

Testimony of Ellen Seidman
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Before the Senate Committee on Banking, Housing and Urban Affairs
March 2, 2009

Chairman Dodd, Ranking Member Shelby and members of the Committee. I appreciate your inviting me here this morning to discuss consumer protection and oversight in the financial services industry in the context of the current economic crisis, and to provide my thoughts on how the regulatory system should be restructured to enhance consumer protection in the future. In quick summary, I believe that the time has come to create a well-funded single federal entity with the responsibility and authority to receive and act on consumer complaints about financial services and to adopt consumer protection regulations that would be applicable to all and would be preemptive. However, I believe that prudential supervisors, in particular the federal and state banking regulatory agencies, should retain primary enforcement jurisdiction over the entities they regulate.

My name is Ellen Seidman, and I am a Senior Fellow at the New America Foundation as well as Executive Vice President, National Program and Partnership Development at ShoreBank Corporation, the nation's first and leading community development bank holding company, based in Chicago. My views are informed by my current experience—although they are mine alone, not those of New America or ShoreBank—as well as by my years at the Treasury Department, at Fannie Mae, at the National Economic Council under President Clinton, and as Director of the Office of Thrift Supervision from 1997 to 2001.

During my tenure at OTS, we placed significant emphasis on both consumer and compliance issues and on the responsibility of the institutions we regulated to serve the communities in which they were chartered, both because of their obligations under the Community Reinvestment Act and because it was good business. We paid particular attention to compliance, building up our staff and examination capability, establishing a special award (done away with by my successor) to honor the best performer in compliance and community affairs, reaching out to consumers and communities, and enhancing our complaint function. We were by no means perfect, but we worked to put compliance on an equal footing with safety and soundness.

Since I left OTS, I have spent much of my time working on issues relating to asset building and banking the underbanked, in which context the importance of consumer protection, for both credit and other products, is plainly apparent. Finally, my years at Fannie Mae and at ShoreBank and the community development work I have been doing have made me both conscious of and extremely sad about what has happened in the mortgage market and the effects it is having on both households and communities.

Based on my OTS experience, I believe the bank regulators, given the proper guidance from Congress and the will to act, are fully capable of effectively enforcing consumer protection laws. Moreover, because of the system of prudential supervision, with its on-site examinations, they are also in an extremely good position to do so and to do it in a manner that benefits both

consumers and the safety and soundness of the regulated institutions. In three particular cases during my OTS tenure, concern about consumer issues led directly to safety and soundness improvements. Two involved guidance that got thrifts out of sub-prime monoline credit card lending (just months before that industry got into serious trouble) and payday lending. In another case involving a specific institution, through our compliance examiners' concern about bad credit card practices, we uncovered serious fair lending and safety and soundness issues. Consumer protection can be the canary that gives early warning of safety and soundness issues—but only if someone is paying attention to dying birds.

We also sounded the alarm on predatory lending. Sub-prime guidance issued in 1998 by all the bank regulators warned of both safety and soundness and consumer protection issues. In speeches and testimony I gave in 2000, concerns about predatory lending and discussion about what we were doing to respond were a consistent theme. Nevertheless, as I will discuss below, I think it is time to consider whether consolidation of both the function of writing regulations and the receipt of complaints would make the system more effective for consumers, for financial institutions and for the economy.

The Current Crisis

The current crisis has many causes, including an over-reliance on finance to “solve” many of the needs of our citizens. When real incomes stagnate while the cost of housing, health care and education skyrocket, there are really only two possible results: people do without or they become more and more overleveraged. Financial engineering and cheap investor funding, largely from abroad, enabled the overleveraging, but a lack of adequate attention to the manner in which the financial services system interacted with consumers certainly kept the process going and caused consumers and the economy to fall harder when it ended. There were really two parallel problems: the proliferation of bad products and practices and the sale of hard-to-understand credit and investment products to consumers for whom they were not suitable; and the lack of high quality products that meet consumer needs, well priced and effectively marketed, especially in lower income communities.

I believe that there were three basic regulatory problems. First, there was a lack of attention, and sometimes unwillingness, to effectively regulate products and practices even where regulatory authority existed. The clearest example of this is the Federal Reserve's unwillingness to regulate mortgage lending under HOEPA. However, as the recent actions by the Federal Reserve, OTS and NCUA have demonstrated, there was also authority under the FTC Act that went unused. It is important to understand that this is not only an issue of not issuing regulations or guidance; it is perhaps even more importantly a lack of effective enforcement.

Compliance has always had a hard time competing with safety and soundness for the attention of regulators—which is one reason I spent a good deal of my tenure at OTS emphasizing its importance—but there was a deliberate downgrading of the compliance function at the federal level at the start of the Bush Administration. Moreover, neither the Federal Reserve nor the OTS—at least until fairly recently—has seriously probed the consumer practices of non-depository subsidiaries of the holding companies they regulate. This is not just an issue at the federal level. While there are certain states—North Carolina, Maryland and Massachusetts

prominent among them—that have consistently engaged in effective enforcement of consumer protection laws with respect to the entities under their regulation, others, including California, the home of many of the most aggressive mortgage lenders, were even less aggressive than the Federal regulators. Moreover, ineffective enforcement is not just an issue of consumer protection regulation per se; the ability to move badly underwritten products completely off the balance sheet, earning fees for originating them, but holding no responsibility for them and no capital against them, only encouraged the proliferation of such activities.

Second, we need to acknowledge that there were, and are, holes in the regulatory system, both in terms of unregulated entities and products, and in terms of insufficient statutory authority. The clearest case relates to mortgage brokers, where there was no federal regulation at all, no regulation beyond simple registration in many states, and ineffective regulation even in most of the states that actually asserted some regulatory authority. But there are other examples—payday lending is prohibited in some states, regulated more or less effectively in others, and pretty much allowed without restriction in still others. And then of course there is the question of what kind of responsibility sellers of non-investment financial products have to customers. We know we have not imposed a fiduciary duty on them, but does that mean there is no responsibility to match customer with product?

Finally, there is and was confusion, for both the regulated entities and consumers and those who work with them. Consumer protection comes in many forms, from substantive prohibitions like usury ceilings and payday lending prohibitions, through required terms and practices, to disclosures and marketing rules. I would assert it also includes the affirmative mandate of the Community Reinvestment Act; recent experience has demonstrated that where well-regulated entities do not provide quality services that meet needs and are well marketed, expensive and sometimes predatory substitutes will move in.

Multiple regulators and enforcement channels exacerbate the confusion. At the federal level, there are multiple bank regulators, not to mention the NCUA, the FTC and HUD, and their jurisdiction is frequently overlapping. States and even localities also regulate consumer protection, again often through multiple agencies. And of course, sometimes the federal and state laws overlap. The enforcement mechanisms are just as confusing, involving examinations, complaints, collateral consequences such as limitations on municipal deposits or procurement, and both public and private law suits.

The system clearly could be improved. But as we do so, we should not be lulled into thinking the solutions are obvious or easy. In general they're not, and I would assert that they are harder and more subtle than is the case with manufactured consumer products. The products, even the good ones, can be extremely complex. Just try describing the lifetime interest rate on a Savings Bond or how a capped ARM works. Or for that matter whether a payday loan or a bounced check is more expensive. Many products, especially loans and investments, involve both uncertainty and difficult math over a long period of time, which is hard for even the most educated consumer. And the differences between a good product and a bad one can be subtle, especially if the consumer doesn't know where to look. An experienced homeowner knows the importance of escrowing insurance and taxes, but the dire consequences of the lack of an escrow

are easy for a first-time homebuyer to miss. And a relatively safe ARM can turn into a risky one when caps are removed or a prepayment penalty added.

Finally, different consumers legitimately have different needs. To take the example economists love, when there is a normal, upward sloping yield curve, most homebuyers are better off with a 5-year ARM than with a 30 year fixed rate mortgage, because with the long-term loan they are paying a higher interest rate for an option they are unlikely ever to use, since they will likely move, prepay or refinance long before 30 years are up. But for a consumer whose income is unlikely to increase, who has few other resources, or who has difficulty budgeting—or who is just plain risk-averse—the certainty of the fixed rate mortgage may well be worth the additional cost.

Looking Forward

Before turning to regulatory issues, I suggest there is a broader social context of change that we need to consider. To what extent can we turn some of the complex, long-term financial obligations that we have foisted on individual consumers—most clearly retirement and health care—back to more collective management? We also should recognize that there is some level of interest and some level of financial engineering at which “availability of credit” is an excuse for both not having sufficient income and collateral supports (such as health care) and an insufficient level of financial understanding—it’s not a way of life. We need to educate our children from day one about what money means, how interest rates work, and who to get help from, and we need to create systems of helpers, which can include the internet and things like overdraft alarms, but which also requires low-cost access to people who are competent to give advice and have a fiduciary duty to the consumer.

In this period when consumers are being forced to deleverage and cut back, and are actually beginning to save more on their own accord, we should once again make saving easy and an expected part of life. Having an account at a bank or credit union helps encourage saving, although the account needs to be designed so consumers have the liquidity they need without paying for it through excessive overdraft fees. Tying savings to credit, such as by requiring part of a mortgage payment to go into a savings account for emergencies like repairs or temporary inability to make a payment, can also help. And so would moving toward more savings opt-outs, like payroll deductions for non-restricted savings accounts that can be used in an emergency (as well as for retirement accounts), a concept we are testing at the New America Foundation as AutoSave.

Principles for Regulation

The regulatory framework, of course, involves both how to regulate and who does it. With respect to how, I suggest three guiding principles. First, to the maximum extent possible, products that perform similar functions should be regulated similarly, no matter what they are called or what kind of entity sells them. For example, we know that many people regarded money market mutual funds and federally-insured deposit accounts as interchangeable. Either they are, and both the products and—to the extent the regulation has to do with making sure the money is there when the customer wants it—the regulation should be similar, or they are not and

they should not be treated as such, including by regulators who are assessing capital requirements. To take another example, payday loans and bounced check protection have a good deal in common, and probably should be regulated in a similar manner. This also means that a mortgage sold directly through a bank should be subject to the same regulatory scheme and requirements as one sold through a broker.

Second, we should stop relying on consumer disclosure as the primary method of protecting consumers. While such disclosures can be helpful, they are least helpful where they are needed the most, when products and features are complex. The Federal Reserve's recognition of this with respect to double cycle credit card billing was a critical breakthrough: by working with consumers, they came to understand that no amount of disclosure was going to enable consumers to understand the practice. The same is true of very complex mortgage products. The "one page disclosure" is great for simple mortgage products, but where there are multiple difficult-to-understand concepts in a single mortgage—indexes and margins, caps on rate increases and on payments, per adjustment and over the loan's lifetime, escrows or not, prepayment penalties that change over time, option payments and negative amortization, and many different fees—the likelihood is low that any disclosure will enable those for whom these issues really make a difference to understand them.

In the last few years, several academics have suggested some potential substitutes for disclosure that go beyond the traditional type of prohibitory consumer protection rules. For example, Professor Ronald Mann has suggested that credit card contracts be standardized, with competition allowed on only a few easily-understood terms, such as annual fees and interest rates.¹ In some ways, this is what the situation was with mortgages well into the 1990s. Professors Michael Barr, Eldar Shafir and Sendil Mullainathan have suggested the development of high quality, easily understood "default" products such as mortgages, credit cards and bank accounts, allowing other products to be sold, but with more negative consequences for sellers if the products go bad, such as requiring the seller to prove that the disclosures were reasonable as a condition to enforcing the contract, including in a mortgage foreclosure action.²

Third, enforcement is at least as important as writing the rules. Rules that are not enforced, or not enforced equally across providers, generate both false comfort and confusion, and tend to drive, through market forces, all providers to the practices of the least well regulated. This is in many ways what we have seen with respect to mortgages; it is not just that some entities were not subject to the same rules as others, but also that the rules were not enforced consistently across entities.

Who Should Regulate

¹ Ronald Mann, "'Contracting' for Credit," 104 Mich LR 899 (2006) at 927-28.

² Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "A One-Size-Fits-All Solution," *New York Times*, December 26, 2007, available at <http://www.nytimes.com/2007/12/26/opinion/26barr.html?scp=1&sq=michael percent20barr percent20mortgage&st=cse>. See also Michael Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Financial Services Regulation" (Washington, DC: New America Foundation, October 2008), available at http://www.newamerica.net/files/naf_behavioral_v5.pdf.

As discussed above, that there are currently a myriad of regulators both making the rules and enforcing them. This situation makes accomplishment of the substantive principles discussed above very difficult. To a substantial extent, both the Federal Reserve and the FTC have broad jurisdiction already; whether they take action to write rules depends to some extent on capacity, will and priorities. But even where they have such authority and take it, significant problems remain concerning both enforcement and to what extent their rules trump state rules. The bank regulators, both together when they can agree and separately when they can't, also write rules and guidance that is often as effective as rules, but those apply only to entities under their jurisdiction, and generate very substantial controversy concerning the extent to which regulations of the OCC and OTS preempt state laws and regulations.

As I mentioned at the start, I believe the bank regulators, given the guidance from Congress to elevate consumer protection to the same level of concern as safety and soundness, can be highly effective in enforcing consumer protection laws. Nevertheless, I think it is time to give consideration to unifying the writing of regulations as to major consumer financial products—starting with credit products—and also to establish a single national repository for the receipt of consumer complaints.

The mortgage situation has shown that a single set of regulations that governs all parties is a precondition to keeping the market at the level of those engaged in best practices—or at least the practices condoned by the regulators—not the worst. The situation with payday lending, especially in multi-state metropolitan areas, is similar. And among regulators with similar jurisdictions, whether the federal bank regulators or state regulators, having major consumer products governed by a single set of regulations will reduce the opportunity for regulatory arbitrage.

A single entity dedicated to the development of consumer protection regulations, if properly funded and staffed—unfortunately the experience of both the FTC and CPSC over the last 8 years, but in fact for many more years suggests that's a big “if”—will be more likely to focus on problems that are developing and to propose, and potentially, take action before they get out of hand. In addition, centralizing the complaint function in such an entity will give consumers and those who work with them a single point of contact and the regulatory body the early warning of trouble that consumer complaints provide.

Such a body will also have the opportunity to become expert in consumer understanding and behavior. This will enable it to use the theories and practices being developed about consumer understanding and how to maximize positive consumer behavior—the learnings of behavioral economics—to regulate effectively without necessarily having a heavy hand. The regulator could also become the focus for the myriad of scattered and inefficient federal efforts surrounding financial education.

The single regulator concept is not, however, a panacea. Three major issues that could stymie such a regulator's effectiveness are funding, preemption, and the extent of its enforcement authority.

How will the new regulator be funded, and at what level? It is tempting to think that annual appropriations will be sufficient, but is that really the case? Political winds and priorities change, and experience suggests that consumer regulatory agencies are at risk of reduced funding. Is this a place for user fees—a prospect more palatable if there is a single regulator covering all those in the business rather than multiple regulatory bodies for whom lower fees can become a marketing tool? In any event, it is essential that this entity be well funded; if it is not, it will do more harm than good, as those relying on it will not be able to count on its being effective.

What will be the regulator's enforcement authority? Will it have primary authority over any group of entities? Will the authority be secondary to other regulatory bodies that license or charter those providing financial services? My opinion is that regulators who engage in prudential supervision (federal and state), with on-site examinations, should have primary regulatory authority, with the new entity empowered to bring an enforcement action if it believes the regulations are not being effectively enforced. Coupled with Congressional direction to the prudential supervisors to place additional emphasis on consumer protection, the supplemental authority of the consumer protection regulator to act should limit the number of situations in which the new regulator is forced to take action.

And finally, will the regulations written by the new entity preempt both regulations and guidance of other federal regulators and state regulation? My opinion is that where the new entity acts, their regulations should be preemptive. We have a single national marketplace for most consumer financial products. Whereas in the past the argument that providers can't be expected to respond to a myriad of rules held sway, as technology has advanced this argument has lost its potency. But consumers are entitled to a consistent level of protection no matter where they live and with whom they deal. Yes, there may be times when the agency does not work as fast or as broadly as some advocates would like. But the point of having a single agency with responsibility in this area is to create a single focal point for action that will benefit all Americans. Where the agency does take action, it should fill the field. But preemption may well be the most difficult issue of all, not only because preemption is ideologically difficult, but also because the uniformity that a single regulator can provide will always be in tension with the attempts of some actors to get around the regulations and of regulators and other parties to move in to respond.

Conclusion

While the current crisis has many causes, the triggering event was almost certainly the collapse of the sub-prime mortgage market. That is an event that need never have happened if both our regulatory system and regulators had been more completely and effectively focused on protecting consumers. For many years, many of us have been pointing out that bad consumer practices are also bad economic practices. Not only because of the damage it does to consumers, but also because when the music stops, we all get hurt. The current state of affairs provides a golden opportunity to make significant improvements in the regulatory system. If not now, when?