TESTIMONY

OF

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BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

ASSESSING THE EFFECTS OF CONSUMER FINANCE REGULATIONS

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Chairman Shelby, Ranking Member Brown, and members of the Committee, my name is Leonard Chanin. I am Of Counsel in the financial services practice group of the firm Morrison & Foerster here in Washington D.C. and have more than 30 years' experience working as an attorney on consumer financial services issues. I spent 20 years with the Federal Reserve Board, including six years as Assistant Director and Deputy Director of the Division of Consumer and Community Affairs. In addition, for 18 months I was Assistant Director of Regulations at the Consumer Financial Protection Bureau ("CFPB"). I have spent nearly 10 years in private practice advising banks and other financial institutions on a number of federal consumer financial services laws. I am pleased to be here today to address the effects of consumer finance regulations.

The primary federal agency entrusted with regulating consumer financial products and services is the CFPB, a creation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Dodd-Frank Act sets out in broad terms the purpose of the CFPB. The Act states that the CFPB shall "seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."

This goal is challenging to achieve. "Fairness" to consumers depends on what one views as being "fair," and it is open to a wide variety of perspectives. The overzealous pursuit of "fairness" adversely affects the ability and willingness of financial institutions to offer products to consumers and, thus, negatively affects the ability of consumers to obtain

such products. In addition, access to financial products is affected—both directly and indirectly and both positively and negatively—by rules and other actions taken by federal agencies that regulate consumer financial services products and services.

While it is difficult to quantify the precise impact that CFPB rules, guidance, enforcement orders and other actions, as well as activities by other federal banking agencies, have had on consumers and the broader market for financial products and services, it seems clear that such rules and other actions have had a significant adverse impact on the ability and willingness of institutions to offer those products and services. Anecdotal and other evidence clearly indicates that institutions have reduced the products and services offered to consumers and some institutions have been reluctant to offer new products and services. Recent CFPB rules on mortgages illustrate this result. In addition, the use of enforcement orders by the CFPB to establish policy has had adverse results; for example, enforcement orders dealing with the pricing of indirect auto loans and alleged discriminatory practices have created an unlevel playing field in the automobile loan market.

THE IMPACT OF REGULATIONS

Federal consumer financial regulations unquestionably have a significant impact on consumers, financial institutions and the broader economy. The effect rules have and whether they actually harm consumers, hinder competition, or reduce the products available to consumers, likely depends on the specific rule and which consumers are considered.

There can be benefits to regulation. If properly designed, regulations can better ensure that standardized approaches are used to provide disclosures to consumers to enable them to compare products and choose the ones that best suit their needs. Regulations are most effective when they require all institutions that offer consumer financial products to "play by the same rules." This better ensures a competitive marketplace, where all participants are subject to the same legal requirements.

But, there are many risks and dangers to regulating "too much." Regulations need to be clear, but at the same time provide flexibility to accommodate new products, new delivery channels and new ways of doing business. Clear rules are needed to ensure that institutions know what is required to comply and manage risks. However, detailed, proscriptive rules can inhibit the development of new products and new ways of doing business. In addition, rules that lack flexibility can discourage, and, in some cases, stifle the development of new products or services or new features of financial products or services. Furthermore, new rules can be very costly, particularly, for example, for smaller institutions that may make few loans. For those institutions, the overall costs to support a small loan program may be so great that they may simply exit the business.

So, what impact have the CFPB mortgage rules had on the market? Some institutions that previously offered mortgages have stopped doing so because the costs of complying with the new rules cannot be spread over a sufficient number of loans to enable them to effectively compete in the marketplace. In addition, a number of institutions have reduced the products offered to consumers. In fact, a recent American Bankers Association survey revealed that, due to the CFPB mortgage rules, 75% of banks

surveyed eliminated one or more mortgage product offerings, such as construction loans and loans with payout options.

An examination of the CFPB rules that integrate mortgage disclosures under the Truth in Lending Act (Regulation Z) and the Real Estate Settlement Procedures Act (Regulation X) illustrates the adverse impact that regulations can have on consumers and the broader market.

The CFPB's integrated mortgage disclosure rules and explanatory information are hundreds of pages long. They contain dozens upon dozens of sub-rules and prohibitions dealing with how creditors must disclose information about mortgages to consumers. A small bank or credit union cannot hope to comply with the extraordinary level of detail required. And even the largest institutions face great difficulties in ensuring compliance and likely face litigation risks if they make a mistake.

One example illustrates the extraordinary level of detail required under the integrated mortgage disclosure rules. There are several different rounding rules for the disclosure of dollar amounts and percentages (rates). One sub-rule states that the principal and interest payments must be disclosed using decimal places, even if the amount of cents is zero. (Thus, a disclosure of a payment of "$800" violates the rule, whereas a disclosure of "$800.00" complies.) This sub-rule is in contrast to the sub-rule for disclosing the loan amount, which actually prohibits the use of decimal places in disclosures. (Thus, a disclosure of a loan amount of "$240,000.00" violates the rule, whereas a disclosure of "$240,000" complies.)

The adoption of such a proscriptive rule can only lead to errors and ultimately can result in litigation, even if a consumer did not rely on the

information and was not harmed by the error. In addition to litigation risks, failure to comply with the integrated mortgage disclosure rules could lead investors who purchase loans to require lenders to buy back any loans where lenders make errors in providing disclosures.

USE OF GUIDANCE AND ENFORCEMENT ORDERS TO ESTABLISH POLICY

In spite of the "dangers" and problems associated with regulations, they are vastly preferable to "regulating" by the issuance of guidance, or, even worse, use of enforcement orders to establish policy.

Guidance

Guidance can be helpful to institutions in understanding laws that apply to specific transactions or products. But any such guidance should be published for public comment. Failure to do so can lead to confusion as to the scope and meaning of the guidance and create operational and other compliance problems. In addition, agencies benefit by allowing the public to comment, as it results in clearer and better guidance. The CFPB has issued dozens of guidance documents, in the form of official CFPB bulletins, as well as by using blog posts and other ways of communicating its views on issues. These documents are not published for public comment. Failure to get public input creates significant problems.

By way of an example, one of the most problematic documents deals with indirect auto lending and the application of the Equal Credit Opportunity Act ("ECOA") and implementing Regulation B to institutions that purchase loans made by automobile dealers. The CFPB issued a bulletin interpreting Regulation B on this issue, rather than publishing a proposed revision to the Regulation for public comment. The bulletin

addresses the obligation of indirect auto lenders (those who purchase loans made by auto dealers) to address potential discrimination in the pricing of loans by auto dealers.

The failure of the CFPB to issue guidance for comment on issues such as this creates significant problems. Because the public was not afforded the opportunity to comment on the indirect auto lending bulletin, the guidance fails to address important issues. The bulletin does not state that use of discretionary pricing to compensate auto dealers is illegal, but states that lenders should monitor and address the effects of such policies to ensure that discrimination does not occur. However, aside from "conducting regular analyses" of dealer-specific and portfolio-wide loan pricing data, the guidance fails to inform lenders about what analysis would be satisfactory to avoid fair lending violations. For example, should analysis be done on a monthly, quarterly, or annual basis? What if a quarterly analysis shows potential issues, but a semi-annual analysis shows no statistically-significant disparities? What action should a lender take to address any risks in these circumstances? Neither lenders nor consumers are helped when guidance issued is not clear. Such guidance frequently leads to inconsistencies in the marketplace, due to differing interpretations of such guidance.

Enforcement Orders

"Regulating" institutions that offer consumer financial products and services by use of enforcement orders is a new trend. Although the prudential banking agencies and other agencies have long entered into public enforcement orders with institutions, this practice has increased

exponentially by the CFPB. Moreover, it seems quite clear that the CFPB uses enforcement orders to establish policy.

Public enforcement orders are not inherently inappropriate or a "bad" tool for agencies to use. But, when enforcement orders are used to establish policy, there can be many problems and drawbacks. First, enforcement orders do not apply to any company or person that is not a party to the order; thus, other companies can take a variety of approaches regarding their views of such orders. Oftentimes, some companies may "comply" in a certain way and others may take a different approach. This results in inconsistency—inconsistency for consumers and for institutions' practices—which results in a marketplace that offers products and services not governed by the same standards. Second, most CFPB enforcement orders lack specificity about the practices involved and only give a brief statement of facts and issues. It is often difficult to discern how to "apply" any guidance in orders to the variety of products or practices that exist in the marketplace. This also creates inconsistency. Third, the failure to create rules that apply to all players in the marketplace can have the unintended effect of driving some parties to entities that "don't comply." Anecdotal information suggests that this is precisely what is happening with so-called discretionary dealer pricing and auto loans, where the marketplace is highly diffuse and where some auto dealers may do business with those lenders who offer dealers greater compensation for loans the dealers originate. Fourth, unlike rules, enforcement orders are not published for comment. This deprives the public of the opportunity to comment on significant issues and also deprives an agency of the ability to consider operational and other issues as well as potential negative or unforeseen consequences. Fifth, enforcement orders

that contain broad statements and allege unfair, deceptive or abusive acts or practices may result in financial institutions simply choosing not to offer new products, certain product options or new ways of delivering products due to lack of certainty about what is "required," as well as uncertainty about how to effectively manage potential risks.

For these reasons, use of enforcement orders to establish policy is both inappropriate and unsuccessful. The pricing of auto loans and use of fair lending enforcement orders illustrates this problem. The CFPB has entered into several enforcement orders with financial institutions asserting that institutions that purchased consumer car loans made by multiple auto dealers have violated the ECOA. While recognizing that it is appropriate for dealers to be compensated for work done on transactions, the CFPB orders conclude that financial institutions that purchase auto loans violate the ECOA because the CFPB determined that the pricing approach used had a discriminatory impact on consumers on the basis of race or ethnicity.

Leaving aside the significant issue of the validity of the CFPB's methodology and analysis in the orders, the use of enforcement orders in this circumstance has resulted in an unlevel playing field and has raised numerous questions for which the orders provide no answers. For example, the most recent orders state that an institution must select one of three options. One option is for the institution to limit dealer discretion to no more than 1.25 percentage points above the buy rate for loans with a term of 60 months or less, and 1 percentage point for loans with a term longer than 60 months. For this option, the institution must "monitor for compliance" with the limits.

But, what if institutions not subject to the orders want to retain a dealer discretion model of compensation to effectively compete in the marketplace? The orders only recognize two options. There are hundreds and perhaps thousands of banks, credit unions and finance companies that purchase auto loans. Anecdotal evidence indicates that institutions have taken a variety of approaches in how they deal with pricing and the purchase of loans made by auto dealers, due to competition in local markets and a variety of other factors. By using enforcement orders to create a policy addressing how lenders can compensate dealers for dealers' work in originating auto loans, the CFPB has failed to recognize that there may be many other legitimate methods institutions can use to compensate dealers and still comply with the ECOA. By using enforcement orders to create new legal requirements, and doing so without publishing proposed changes to Regulation B to address these issues, the CFPB has failed to provide critical guidance to lenders on what the law requires or permits.

In this case, if the CFPB believes the way in which institutions interact with auto dealers regarding the pricing of car loans is contrary to the ECOA, the far better approach for consumers and financial institutions would be for the CFPB to formally propose changes to Regulation B. This would ensure that any policy applies consistently to all financial institutions. In addition, engaging in a rulemaking proceeding would allow the public to comment on the approach, ensuring that the CFPB has an opportunity to address any concerns or issues raised. Rulemaking, of course, takes more time than issuing "guidance" or entering into enforcement orders. But such an approach better ensures the creation of sound policy. Establishing a policy by regulation also enables a company or person who disagrees with a

rule to challenge that policy and have a court independently review the agency action.

CONCLUSION

The CFPB is a new agency—less than 5 years old. It continues to develop expertise and a broader understanding of consumer financial services markets. The question remains as to how the CFPB will balance its mandated purposes of ensuring consumer access to financial products and services while ensuring fairness in these markets.

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Thank you for the opportunity to be here today. I would be happy to respond to any questions.

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