Remarks by

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The subject of this symposium, “Understanding Consumer Credit: Expanding Access, Informing Choices, and Protecting Consumers,” could hardly be more timely, and I am honored to join you today.

Much earlier this year, when I was approached about this presentation, I thought that the topic sounded pretty interesting, and that the scope of the symposium was very relevant to developments that were emerging in the mortgage markets, particularly with respect to subprime mortgages. Few would have predicted then – and I certainly didn’t – that what were fundamentally consumer protection issues with subprime mortgages – extensions of credit on terms that borrowers didn’t fully understand and couldn’t realistically repay – would have ignited market disruptions, caused billion dollar write-downs in asset values, unhorsed financial industry chieftans, and damaged communities and individual borrowers in the dimensions that we have seen.

There are many lessons to be learned from these developments. The one I am going to tackle today is what lessons we might learn about different approaches to consumer protection regulation of consumer credit. This topic has an abundance of tough issues, and approaches reflect trade-offs more than clear-cut solutions. Nevertheless, I think several key themes can be extracted from current events:

- The traditional and prevalent regulatory approach to consumer protection in the consumer credit area – disclosure – has not worked well; not because it couldn’t work well, but because it has not been effectively implemented in a way truly useful to consumers;

- Product-focused regulation in the form of substantive prohibitions and restrictions on terms of credit, which some may label the “we know what’s good for you approach,” has a place, but is a regulatory technique to be used with great care; it can strike at transactions that are abusive and overreaching in some contexts, but if its not applied with precision, it also can reduce legitimate credit opportunities for borrowers with limited or non-traditional credit profiles;

- There are other approaches to regulation, such as provider-focused regulation, used in other industries or in other contexts in financial services regulation, that have not been extensively employed in consumer credit regulation, that could be used to beneficial effect; and

- There needs to be a realistic recognition that some types of financial services providers are more extensively regulated than others, and that fact has implications for the regulatory standards that are applied to them and the mechanisms that are used, directly and indirectly, to obtain compliance with those standards.

Disclosure-Focused Consumer Protection

Disclosures currently are the primary regulatory approach to consumer protection for consumer credit transactions. At the federal level, statutes such as the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) set out detailed requirements for what, when and how various disclosures are to be provided to consumers. The rationale for the disclosure approach to consumer protection is generally that, through disclosure, consumers have the broadest access to products and services, and also have the information necessary to make rational decisions in their economic self-interest. This avoids the government stepping into a role of dictating prices and terms of financial products, and preserves the healthy effects of competition, choice and the operation of free markets.

But the disclosure-focused model for consumer protection only works if disclosures are understandable and convey the information consumers want and most need to know. Put another way, consumers need meaningful notice in order to be able to make meaningful choices about whether or not to obtain or reject a product based on its various features, or when terms are changed. And, the disclosure-focused model of regulation only works if disclosures effectively convey information relevant to those choices.

Concerns have been raised – including by my agency, the OCC – that the types of disclosures required to be provided today in consumer credit transactions are not effective in achieving these desired results. Subprime and non-traditional mortgage borrowers received extensive disclosures in connection with their mortgage transactions, but those disclosures obviously failed to warn many, many borrowers away from loans that they could not afford. Think of your own experiences. Do you read, and if you do, do you understand your credit card agreement? If you have taken out a mortgage, was that pile of disclosure documents you received at closing helpful to you? Did you just sign where you were told to?

The bad news is that required consumer credit disclosures have not been achieving the goals of a disclosure-focused system. Disclosures often are presented at a level not likely to be understood by most consumers who will receive them; are poorly organized and not formatted to aid reader comprehension or comparison; are overly complex and detailed; and fail to effectively focus the consumer on information key to the consumer's decisions.

This is not the result of lenders deciding they want to provide poor disclosures; in most respects, these shortcomings are the result of lenders following applicable regulations that specify required disclosures – sometimes in mind-numbing detail. Lenders understandably are wary of deviating from those requirements for fear that different disclosures – even if arguably better disclosure – could expose them to lawsuits.

There is some good news here, however, and that is that key regulators and Congress recognize these flaws, and there are important initiatives underway to fundamentally revamp consumer financial disclosures. The Federal banking agencies have issued guidance on model short-form consumer disclosures for various mortgage products, the Federal Trade Commission (FTC) staff completed a major study on "Improving Consumer Mortgage Disclosures" and made detailed suggestions for improvements, and the Federal Reserve Board has undertaken extensive consumer testing in connection with a major rulemaking project to substantially reform disclosures provided to credit card customers, and will soon be proposing new consumer protection regulations in the mortgage area.

Importantly, there finally seems to be broad-based consensus that consumer testing is essential to designing effective consumer disclosures. As the FTC study noted, "for most disclosures, particularly those regarding something as complicated and difficult to understand as mortgage transactions, testing is essential to ensure that the disclosures effectively convey the desired information to consumers."

Also interesting to note here is the "Mortgage Reform and Anti-Predatory Lending Act of 2007" (Mortgage Reform Act), which recently passed the House of Representatives. This legislation contains new, required consumer disclosures in connection with mortgages, <u>and</u> new obligations on loan <u>originators</u> to provide them.

So where are we now? Disclosures provided in consumer credit transactions can, should, and apparently will, be much improved. But is good disclosure enough?

<u>Product-Focused Consumer Regulation</u>

Experience teaches that even improved consumer disclosures are not alone a sufficient system for effective consumer protection regulation of consumer credit. Some consumers just won't read disclosure materials that they receive. Some consumers may not have the literacy – or the financial literacy – to understand the significance of the information they receive. Some products can be quite complex and inherently confusing and it may be very difficult to reduce their characteristics to a simple disclosure statement. Some products may contain features that are difficult to justify as fair to a customer under any circumstances. And, regrettably, some product providers will provide incorrect or incomplete information, or urge consumers to brush aside information in written disclosure materials, as they push products, focusing only on closing a deal.

The difficult issue this presents is when government should step in with product-focused regulation. When is an interest rate too high? When is a product feature simply unacceptable? Or unacceptable only for certain customers? If certain classes of borrowers are more vulnerable, how are they identified? How are additional protections targeted to them and to abusive providers rather than blanketing the market generally?

At the federal level, the Home Ownership Equity Protection Act (HOEPA), enacted in 1994, is an example of an approach that uses interest rates and fees charged as triggers for application of protective provisions for certain mortgage transactions. The triggers act as proxies for identifying a category of subprime borrowers judged to be in need of additional protections – restrictions on specific loan terms and practices, including balloon payments and prepayment penalties, as well as specialized advance disclosures to borrowers receiving HOEPA-covered loans.

Beginning in the late 1990’s and over the subsequent decade, many states enacted anti-predatory lending laws – sometimes termed “mini-HOEPA” laws – to combat lending abuses. Details of these laws vary. Some states use interest rate and fee triggers lower than the HOEPA triggers and thereby cover more mortgages. Some prohibit a greater range of loan terms and practices than HOEPA addresses. And some do both.

There is much debate about the impact of these product-focused laws. Many lenders and some studies assert that the laws drive up lenders’ operating costs and create new and sometimes ambiguously defined potential liabilities, which drive up the cost of credit and reduce the overall availability of legitimate, risk-priced credit for subprime borrowers. On the other hand, supporters of these laws, and another group of studies, argue that this type of legislation is needed to protect vulnerable customers for whom a disclosure-based consumer protection system does not suffice. They also contend that the laws only deter loans with abusive terms, and that any increased costs are outweighed by the enhanced protections borrowers receive.

In many ways, both sides are right. There is no single, right answer. How extensively to apply product-focused regulation is a matter of trade-offs where legitimate differences of opinion will exist.

For example, from my perspective as a bank regulator, I can tell you that very few of the banks we regulate make loans subject to HOEPA, and those that do, make relatively few. Generally, the reasons for this that we hear are that the additional compliance costs associated with HOEPA loans, plus the additional dimensions of potential liability, simply are not worth the return that can be achieved. So the end result is that one category of highly regulated and supervised lender pulls away from a particular line of business, leaving that market dominated by lenders that are subject to less extensive supervision.

That's a trade-off. It has benefits, but it also has a clear downside. And it teaches an important lesson; that increased compliance burdens, and increased exposure to potential liability, will cause already extensively regulated lenders to evaluate whether the cost/risk-reward proposition has tipped, so that continuing to offer certain credit products is no longer economically rational. I'm not suggesting that policymakers shouldn't make these trade-offs and shouldn't apply more product-focused consumer protections where they think those protections are needed. I am saying that these are tough calls that involve trade-offs with sometimes substantial downsides that need to be recognized when those judgments are made.

Provider-Focused Approaches to Consumer Protection

Effective regulation of consumer credit also can learn from regulatory approaches applied in other business sectors. One particular approach, provider-focused regulation, hasn't been used extensively in federal regulation of consumer credit, but now is being explored at the national level in the Mortgage Reform Act, currently under consideration by Congress.

Sometimes I call this the "pharmacist approach" to consumer protection. But, kidding aside, consider this: If you have flu symptoms that you just can't shake and need an antibiotic, need medication to lower your blood pressure or even to treat a really bad cough, you deal with providers – pharmacists – that are specially trained and licensed. But if you propose to take out a mortgage – to embark on what is likely the most significant financial investment you will make in your life, one that could make or break your financial health, there is no uniform assurance that the loan originator with whom you do business has any particular experience or expertise, or is subject to any particular standards of conduct relative to how you are treated.

This is an area where other federal regimes and efforts at the state level could provide an experience base to help construct provider-focused consumer protection standards for consumer credit. The Mortgage Reform Act, for example, embodies several components of a provider-focused approach. Whether or not any portions of this legislation ultimately become law is, of course, not possible to predict, but it is significant as a major initiative to apply provider-focused consumer protection for an important consumer credit product.

First, the legislation would establish a national system of registration of mortgage loan originators – so that if you were a prospective borrower, you could check out the experience and disciplinary history of a loan originator with whom you were considering doing business.

Second, it would institute a national system of licensing for loan originators. This would be accomplished through new licensing qualification standards for loan originators that are not employees of depository institutions or subsidiaries of depository institutions, and oversight of loan originators employed by depository institutions and their subsidiaries through the federal banking agencies' oversight of the mortgage lending operations of those institutions.

And third, the legislation would establish various conduct standards for all mortgage originators. Mortgage originators would be required to comply with a "duty of care" to "diligently work to present" a consumer with a range of mortgages for which the consumer "likely qualifies and which are appropriate to the consumer's existing circumstances." The bill also prohibits mortgage originators from receiving any "incentive compensation," that is based on or varies with, the terms of any mortgage. In addition, the federal banking agencies would issue joint regulations prohibiting mortgage originators from "steering" any consumer to a mortgage that the consumer "lacks a reasonable ability to repay" or, in the case of refinancings does not provide the consumer with a "net tangible benefit," or that has "predatory characteristics."

Provider-focused protections can complement and support other approaches to consumer protection, but whether used alone or in combination with other approaches, they present their own trade-offs. The very difficult challenge facing policymakers then is to come up with just the right brew of regulatory approaches to maximize beneficial consumer protections, while minimizing downside consequences such as curtailing the availability of legitimate credit, driving reputable lenders from the line of business where new requirements are being applied, or reducing liquidity in a particular credit market.

These concerns are particularly relevant today to regulation of mortgage products, given the recent upheavals in this industry and the delicate state of secondary market funding sources. We don't want to see today's discussions of enhancing credit access and providing effective consumer protections mooted by the absence of credit availability for non-prime borrowers.

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Supervision and Enforcement of Consumer Protection Standards

And as good as any set of consumer protection standards may look on paper, they are only as good as they work in practice. A critical factor in that regard is whether they are applied through an effective system of supervision and regulation. For a lesson learned on this score, I quote a recent editorial in the Boston Globe by Barney Frank, Chairman of the Financial Services Committee of the U.S. House of Representatives:

> "One aspect of the subprime mortgage crisis that deserves special attention is that it was in large part a natural experiment on the role of regulation. And the results are clear: Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis.
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> "At every step in the process, from loan origination through the use of exotic unsuitable mortgages, to the sale of securities backed by those mortgages, the largely unregulated uninsured firms have created problems, while the regulated

> and FDIC-insured banks and savings institutions have not. To the extent that the system did work, it is because of prudential regulation and oversight."

There is a fundamental difference in ongoing oversight of federally-regulated depository institution lenders and other lenders. Bank regulators conduct extensive ongoing examination and supervision of the institutions we regulate, and we devote very substantial resources to this job. Non-bank lenders generally have not been subject ongoing examination and supervision and the resources many states have available to conduct this function are dwarfed by the numbers of non-bank lenders and brokers subject to state jurisdiction. Recognizing these differences leads to some closing observations about crafting consumer protections for credit transactions.

First, how lenders are examined and supervised is as important to an effective consumer protection regime as the mix of consumer protection standards that are applicable to them. And I do mean examination and supervision, not just the existence of enforcement authority that can be wielded when bad conduct becomes obviously evident. The ability to take enforcement action is important, but the current subprime lending environment teaches that regular supervision and examination are vital to assure that lenders stay on track following sound practices.

Second, because of the disparate approaches and capacities of the regulatory systems that apply to different types of lenders, the same consumer protection standards applied across the board to all types of lenders will fall hardest on the lenders that are already most regulated – banks and savings institutions – which generally have not been the source of subprime lending abuses. This argues for some recognition of their existing supervisory and regulatory scheme and calibration of the extent to which new requirements are imposed on them.

Third, because of differences in the extent of ongoing supervision of different types of credit providers, the most effective standards probably are those that are simple – where its not hard to tell if a lender is in compliance or not. Where resources are at a premium, they need to be applied to actual supervision, not to parsing complex and intricate sets of requirements and debating what is, and is not permitted.

And fourth, when robust supervisory oversight is not present, secondary sources of discipline may be enlisted to help shape conduct. One example of this approach, contained in the Mortgage Reform Act, would vary the potential liability of assignees and securitizers in connection with mortgages they acquire, with limited liability provided when mortgages met certain standards that, presumably, assignees and securitizers could readily check. The theory here is that lenders won't make certain types of loans if they can't sell them. Use of secondary sources of discipline can involve very delicate tradeoffs, however, where, as here, provoking a broad reaction in the mortgage markets could produce unintended and very undesirable results.

Conclusion

To sum up, effective consumer protection regulation of consumer credit involves balancing the benefits and consequences of, and the interactions between, different regulatory techniques, and an appreciation of the crucial role of an effective supervisory system to actually achieve the desired results. These are very challenging issues and I appreciate the opportunity to discuss them with you today. Thank you.