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Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK *of* CLEVELAND

Making Financial Markets Safer for Consumers

INSIDE:

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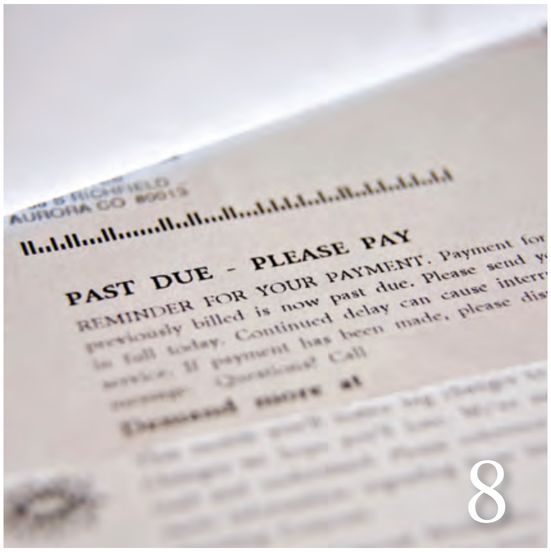

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Making Financial Markets Safer for Consumers: Lessons from Consumer Goods Markets and Beyond

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In the wake of the mortgage meltdown, policymakers are discussing how best to protect consumers in financial product markets. The Federal Reserve Bank of Cleveland hosted a seminar, "Consumer Protection in Financial Product Markets," in September 2009 to exchange ideas with other regulators about consumer protection and the role of the courts. Conference participants zeroed in on four areas of reform:

- **Increasing oversight of lightly regulated lenders**
- **Ensuring that disclosure statements are rigorously tested for comprehensibility and effectiveness**
- **Encouraging market interventions that make comparison shopping easier**
- **Introducing new legal requirements that firms match buyers with the most suitable products**

Some mainstay economic principles were suggested to guide reforms, such as supporting competition and consumer choice, and strengthening borrowers' and lenders' incentives to deal in safer products.

All quotations in this article come from discussions and panelists' statements during the conference.

The Exploding Toaster Analogy

The exploding toaster holds a special place in consumer protection lore. It is obviously an unsafe product: If they knew about the danger, consumers would not buy the toaster and regulators would pull it off store shelves. The exploding toaster analogy highlights the differences between consumer goods markets and the often more complicated market for financial services. Some believe that although consumers wouldn't knowingly buy an exploding toaster, in the past few years millions of them took out an "exploding mortgage."

Granted, this is a simplified analogy. But it underlines the observation that ordinary consumer goods seem a lot safer than some financial products. How do consumer goods markets—and their regulators—differ from consumer finance markets?

Quite a bit, actually.

For some time, consumer finance regulation in this country has been guided by a couple of fundamental (and still true) economic principles: First, competition usually works in consumers' favor. It lowers prices, raises quality, and gives people more choices. Second, information, often in the form of disclosures, helps consumers understand a product's strengths and weaknesses.

Both of those notions have been tested in the current financial crisis. Competition was intense, to judge by the sheer number of mortgage brokers and lenders. Unfortunately, competition did not always translate into high-quality, affordable products for consumers.

How about disclosures? Anyone who has been to a mortgage signing ceremony has witnessed the lengthy disclosures involved in the borrowing process. But borrowers' ability to fully digest and comprehend page after page of disclosures is doubtful.

It is time to step back and re-evaluate our approach to consumer protection in financial markets. To get started, we can examine how a consumer's shopping experience could be affected by product regulation and pre-market approval; information and disclosures; and gatekeepers.

Product Regulation and Pre-Market Approval

In 1970, the National Commission on Product Safety reported to Congress on a two-year study of consumer goods safety. The findings were appalling: a total of 30,000 deaths and 20 million injuries from common household products each year. Lawn mower blades chopped off hands and feet. Infants strangled when they wedged their heads between crib slats. Hair dryers, even when turned off, fell into bathtubs and electrocuted people. Most of these products were labeled clearly with easy-to-understand warnings, but those labels proved disastrously inadequate. Today's regulation of financial products is not much different. Regulators require disclosures, which we assume will protect consumers from harm.

"That was an indifferent marketplace. That was a marketplace where year in and year out, these things were happening, and unless you knew one of those people [the victims], you wouldn't even know this happened," said David Pittle, one of the original five members of the U.S. Consumer Product Safety Commission and former senior vice president for technical policy at Consumers Union.

Today, by federal mandate, lawn mowers shut off within three seconds after the operator lets go of the handle, the spaces between crib slats are too narrow to trap an infant's head, and hair dryers have a ground-fault circuit interrupter that prevents electrocutions. "Those changes don't happen by themselves," Pittle said. "It takes a federal presence to make that happen."

The Consumer Product Safety Commission was formed in 1973. According to Pittle, this was an essential step in identifying safety issues and forcing corrective action. Before the commission was formed, consumer goods were regulated by a variety of agencies and some were completely unregulated. For financial products, the same situation still prevails.

The safety commission's experience shows the power of information gathering. When data for a household product show clear patterns of injury and death, firms can respond —or can be compelled to do so. We have no comprehensive data linking financial products to foreclosures, however. As a result, subprime loan abuses reported early in this decade could be dismissed as isolated incidents.

In addition, products that pose serious potential danger to consumers must have regulatory approval before they go on the market. That is how it works with the processed food and pharmaceuticals overseen by the Food and Drug Administration (FDA), which has partial or full veto power over new product releases.

CHRIS PAPPAS

Legal experts, academics, and government officials presented research, practitioner experiences, and the current state of the law at the Cleveland Fed's September 11, 2009, seminar on consumer protection.

Top row: Mark Sniderman
Fourth row, from left: Stephan Whitaker, Susan Wachter, Kathleen Engel
Third row, from left: Janis Pappalardo, Patricia McCoy
Second row, from left: David Pittle, Gregory Elliehausen, Dan Carpenter, Tom Fitzpatrick
Bottom row, from left: Ray Brescia, Jerry Fons, John Lynch, Creola Johnson, Alan Levy

Harvard political scientist Dan Carpenter argued that the FDA has produced positive outcomes because it has focused on high-quality research, which has benefited food and pharmaceuticals consumers immensely. "In the FDA model for drugs—and I'm not saying it's the right model for consumer finance—the veto power [to keep products off the market] induces this experimental incentive," Carpenter said.

After a product has FDA approval based on information rigorously acquired from randomized clinical trials, the product must have clear labeling that tells consumers what it has been approved for. "Institutions are needed as well as markets for the provision of that kind of information," Carpenter said. "I just don't think markets [alone] are going to get you there."

In the case of financial products, some firms already have databases to identify their own potential risks. The issue is whether a regulator can gather comprehensive data for consumer protection, or give firms an incentive to use those data internally to avoid harming consumers.

Standard economic theory would suggest that pre-market approval would decrease supply and eventually would hurt consumers by restricting choice. But several research papers on regulatory standards for food that were established in the early 1900s reached the opposite conclusion: Consumption of processed food greatly expanded in states that adopted standards for regulating food quality.

The notion that regulation can actually spur innovation may also apply to the withdrawal of products from a market. For example, what happened in the early 1970s when the FDA removed mental health drugs that had bad side effects? Pharmaceutical companies conducted research that developed several new drugs, including antidepressants such as Prozac. "In large part, the sort of revolution in psychopharmacology has occurred because we got rid of the lemons in the marketplace," Carpenter said.

Information and Disclosures

Let's visit the supermarket. People shopping for low-fat yogurt usually don't have the means to perform a nutritional analysis, so the FDA requires the manufacturer to provide that information; it also regulates the manufacturers' claims closely. Yogurt can't be called low-fat unless it satisfies the FDA's definition of the term. But even accurate information, clearly displayed on the carton, doesn't guarantee that the consumer will make the decision that is best for him. Research shows that very few shoppers turn the yogurt carton around to read the ingredients list and nutritional information on the back.

Many claims are made for financial products as well. Instead of reading a small label, consumers must read through stacks of disclosure statements to test those claims.

The danger with claims, according to Alan Levy, a senior scientist with the FDA, is that they can truncate the search for information. Consumers may get a product that only partly meets their needs, or they may miss out on a much better product.

People read labels because they want to make good decisions. "But their sense of what constitutes a good decision is quite different from a search for truth and the cost–benefit calculation that is often assumed to characterize their choices," Levy said. "Too much of our policy attention is devoted to perfecting claim language, and not enough is devoted to getting consumers to ask better questions."

If product labels aren't enough, what else can be done? John Lynch, a University of Colorado psychologist who studies consumers' decisionmaking, thinks that the most significant predictor of choice is whether the product is in the consumer's "consideration set" in the first place. "For an option to be chosen, it has to be considered. It sounds obvious, but it's profound," Lynch said. "Most of the time when an option is not chosen, it's not because it was examined and found wanting. Rather, it was not even considered."

This brings us to the concept of nudging. Richard Thaler and Cass Sunstein wrote the book that made the term famous. "A nudge is trying to help consumers make better decisions by changing the choice context subtly or by changing defaults that make the most likely mistakes less likely," Lynch said. Nudges preserve choice but subtly direct people either to the choice that is best for them or to the most socially desirable choice. The authors have called it "libertarian paternalism."

Nudging has shown some promising results. For example, it is becoming standard practice to make 401(k)s the default choice when employees sign up for benefits. That means that employees must opt out if they don't want to set up a company-sponsored retirement savings plan. The optimal decision—to participate—is the same however it is reached. But with opt-out nudging, more employees make the optimal choice because of the way it's offered to them. Similarly, European countries with opt-out for organ donation programs have about 90 percent participation; only 20 percent participate in countries where donation is opt-in.

This is not to say that disclosures don't matter at all. In a nudging regime, they matter a lot. The least safe products in a consideration set, for example, would have to carry detailed disclosures (see sidebar below).

Gatekeepers

Today's financial instruments are so complicated that an expert gatekeeper is often needed to guide consumers through the selection process, much as doctors are the gatekeepers of prescription medications, and attorneys guide clients through complex legal proceedings.

At the business level, credit rating organizations, such as Moody's and Standard & Poor's, are intended to serve as gatekeepers who evaluate companies' creditworthiness so that people who buy and sell securities have accurate information. Government regulation makes these ratings the "keys" that open "gates" for investable assets. That is, receiving an investment-grade rating opens a world of investors that would otherwise be closed.

For consumers, mortgage brokers or loan officers are obvious candidates for the role of gatekeeper in home loan markets, said Federal Reserve Bank of Cleveland economist Thomas Fitzpatrick. Many borrowers assume that their mortgage broker has their best interests in mind. "By one study, 40 percent of American adults believe that lenders are lawfully required to give them the best possible rates," Fitzpatrick said. The fact is that no such law exists. Although brokers may not commit fraud and must abide by laws governing unfair or deceptive practices, they have no obligation to get their clients the best rate.

To overcome this problem, Fitzpatrick proposed applying "duty-of-care principles" to the mortgage broker business. Some jurisdictions impose such duties on brokers, but only in circumstances so specific that it is relatively easy to avoid liability.

The Mortgage Decision: How Nudging Might Work

A prospective homeowner logs on to a mortgage recommender website, which could be required, designed, and maintained by a regulator.

- The site asks questions about personal circumstances that affect the borrower's relative level of risk for different loans.
- It inquires about the borrower's preferences about the trade-offs between different loan features.
- Software searches a database with offerings from various providers and recommends five loans that regulators consider safe for the current borrower and that have the characteristics he prefers. The best fits—which might even recommend an optimal down-payment level—head the list.
- A borrower is more likely to investigate at least some options if he is not faced with hundreds of loan products. Having too many choices can overwhelm people, causing them either to avoid purchasing anything or to pick a product without any serious investigation. (This phenomenon has been observed with 401(k) plans: When companies offered hundreds of choices, employees dropped out of the program or chose what they considered "safest," reducing their return on investment.)
- Freedom of choice is maintained. Borrowers can ask to see loans further down the ranking, and even select a loan considered unsafe (off the recommended list), but experience in other contexts suggests that the vast majority will select one of the five suggested loans. As a rule, no loan can be originated without the borrower's signature on a print-out of his "recommended" list.

If the nudging system is optional or only available online, it may fail to reach less-sophisticated consumers, who need it the most. If automating the selection process proves too difficult, a broker who is obligated to select safe products could recommend five products or providers.

As University of Colorado psychologist John Lynch puts it, the recommender system is "a form of a nudge that allows for the possibility that people in different circumstances could be affected by different risk levels for different kinds of loans." In some ways, it resembles a supermarket for mortgage loans, which organizes products by standards that are relevant to consumers.

CHRIS PAPPAS

John Lynch

Under duty-of-care principles, brokers could be held liable for selling faulty loans, much as investment advisers are liable for violating their fiduciary duty to clients. "A duty of care would allow a borrower to collect [damages] from a broker if that broker violated its duties," Fitzpatrick said.

But broker liability may not be enough, he warned; it may also be necessary to add a step so that mortgage loan holders could not force a victim of unlawful origination practices to pay the full amount of the loan. "The idea is that once secondary market purchasers are liable, they're going to start paying more attention to the practices of originators," Fitzpatrick said.

As evidence, he cited a case from the consumer product market. In the 1970s, people could buy refrigerators by signing a promissory note. The retailer would sell the promissory note to a finance company, which would collect the buyer's payments. If the refrigerator was defective, the consumer would still have to make payments to the finance company while trying to get compensation from the retailer that sold the faulty product. Consumer complaints mounted until the Federal Trade Commission assigned liability to finance companies. As a result, finance companies changed their contracts by inserting buy-back provisions, which could force the retailer to buy back the notes. The commission's new rule was not reported to restrict credit or hurt small retailers.

Preserving consumers' legal claims and defenses "forces the market to internalize those costs and re-price credit appropriately," Fitzpatrick said. "By many accounts, it's been effective in accomplishing its goals."

The details are complex, of course. The roughly 8,000 banks in the country are all closely supervised by state or federal regulators, and often by both. But there are many thousands more mortgage brokers than banks. How specific and flexible should the rules be as the market evolves? Will regulators merely supervise the market, or will violators be prosecuted? Will it be a federal effort? "If we leave it to the states alone, we end up with a patchwork of laws that is somewhat more difficult for companies to comply with if they operate over state lines," said Pat McCoy, a law professor at the University of Connecticut.

On July 30, 2008, the Fed issued a rule regulating a broad spectrum of mortgages, which it may broaden further. As both Fitzpatrick and McCoy noted, some reformers argue that liability should be imposed not only on brokers and lenders but also on secondary market purchasers, such as the government-sponsored enterprises Fannie Mae and Freddie Mac. That liability would encourage lenders to suggest loans that the borrower has a good chance of repaying, and would encourage secondary market investors to deny funds to firms engaged in fraudulent practices.

A New, Reality-Based Approach

Gatekeeping, product regulation, and pre-market approval already exist in consumer finance—but to a smaller extent than in consumer goods.

The dangers from faulty consumer goods include death, injury, disease, and destruction of property. Financial dangers take the form of bankruptcy, foreclosure, and a diminished standard of living.

The recent financial crisis has shown that disclosure-based regulation of mortgage products is inadequate. Given the comments of the conference participants, how might a new consumer protection regime affect the mortgage market?

- It would track mortgage products by classification according to their risk to better identify dangerous products.
- The concept of disclosure would change from giving consumers all of the details about one product to encouraging and enabling them to comparison shop. This might mean selecting a manageable number of important details and requiring consumers to consider a minimum number of products or providers before entering into a contract.
- There is strong evidence that consumers greatly value convenience and avoid extensive search efforts. Establishing financial services "supermarkets," perhaps structured as recommender systems, would help make the market more competitive and shopper-friendly.
- Disclosures should be rigorously tested for effectiveness. In the realm of pre-market approval, firms should build and test products for safety before releasing them to the market.

Disclosure Disorder

Competition benefits only those consumers who get honest information. Multipage disclosure forms do not help if they are too complicated for a non-expert to decipher, too long to read in one sitting, and too late to affect the key choices of house and lender. Even diligent shoppers have trouble breaking through the noise.

The Federal Trade Commission's Janis Pappalardo and Jim Lacko noticed that in many deceptive lending cases, disclosure statements had been properly filled out, yet borrowers were still deceived. Their research showed that many borrowers "were unaware of, did not understand, or misunderstood key costs or features of their loans." Did they have up-front points? An ARM? Prepayment penalties? Borrowers were often confused, and for good reason.

Many mortgage disclosure forms tell borrowers to check boxes that offer choices like "may have prepayment penalty" or "may not have prepayment penalty." May? Which is it? "The thing that's really shocking was that, in some respects, the disclosures were worse than ineffective," Pappalardo said. "They actually seemed to create consumer misunderstandings."

More information is not the solution. Simplicity would be a step in the right direction, but what's really needed is solid, objective, quantitative testing of disclosure forms. The results would help regulators take into account consumers' preferences, differing educational backgrounds, and time constraints.

- Incentives for firms and gatekeepers should be aligned with the interests of consumers. The costs of providing unsafe products should be internalized: If a borrower is unlawfully led into a loan product—perhaps deceived or tricked with fraudulent promises—he should be able to use the loan originator's unlawful conduct as a defense against paying on the loan, no matter who currently owns it. If loan purchasers were made liable for originators' conduct in this way, purchasers would insure themselves against such losses and could spread the cost across all borrowers, instead of externalizing or passing it off on the wronged borrowers.

To understand why consumer protection in financial product markets misfired during the mortgage meltdown, it is instructive to think about some of the factors that play into people's decisions.

First, people respond to incentives. Second, they differ from one another in their preferences, financial means, and time constraints and generally choose what seems best for them over the long term.

Therein lies the challenge in consumer finance markets. Products like adjustable-rate mortgages (ARMs) or payday loans are far more complicated to use than toasters. How do you structure incentives so that consumers make the choices that best suit their preferences, incomes, and time constraints?

For instance, many would consider an ARM with prepayment penalties the financial equivalent of an exploding toaster, but it's not necessarily so. A borrower who is fully informed about his options—and the risks of each—might still choose an ARM, and it might well be the best choice. For this borrower, the mortgage probably won't explode.

That's because credit helps people smooth their lifetime income. Janis Pappalardo, a Federal Trade Commission economist who looked into consumers' different ways of making choices, came away convinced that we should not jump to conclusions when it comes to consumer behavior. "One person came in with an ARM—I think it was a piggyback [a second loan used in place of a down payment]—and he knew exactly why he was doing it," Pappalardo said. "He was in graduate school. His future income stream was going to be going up, so it was the right deal for him."

That lesson is as important as any: Consumer protection can go too far. The trick is to find an equilibrium between helping people choose and making sure they are free to make the choices that are best for them. ■

Papers and Presentations

Consumer Protection in Financial Product Markets, a Sept. 11, 2009 conference. ***www.clevelandfed.org/research/Conferences/2009/9_10-11-2009/index.cfm***