

**Testimony of Kathleen E. Keest
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“Regulatory Restructuring: Enhancing Consumer Financial Products Regulation”

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Mr. Chairman, Ranking Member Bachus, members of the Committee: Thank you for inviting the Center for Responsible Lending to discuss consumer financial products reform – a fundamental component of the effort to modernize and repair our financial regulatory system.

Over the past decade, federal bank regulators looked the other way as responsible loans were crowded out of the market by aggressively marketed, tricky financial products carrying hidden costs and fees. Dangerous products, whose most “innovative” feature was their ability to obscure their true costs and risks, led a race to the bottom that stifled true innovation, deprived consumers of meaningful choice of products, stripped away billions of dollars in hard-earned wealth from millions of Americans, and ultimately led to today’s foreclosure crisis and economic meltdown.

The key lesson of this experience is that strong consumer protections are essential to financially sound banks and a healthy economy. For too long, consumer protection has been entrusted to regulators whose primary mission and focus has been prudential (“safety and soundness”) regulation. Because abusive practices often produce short-term profit, these regulators have typically viewed consumer protections as nothing more than a constraint on bank activity and revenues, rather than as an integral part of the safety and soundness of the system. These regulators’ failure to restrain the abuses that led to today’s credit crisis demonstrates the need for an agency solely focused on the rigorous consumer protection needed to ensure that financial institutions can flourish in a sustainable way.

For this reason, we strongly support a vibrant, innovative, state-of-the-art consumer protection agency for financial products, such as has been introduced by the Administration and in both Houses of Congress, provided that it is strong, well-resourced, independent of the companies it regulates, and fully transparent and accountable to the public. An independent consumer protection agency, dedicated and empowered to keep the markets free of abusive financial products, committed to transparency, and fully accountable to the public and Congress, would help to restore consumer trust and confidence, stabilize the markets, and put us back on the road to economic prosperity.

In other areas of economic life, American markets have been distinguished by the standards of fairness, safety and transparency of the products marketed to consumers. Financial products should not be the exception. Despite the years of rhetorical threats

that more regulation would dry up credit, we now know that what dries up credit – and a great deal more – is a failure of consumer and investor confidence.

CRL views these matters from the vantage point of a small, independent financial institution serving a segment of the population devastated by the market and regulatory failures that produced the current crisis. Our affiliated financial institutions would be directly regulated by this independent agency.

You have asked us to focus on three areas of inquiry:

1. Whether the agency should be independent or integrated with the prudential supervisors of depository institutions. We believe it should be an independent, stand-alone regulator with the primary mission of consumer protection. An independent agency is necessary to counteract the forces that drive regulators to put concerns about consumer protection on the back burner.

2. The scope of rule-making, examination and enforcement authority of the agency and the types of financial products that should be within its regulatory purview. The agency should have rule-making, supervision and enforcement authority over all providers of consumer credit, deposit, and payment systems (as well as over ancillary goods and services). At the same time, this authority should not displace the right of the states' to protect their citizens from abuses within their border, so federal law, including this agency's rules, should set the floor rather than the ceiling on state consumer protection. The agency should coordinate with the states to ensure robust state and federal enforcement.

3. The importance of, and the potential methods for, funding the agency. It is essential that the agency be funded in a way that ensures its capacity, strength and independence. We recommend that the agency be funded through a combination of appropriations, user fees, and assessments to minimize the risks that attend each option as a stand-alone mechanism.

I. Background

The Center for Responsible Lending is the research and policy affiliate of the Center for Community Self-Help (SH), a community development financial institution whose services include direct mortgage lending to low-wealth families, small business and neighborhood revitalization lending, a secondary market program that facilitates other lenders in their responsible lending to low-wealth families and neighborhoods, and retail credit unions in North Carolina and California. Since its founding in 1980, SH has made nearly \$5.6 billion in financing available to over 62,000 families. Among our affiliates are entities subject to both state and federal regulation.¹ Consequently, we, too, must consider compliance costs and “regulatory burden” just as much as any other financial services provider of any size.

Yet we do not automatically equate either structural or substantive regulatory reform with extra and undue costs and burdens.² Technology has made compliance evaluations

relatively easy and cost-effective. Just last week, SH evaluated the credit card program offered by its retail credit union to compare it against the requirements of the new CARD Act, passed with the leadership of Congresswoman Maloney and others on this Committee. For common-sense products, the Act's common-sense requirements do not impose significant extra burdens. Furthermore, viewed from a societal perspective, compliance costs are a bargain when compared to the cost of recklessness.

More telling is SH's experience in mortgage lending. It has kept its eye on the bottom line reason for encouraging home ownership in the first place: asset-building and promoting stability for families, neighborhoods and communities.³ Indeed, CRL was founded when SH leadership recognized that much of the mortgage industry had lost sight of that fundamental principle.

For example, in the run-up to the current foreclosure crisis, subprime mortgage originators typically marketed to consumers a loan that had to be refinanced every two years, typically requiring the borrower to pay over 3% of the loan balance, plus refinance fees, with each transaction. In most instances, the homeowner could have received a 30-year fixed rate loan that would have cost less even just over those first two years, as well as far less when compared with the higher rates that prevailed after the second year. Instead of offering these lower-cost, more stable, more sustainable loans, subprime lenders pushed homeowners into more expensive, more volatile loans because of the higher fees they generated and because there would likely be another new loan in fairly short order.⁴ Federal regulators could have and should have stepped in, but didn't – at least, not until long after the damage was done.

The regulators' collective failure to rein in the abuses stifled the development of safe, sustainable loan products that would have provided consumers with real choice. Lenders who might otherwise have been prepared to offer homeowners the lower-cost, fixed-rate loans for which they qualified eschewed these products in favor of the more expensive, refinance-generating subprime loans that allowed the loan originators to realize greater fees and to offer higher short term returns to the investors. Expensive loan terms such as prepayment penalties were touted as "choices" for consumers, but in fact, most consumers in the subprime market were given no real choice. In the long run, competition among loan originators to attract investors, coupled with the regulatory failure to ban the abuses had the unintended consequence of severely reducing consumer choice through the major credit crisis we are now experiencing.

For these reasons, we reject the assertion that an independent agency charged with protecting consumers – keeping the field swept of landmines, as it were – will stifle innovation. It is a false dichotomy to say that a market that is safe for consumers is bad for business. Again, to look at the experience of the last decade or so, we found that "Gresham's Law" is a strong force in the financial marketplace: bad money drives out good money, setting competition on a downward trajectory that hurts honest, ethical and efficient businesses.⁵ Natural experiments with state laws show that pruning out bad practices makes room for good ones to develop and flourish.⁶ Balanced and objective regulation thus stimulates productive innovation.

We also do not believe that this Agency would impose untenable burdens on smaller financial institutions. Indeed, it may actually create a more level playing field. How could a small community bank offering a 5.5% “plain vanilla” fixed-rate mortgage compete with Ameriquest’s exploding 2/28 loan when Ameriquest’s Super Bowl ads were reaching millions of households? If one of the biggest lenders in the country is offering brokers twice as much to deliver a risky payment option ARM to it pays for a fixed-rate loan, how can that small bank compete for broker channel loans? That competition for the middlemen is called “reverse competition,” and it gravely distorted the market.

II. An independent agency is necessary to assure adequate, impartial, and fully informed oversight that is market wide

The lesson of the current crisis is that responsibility and accountability for sound, balanced, and evidence-based consumer protection and fair lending regulation and enforcement must reside in an independent agency whose primary mission is consumer protection. This agency must have jurisdiction over the entire market, not just pieces of it, and it must be structured to minimize conflicts of interest.

A. A single independent agency avoids regulator shopping and the race to the bottom for weak rules and weak enforcement.

The current system allows regulated depository institutions to shop for their own regulator. They can choose between state and federal regulators, and they can choose among federal regulators. With that choice, they can also choose what laws apply, or – given the federal regulators’ aggressive preemption of state laws – whether any law applies at all. (See section II-D, below.) The result has been the unseemly behavior of federal regulators out shopping for “customers” (as they call their supervisees), and unashamedly using the preemption as a marketing tool.⁷

These regulators have an extremely poor record of treating consumer protection and fair lending as integral to prudential supervision. Indeed, by its own admission, the OCC did not exercise its consumer protection authority to address unfair and deceptive practices under the FTC Act for *twenty-five years*.⁸ When it finally did so, it was a strategic move driven by its aggressive campaign of substantive and enforcement preemption.⁹ Whether their effort to prevent states from enforcing even non-preempted state laws will succeed is something the Supreme Court will tell us shortly. But we know that the OCC’s fair lending and consumer protection enforcement has been abysmal.¹⁰

Leaving consumer protection and fair lending oversight with the prudential supervisors would be simply to retread the failed path taken after the S&L crisis, when the Federal Home Loan Bank Board was eliminated and replaced with the OTS. As they did once the S&L crisis had passed, the prudential regulators will revert to norm, and forget the lessons learned.

The FHLBB/OTS had rule-making authority under the Alternative Mortgage Transaction Parity Act (AMPTA), an authority that applied to non-bank state chartered lenders, as well as its own supervisees. With that authority, some 14 years after AMPTA was passed, the OTS decided to further open the market to risk-layering, risk-enhancing features. It issued a rule in 1996 that preempted state laws limiting prepayment penalties for all “creative financing” loans – including adjustable rate loans. It can be argued that this was part of the reason that both adjustable rate loans and large prepayment penalties became so deeply embedded in the subprime market.¹¹

It was not simply in its rule-making that the OTS failed consumers. Its failure to adhere to consumer protection principles integral to safety and soundness led to the failure of large institutions under its watch. Several were heavily exposed to poorly underwritten subprime and non-traditional mortgages. For example, even as Washington Mutual had OTS examiners permanently on-site from 2004 to 2006, risky products constituted half of its real estate loans. By mid-2008, over a quarter of its 2006-07 vintage subprime loans were delinquent.¹² In the short run, those loans looked good for growth. But then, at first, so did the S&L loans that led to that industry’s collapse twenty years ago. There is no reason to believe that the same regulators performing the same mix of duties would work any better this time.

Our analysis would not change if the OTS were to be merged into the OCC for a single federal charter regulator, as the consumer protection performance of both agencies was severely substandard. While an OTS/OCC merger would eliminate that particular charter competition, the OCC would still have incentive to compete for charter share with states unless we make absolutely sure with this and other legislation that federal consumer protection and fair lending laws are a floor, not a ceiling.¹³ What’s more, there is still the incentive structure posed by the fees that fund its existence. The OCC’s fees rose from \$609 million in 2006 to \$707 million in 2008, in part from getting new and larger institutions to sign on.¹⁴

The most recent example of the value the OCC places on consumer protection is found in the credit card market. The practices that Congress, the FRB, the OTS and the NCUA found unfair and deceptive became industry standards in large part because of OCC’s preemption rules. Those rules essentially deregulated the credit card industry by permitting other depositories to, in effect, ignore the same laws the national banks were permitted to ignore.¹⁵ Although several of the country’s largest credit card issuers are national banks, the OCC did not rein in those practices. It even filed a comment letter opposing part of the other agencies’ UDAP rules.¹⁶

This Committee is also aware of another recent example of the OCC taking action against a large bank only when forced to, and only to the degree forced to. Chairman Frank and two colleagues supported the efforts of consumers harmed by Wachovia’s relationship to a telemarketing fraud to get meaningful restitution to the victims. The OCC had touted a \$125 million settlement with Wachovia, but constructed the distribution plan so that the actual restitution to victims probably would have been less than \$15 million, with the difference reverting to Wachovia.¹⁷

Moreover, while the OCC consistently denies that national banks originated any toxic subprime loans, this assertion is belied by the facts. Some OCC entities, such as Wells Fargo, did indeed make harmful subprime loans. In fact, evidence is now becoming public that Wells steered minority borrowers to those loans.¹⁸ And, as noted above, the OCC has been careful not to deny that national banks made many risky Alt-A loans, which have aged no better than the subprime loans (and in some cases worse).

The litany of the federal financial supervisors' failures is long and much is being detailed in other testimony today, so we will not repeat it here.¹⁹ Suffice it to say that the prudential supervisory agencies have not earned the confidence that they are up to the task that we hope Congress will set for this new agency.

B. A single regulator eliminates the regulatory gaps and the uneven playing field.

The model of “functional regulation” recognizes that similar products are offered by a wide array of providers, and the products and services should be consistently regulated. Today, national banks compete with payday lenders for triple-digit interest rate, short-term small loans. Depository institutions compete with non-banks to get origination business from mortgage brokers. Indeed, Countrywide wrote risky, poorly underwritten payment option ARMs (“POARMs”) through its non-bank entities, its national bank, and finally through its federal thrift charter, implicating literally dozens of different state and federal regulators. Depository institutions have mortgage servicing affiliates that perform the same function as non-bank-affiliated servicers. Credit card issuers, supervised by federal prudential supervisors, team up with third party telemarketers who use the access their bank partners give them to “cram” expensive, useless products onto those accounts.

Leaving consumer protection in the hands of the safety and soundness regulator raises the question of what entity would regulate non-depository institutions that are not subject to safety and soundness supervision. The same standards and protections should apply to all consumer products, regardless of the nature of the originating lender. Creating a single consumer protection agency to cover all products would ensure a level playing field among lenders and consistency of regulation.²⁰

C. A single, independent market-wide regulator can mitigate the risk of regulatory capture.

The phenomenon of close relationships between the regulator and the regulated is not a new one, nor is it limited to the financial services industry. The risk of regulatory capture is always present, and it can undermine rigorous rule-making and enforcement. Thus, in reforming the consumer protection function, it is important to include structures that will minimize the risk where possible. An agency tied to one segment of the market, over time, almost inevitably will try to assure that its supervisees have a competitive edge. An agency that covers the entire market will be able to work toward a fair, competitive, playing field for all players.

Consider what happened when federally chartered institutions wished to have some of the market share they saw in the subprime and non-traditional markets. Citi purchased Associates, even as the latter was under FTC investigation. HSBC purchased Household, even as it was under investigation by the states, and then got an OCC charter the following year. Professor Patricia McCoy's testimony to the Senate Banking Committee in March details the involvement of federal thrifts and national banks in risky loans during the credit bubble.²¹ Yet the federal regulators were slow to clamp down, although insured deposits were at risk, and it was not until October 2006 that the federal financial regulators issued "guidance" on how to handle those products.²² Countrywide, the top nontraditional originator in 2006, estimated that over 80% of its non-traditional loans would not qualify.²³ The performance of the 2007 vintage non-traditional loans has been among the worst, suggesting that the 2006 "guidance" received little respect. According to Prof. McCoy, IndyMac, Washington Mutual and Downey made loans in disregard of the guidance, and under the OCC's soft touch, some small banks rode that road to ruin, while Bank of America kept making stated income and no-doc loans until the market dried up in the late summer of 2007.²⁴

In creating this new agency, it is also important to ensure that the funding mechanism does not encourage regulatory capture. Funding issues are discussed further in Section IV of this testimony and extensively in the testimony of witnesses Ed Mierzwinski and Travis Plunkett.

III. The agency should have regulatory, supervisory, and enforcement jurisdiction over providers of credit, deposit, and payment systems (and ancillary goods and services).

A. Covered products and services should cover the full range of traditional banking services, their non-banking counterparts, and ancillary goods and services.

We believe that the scope of products and practices that should be subject to the Agency's jurisdiction falls broadly into the categories of credit, deposit/savings, and payment systems, including stored value cards, plus closely related products and services. This universe of products, practices and providers parallels that suggested by Congressmen Delahunt and Miller in H.R.1705, (Section 3), as well as that envisioned in the proposal released by the Administration last week. They are the financial services that are central to the day-to-day economic life of American households. It is extraordinarily difficult for the average family to avoid using some or all of these products.

Ancillary products and services would include, for example, loan brokering, mortgage servicing, loan modification and foreclosure prevention services, debt collection, and payment processing. The agency should also have jurisdiction over additional products that are linked, intrinsically or by practice, to a credit transaction, such as credit insurance, gap insurance, and debt cancellation agreements. For example, credit

insurance was a primary tool used to strip equity in the subprime loans in an earlier business model for predatory lending. That variety of equity stripping credit insurance was curbed by a pincer movement of state laws, public law enforcement and private litigation, as well as the FRB's amendment to HOEPA to add credit insurance premiums to the list of HOEPA trigger fees. There are bound to be variations on this theme, as there is no lack of imagination when it comes to devising these kinds of tricks. This agency must be able to look at the whole of these transactions and cover all related products and services for it to perform its function well.²⁵

B. The agency should have the rule-making authority relating to these subject matter areas that are currently scattered among at least half a dozen agencies, sometimes overlapping and sometimes leaving gaps.

The fragmented system of identity-driven silos of regulation is compounded by fragmentation of rule-writing authority among at least half a dozen agencies. At CRL, we have catalogued nearly twenty consumer protection laws, including the Equal Credit Opportunity Act. *See Appendix B.* The Federal Reserve Board has exclusive rule writing authority for nine of them; the FTC has rule-writing jurisdiction for three; HUD has rule-writing jurisdiction for one, the Real Estate Settlement Procedures Act (RESPA), which overlaps with one under the FRB's jurisdiction, the Truth in Lending Act (TILA); and the Department of Defense has rule-writing authority over one. Rule-writing jurisdiction is shared under four of them, sometimes concurrent and sometimes joint. The latter, in particular, has led to gridlock, as the agencies cannot come to agreement. For example, in developing furnisher accuracy guidelines pursuant to Section 312 of the Fair and Accurate Credit Transaction Act of 2003, the FTC and Banking regulators could not agree on a definition of "integrity" or whether to place that definition in regulations or guidelines.²⁶ In three cases, no rule-writing authority is explicitly granted, and in one case, agency rule-writing authority is explicitly denied.

This rule-making authority is even more fragmented than the supervision structure, and compounds the "silo" problem that precludes anyone from training a clear eye on the market as a whole. Part of the impetus for a single-mission consumer protection agency comes from the recognition that no one has been looking at the full picture, keeping an eye on the overall market trends on products and practices, and evaluating their overall impact. A consolidated rule-writing authority in this Agency would make it more likely that rules could be harmonized, made more consistent, and evaluated for their usefulness. If the statutes themselves need revision, this agency could freely suggest consolidation, changes, or elimination of some requirements that serve no purpose, without fear of losing "turf." Thus by streamlining rules and grounding them in real-world behaviors, this consolidation into a single agency may ultimately *reduce* the level of "regulatory burden" on providers rather than increase it.

C. The agency should have authority to collect and evaluate data to ensure that regulation and enforcement are informed by empirical, real-world information.

1. The agency should test the performance of new products and practices under real-world conditions.

The ability and willingness of an agency like this to test the real-world function and performance of products in the marketplace is almost alone worth the effort of its creation. One of the most puzzling aspects of the run-up to the crisis is the absence of empirical scrutiny of the products and practices that dominated the market.

Red flags abounded, but faith among the regulators was unshaken. Assertions justifying both the safety and value of practices were relied upon, when those practices could have and should have been tested. Warnings came for years from community groups, lawyers representing homeowners, and counseling agencies that there were serious structural problems in the subprime market, and later, in the non-traditional market as that one grew. The disparate impact on borrowers of color has been a major theme of those warnings for nearly twenty years, since the early days of that market.²⁷ Yet although these warnings came from all parts of the country, over a number of years, about many different providers in the subprime and non-traditional market, they nonetheless were discounted as “anecdotes.”

Shortly after trade press began reporting data on subprime originations separately in 1996, alert regulators could have noticed an inordinate number of business failures from the list. By 2005, a cursory look at the year-by-year list of top subprime originators would have shown an unsettling number of them had collapsed of their own weight or had been the targets of major law enforcement actions.

For example, two of the three top subprime originators in the five years between 1998 and 2002 were the subject of state and FTC actions by the end of 2002, each ending in record settlements. Household's settlement was for \$484 million, and Associates for around \$300 million. Then, after the crack-down on Household and Associates, Ameriquest jumped to the top spot for 2003-2005 using similar unfair, deceptive, and illegal practices. Together, these three entities perched at the top of the subprime market over an eight year period. Together, they were hit with over a billion dollars in liability as a result of enforcement actions. That should have been a clue that there were fundamental problems in the subprime market.

As early as 2000, when the fire was perhaps still small enough that it could have been contained, there were warnings of unusually high delinquency and foreclosure rates. But the warnings didn't come from regulators. Professor Cathy Lesser Mansfield and Alan White, then a legal aid attorney, collected default and foreclosure data from SEC filings in 2000, and they found the foreclosure and seriously delinquent rate for subprime was 4.62%, compared to 2.57% for FHA loans, which serve comparable borrowers. Even more troubling was what they found when they looked at the longitudinal performance of one static pool of loans made in 1998 by WMC, the 15th largest subprime originator in 1998) They found that nearly 25% of those 1998 vintage loans failed by the end of 1999. This data was presented to a joint HUD-Treasury hearing, and, in fact, to this Committee as well, in May 2000.²⁸

Yet the industry, as well as most of the Washington regulators, continued to oppose regulation, asserting that it would have the “unintended consequence” of impeding access to credit. No one seemed to look behind that talking point, although the concomitant rise of America’s debt-to-disposable income ratio from 60% in 1980 on its way up to 133% by 2006 could have been another clue that a debt bubble was growing.²⁹ A third clue was the fact that the ratio between the aggregate annual household income and aggregate household debt rose from 24% in 1975 to 110% in 1999 to 168% in 2006.³⁰

Another argument advanced against regulator action was that subprime lending contributed to higher homeownership rates, particularly among minorities. That assertion was unlikely on its face, given that subprime was overwhelmingly a refinance market, not a purchase money market, but no one looked behind it. Mansfield and White estimated that 90% of those facing foreclosure in the subprime market in 2000 had owned their homes before getting the subprime loan. Even as the purchase money share of the subprime market grew with the housing bubble, it was still a majority refinance market even as the market peaked in 2006.³¹ Even before the foreclosure meltdown, CRL predicted a net *loss* of nearly one million homes, not a gain – and that is a number that was likely far lower than the reality will turn out to be.³²

The data exists to resolve the questions we just raised. A good regulatory system could have and should have followed through. A high failure rate would support the allegations of structural problems and widespread abusive practices. Indeed, when CRL looked at the longitudinal performance of about 6 million subprime loans, our study found that subprime loans had a very high failure rate from the earliest vintages we studied, just as Mansfield and White had found. Loans originated in years 1998 to 2001 had already failed at a rate of 1 in 4-to-5 by spring of 2005, and 2003 originations were already on that same trajectory by spring of 2005.³³ That level of failure is too great to dismiss by blaming the borrowers. As Alan White remarked, “If 1 in 5 cars failed within the first 4 years, would you blame the consumer, or look for a design flaw?”

Table 1: Increased Risk of Foreclosure of Common Subprime Loan Features

	Increased likelihood of foreclosure ³⁴	Average share of the feature in ten mortgage-backed securities offerings in the first half of 2007 ³⁵
ARM	72% (117% for 2003 vintage loans)	77% (90% of which were to reset in 2-3 years)
Prepayment penalty	52%	70%
Stated income or low-documentation	29% (64% for 2003 vintage loans)	37%

Not only did these risk-enhancing terms predominate, but they tended to be “risk-layered,” so that the same loan had more than one such feature, creating yet more risk. If regulators had drilled down like this in 2004, they might have mitigated what happened next. Those results would have been at least a yellow light for the non-traditional Alt-A products that grew phenomenally from 2004: interest-only loans skyrocketed from \$55 billion in 2004 to \$418 billion in 2005 and POARMs grew from \$145 billion in 2004 to

\$255 in 2006.³⁶ These loans had even more risk-enhancing features. *Only about 17% of the POARMs originated between 2004 and 2007 were fully documented.*³⁷

A single, market-wide regulator could have taken the long-view. There were different business models during the ten years, but there were common threads among all of them. The first was that they were “designed to terminate.”³⁸ Forced refinances kept the origination volume up and growing to feed hungry investors. All the market incentives worked toward making loans less rather than more sustainable for the borrower. The second common thread was that underwriting became considered not only expendable, but actually an impediment to continued growth in a saturated market. Mortgage securitization enabled the originators to pass the risk right through to Wall Street, which then added yet more layers of “protection” through derivatives and credit default swaps.

2. The agency should have authority and responsibility to obtain data necessary to understand how products and practices work in the real world and what their impact is on customers.

Data collection, market monitoring and evaluation functions are key to effective regulation. Right now, the financial services industry controls the data. Access is rationed and controls are placed on its use, making it extraordinarily difficult to bring transparency to the way these transactions work in the real world. Indeed, fees for commercial databases are so expensive as to be an insurmountable hurdle for most non-profits and academics. But even more troubling than is the fact that, once obtained, its use may be controlled. Access may be conditioned by restraints on publication of the results, or access to the data may be denied altogether. For example, after publishing some of our early studies, we at CRL have been denied access to some commercial data.

Both of the current proposals recognize the importance of data collection and access. If there is concurrent supervisory authority, the agency must have the same access to the data as the prudential regulator. Furthermore, since providers typically collect a great deal of data for their own business purposes, data reporting requirements should not be opposed as an additional cost burden.. In my experience as a regulator and law enforcement official, the automatic response from the lawyers and government relations representatives was that they did not have it and it would be a burden to collect it. We’d ask them to check with their IT people, and their answer was just like the advertisement, “Yeah – We’ve got that. No problem.” We recognize that there are legitimate concerns of privacy for consumers, and for the industry. But there is enough experience to tell us that these needs can be reconciled with meaningful transparency.

3. A procedure for reviewing new products and practices will provide an opportunity for review and realistic risk assessment, with streamlined systems for safe harbor products.

For some products or features, there is a point before sufficient data has been accumulated to give concrete results. What then? Most proponents of this consumer protection agency model recommend that there be some reasonable “safe harbor” for

products that do not present obvious concerns. For truly new products and practices (and there are fewer of them than we like to think in this field³⁹) some simple, common-sense questions may be all that's needed.

For example, when a marketing company began to approach banks about offering a fee-based "discretionary" bounce program, one regulator in Iowa initially balked, and asked, "Why would you encourage your customers to bounce checks?" This was a rather obvious question, particularly when there were perfectly sensible and widely available alternatives such as contracted-for overdraft agreements and linked savings programs. So what is the "value-added" to this product? One obvious one is that it exploited a legal loophole in the FRB's Regulation Z, so that, although it competed with other short term loan products, it didn't compete fairly and transparently. Simply asking the questions suggests some solutions.

These concepts are consistent with suggestions from Professor Dan Carpenter that a provider can propose a new product with an opportunity for the agency to review, as long as there is a commitment for empirical assessment of the program as it plays out in the real world. Similarly, the Administration's proposal suggests that proposed contracts and disclosures could be submitted for review and the equivalent of a "no-action" letter issued if they adequately present the benefits, costs, and risks. We caution, however, that this authority should not operate as the equivalent of a "filed-rate" doctrine in other areas, where notice filing and no agency action can insulate the product in all cases.

D. The agency should have supervision and enforcement authority over laws in its jurisdiction.

We believe that the Agency's rule-making authority must be bolstered by supervisory and enforcement authority over matters within its jurisdiction. However, the market is too vast for exclusive enforcement to rest with the agency, so States should have concurrent enforcement authority. We also support the position taken in HR 1705 that consumers should be able to enforce their own rights.

The agency should have supervisory jurisdiction. We have models of agencies with rule-making authority, and enforcement authority, but without routine supervisory authority. That gap shows. The Iowa Consumer Credit Code vested the authority to interpret and promulgate rules with the Attorney General, who also has authority to enforce it. I was the assistant attorney general who handled those interpretive duties and was charged with the enforcement. But our office did not have specific authority to do routine monitoring to catch problems early. That was vested in the banking division, even for non-depositories.

As a practical matter, that is the same situation faced by the Federal Trade Commission. There are three tools in a regulatory tool box, but an agency without supervisory jurisdiction is missing a key one. Supervision, when the will and capacity is there, can catch problems early, before they spread, and the agency is not doomed to trying to put

out fires that started yesterday. Without supervisory authority, that is, in effect, what will happen.

It is simply not reasonable for the current financial supervisory agencies to retain exclusive supervisory authority. Earlier in this testimony we cited the example of on-site supervisors at large institutions even as those institutions loaded up with highly risky products, and supervisory guidance issued, and, by all appearances, ignored.

The size and nature of the market makes it unrealistic to envision supervision in the same way that bank examiners do. A wide array of methods might be used to accomplish that. Routine filings, similar to call reports, but better designed, might be required for some kinds of products. Mystery shoppers might be used to test sales practices. Workable plans will evolve, but the key thing now is to ensure that the Agency can implement them.

There should be concurrent enforcement, but structured so that the Agency retains the capacity to assure that there is consistency among federal agency enforcement. The record of the financial supervisory agencies on enforcement of consumer protection and fair lending laws is far too weak to make a credible case that exclusive enforcement authority should rest with them. Since 1987, the OCC brought only four enforcement actions under the ECOA, and since 1999, it made only one fair lending referral to DOJ based on race or national origin.⁴⁰

Moreover, most of the enforcement violates one of the central tenants of effective reform: transparency. The OCC has essentially said that, in matters of consumer protection and fair lending enforcement, they do most of it in private: “Trust us.”⁴¹ Yet the performance of the agency – even on its core safety and soundness supervision – gives us little confidence that they have earned that trust. Inspector General reports for both the OCC and OTS have criticized the agencies for laxity in following through even when they had concerns.

Finally, enforcement by silos would still leave the regulators in the dark as to overall market impact. The ability of the agency to monitor market-wide trends and their impact on communities of color is another area where it could bring great value. The evidence is that across the spectrum, from small dollar loans to payment services to mortgage lending, the products and services offered to these communities more often focus on wealth extraction rather than asset building. Unlike the current regulatory model, which focuses on one provider at a time, a market-wide agency with strong supervision and enforcement authority is better positioned to identify the cause and facilitate market-based solutions.

E. The states should be partners: the agency’s rules should be a floor, not a ceiling, and states should have concurrent enforcement authority.

Federal rules must be a floor, not a ceiling. One clear lesson of the meltdown is that overly aggressive and over-broad preemption helped spread the virus that affected the

market. The deregulation of the credit card market occurred by preemption, not by explicit Congressional action, and the result was widespread abuse. States have tried since 1999 to recognize the abuses in the mortgage market and take timely action, but the response from the regulators has been to preempt those laws. While the agencies argue that state laws could still rein in the non-bank subprime lenders, they ignore the fact that many of their institutions were engaging in equally devastating practices in the non-traditional market. Indeed, Congress still has a law on the books that precludes states from taking action on adjustable rate loans.⁴² It is also true that one reason more states have not acted is that they do not want to put their own institutions at a competitive disadvantage with banks that can ignore their law. Again, the result is a race to the bottom.

Those are examples where preemption has directly contributed to the current mess. But there are numerous additional examples where the OCC has devoted enormous energy and resources to exempting its regulated banks from state consumer protection law. This is in stark contrast to its extremely anemic and ineffective effort to protect consumers. For example, over the past several years, the OCC: (1) preempted a Maryland law limiting prepayment penalties that made it difficult for homeowners to refinance out of adjustable rate mortgages;⁴³ (2) preempted a Michigan law proscribing excessive “document preparation” fees by mortgage lenders;⁴⁴ and (3) preempted a New Hampshire law on “gift cards,”⁴⁵ to name just a few.

The time has come to recognize the vital role that states must play. They have their fingers closer to the pulse of the market and they can act more quickly to address problems – for both the consumers and providers.

States should have concurrent enforcement authority. This is a vast country with over a hundred million households, and about \$13 trillion just in household credit outstanding. It is unrealistic to suggest that the federal enforcement alone is adequate. Consumer protection is a traditional state function, and states have considerably more experience in enforcement than the federal financial regulators. This should be an essential feature of this reformed system.

Private enforcement must also be available. H.R. 1705 would allow consumers to enforce the Agency’s rules. Public enforcement, even with state concurrent enforcement, will never have adequate resources. That means that many consumers would never get relief at all, or not when needed. The existing foreclosure crisis is a prime example. Public enforcement officials cannot defend individuals in foreclosures. To deny private enforcement is to deny a homeowner the benefit of these consumer protection and fair lending rules at precisely the time when it is most important that they be vindicated.

IV. The agency should be funded with a mix of sources.

The last question we were asked to address is how the agency should be funded. Single source funding from each of the sources suggested comes with some inherent problems. Funding by supervisees can lead to conflicts of interest at one end of the spectrum, while

appropriations alone may lead to funding inadequate to permit the Agency to do its job right. We agree with the recommendation of the Consumer Federal of American, the U.S. Public Interest Research Group, and others that a mix of sources will over the most stable source of funding.

Conclusion

Meaningful, substantive consumer protection is the foundation of a sustainable market for financial products, for the soundness of its institutions, and for the stability of the capital markets that provide its liquidity. Effective consumer protection requires a strong, properly-resourced, independent regulator whose mission is devoted to this purpose.

In terms of specifics, separating the consumer protection function from the “safety and soundness” function will help to guard against the tendency of prudential regulators to regard consumer protection as conflicting with lender profits, and ensure that conflicting interests do not relegate consumer protection to the background. Giving a single regulator authority over all consumer financial products, whether or not originated by depository institutions, will ensure a level playing field across the market. And ensuring that federal regulation and enforcement set the floor, not the ceiling, will allow states to continue their important role in innovating regulatory improvements, and protecting their citizens from the particular abuses that arise within their borders.

We strongly support the creation of an innovative, empowered, independent Consumer Financial Products Agency, and look forward to working with this Committee toward its realization.

¹ Self-Help’s North Carolina retail credit union is a state-chartered credit union, and SH recently opened a federally-chartered credit union in California.

² Over thirty-five years in this field has taught me that, unfortunately, part of what some call “compliance” costs entails expense in trying to figure out how to get around common sense rules, as well as how to turn competitive pressures against the interests of the customers.

³ See Lei Ding, Roberto G. Quercia, Janneke Ratcliffe, Wei Li, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, comparing loans of this type to those which characteristics common in subprime., http://www.ccc.unc.edu/abstracts/091308_Risky.php

⁴ Anthony Pennington-Cross calls these loans “designed to terminate” See Souphala Chomsisengphet, Timothy Murphy, Anthony Pennington-Cross, et al, *Product Innovation & Mortgage Selection in the Subprime Era*, Subprime Housing Crisis: Interdisciplinary Policy Perspectives (Univ. of Iowa, Oct. 10-11, 2008). http://ppc.uiowa.edu/dnn4/PenningtonCross_Anthony.pdf

⁵ One of the central figures in 20th century neoclassical economics noted ruefully some 70 years ago that “there is truth in that allegation that unregulated competition places a premium on deceit and corruption.” Frank Hyneman Knight, *The Ethics of Competition* (1935, reissued 1997 Transaction Pub., New Brunswick, NJ), at 42.

⁶ Wei Li and Keith Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (February 23, 2006), p. 15.

⁷ See, Amanda Quester & Kathleen Keest, *Looking Ahead After Watters v. Wachovia Bank: Challenges for Lower Courts, Congress, and the Comptroller of the Currency*, 27 Rev. of Banking and Fin'l Law 187, 200-201 (2008).

⁸ Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. La. 1243, 1244, 1246 & n. 25, 1253 (2003).

⁹ Even then, i

It acted against a credit card issuer after state officials acted against the bank, and the agency was beginning its effort to expand its interpretation of exclusive visitation. As one lawyer who was a Treasury official at the time told a conference I attended, “they recognized they couldn’t replace something with nothing.” [speaking of consumer protection enforcement] (Practising Law Institute, Consumer Financial Services Litigation Conf., San Francisco, CA, May, 2002.)

¹⁰ That record is detailed in Brief of *Amici Curiae* of Center For Responsible Lending, et al, *Cuomo v. Clearinghouse Assoc’n, L.L.C. and Office of the Comptroller of the Currency*, No. 08-453 (filed March 4, 2009), pp. 20- 38. .

¹¹ The OTS had rule-making authority for the Alternative Mortgage Transaction Parity Act (AMTPA), and it used it to preempt state prepayment penalty limitations for AMTPA loans in 1996. It took seven years to get the OTS to repeal that rule. The repeal was effective July 1, 2003.₂

¹² This and other examples are described in detail in Statement of Patricia A. McCoy, *Hearing on “Consumer Protections in Financial Services: Past Problems, Future Solutions” before the U.S. Senate Committee on Banking, Housing and Urban Affairs* p. 19-20 (March 3, 2009), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=11be680d-04db-42cc-89bf-7fe4ffe4d9cd&Witness_ID=b6ba604a-d441-43e3-9951-1fbab4b11e57

¹³ See, e.g. Liz Moyer and Niv Elis, *The Real Problem in Banking*, <http://www.forbes.com/2009/06/15/banking-regulation-obama-business-beltway-reg.html> (June, 15, 2009) (noting that JP Morgan and HSBC went to the OCC “lured away from New York charters by the promise of federal preemption from stricter state consumer privacy and lending laws.”)

¹⁴ *Id.*

¹⁵ See generally National Consumer Law Center, *The Cost of Credit* §§3.7.2-3.7.3 (3rd Ed. 2005).

¹⁶ Cited in today’s testimony of Consumer Federation of America, et al.

¹⁷ Reps. Barney Frank, Edward Markey and Joseph Sestak filed an *amici* brief in support of a n intervenor’s motion for Injunction Under the All Writs Act in *USA v. Payment Processing Center, LLC*, No 06-0725 (E..D. Pa. May 29, 2008). The case is described in the Brief of Amicus Curiae Center for Responsible Lending, et al, *Cuomo v. Clearinghouse Assoc’n* No. 08-453, p. 29-33 (filed Mar 4, 2009)..

¹⁸ See Michael Powell, *Bank Accused of Pushing Mortgage Deals on Blacks*, New York Times, (June 6, 2009), http://www.nytimes.com/2009/06/07/us/07baltimore.html?_r=1&partner=rss&emc=rss

¹⁹ See, *Testimony of Consumer Federation of America, et al. See also* Testimony of Patricia M. McCoy, *Hearing on “Consumer Protections in Financial Services: Past Problems, Future Solutions,”* Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, (March 3, 2009), at p. 16-24 (detailing regulatory failures of FRB, OCC and OTS) [McCoy].

²⁰ Perhaps because this Committee does not have jurisdiction over the Federal Trade Commission, we were not asked to discuss it as a third alternative to either a new agency or prudential banking regulators. Though it is outside this Committee's purview, we do discuss it briefly in Appendix A, because it is relevant to the issue of whether a new Agency or existing agencies are best suited to the task.

²¹ McCoy, *supra* note 19.

²² The federal agencies' guidance instructed lenders to evaluate the borrower's ability to pay based on the fully-indexed, fully-amortizing payment. *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. 58609, 58614 (October 4, 2006).

²³ Countrywide's estimate from Countywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007. Countrywide originated through both state chartered non-banks and a national bank. In March, 2007, it moved to an OTS charter. We do not know the allocation of originations between the state and national bank charters prior to the move to OTS. We have seen some of the egregious POARMs written by the national bank, but most appear to have been made through the federal charters.

²⁴ See McCoy, *supra* note 19 at 20-21; Office of the Inspector General Audit Report, *Safety and Soundness: Material Loss Review of First National Bank of Nevada and First Heritage Bank*, , 4-6, 13NA , OIG-09-033 (Feb. 27, 2009)

²⁵ Indeed, a colleague recently shared with me a mortgage variation of selling monthly credit insurance, adapting the same kind of tactics used to cram credit card accounts: after a free period, it's an additional \$60 a month, unless one opts out.

²⁶ This disagreement could not be resolved prior to the issuance of the Notice of Proposed Rulemaking, and is openly reflected in the Federal Register notice, which included two competing versions of the proposal. See 72 Fed. Reg. 70944 (Dec. 13, 2007) This has troubling implications for the joint rule-writing provisions in H.R. 1728, the mortgage origination reform bill recently passed by the House and referred to the Senate.

²⁷ See, e.g. Nature Abhors a Vacuum: High-rate Lending in Redlined, Minority Neighborhoods in Boston, NCLC REPORTS *Consumer Credit and Usury Ed.* p. 21 (May/June, 1991). The Boston newspapers covered the issue heavily in May and June 1991. The first use of a fair lending law to attack predatory lending as "reverse redlining" was in 1991. *Alexander v. Kaye-Co, et al* (Civ. No. 91-RCCV-681)(Super. Ct. of Richmond Cty, [Ga], filed Aug. 20, 1991)(alleging defendants, including brokers and Fleet Finance targeted African American homeowners for high-rate loans unjustified by any legitimate business reason, in violation of Georgia's Fair Housing Act.) A class was certified, and the case was settled.

²⁸ Alan M. White and Cathy Lesser Mansfield, *Subprime Mortgage Foreclosures: Mounting Defaults Draining Homeownership*, (May 12, 2000), presented to the HUD-Treasury Joint Task Force on Predatory Mortgage Lending (May, 2000), available at <http://facstaff.law.drake.edu/cathy.mansfield/subprime.html> [hereafter White-Mansfield study]; Testimony of Prof. Cathy Lesser Mansfield Before the U.S. House of Rep. Committee on Banking and Financial Services, (May 24, 2000).

²⁹ Dean Baker, *Dangerous Trends: The Growth of Debt in the U.S. Economy*, at 4, Fig 1 (2004); Stephen Roach, *Comment: America's Inflated Asset Prices Must Fall*, Financial Times, January 8, 2008.

³⁰ See Comments of the Center for Responsible Lending on the Proposed Rule Regarding Unfair and Deceptive Acts and Practices with Respect to Credit Cards, at pp. 21-22, text accompanying notes 82-84 (August 4, 2008), http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/cc-udap-comments-final_2_-080408.pdf

³¹ Of 2006 subprime originations, 56% were refinances. *Subprime Lending: A Net Drain on Home Ownership*, p. 3, Center For Responsible Lending Issue Paper No. 14 (March 27, 2007). The White-Mansfield foreclosure study, *supra* they estimated that only about 10% of the loans in their study of the 16 top subprime lenders were purchase money. White-Mansfield at p. 2.

³² See White-Mansfield study, p. 2 (2000 data); *Subprime Lending: A Net Drain on Home Ownership*, p. 3, Center For Responsible Lending Issue Paper No. 14 (March 27, 2007). See also, Yuliya S. Demyanyk, *Quick Exits of Subprime Mortgages*, REVIEW Fed. Reserve Bank of St. Louis 91:79 (Mar/Apr. 2009)(effect of subprime lending on increase of homeownership most likely overstated); Krisopher S. Gerardi and Paul S. Willen, *Subprime Mortgages, Foreclosures, and Urban Neighborhoods*, Fed. Res. Bk of Boston, Pub. Policy Disc. Paper No. 08-06, (Dec. 22, 2008) (Mass. evidence suggestions subprime lending did not lead to increase in homeownership by minorities).

³³ Ellen Schloemer, et al, Keith Ernst, Wei Li, and Kathleen Keest, *Losing Ground*, *supra* note 3, at Table 4, p. 13. A failed loan, as used here, is one which was either foreclosed on or “prepaid in distress,” meaning that the loan balance went to \$0 in any given month when it had been listed as in foreclosure, bankruptcy, or real-estate owned by the lender (REO) the previous month.

Origination Year	% foreclosed or distress prepaid by May 2005
1998	20.5%
1999	23.0%
2000	24.0%

In Philadelphia, as early as 2000-2003, subprime foreclosure filings in one neighborhood reached 19% of the housing stock. Ira Goldstein, *Lost Values: A Study of Predatory Lending in Philadelphia*, p. 58 (The Reinvestment Fund, April 2007), available at http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf.

³⁴ Schloemer, et al, *Losing Ground*, *supra* note 3, above, at p. 21. Unless otherwise stated, the increased odds of foreclosure are those for 2000 vintage subprime loans. The study analyzed the performance of subprime loans originated 1998 – 2004 as of May, 2005. The foreclosure trend line for the more recent years, where the loans had not yet aged, was tracking the performance of 2000 originations. *Id* at p. 12.

³⁵ Details about the MBS offerings are found in Testimony of Michael Calhoun Before the U.S. Senate Committee on Banking, Housing and Urban Affairs – Subcommittee on Housing, Transportation and Community Development, *Ending Mortgage Abuse: Safeguarding Homebuyers* p. 3, 12-13 (June 26, 2007), available at <http://banking.senate.gov/public/files/calhoun1.pdf>.

³⁶ Inside Mortgage Finance, *I Mortgage Market Statistical Annual: 2009*, p. 6

³⁷ *Option ARMs: It’s Later Than It Seems*, Fitch Ratings (September 2, 2008), at 5.

³⁸ See *supra* note 4.

³⁹ Today’s payday market, for example, is the old salary-lending business from the turn of the 20th century, only slightly tweaked.

⁴⁰ This information is found in annual reports that the FRB and US Attorney General provide to Congress.

⁴¹ See Stephanie Mencimer, *No Account*, The New Republic, Aug. 27, 2007, at 14.⁴¹

⁴² The Garn St Germain Alternative Mortgage Transactions Parity Act of 1982, 12 U.S.C. XX. §3801, et seq.

⁴³ See Center for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners*, at 21 (Dec. 2006), available at <http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf>. In *National City Bank of Indiana v. Turnbaugh*, 463 F.3d 325 (4th Cir. 2006), the OCC argued that Maryland law on prepayment penalties was preempted by OCC regulations and could not be applied to state-chartered mortgage companies that are operating subsidiaries of national banks. The court deferred to the OCC and held Maryland law preempted, leaving borrowers without an important protection against a practice that has strong implications for rising foreclosure rates in local housing markets.

⁴⁴ The Michigan Consumer Protection Act imposes certain limitations on the fees that state-chartered lenders can assess for the preparation of loan closing documents. State laws like this one protect consumers from efforts by lenders to get around the provisions of the Real Estate Settlement Procedures Act (RESPA) and to exploit a loophole in the Truth In Lending Act (TILA). The former was intended to protect consumers from unnecessarily high settlement charges, and the latter was intended to provide consumers with a standardized pricetag for the cost of credit. Lenders attempt to designate closing costs as “document preparation fees” in order to avoid the restrictions and disclosure requirements set forth in RESPA and the regulations thereunder. Consumers sued a state-chartered operating subsidiary of a national bank for violations of the Michigan law. The OCC submitted an amicus brief in support of the defendant mortgage company arguing that OCC regulations preempted the Michigan Act and rendered it inapplicable against the operating subsidiary. The court granted Huntington Mortgage’s motion for summary disposition holding that the Michigan law did not apply. *Brannam v. The Huntington Mortgage Co.*, 00-40439-CH (Muskegon (MI) County Circuit Court).

⁴⁵ New Hampshire attempted to enforce the provisions of its Consumer Protection Act that would have imposed certain requirements on a state-chartered company that distributes “gift cards” at shopping malls within the state. The company is not a national bank or even an affiliate of a national bank. Rather, it is owned by a company that owns and operates shopping malls. Nevertheless, because the cards were issued by a national bank and a federal savings association, a federal district court in New Hampshire held that OCC and OTS regulations preempted the state law gift card rules, and precluded their application to the state-chartered shopping mall affiliate. See *SPGGC v. Ayotte*, 443 F.Supp.2d 197 (D.N.H. 2006). The reason that states seek to regulate gift cards is that they are frequently subject to expiration dates and hidden fees that reduce their value well below their face value. Preempting state law in this area allows gift-card vendors to mislead consumers about the value of what they are buying.