a lot of the different products that we talked about this morning, the hybrid ARMs, option ARMs stated income necessarily didn't have that effect. And, you know, that has to be the underlying premise, I think, when we look at homeownership is going to be what -- I think building wealth, building assets is the only way we're going to address disparities in this country through race, class, gender, whatever you want to look at.

It was interesting to read the credit card discussion and see that the rationale for improving the -- for increasing the disclosure period on a rate term was from 15 to 45 days to allow a borrower to find alternative financing. That was the justification that was used in that section. I

would argue that the same philosophy should be applied to prepayment penalties.

So what that means is that if you are in a product or a 2/28 product or a 3/27 product, that before that loan resets, you have an option to find a better alternative product. You know, I think one of the fears within the secondary market is you have someone who would, if there is no prepayment penalty in subprime, within six months, they are going to get out of that product.

You know, if it's a 2/28 product, then, you know, let it run for 22 months or -- you know, so there is two months at the end where they can get out of that, get into the better term product, a prime product, as Stella mentioned, so that may be a way to keep the prepayment penalty in there, but not -- and still have the borrower to move up a product after demonstrating good payment history.

MR. EGGERT: Okay. And my last point before I turn it back over to Stella is the purpose of these regulations should be sort of twofold. One is to force lenders to compete based on price and so to make their price disclosures effective, so the borrowers can see what's the lowest-based product, lowest-priced product for me.

The other purpose is to reduce or eliminate terms that dangerously increase default rates. We want to have these be safe products, as well as inexpensive products. I think if we look at that, prepayment penalties fail on both accounts. They are not a very transparent way to disclose price. If a significant portion of the price is this prepayment penalty that you may or may not get, most consumers have no way of saying, well, this is a more expensive loan than this one, because this one has a such and such prepayment loan at two and three years. That's a too complex price analysis for borrowers to make.

So if you eliminate prepayment penalties, you make price disclosures much more transparent and easier for borrowers to make.

On the other forum, we want to reduce terms that dangerously increase default rates. The increased default rates we have seen in the subprime market are, I think, largely caused by the terms of the loan, which is an amazing thing. We have a relatively stable economy, but we have surging foreclosure and default rates that are by and large due to poorly designed products or products that have dangerous terms.

And I think as Alan pointed out, prepayment penalties are one of those in that they increase foreclosure rates. They also make it harder for borrowers who are in default to get effective loan modifications, because there is the danger that the prepayment penalty has been

separately securitized. I just wanted Faith to see we are, in fact, talking about securitization and we always do.

But if you separately securitize the prepayment penalty, you may drive a wedge between the borrower and their ability to do an effective loan modification. That's a danger. And so if you are -- by eliminating prepayment penalties, I think you make price more transparent and you also make unnecessary defaults less.

MS. ADAMS: Thank you. At this point, we're going to talk about escrow, whether escrow should be required and mandated on all products or whether it should be optional. And I'm going to ask Terry Theologides to start the conversation and then, Patty, you will be next.

MR. THEOLOGIDES: Thanks, Stella. Our discussion about escrow was, I think, a little less heated. I think there was a consensus that clearly sound underwriting should take into account the tax and insurance payment obligations. There was also a consensus both among lenders and advocates that, you know, in our experience, loans that have the escrows perform better. There is less of a risk of misunderstanding the potential payment -- for a large payment nugget when taxes or insurance come due.

And I don't think, well, no one thought disclosure was a panacea. I don't remember there being a real objection to room for improvement about clear disclosure about whether a payment that is being quoted is including or excluding taxes and insurance. And I think there was also recognition that there is the prospect at the loan originator level or at the consumer level for misunderstanding on that point of view and that that can cause difficulty particularly for credit-impaired borrowers.

Having said that, I think some folks expressed and I should certainly share this view about an across-the-board mandate of escrows for taxes and insurance. There, I think, is a view that the risks of potential for abuse or misunderstanding aren't level across the board and certain factors such as credit worthiness, debt-to-income ratio, whether they are refi-ing out of a loan that may or may not have an escrow, all of those things can weigh into the degree of risk involved in that area.

There was also concern about, you know, to the extent it's not mandated or to the extent it's encouraged, but should there be an opt-out rather than just leave it kind of open or as an opt-in. And I think there was a discussion there that the reality of the application process is that an opt-out would probably be a form that could be layered into a lot of other disclosures and there was

still the prospect that it wasn't a well-informed opt-out.

The interesting dynamic though with escrow and insurance is that there is -- it's not an immutable decision. There is a possibility after origination for an opt-out. And so there was some exploration about that, so that, you know, you have not eviscerated consumer choice just because at the inception of the transaction for some group of borrowers you may have required it. And I think that was one of the reasons why there was a little bit less intense, you know, debate, because I think you could find a little bit more fertile ground for compromise there.

And I think at least where I ended up on this was that, you know, there is probably a subset of borrowers defined by kind of the risk characteristics of the debt-to-income ratio and LTV where having a mandate at inception of the loan transaction is worth further exploration, so that at least those first few payments and the materials you are getting are more likely to be well-understood to include tax and insurance. And then you can preserve those borrowers' choice should they -- by allowing a subsequent opt-out at some point. There may be some logistical issues to the extent a lot of these loans are securitized that an interim servicer may not want to go through the process of establishing an escrow fund, you know, and then only to have it moved three months later.

But, at least in my experience, within six months or so, those loans have come to rest in a trust for the longer haul. And so I think that's at least a starting point of where we ended up from yesterday's discussion.

MS. ADAMS: Patty?

MS. HASSON: I think you've heard a lot. I listened to the hearings last week, but it's often used as a marketing tool and that gets hard then to compare and shop, because you are looking at one with and one without. So I won't go a lot into that, except to say that many of the clients that we see today in foreclosure coming in that are delinquent, that's a big factor. They thought that their taxes were being escrowed.

And as we move into the discussion around debt to income and ability to pay, I think you've got to think very hard about making this a rule, making certain criteria of loans be mandatory, because the individuals we work with -- one little blip, you know, one little health care crisis, one refrigerator going out, they are going to take that fund and, I can guarantee you, use it and then their taxes are going to come due.

And I think every lender here has talked about or I know Faith has said that they

performed better. From a performance standpoint, banks agree and I think from a consumer standpoint, most consumers given that option thought they already had it and want that option.

MS. ADAMS: Joe and then Edna.

MR. FALK: Real briefly, I think that there was generally unanimity that at some point there should be a requirement, a hard-wired requirement on escrow of taxes and insurance, but it brings to mind something that we talked about and -- is that me?

MS. ADAMS: So ahead, Joe, we'll just try to live with it.

MR. FALK: Okay. It brings to mind the question of whether or not you are going to use the HOEPA triggers, or you're going to come up with some different definition of what is non-prime subprime. And the committee talked about some of the ways you can do that. I don't think there was any disagreement that we would be using the HOEPA triggers. That was not the point, the reason that I said it. But to the degree that you are going to start to parse out different levels of consumers, we talked about do you use the HMDA triggers on a high-cost loan to trigger these escrow requirements? Do you consider 150 basis points over the Fannie Mae rate to trigger some kind of a requirement?

I mean, how are you going to define non-prime for the purposes of the required escrow? And I think that ultimately, how you define non-prime, which is ultimately unclear at this point, again, no one should get crazy or I'm not suggesting that it should be the HOEPA triggers, but at some point that debate, that decision is going to have to be made by the Board, where is that line. And I think that we were thinking in terms of pricing rather than borrower characteristics -- whether it be, you know, education or credit score or, you know, whatever, try to find that equal level on pricing rather than other characteristics.

MS. ADAMS: Edna will be the last word on this, because we have got 15 minutes left for the big stuff.

MS. SAWADY: Thank you. As I was listening to my colleagues throughout the discussion on mortgages across all the topics that were discussed, I was struck by how frequently the word complexity came up. The word complex, complexity came up in almost every single sentence that anybody had talked about today.

So my proposal is to look at an industry that has been dealing with complex products for a long time -- with the securities industry -- and maybe looking at some of the practices that they have been using to deal with this issue. Two, in particular, that come to mind. One is as

products become more and more complex, the licensing requirements change, so that not everyone can sell every product, but you need to be licensed at a different level to sell products that have different complexity to them.

And the other practice that I think is appropriate in this context is there is for some families of very sophisticated products, there is an obligation at the point of sale to ascertain that it is a sophisticated investor who is getting these products. So that gets us to a point that Kurt made at the very beginning of the discussion this morning about striking a balance between consumer choice and consumer protection, but when we get to those levels of the esoteric products that are extremely complex for all of us to understand, maybe that's a point where we need to ascertain whether it is a sophisticated purchaser that is looking into buying those products. Thank you.

MS. ADAMS: Now, we're going to spend the next 15 minutes on talking about the ability to repay and stated income loans and whether or not they should -- stated incomes should be allowed and whether or not the ability to pay -- what that means and how we would like for you to address it in your rule-making. Because we have 15 minutes, it's going to be kind of free-flowing. But there are some pieces of stated income that didn't come up in our discussion yesterday, but I know are issues that are out there. And I have asked Cooke if he would take a minute to talk about stated income loans as they relate to immigrant communities, just so that we get that issue on the table.

MR. SUNOO: Okay. Thank you very much for the opportunity. I'm sorry I didn't come up yesterday, I wasn't in that committee. Stated income is very important. It's important, I think, in our lower-income communities. It's particularly important in our immigrant communities. In our immigrant communities -- we have, for instance, in the Korean community in Los Angeles -- this will make sense in a second -- 60 percent of the households are supported by entrepreneurial endeavors, the large majority of which are very small.

And as I think we all are very aware of, small businesses do a lot of cash transactions that are not reported to the IRS. Stated income is income that is not reported to the IRS. So there is a whole wealth economy that is going on in our immigrant communities in that type of an instance.

Additionally, we have a lot of cash going, changing hands in terms of employment, in terms of our immigrant communities. In our immigrant communities, many people

are paid in cash and make fine incomes. Make no mistake about it. Anecdotally, I just had my house painted, and I paid my painter. I wrote him a check, but I saw him paying his workers on a weekly basis $150 to $200 a week for their work.

You put that together in a dual-income household, and they certainly are a potential homebuyer where that household is making $80,000 a year or more. So the idea that stated income or that income should be 1040-reported income doesn't make sense in a lot of communities, immigrant communities being high in that realm. There are many other ways that we can track the income of people: their assets, their credit records, their bank accounts, their bank activities.

Banks today are using, in California at least and other states, the matricular card as a viable sense and viable way of tracking activities. So just in conclusion, yes, we need to get these people reporting their incomes. We need to get them to be paying taxes. It's not good for us if we don't. We need to get them banking their incomes. There are a number of us around the table that are involved in activities that are leaning in that direction, but until then, let's deal with the fact of life that there's a lot of money out there changing hands without IRS records.

MS. ADAMS: Okay. I am going to go with Lisa, the Chair.

CHAIR SODEIKA: I was telling someone yesterday, as a former underwriter, I remember years ago first hearing about stated income loans, and I said sure, I can do stated income. And after you state the income, send me over the docs, I'll take a look. It scared me. But I have since learned a lot since then. I know that there is a market for this and it all ends. You know, just hearing what Cooke just said and at the high end of the market for certain consumers, this is a product that works.

So I think the question is how do we make our best effort to make sure that consumers are getting the product that they do qualify for to prevent these instances where someone does have W-2 income that they can show and in doing so gets a better rate loan.

And then the other issue is how do we make sure that we are at least showing some intent to verify income? There's lots of ways to verify income, if not on a W-2, bank statements, rental receipts. There are ways, and I think Sarah had a better way of putting it in terms of how we might write guidelines or regulations around it, but something to the fact that we are making our best efforts to verify income.

I think these are a little bit more -- some sort of more cautious approach, because again, we're talking about stated income and these are people's homes. We're not talking about, you

know, buying a new bike or buying a toaster oven. We're talking about an investment in a home that is supposed to build wealth. So I think some form of caution, conservatism in the guidelines would be helpful.

MS. ADAMS: Sarah, but keep it short, because I only got 5 minutes and I want to keep some of that.

MS. LUDWIG: Because of the havoc for this product, we think there are a lot of people who would say get rid of the product. But I think there is a way to craft a really effective ability-to-repay standard that allows you to make sure that stated income loans, to the extent that they are made, are made responsibly. And one point is what Lisa said, which is that there needs to be a basis for making somebody a stated income loan.

There needs to be a reason that it's stated income and not using their traditional forms of income verification. The other is the ability-to-repay rule can have in it not just best available documents to verify affordability, but it can also be based on -- not on income, right? You can show that somebody has a wherewithal to afford the loan, but maybe it's not an income basis.

MS. ADAMS: Thank you. Luz and then Dorothy.

MS. URRUTIA: I think a lot of the problem, having been lending for the last five years into a 100 percent immigrant community on stated income basis, part of the problem is that the lender has the ability to sell off 100 percent of the risk. I think that, you know, a lot of lenders if they realize that at least a portion of that risk they still have to keep in their portfolio, I think some of the loose underwriting guidelines and criteria and qualification would change.

We may -- and this obviously is not scalable, but, you know, we have made over 500 loans to ITIN individuals that do not have Social Security numbers, that are tax identification number individuals, and we have experienced a zero percent charge-off. So you can lend to communities on a stated income basis, and you can do it responsibly, but you cannot be greedy, and I think that's part of the problem.

MS. BRIDGES: Stella, my comments are more a summation of this whole discussion, so I can hold off until you are ready to wrap up.

MS. ADAMS: Okay. I'm going to do Carolyn, a statement, and then you and then Ed.

MS. CARTER: I favor a rule that would require the best and most appropriate form of documentation of income. I think that that would resolve the problems that Cooke

describes. It would be responsive to Lisa's experience. I think that no documentation loans, loans based purely on stated income, are really inappropriate.

The other point I would like to make though relates to loss mitigation. And loss -- it's my position that the Fed should require lenders to engage in loss mitigation before pursuing foreclosure. This relates to the ability-to-pay issue, in my view, because it requires ability. It not only would mean that ability to repay would be required at the front end of the loan, but then at the back end of the loan, at the future time after the loan had been in effect for a while, it would require the person who is then on the hook to deal with the affordability question.

And if the loan hadn't been affordable in the first place, then to be required to try to work with the borrower to make that loan affordable, at that point.

MS. ADAMS: Thank you. Dorothy?

MS. BRIDGES: My comments are more general and overall and not just stated income or ability to repay. First, let me say that I would love to thank the Board for taking this step toward trying to curb some bad activities and bad practices in our communities, because our communities are suffering because of this. And there are a few apples in the bunch that have created a big problem for the rest of us. So I really applaud you.

I also would like to applaud you for looking at existing regulations to try and curb this activity and not developing new regulations, because that will only add to the burden and make these conversations even longer.

Thirdly, I would like to say to Joe while you are very willingly sharing the flogging, I think I will pass on that opportunity. This is in reference to your comment earlier about lenders and creating barriers to UPASS and certain laws on disclosures. I'll gladly let you keep that flogging.

I think for community banks, we are wholeheartedly in favor of doing whatever it takes to curb this behavior. I don't have a dog in this fight in terms of mortgage. I don't originate them. We don't have brokers and lenders that do, but I have learned around this table that we have passionate, caring individuals, both on the consumer side and on the lending side. And it is very, very rewarding for us to come together.

Now, maybe some divisive issues, but like I said, 80 percent of what HOEPA is about there is unanimity. There is a unanimous vote about it. Where it really gets to be a little bit concerned in the mind is when you apply something that traditionally has always been underwriting

guidelines and want to create rules. You have to be careful with that, because you're going to brush everybody with the same stroke. Personally, for instance, escrowing -- as a consumer, I don't want you to mandate that I have to escrow for my taxes and insurance.

And so when we look at those issues, we have to be very careful about setting the standards to get to the very people that you are trying to get to and not make it onerous for everybody else. So again, thank you all for this discussion, and I know community banks and speaking as a representative of community banks, we really, really appreciate all the help we have been getting in this area.

MS. ADAMS: Thank you. Ed?

MR. SIVAK: I just wanted to echo that I think this is a product that where a rule is appropriate, because of the coverage that a rule allows. It's a product where the rule isn't made, guidance will only cover a sliver of the marketplace. And so I'm again really recommending the ability-to-repay standard showing that up front on the stated product.

And then also, just being wary of, you know, comments about unintended consequences if we were to do that. I think we are living in the unintended consequence right now. And so if as we talk about that or use that as justification not to do that, let's just remember that as we approach this process.

MS. ADAMS: And I get the last word. And I'm going to give a plea to the Governors to exercise the power that you have been given to do rule-making, because that's the only way you can -- you are the only people right now who can protect the entire market. I want to echo what Ed said about the concern about unintended consequences. I can tell you that the consequences on the ground in my community are dire.

The consequences of no consumer protection are that we have neighborhood after neighborhood with boarded-up houses. The consequences of not having consumer protections in this area is that we have the unintended consequence of firefighters, who are going into boarded-up, abandoned houses that were used in the wintertime by people who were homeless, homeless perhaps because of the unintended consequences of some of these loans, pulling out people.

There are unintended consequences. There are consequences to inaction. Right now, you have the power to act. I am – and act in the interest of the entire mortgage market, and it has changed from the time you were given this rule-making authority and we need you. We need you to use that authority. We need you to use it judiciously. And we are not opposed as consumers

to you using it judiciously, but we do need you to use it.

Write rules and give guides on how those rules will apply, but make the rules apply to the entire industry. Your guidance will protect, will make it more uneven, because the good guys who follow the guidance cannot compete against the guys who choose not to. If you say mandate escrow, put escrow in it and that's the guidance and the good lenders do it, the payment is going to be different.

I can get you a $400 a month payment versus the $600 a month payment -- that means you're going to be stable. You have got to make it so that it's an even playing field for all of the people, and that it doesn't matter whether you live in one of the 30 states that have adopted your guidelines or if you live in the 20 states that have not, that you will have equal protection in the most important purchase of your life. So that's the last word, because I get to say it.

CHAIR SODEIKA: Thank you, Stella.

MR. EGGERT: Well done.

CHAIR SODEIKA: Thank you, Stella, and thank you, everyone, for the thoughtful discussion yesterday and today.

Now, it's time for our Members Forum. As many of you know, during each of our meetings, we have the privilege of hearing from one of our Council members on programs and initiatives at their organizations. For this meeting, Faith Anderson will provide us a brief presentation.

Faith is Vice President of Legal Compliance and General Counsel for American Airlines Federal Credit Union, the largest credit union in Texas. The credit union's offerings include savings and checking accounts, consumer and real estate loans, overdraft protection, ATM cards, and debit and credit cards.

Faith is responsible for compliance and implementation of federal and state laws and regulations, including Check 21 and the Fair and Accurate Credit Transactions Act regulations. I'll now turn it over to Faith.

MS. ANDERSON: Good morning or good afternoon, everyone. Thank you for taking the time to listen to my presentation. What I'm going to talk about is the background of credit unions, in general. I know some of you belong to credit unions and are members. And then what makes American Airlines Federal Credit Union unique from other credit unions. And also, actually, what we do to serve our members.

Credit unions, in general, are financial cooperative institutions owned by their members. Currently, there are about 8,500 credit unions as of the end of 2006. Credit unions have approximately 87 million members located throughout the country. About 62 percent of credit unions are federally chartered. The rest are state chartered. Credit unions are not-for-profit entities. Income after expenses is either returned to the members in the form of higher dividends or lower loan rates, or we retain it as reserves or capital.

Most credit unions generally -- when I mean most, I mean federal credit unions -- do not have access to any other types of sources of capital, whether it be debt or equity. Each member, regardless of the balance or their mix of products, is entitled to the same ownership interest as to the member with a million dollars versus just having $10. And each member is entitled to one vote at an annual meeting or an election.

Credit unions have $71.1 billion in assets or 7 percent of the financial institution depository market, and that 7 percent if you include banks, thrifts, and credit unions, the largest three banks in the world or country, Citi, Bank of America, and JP Morgan Chase. They each have more assets than all of the assets of all of the credit unions combined.

Our credit unions have about 2 percent of the total U.S. financial assets and that's if you add in the Merrill Lynchs of the world. But in terms of savings -- I know we have harped about savings and financial literacy -- credit unions hold 10 percent of the savings market in the country.

Our credit unions have volunteer boards. It's interesting when it's up, time for election. I'll sometimes get a call from a member, and they will ask, how much do you pay for -- to attend a board meeting and I say, well, we'll give you a free lunch and then, I mean, because they are required to meet monthly, they do put a lot of time and effort into the meeting. And in December for the holiday, we give them a nice dinner.

Also, our supervisory committee members are similar to our board members. They function like an audit committee, like an SEC reporting company, and they are also volunteers. Our accounts are not insured by the FDIC, but are instead insured by the National Credit Union Share Insurance Fund and that is administered by our regulator, which is different. It's the National Credit Union Administration.

And the insurance fund is supported by deposits from credit unions of 1 percent of their deposits. It is not given any appropriations from the federal government, and the insurance

fund has never received any taxpayer dollars to support it. But like the FDIC, it is backed by the full faith and credit of the United States government.

Back on about American Airlines Federal Credit Union. We were founded in 1936 at Midway Airport in Chicago, Illinois. We celebrated our 70th anniversary last year, and currently our headquarters is located right next to the American Airlines headquarters. We have a single common bond occupational credit union. Most of our membership is made up of employees of American, American Eagle, and they can range from the flight attendants, the pilots, the management to the ramp workers.

But we also have members who also work at airports. We have approximately 209,000 members located throughout the country, and 40 percent of our membership are active employees of the airline. We are able to offer specific types of loans to help our members, because they are located throughout the country. We offer these disaster loans. And so when there is a natural disaster, as declared by FEMA, we will offer a $1,000 low interest rate loan. And you may be shocked that there is no debt-to-income requirement, and there is no credit score requirement. But actually, these are not high-risk loans for us, because of our strong loyalty from our members.

And we actually have employees when we had Hurricane Katrina and Wilma in 2005, who flew down to Florida to the hurricane because our branch managers had to take care of their own personal situations and so we had pictures of those. In 2005, we gave 3,000 disaster loans. We haven't had any major disasters lately, which is good.

And really our employees really came through and our members after Hurricane Katrina. We were able to raise $425,000, which is really a lot for us, which we were able to then donate to the American Red Cross.

We also help our members by giving what we call “heart” loans, and these are for members who suffer a temporary hardship, whether it be loss of a job, an important member of their family has died and so they don't have money for the funeral. And again, we require a minimal disposable income. These members would otherwise not qualify for a loan. We offer a maximum, up to $1,000, and we have also had very good responses on these.

In 2006, we gave 1,900 of these loans, and in 2005, we gave 1,500 heart loans. Other ways we help our members, we have an in-house credit education department, and we have six certified counselors who meet with members, and it's really just what we are all talking about this morning where we teach them how to improve their credit, reduce their debt, develop projects, learn

how to balance their checkbook. We help members also work with their other creditors.

We have what's called an NSF Outreach Program. So if you are a member and you have had six or more returned items in one month, we will actually send you a letter and tell you to stop that. And it's not because we don't want your fees. It's just that we know it's not good for our member. And so if our member agrees to enter into that program, we will refund the NSF fees, and since that program started, we have mailed out 10,000 letters and we refunded $16,000 in NSF fees.

I have a couple of good stories that I would like to share. One is with one woman, she was going through divorce and she had three children. She was temporarily unemployed. So then she got into a payday lender. We were able to break her out of the cycle from the payday lender. She had 68 NSFs, and she had a negative savings balance of $1,200. And then she contacted our credit department, and now she has been able to see that she is on the right track. Her stress has been reduced, and we're also looking at opening a checking account for her.

We also had another member who had a terrible credit score. His score was 456, and he came to us in July of 2006, and he has been working closely with our branch manager and our credit counseling department and actually his score has increased to 591 points, and so that was such a big increase that we did open a checking account for him. And see he just keeps close contact with us.

What we also offer that's different is for members in the military. As you all know, we're required to give the statutory 6 percent rate on their loans. Well, after 120 days if they are still in the service, we will lower the rate to a zero percent, and that can vary from just a few months until the end of their duty, which sometimes will range up to three years. And also if our members of the military are experiencing other hardships, we will work with them to extend their loan payments.

Other ways we help our members, which is the bread and butter of most credit unions, is help them to negotiate on car purchases. We offer seminars, and we also provide online services where we will teach them how to negotiate when looking at what the prices are, the invoice prices are, the dealer's prices. And we believe that we can help a member save more on negotiating on the car up to $2,000 versus just providing the low interest rate, which we also do.

Our loan officers actually have become very passionate. They have been known to show up at dealer lots to help our members, especially the elderly who are afraid to negotiate, or they will tell our member that is not a good deal and they will go and help them negotiate a good

deal.

We also offer risk-based lending. And what's different from ours is that our goal is to have no more than 100 basis point spread between the A paper and the D paper members, so that we're not making money off the members who are in financial stress. And that's also obviously after charge-off and cost of servicing.

Here is a picture of a staff member helping a member use the online service for the CAARS Program. Other ways we help our members is we offer a first-time homebuyer program, and this is a 5/1 adjustable-rate product. But what is great about our product is that the annual cap is 1 percent, and for the lifetime of the loan it is capped at 5 percent. And also it has to be owner-occupied. We do require proof of income. We don't do stated income.

And so for that one, we have had approximately 127 members take advantage of that program. We also have what's a great certificate, which is almost similar to a CD. We call it our Dream Plan Certificate. And we started offering that last May, and what's great about this is it helps members who have never saved learn how to save, because we offer them a premium rate.

They are just required to deposit just $25 a month minimum for 60 months, and then the dividend premium that we're offering them is 5.25 percent of the rate and so at the end of the 60 months, they are able to save $1,648. Where currently to get this rate, you would have to have $1,000 minimum deposit.

And I know education is a big -- there is a strong emphasis on education. And what we try to offer is we have free seminars, whether we have credit union days or just we have seminars on how to buy a home, how to sell your home. We will offer box dinners to encourage members to attend, and it's our staff that gives these presentations: The Time Value of Money, How to Save for Retirement, How to Save Generally, How to Balance Your Checkbook and How to Budget.

And also one of the important give-backs to the community is really the United Way. We sponsor a golf tournament every year for the last 11 years, and this is really where it's our employees who are in charge of setting up the golf tournament. We ask vendors to participate. And this year I'm proud to say that in May my group was in charge of the golf tournament.

It's also good just for management growth, because I'm not a golfer, and so to be in charge of a golf tournament where you had to raise -- our mandate was $55,000, I'm talking net, too, that was a big challenge, but we were able to meet it. And we were actually able to raise a little

bit over $60,000. And so we're always proud that we are able to give back to the Dallas-Fort Worth Airport United Way.

Children's Miracle Network is another one that a lot of credit unions also participate and contribute to and we do that. DFW has an airport -- I listed it here as R&R, but it's the Welcome Back Heroes Program. That's when soldiers are able to come back to the country and have two weeks of R&R. And last week we were proud to participate in the 500 soldiers who came through that airport.

There are also other ones that I have listed that you are familiar with: Habitat for Humanity, and this is where our employees give their time and money, and it's not just credit union funds. Here is an example of attendees at a credit union day. This was taken in Raleigh-Durham. These folks work for Sky Chefs, and they are the folks who prepare the food that go on-board for the airplane.

What makes American Airlines Federal Credit Union unique is that we're cashless. What I mean that we're cashless, I mean, that if a member comes to us and they have a check, we don't cash a check. They would have to go to the ATM to get cash, and the reason that we are able to offer that is because we started off with American Airlines working, having our branches at airports and so we didn't want that every two weeks our branches would be full of people wanting to cash their checks and then we would have -- no one at operations running the gates.

And so it's really worked out well. When I first joined, I was surprised and I said what, we do take in cash, we just don't give it out. And so because of that, we're able to have smaller branches of three to four people. Our members access the ATMs. We usually have one outside our branch. But we also participate in the shared branching network, which came in handy for Hurricane Katrina for a lot of credit unions where the buildings were damaged.

We didn't have any branches that were damaged out there, but I know other credit unions did. And by participating in the shared branching network, they were able to give members their money. And we also are a member of the co-op network, and so around the country we're able to -- our members are able to access 24,000 ATMs, because we only -- our credit union only owns about 150 ATMs.

We also have a very close relationship with American Airlines. We have a big board. We have 50 members on our board, and about 10 of those folks are officers or managers of American and on our supervisory committee about 2 to 3 people are also employees of American.

And since we do have a close relationship, we are able to offer payroll deduction to our members.

Here is an example of a typical branch. This is actually in the headquarters of American Airlines, and you can see we have one teller line and there is another office that's not shown for the loan officer. Our branch approach is to offer workplace convenience at airports, because that is where most of our airports -- or most of our members work. We do have a few off-airport sites where we have heavy member concentrations. And we are able to develop strong personal relationships, because our employees stay with us for a long time.

For example, our branch managers -- 35 percent have been with us for 15 years or more, and another 31 percent have been with us from 5 to 14 years of service, so they really get to know the members on a personal basis. And because of that, we are able to be their educator, advocate, trusted advisor, because they have come to trust us.

And here is an example of extreme workplace convenience, where we're out at the ramp delivering a check, but we have been known if we have the manpower to go where our members are, whether it be the ramp or somewhere else in the airport and deliver a loan check to them. And this is just actually a typical benefit to members. If they have a share or what we call a savings account, and if they have an average balance, and if there's a new auto loan, they have one with us, or a home equity loan, the benefits to the members will be about $975 per year based on dividends earned and the low interest rates.

I wanted to get to this one. This is our branch location map. And you will see that we're mostly located where American Airlines has a hub. So we're in JFK, Boston, LaGuardia, here at Ronald Reagan, Miami. We have a branch in San Juan, because that's our gateway to South America. Branches in the Dallas-Fort Worth area, Chicago, Tulsa, because that's where they do their maintenance and payroll, and also out in LA. And then we do have a fun branch out in Hawaii, too, where people would like to go visit.

And then my last slide is actually this one. I know I focused on what we return to the member, and I haven't really concentrated on any financials. I know a lot of you are into return on assets, and we believe that that's only one measure of what is important as a credit union. So while we believe that finances are also important, for us it's also important to be the advocate, advisor, educator of our members. And we empower our employees to make decisions that are in the best interest of the members.

And sometimes that means that no, I'm sorry, but we cannot give you that loan,

because it's not good for you. And also, we educate our members not to just be -- not to just get all their products from us, but to just be smart consumers of financial services in general. And I have mentioned the workplace convenience, and we actually have a really good tension between offering the lower loan rates and the higher dividends, but that's offset by having lower operating costs.

You know, that comes from being cashless, having the small branches, not having many employees and because of that, we are able -- we reward our employees, if we give maximum value to our members. So I would like to thank you for taking the time again to listen and thank you again for a great morning session.

(Applause)

CHAIR SODEIKA: Thank you, Faith. Thank you. That was really interesting and some terrific programs. I like the NSF incentive, the refund of NSF. And then before we close the meeting today, we'll just take a few minutes to ask the subcommittee chairs for committee reports on our topics for the next meeting. And, Kurt, if I may, I'll start with you on behalf of the Consumer Credit Committee.

MR. EGGERT: Okay. We have five things that we think would be good to talk about next time. One is a broad overview of Reg Z comments to the extent they are available. We would love to hash that out, because we are just excited by Reg Z.

Another is talking about credit scoring issues, including protection for data and issues about selling of data.

A third one is the FACT Act. We hope and anticipate that there will be some aspect of the FACT Act that will be ready for our discussion.

DIRECTOR BRAUNSTEIN: Do you want me to come testify again?

MR. EGGERT: That would be great. We could just set up a desk right in the middle. A fourth thing is a discussion of loan modifications and barriers to loan modifications. A lot of the industry is looking at these as the solution, and I think this October would be a good time to talk about whether that will work and how.

And the fifth is issues involving the Bankruptcy Act and how it is affecting consumers. Thank you.

CHAIR SODEIKA: Thank you. Stella on the Community Affairs and Housing Committee.

MS. ADAMS: We will be discussing HOEPA again, we're sure, fair lending,

foreclosure bailout issues and --

MR. EGGERT: Advertising.

MS. ADAMS: -- advertising, deceptive advertising, in terms of foreclosure scams, as well as in terms of soliciting loans for folks. And Katrina recovery -- we will receive an update, and we hope to actually be able to update what has happened since the moratorium on foreclosures will be up by that time.

CHAIR SODEIKA: Okay. Thank you. Marva on the Compliance and Community Reinvestment Committee.

MS. WILLIAMS: Well, in honor of the 30th anniversary of CRA, our committee spent June and we'll also spend October talking about CRA. And in our meeting yesterday, we talked a great deal about some of the challenges and limitations in CRA, although I think most of us believe that it has provided a significant incentive for banks to provide loans and services and investments in lower-income and minority communities.

And so in October, we're going to return to that discussion, and our goal is to begin developing ideas, proposals, policy alternatives on how we can sort of move forward in modernizing CRA. And what we would like to do is to think about it from a clean-slate perspective, sort of in an ideal world what might an effective CRA policy look like.

CHAIR SODEIKA: Thank you. And Deposit and Delivery Systems, Faith, please.

MS. ANDERSON: Hi. For next time, we have put on our list to discuss remotely created checks. There has been issues with fraud where a consumer will give their information to a third party for just maybe let's say one purchase and with a specific dollar amount, and that third party will then use that information and generate more checks in amounts that, you know, obviously were not authorized.

We have also discussed -- we wanted to discuss this for a while, but we have just been having so many other things to discuss. Stored-value cards and preapproved or not preapproved, gift cards and prepaid cards, whether those should be under Regulation E. And we also will be discussing uniform consumer protections. For example, under Regulation E and Regulation Z, the liability on a consumer is different, so we're going to try to focus on just three issues to see what we can do to make it easier for consumers to understand what their rights are.

We also expect to review Reg Z if the comment period will end and to get an

update on that. And then in the event there is any final proposal on the FACT Act, we will leave room for that also.

CHAIR SODEIKA: Thank you. Well, we have a full agenda set for October for sure. Thank you very much everyone for your participation today and lunch follows in Dining Room L.

(Applause)

(Whereupon, the meeting was concluded at 1:03 p.m.)