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A Conference on Consumer Protection in Financial Product Markets

By Stephan Whitaker

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A conference organized by the Federal Reserve Bank of Cleveland engendered an informative discussion of consumer protection in financial products markets. Anticipating significant changes in financial regulation, the conference asked the question, "how could regulators successfully protect consumers?" It intentionally looked beyond the existing institutions. The first of three panels discussed how consumers gather information and process it to make purchase decisions. Lessons learned from research on food labeling and shopping were discussed. Another panel examined the roles of professionals who guide consumers through a marketplace. Panelists discussed the legal obligations of brokers and rating agencies. The final panel focused on product preapproval processes like the FDA's regulation of pharmaceuticals and the Consumer Product Safety Commission's post-market tracking of injuries. This *Policy Discussion Paper* summarizes the presenters' material and draws out themes that point a way forward for efficient, competitive financial product markets that are safe for consumers.

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POLICY DISCUSSION PAPERS

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Introduction

In past financial crises, American consumers suffered loss of deposits and investments, and loss of employment in the ensuing economic slowdown. In the run-up to the current recession, consumers did not leave financial speculation to the experts; they participated directly to an extent unprecedented in U.S. history. A confluence of global and national forces sent waves of inexpensive credit toward American households, allowing consumers to buy homes at prices four and five times their annual income. They took second mortgages backed by the value their homes appeared to have appreciated to. They used home equity loans to pay off credit cards, then ran those cards up to the limit again. Like all financial excesses, it ended badly. Since mid-2007, the receding tide has left behind piles of foreclosures, bankruptcies, damaged personal credit ratings, and fear among lenders and borrowers.

Observing the carnage, the Obama administration proposed reforming regulation, with a new organization, the Consumer Financial Protection Agency, at its center (Consumer Financial Protection Agency Act of 2009). The Office of Policy Analysis at the Federal Reserve Bank of Cleveland decided to contribute to the debate surrounding the proposal by holding a conference, "Consumer Protection in Financial Product Markets," on September 11, 2009. The animating questions included: What should a consumer protection agency do? How does one go about protecting consumers? What works and what does not work?

At a major turning point, like the one where financial consumer protection currently stands, it is appropriate to take a broader view of regulatory strategy. The organizers of the conference set out to look at consumer protection in other markets, such as food and household products. A survey of the field revealed that a major part of consumer protection activity happens in the judicial system, including class action suits, Attorney Generals' prosecutions, and Federal Trade Commission activity. Therefore, the agenda was designed to include experts in nonfinancial consumer protection and legal consumer protection, along with people who have worked in financial consumer protection.

The conference brought out several concepts from other consumer protection fields that show great potential for adaptation to the financial arena. There are also measures that seem best suited for resolution in the courts. Together with improvement of existing practices, a reworked consumer protection regime should be able to shield American consumers from another wave of underpriced credit.

This discussion begins with Susan Wachter's overview of the current crisis (section 2), followed by Janis Pappalardo's description of the prevailing economic theory of consumer protection and the potential for improving its implementation (section 3). In section 4, I share the insights offered during the first panel that encourage new, more nuanced thinking about disclosure and how consumers use information to make financial decisions. Section 5 discusses finance professionals who could guide consumers through the complex marketplace. In section 6, I discuss the applicable ideas from Dan Carpenter's description of product pre-approval processes and David Pittle's explanation of post-market monitoring. Section 7 relates material regarding the institutions of regulation, primarily as presented by Pat McCoy. Section 8 gives a brief account of the deliberations surrounding the presentations, including the concluding discussion led by Mark Sniderman. The paper's conclusion (section 9) discusses recommendations that can be supported with the evidence presented at the conference.

Overview of the Recent Crisis

Among people who hold any of the numerous differing opinions about the financial crisis of 2008–09 would argue that there was any single cause. Susan Wachter explicated the various forces that converged to create what she characterized as "the pro-cyclical production of risk." Everyone involved in financial markets is expected to observe the price of credit and buy or sell quantities in response. The prices should reflect the risk of each type of transaction. If the prices are wrong, there is no reason to expect the markets to clear the correct quantities. Starting at the consumer level, Wachter explained that investing in homes appeared to be riskless before the crisis. Consumers perceived that home prices only increased, and there were few counterexamples in recent memory. Coastal regions in particular had seen strong home price appreciation for at least a decade (Shiller 2007). Constant appreciation meant the homeowner could always sell the home if they experienced a negative income shock. The only risk was on the up side. Speaking of buyers, Watcher said that "we particularly want the most house now because as behavioral economists also tell us, a major driver. . . is regret aversion. We don't want to seem stupid. We don't want to miss out." Collecting the appreciation on a home appeared to provide earnings without labor and wealth without saving. Some consumers feared the day when prices would rise so high they would be "priced out of the market forever."

The brokers and nonbank lenders who sold mortgages and home equity loans to these consumers perceived, perhaps correctly, that they faced no risk. In their business model, they held few or none of the notes. They collected the fees, profited, and immediately sold the loans into the secondary market. Purchasers on the secondary market also perceived minimal risk because they bought the mortgages in the form of investment grade (highly rated) mortgage-backed securities. (MBS). Secondary market purchasers did not face any legal risk, even if the mortgages were fraudulently originated, because current laws held only the originator liable. The ratings firms likewise protected themselves from suits that might claim they misled investors: Their purchase agreements added the caveat that the expected losses suggested by their ratings were valid "under current conditions" only. For a number of years, they were valid, and then clearly, the residential real estate market conditions changed.

Investors' eagerness to get the relatively high returns offered by MBS with the perceived safety of investment-grade ratings brought capital into the real estate market. With home prices rising much faster than household incomes, lenders had to innovate to meet the demand for these securities. They either had to lower underwriting standards to make loans to people who would not have qualified under traditional standards, or they had to develop new loan products that at least temporarily lowered payments to a level the borrowers' incomes could cover. They did both. Subprime mortgage originations expanded from 10-15 percent of the market in the 1990s to 50 percent in 2006 (Pavlov and Wachter 2006). Among the subprime and Alt-A loans, nontraditional products such as interest-only loans and negative amortization loans grew from almost nothing to over 50 percent of originations (McCoy, Pavlov, and Wachter 2009).

Some investors, realizing they could not analyze the performance of mortgage portfolios in real time, acknowledged that they did not know the risk of their MBS holdings. So they purchased credit default swaps (CDSs), a form of insurance against falling asset values. This further lowered their perception of the risk they faced. The sellers of the CDSs, having observed the response to the collapse of Long Term Capital Management, acted as if they were too big to fail. In the event of major losses, they expected regulatory agencies to arrange a rescue effort that would prevent a complete loss. Having transferred their risk to the broader financial industry or the taxpayer, the CDS sellers felt they did not need to set aside large reserves against losses. This lowered the price at which they could sell the insurance, again underpricing the risk.

As the high returns and the illusion of minimal risk attracted more funds into real estate markets, the cycle reinforced itself. Easy credit raised home prices, reinforcing the consumers' belief that homes could be a source of wealth and income, if they got in soon enough. As there were many processes at work, there were also many points at which the cycle could reverse.[1] Clearly, the cycle did reverse, causing enormous losses for consumers, lenders, investors, and taxpayers.

The Prevailing Consumer Protection Regime: An Economist's Perspective

Having surveyed this situation, a regulator must ask what consumer protections were in place—and did they function? Janis Pappalardo is an economist at the Federal Trade Commission (FTC), an agency whose primary mission is consumer protection. She examined consumer protection from an economist's perspective. This begins with the concept of the competitive market. Consumers are assumed to be fully informed and able to compare products. With these provisions, producers will bring products to the market and sell them at cost (competitive markets create zero profits). According to Pappalardo, this forces us to think of competition as inherently pro-consumer. The consumer will be protected from dishonest producers because their inferior product or inflated price will be discovered in the market, and consumers will switch to a competitor. Much of the FTC's work is directed at promoting competition. This often takes the form of enforcing antitrust statutes.

The economists' models allow for relaxing the assumptions and acknowledging that violations of the assumptions will change the prices and quantities in the market. For example, the search costs that consumers must pay to gather information about products may not be zero,

1. A candidate for the tipping point is that the 2006 vintage of subprime mortgages finally overreached. These mortgages went very bad, very quickly, with 20 percent of borrowers defaulting within a year of origination (Demyanyk and Van Hemert 2008). Without new buyers constantly coming into the market, prices stagnated and then began falling. Borrowers who had put little down or borrowed all their equity were under water. Banks would not refinance loans on the depreciated homes. The ensuing foreclosures flooded the market and pulled prices down further.

as a purely competitive market requires. Some products cannot be evaluated at all until they are consumed. In that case, the producer has information the consumers cannot have, creating a situation called "information asymmetry."

One of the FTC's primary functions is reducing information asymmetries by ensuring that the information producers pass to consumers in the marketplace is factual. Pappalardo broke FTC tasks down into the areas of "inform," "educate," and "regulate." Informing involves the regulator selecting certain facts and requiring that producers convey those facts to consumers. Education in this context, refers to teaching the public how to process those facts in making their decision, as through public service announcements or literature. In regulating, the strongest action, the FTC acts directly on the producer.

Producers who state outright falsehoods may be prosecuted for fraud if their misrepresentations of products' qualities are deemed to cause harm; in that case, the FTC can take legal action against producers. However, most offenses are prosecuted under the legal concept of "unfair and deceptive acts and practices," which can be proven more easily than fraud.

Pappalardo reiterated a principle widely accepted among economists: that variety—and innovations that create it—are good for consumers because there is large variance in consumers' preferences and resources. Consumers generally have more information about their individual preferences and resources than a regulator does. Therefore, it is difficult or impossible for a regulator to definitively label a consumer's choice to be wrong.

The concepts of variety and information can be seen in the current consumer protection regime, which revolves around disclosure. Providers can create products with unlimited combinations of contract terms, as long as they disclose those terms to consumers before a contract is signed. Consumers generally sign documents to indicate they have received the disclosure and agree to the terms. The FTC can prosecute lenders if disclosures contain false statements or omit important details.

Very few of the complaints that consumers bring to the FTC can be prosecuted as fraud because the lenders completed the required disclosures properly, and consumer signed off on them. The disclosed contract terms are often unfavorable to consumers, but consumers sign them nonetheless and lose their down payment or home. How is this possible? Pappalardo pointed to increasing doubts regarding the efficacy of disclosures (Barr, Mullainathan, and Shafir 2008; Renuart and Thompson 2008). Disclosures failed to stop millions of recent homebuyers from entering into contracts that, in hindsight, were very bad for them financially. Instead of protecting consumers, the disclosures end up protecting lenders from accusations of unfair or deceptive practices.

There has been little empirical research on disclosure forms, and Pappalardo's own experimental testing suggests that those currently in use do not work well (Lacko and Pappalardo 2004). Pappalardo, and her colleague, James Lacko, convened a random sample of 800 mortgage holders. These people did not contact any agency to lodge a complaint. At the beginning of the interviews, a majority of the borrowers indicated that they were satisfied with their mortgages. FTC staff examined their loan documents and asked the borrowers basic questions that are answered by the documents. The borrowers' replies indicated very low understanding of the terms of their loans. This lack of understanding existed despite the consumers receiving and signing all the required disclosure statements. In some cases, Pappalardo concluded, "the disclosures were actually worse than ineffective. They actually seemed to create consumer misunderstandings."

Building on this research, Pappalardo and Lacko designed an experiment. They selected widely used disclosure documents for home mortgages and designed some simpler, clearer forms to convey the same information. They asked the borrowers to examine each document, and then tested their comprehension. Respondents given the simpler forms were able to correctly answer 80 percent of the test questions on average, This was a 19 point improvement over the group given forms currently in use. The experiment demonstrates that rethinking the disclosure forms, developing a standard through rigorous experimentation, and requiring use of those forms could improve consumers' understanding of the contracts they are entering into and could enable them to select contracts more favorable to themselves.

Information and Consumer Decisionmaking

During the first panel of the day, three speakers presented reasons why the disclosure-based consumer protection regime might be insufficient to protect financial product consumers. Greg Elliehausen began with an overview of behavioral economics, a subfield of economics that emphasizes the limits of the rationality that shapes people's economic decisions. He cited studies on risk perception bias, that is, people's inaccurate estimates of the probabilities that must be used to calculate the expected value of a purchase or investment (Kahneman, Slovic, and Tversky 1982). There are numerous other cognitive biases: Shui and Ausubel (2005) found that people underestimate how painful it will be to repay consumer loans. Elliehausen argued that current disclosures are not very effective because they are responses to problems perceived by policy makers, whether research verifies the problems' existence or not. The disclosures are created based on vague, even conflicting, mandates and are not designed to help consumers overcome their cognitive biases.

The second presenter, Alan Levy, shared his insights based on 20 years of experience in the Food and Drug Administration's (FDA) Consumer Studies Team. His research has focused on how consumers relate to claims and nutritional labels. He uncovered considerable evidence that in the real world, search costs are far from zero. Consumers treat their time as very valuable and seek to minimize the time they spend gathering information about products. They read nutrition labels only if they have a specific question in mind (Szykman, Bloom, and Levy 1997). Consumers generally trust that claims made in advertisements or on the front of packages are truthful. For example, a consumer may intend to purchase low-fat yogurt based on their tastes or a doctor's recommendation. They find the yogurt section of the supermarket's dairy department and purchase any yogurt claiming to be low-fat. If the containers are not labeled with claims of "low fat" upfront, the consumer might look at the nutrition label. If the package claims low-fat, the consumer believes the product satisfies his standard, and he does not take the time to confirm it by looking at the label (Roe, Levy, and Derby 1999).

Levy refers to this as the "truncation effect." It can be harmful if consumers end up with products that are not the best for them. On the other hand, consumers actually welcome claims that save them time and effort in shopping. This is why the FDA focuses on making sure product claims are accurate. The parallels to this are the claims firms make to sell financial products. In the case of mortgages, home equity loans, and credit card agreements, even fewer people read the disclosures that are the equivalent of the nutritional label. Consumers rely heavily on the claims made by advertisements, loan officers, and brokers. Part of the problem consumers face in financial product markets arises from the prevalence and long history of consumer protection in other markets. Consumers assume all food on a store shelf is free of parasites and toxic chemicals because government agencies monitor the processing and punish violators. Consumers also assume that financial product providers are legally obligated to provide "safe" products. This means they are apt to accept claims without verifying them by reading detailed disclosures. Levy said, "Most consumers know how supermarkets work as intermediaries between food manufacturers, suppliers, and consumers. But few consumers seem to know how mortgage brokers work… few consumers know much, if anything, about financial regulations."

Levy concluded by highlighting several differences between people's consumption of food and their consumption of financial products. People shop for food frequently and repeatedly and can try an unfamiliar product at little expense. If it is unsatisfactory, they purchase a different product the next week. Over a lifetime, grocery shoppers become very familiar with their own preferences. In contrast, most people buy financial products very rarely, even just a few times in their life. Consequences are major in terms of wealth lost or gained, and consumers do not have a strong sense of what they should judge the products on.

The description of the challenges consumers face in financial product markets dovetails with the John Lynch's description of situations where "nudging" can be helpful. For the benefit of the conference attendees, he defined nudging and explained how it could be applied to consumer protection in financial product markets. "A nudge is trying to help consumers make better decisions by changing the choice context subtly or changing defaults that make the most likely mistakes less likely," he explained. Nudging is most useful, Lynch argues, when decisions, "are hard … infrequent, [and] there is no feedback that would help people learn from experience." He gave the example of organ donation. When surveyed, large majorities of most populations say that making one's organs available for transplant in the case of an accidental death is beneficial to society. However, in countries with opt-in organ donation programs, between 4 percent and 25 percent of people opt in. In countries where the default is participation and citizens must opt out of donating their organs, participation is usually over 95 percent. Choice exists in both cases, but the choice context radically changes the outcome (Johnson and Goldstein 2004).

Another example is retirement accounts. Policymakers and most employees agree that it is good to save for retirement through 401K withholdings. However, if employees must visit their human resources department, fill out the paperwork, and start receiving a smaller paycheck than they are accustomed to, many put off the task indefinitely. Most large employers now make participation in retirement programs the default, which employees must intentionally opt out of (Madrian and Shea 2001; Choi et al. 2002). This results in substantial increases in participation.

In the case of financial products, Lynch argues, a regulator who aims to protect consumers should nudge them toward products that have a low probability of causing financial hardship. To accomplish this, the nudge has to happen earlier in the decisionmaking process than the point when consumers currently encounter disclosures. Lynch and his co-authors have built research on John Hauser's (1978) theory of probabilistic choice models. Their empirical evidence suggests that 78 percent of the variance in consumers' purchases is explained by their consideration set (Alba, Hutchinson, and Lynch 1991). Only 22 percent of the variance can be explained by any information the consumer processes regarding the products he or she considers. "For an option to be chosen it has to be considered," Lynch said, "you know it sounds obvious, but it's profound." Secondly, he explains, "in order for an option to be chosen, the consumer has to fail to consider something they like better." Even comprehensive disclosures have no effect unless better products make it into the consumer's consideration set.

To address this, Lynch suggests we need something that acts like a supermarket for financial products, bringing similar, competing, products together in one place, where the consumer can easily examine them and choose one. Financial products do not need physical shelf space, but a database could facilitate market operations. The regulator could require all providers to periodically file the products they have on the market. Agency staff would then assess the products for consumers' safety in certain economic circumstances. Consumers would work with "recommender" software to search the database, using input regarding their financial situation and preferences. They could express a preference for a bank they already have accounts with or a lender with an extensive record of lending in their neighborhood. This would allow providers to distinguish themselves through customer service and a good reputation and to avoid degenerative competition based on price alone. The system would provide a list of five products deemed safe by the regulators. This accomplishes what Lynch advocates: making sure consumers consider safe products. The vast majority would probably select one of the recommended items, Choice is preserved by allowing people to select a product not on the list if they sign a disclosure indicating its possible dangers.

A stronger, related recommendation is the proposal to require that consumers be offered a plain vanilla product. Consumers could opt out. Lynch made the point that this standardization would ease comparison shopping. Complex products require complex disclosures and comparisons on multiple dimensions, which does not make shopping easier. In the discussion that followed the first panel, Creola Johnson (moderator of the second panel) mentioned another variation of the system suggested by Susan Wachter (2003). Consumers would enter their information and desired loan characteristics into an online system. Lenders would review the requests and offer products. This would result in direct competition between the providers and lighten the consumer's information gathering burden. Lynch suggested that disclosure of loan terms could be made to a regulatory agency or nongovernmental organization, which in turn would guide consumers through the market. David Pittle, a member of the product regulation panel, highlighted the intermediary's incentives, noting that the guide needs to be a disinterested party, not a salesperson who benefits from selling the highest cost product.

The Role of Gatekeepers

Financial professionals were the central focus of the day's second panel. Tom Fitzpatrick spoke directly to the question of aligning incentives. As Susan Wachter had explained, loan originators during the expansion of the housing bubble did not bear the risk of the loans they originated. The loans were immediately sold into the secondary market. Beyond that, Fitzpatrick explained, some brokers and thinly capitalized mortgage companies did not operate under any standards at all. In many states, mortgage originators did not have to be licensed. They were not bound by a legal duty to match consumers with "suitable" products, as investment advisors are. They had no fiduciary responsibility to their clients, as corporate officers have to their shareholders. Without violating any law, originators could sell mortgages that were completely inappropriate for borrowers' needs. When brokers committed outright fraud (for example, by collecting fees and then not), they could simply declare bankruptcy if anyone brought a suit against them. Since brokers' operations required no capital, not even an office lease, some brokers had literally nothing to lose.

In cases where borrowers are defrauded, an archaic law is at work against the consumer. As Fitzpatrick explained, an eighteenth-century ruling by Lord Mansfield established in the common law that an assignee who purchased a promissory note (a mortgage) could not be held liable for actions of the person or firm that originated the loan. The originator's wrongdoing could not even be used as a defense against payment. This ruling was originally intended to encourage people to use banks' promissory notes as currency. In the intervening centuries, legislatures have nullified the ruling in all consumer markets except home mortgages. Reversing this situation is known as imposing "assignee liability" on the market.

If assignee liability is in place, the investors in the secondary market will face significant losses if they purchase loans originated through fraud. Borrowers could use the fraudulent act in court to defend against payment. Fitzpatrick noted a study by Keys, Mukherjee, Seru, and Vig (2009) finding that loans sold into securitization do not perform as well as those held on portfolio. There are several possible explanations for this, including the possibility that originators hold the loans that they believe are more likely to be repaid. The absence of assignee liability discourages secondary purchasers from investigating the details of the loan because if they become aware of fraud before they purchase the loan, they can be held liable for it. The current practice is to avoid detailed investigation and to purchase a pool of loans after the originator has skimmed the best for its own portfolio. This practice allowed underwriting standards to deteriorate with no timely response in the secondary market, harming both borrowers and investors.

In the second panel, Jerry Fons spoke about a type of gatekeeper, albeit one removed from the consumer. His experience and expertise relates to the firms known as Nationally Recognized Statistical Ratings Organizations (NSROs). Most prominent among these are Moody's, Standard and Poor's, and Fitch. The organizations arose to help reduce the information asymmetry between companies and investors in the era of industrialization and railroads. They were supported by subscribers to their publications of ratings until the 1970s, when the business model shifted so that debt issuers paid agencies to rate them. Critics maintain that this creates a conflict of interest. Fons explained that the process has become interactive: A financial firm contacts the ratings organization regarding an asset-backed security. The raters specify the mix of loans necessary to achieve an investment-grade rating, and the firm attempts to assemble a portfolio of such loans. The potential for consumer protection exists if the rating agency gives lower ratings to securities that are backed by fraudulently made loans or loan the consumers will not be able to repay. Lower ratings would close the gate to secondary investors and starve consumer-gouging firms.

Fons explained that ratings agencies never attempted to perform this function, but assumed that loan originators were screening borrowers for their ability to repay. "I think the models were not designed for the decline in underwriting standards that we had," he explained. In hindsight, it is clear that underwriting standards were falling, which is why securities received investment-grade ratings and then failed to perform to the level the rating suggested (Dell'Arricia, Igan, and Laeven 2008; Mian and Sufi 2007). Fons argued that government agencies and regulators should not rely on ratings in their work. Regulators concerned about consumer protection must be aware that ratings organizations have not attempted to protect consumers or motivate safe product offerings by lenders. If rating organizations take on these functions in the future, it will be a major change to the system.

Consumer Protection through Product Regulation

In the third panel, Dan Carpenter spoke from his expertise in the function and experience of the FDA's drug approval process. The FDA conducts product pre-approval, a market-wide gatekeeping function. Carpenter makes the bold claim that drug approval is "…not so much an intervention into an existing market. There is no modern pharmaceutical market without the standards and the information that the FDA created." The agency set a standard for rigorous scientific testing of all medications. Pharmaceutical firms are motivated to conduct the testing or risk having their medication rejected. In the course of the testing, the firms gain tremendous amounts of useful information, which often leads to new innovations.

Carpenter pointed out that, contrary to a simple understanding of markets, in which any regulation imposes costs and decreases quantity, product pre-approval can expand a market. By removing "lemons" and increasing consumer confidence, regulation can increase demand. He cites work by Marc Law (2003), which shows that when state governments first imposed food processing standards, those regulations caused increases in consumption of processed food. Likewise, Carpenter's own research explores the development of the psycho-pharmacology field. In the 1970s, the FDA reviewed all the research on psychoactive pharmaceuticals, and decided to take some medications that had long been in use off the market. Firms responded with major investments in research, which led to the wider array of more effective medications available today (Carpenter 2005). If the regulator had not pulled the ineffective "lemons" from the market, they might have continued to dominate the market indefinitely.

The lessons that can be learned from the FDA pre-approval process would require adaptation. No infrastructure for social experiments currently exists; it would have to be developed. Testing financial products, like testing medications, would be extremely expensive. In pharmaceuticals, patent protection enables firms to recoup R&D expenses, but a newly approved financial product could be offered by competing firms. There would have to be careful consideration of how long a product must be tracked before it can be declared safe. Observing the whole 30-year term of a mortgage would not be feasible, but is one year—or five years—enough?

Post-market tracking is an area of significant overlap for Carpenter's presentation and that of David Pittle. Carpenter explained that many important insights have been derived from the FDA's database of incidents related to medications. Independent researchers have identified dangerous properties of medications that became visible after the medication had been widely used. Dr. David Graham's discovery of Vioxx's adverse cardiovascular side effects is one example (Graham et al. 2005)

David Pittle described how one of the first actions taken by the newly created Consumer Product Safety Commission (CPSC) in 1973 was to establish a database of injuries and deaths related to consumer products. The numbers collected were shocking: 30,000 deaths and over 2 million injuries a year caused by common household products. Faced with this data, manufacturers could not dismiss reported problems as rare instances or anecdotes. The Commission mandated design changes to address the most frequent problems. After-market monitoring is fragmented and mostly proprietary in the financial industry. Private companies maintain their own loan-performance data or purchase it from private data aggregators. Bankruptcies and foreclosures are counted, but not tracked in detail nationally. The Home Mortgage Disclosure Act data tracks loan applications and originations in moderate detail, but contains no performance information. This allows for the same problem Pittle found at the Commission's beginning. Consumer advocates can identify cases of loan products causing harm, but regulators cannot distinguish an isolated problem from a systemic failure.

Pittle related guidelines that he has developed for thinking about consumer protection during his decades in the field. Several of these could be transferred to the financial product markets. Many dangers a product presents are impossible for consumers to assess. They cannot know how a car will protect them in an accident unless they crash the car. They cannot assess the flammability of a product without burning it. In financial products, the larger issue is probabilities and risk.

Consumers will not be aware of the likelihood of a financial problem associated with a product unless they have the financial expertise to locate data and analyze it, or to evaluate existing studies.

Pittle believes that safety hazards become a type of transferred cost. If consumers were aware of a danger caused by a product, there would be lower demand and price for that product. Producers often avoid costs by not building in safety measures, but consumers bears a cost in the expect value of the damages the product may cause them. Government regulation forces producers to make a slightly more expensive product, but the unknown danger is removed. The full cost is in the price, and the consumer can make an accurate cost–benefit decision.

Speaking of consumer products, Pittle said, "It's far more effective to reduce injuries and deaths through the judicious use of safety standards on product performance than it is to teach consumers to adapt their behavior to the hazard." The problem with just informing consumers of risks, as he sees it, is that every consumer has to be educated before every contact with a new product. This is an extremely expensive, never-ending task that will inevitably miss some people. In contrast, design changes that eliminate a hazard are permanent. They protect the unsophisticated as well as the expert.

Ray Brescia, the third panelist, advocated for commodifying the relationship embodied in financial products. He defined commodification as converting a relationship into something that can be sold. Financial products are currently dealt with in the courts through contract law, which treats both parties as partners, equal in all respects. In other areas of life, Brescia explained, we have recognized inequalities and developed the law accordingly. Employers and employees are recognized as unequal in terms of market power, so numerous protections for employees are built into labor laws. Collective bargaining, minimum wage laws, and child labor laws are examples. The landlord–tenant relationship is also "embedded in a richer subtext," according to Brescia. "It wasn't 50 years ago that you could rent out a home and not be expected to provide heat and hot water to your tenants… and the tenant had to pay rent regardless of whether or not he or she received those services," Brescia explained, "So in the landlord–tenant relationship we started to develop warranties, warranty of habitability being the big one." By commodifying the borrower–lender relationship, he believes, minimal consumer protections could be established.

Brescia also argued that mass tort action lawsuits should be filed when a financial product provider harms many consumers. Mass torts, he explains, have several advantages: They are retrospective, so a regulator does not need to anticipate product innovations in order to address problems. The discovery process uncovers qualitative information that would likely remain hidden, even with a post-market tracking system. If tort laws vary by state, experimentation by both plaintiffs and defendants will occur, promoting novel solutions to problems. The existence of mass torts encourages voluntary compliance. Firms may be in the best position to identify dangerous products and keep them off the market. Finally, settlements or damages provide relief to victims, which is not often the case under administrative regulators.

Consumer Protection Institutions

Unique among the day's presenters, Pat McCoy focused primarily on the institutions and politics of consumer protection. She discussed the decisions that must be made regarding the regulator. Will it oversee all entities that extend credit, or only deposit-taking institutions? In the past, deposit-taking institutions were more heavily regulated because regulators were most concerned that deposits would be returned; in the last few years, however, millions of problematic loans were made by non-bank lenders. The question of whether regulation should be done at the state or local level is also important. Those in favor of federal regulation argue that it allows free competition across state lines, benefiting the consumer. Having rules that are consistent in all states keeps compliance costs lower. Those favoring strict regulation fear that state-only regulation would lead to a race to the bottom, relaxing regulations to the point of irrelevance. Critics of federal regulation say that state experimentation will lead to better rules. Consumer advocates may be more likely to get equitable consideration in state legislatures than in Congress.

McCoy went on to discuss detailed regulations being written by Congress. Her argument against this practice is that financial providers will easily innovate to evade any binding restrictions written into the federal code. The administrative rule-making process is better able to react to these changes and achieve protection objectives. As an example, she cited the Home Ownership and Equity Protection Act (HOEPA) triggers set by Congress, which were quickly evaded (Bostic et al. 2008). On the other hand, during economic expansions, business interests point to rules written by administrators and question the political legitimacy of the costs they add. This can weaken support for the rules and undermine their ability to protect consumers.

McCoy spoke directly to the issue of an industry capturing its regulator. "OTS has many, many dedicated, wonderful employees," she said, "but the leadership in recent years became captured." Earlier, in the discussion following her own presentation, Pappalardo cited the breadth of the FTC's mission as one of its strengths. "How do you set up an agency that is independent, and in a way that's least likely to become captured by a particular interest group?" she asked. "…I'll make a pitch for my agency. I think that because we regulate so many products, there isn't focus on just one industry." Because it protects customers in a wide variety of markets, she noted, the FTC has a broader constituency to support its independence and funding, whereas a focused agency can be neutralized if one producer lobby overwhelms one consumer lobby.

Presenter and Participant Discussion

In her comments as moderator, Creola Johnson raised the topic of consumer protection for minority and disadvantaged populations. "The economic crisis has a disproportionate impact on communities of color," she said, "When the media talks about this they assume that all of the consumers out there are similarly situated and they're not…" Johnson called conference participants' attention to testimony by former employees of Washington Mutual, who charged that racially disparaging remarks were used within the company to refer to populations targeted for marketing of subprime mortgages (Powell 2009). Quantitatively, it is clear that subprime and nontraditional loans had larger market shares in minority communities than elsewhere (Haughwout, Mayer, and Tracy 2009; Wachter, Russo, and Hershaff 2006). One study attempted to explain the observed higher annual percentage rates (APR) paid by minorities (Courchane 2009). The APR gap is not significant in traditional mortgages, but it is large in nontraditional products.

Regulation of mortgage lending already takes race and ethnicity into account to some degree. The race and Hispanic origin of loan applicants and recipients is consistently tracked and reviewed through data gathered under the Home Mortgage Disclosure Act (HMDA). The HMDA data are a legacy of efforts to end systematic denial of credit to minorities. Dan Carpenter gave an example of the successful outcome of regulations with differential treatment for minorities from the medical field, where equal treatment is not always optimal. Political interest groups pressured the FDA to focus more on women's and minorities' health issues, he explained. The FDA began to require that clinical trials report results by demographic subgroup. Medical research discovered substantive differences in treatment effects for subgroups. This informed the use or avoidance of treatments, and improved health outcomes overall. "That's a case where the politics in regulation actually improved the quality of the science that we have," Carpenter said.

A discussion led by Mark Sniderman closed out the conference with a review of several important points that were made during the presentation. Sniderman noted what seemed to be general agreement on the need to gather better data, either compiled by regulators or mandated for release from providers. David Pittle added that sometimes no coercive action is needed by regulators beyond the creation of measures. In the automobile market, the Consumer Product Safety Commission began testing vehicles and releasing crash test safety ratings. Then car manufacturers began advertising high marks when they earned them and vigorously developing safer cars. Dan Carpenter came to the defense of disclosures, saying that they need not always be read by 100 percent of consumers; sometimes 20 percent to 40 percent of the consumers reading the disclosure, combined with word of mouth and media discussion, can make product characteristics "common knowledge."

A progressive use of post-marketing monitoring was discussed. For example, if a medication has been approved for prescription use and is used for several years with few safety issues, it can become an over-the-counter medication. Sniderman suggested that the financial products being referred to as "plain vanilla" may be treated like over-the-counter medications, not requiring an expert gatekeeper.

Conclusion

In the shadow of a major meltdown of the financial system, a historical view suggests that Congress and the administration will be politically compelled to address the areas where it embroiled consumers. Regulation will be expanded to cover at least the problems evident in the recent crisis. This is, after all, how the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, Freddie Mac, Fannie Mae, and many other agencies came into existence. They addressed the problems of the past, which included loss of deposits and investments and lack of credit in residential housing markets. In contrast, today's problems arose from an overabundance or underpricing of credit.

With the demand for ordinary home mortgages satisfied, financers had to find other margins on which to expand lending, such as lower down payments, home equity loans, and lower underwriting standards, to qualify more borrowers. Consumers, who for decades were screened by lenders, were now encouraged to take on debt with minimal restraint. This has harmed consumers in a different but no less devastating way. The new forms of consumer protection will seek to prevent consumers from becoming indebted beyond what they could conceivably repay and will seek to have the markets for consumer credit clear near a competitive price.

A knee-jerk reaction could be to ban the exotic lending products that were involved in this latest bubble and to mandate that only "plain vanilla" credit products be sold. However, implementing the recommendations suggested in the conference may make this unnecessary.

The emerging themes of the conference are informational. The first is data collection. There was general consensus that current tracking is not sufficient to identify problems so that action can be taken by any party—lenders, borrowers, regulators, or advocates—to correct these problems. A regulator should have sufficient data to identify products that are associated with disproportionate levels of financial hardship for specific types of borrowers.

Second, steps need to be taken to fix disclosures and ease comparison shopping. Intentionally or not, the complexity of current products was creating an information asymmetry, and some lenders exploited this to overcharge consumers. Designing simplified, standardized disclosures and testing them rigorously for effectiveness can help to reduce this asymmetry. Also, consumers need to be able to choose among loans and lenders before they sink time and fees into a specific choice. This means shifting disclosures from complex forms received at the end of the shopping process to comparable numbers on key dimensions of loans that are easily accessible to all potential borrowers. When these numbers are conveyed through claims, a regulator can assist consumers by making sure the claims are factual and not misleading. The possibility that a regulator could establish an exchange or nudging system that would help consumers find suitable products should be studied further, to determine if it is necessary and feasible.

From the legal perspective, two differences in the law surrounding mortgage lending left this largest of consumer transactions open to misaligned incentives. A duty of care is currently imposed on agents in other consumer markets, including manufacturing and construction. Extending the duty of care to all mortgage originators will make them liable for extreme mismatches of borrowers with loans. Coupled with assignee liability, this should motivate honest dealing. Brokers should help consumers find a reasonable loan for their financial situation. In essence, a new consumer protection regime would ask the gatekeepers of credit to walk a middle path, neither denying access when a loan can be beneficial to a consumer nor allowing consumers to take on unbearable debt.

In the future, if the altered incentives and increased market competition are still insufficient, the increased data collection will reveal if the credit markets are harming the consumer by denying or overextending access. If Congress or the regulator determines that some loan products do need to be banned, the extended data sources could enable an informed and targeted restriction.

The "Consumer Protection" conference provided a valuable overview for anyone who will be involved in financial product regulation in the future. Overall, consumer protection in other markets is much more developed and robust; it is based on a more realistic assessment of consumers' behavior, resources, and role in the market. Regulation of financial product markets has been primarily focused on ensuring equal access and requiring disclosure. In the future, regulators should arrange information flows and align market participants' incentives so that consumers stand a good chance of avoiding products that are dangerous to their financial health.

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