TESTIMONY BEFORE UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES ON PROPOSED CONSUMER FINANCIAL PROTECTION AGENCY

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George Mason University Law and Economics Research Paper Series

09-38

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JULY 15, 2009

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Abstract

This testimony addresses the proposal of the Obama Administration to create a new Consumer Financial Protection Agency (CFPA) which would have the authority to issue and enforce new regulations related to consumer lending products. This testimony criticizes the proposal on three grounds.

First, the basis for the proposal is based on misguided paternalism that arises from a fundamental misunderstanding about the causes of the consumer element of the financial crisis. While there were undoubtedly cases of fraud by borrowers against lenders and lenders against borrowers, the fundamental cause of the crisis was misaligned incentives, not consumer protection problems. Lenders made many foolish loans that created the crisis—but those loans were foolish because they failed to consider the incentives that they created when interest rates rose, home prices fell, and their interaction with other state laws. As a result, they created major safety and soundness concerns, but not major consumer protection problems.

Second, by detaching consumer protection issues from safety and soundness concerns, the CFPA will likely produce unintended consequences that could lead to more foreclosures, less product innovation, and higher prices and reduced choice for consumers. In particular, proposals to ban prepayment penalties on home mortgages would likely increase foreclosures and new regulations on mortgage brokers will lead to reduced competition and higher prices for consumers.

Third, the CFPA will create a new bureaucracy prone to the same dysfunctions and information problems of any other bureaucracy. A new bureaucracy of this sort is not necessary.

Key Words: Consumer Protection, Subprime Mortgages, Bureaucracy, Financial Crisis, Credit Cards, Home Mortgages

JEL Classifications: D10, D14, D18, K35

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Before the
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Banking Industry Perspectives on the Obama Administration's
Financial Regulatory Reform Proposals

Wednesday, July 15, 2009

10:00 a.m.

2128 Rayburn House Office Building

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Professor Zywicki is also Senior Fellow of the James Buchanan Center, Program on Politics, Philosophy, and Economics, at George Mason University, a Senior Fellow of the Goldwater Institute, and a Fellow of the International Centre for Economic Research in Turin, Italy. During the Fall 2008 Semester Professor Zywicki was the Searle Fellow of the George Mason University School of Law and was a 2008-09 W. Glenn Campbell and Rita Ricardo-Campbell National Fellow and the Arch W. Shaw National Fellow at the Hoover Institution on War, Revolution and Peace. He has lectured and consulted with government officials around the world, including Iceland, Italy, Japan, and Guatemala. In 2006 Professor Zywicki served as a Member of the United States Department of Justice Study Group on "Identifying Fraud, Abuse and Errors in the United States Bankruptcy System."

Professor Zywicki is the author of more than 60 articles in leading law reviews and peer-reviewed economics journals. He has testified several times before Congress on issues of consumer bankruptcy law and consumer credit and is a frequent commentator on legal issues in the print and broadcast media. Professor Zywicki is a member of the Governing Board and the Advisory Council for the Financial Services Research Program at George Washington University School of Business, the Executive Committee for the Federalist Society's Financial Institutions and E-Commerce Practice Group, the Advisory Council of the Competitive Enterprise Institute, and the Program Advisory Board of the Foundation for Research on Economics and the Environment. He is currently the Chair of the Academic Advisory Council for the following organizations: The Bill of Rights Institute, the film “We the People in IMAX,” and the McCormick-Tribune Foundation “Freedom Museum” in Chicago, Illinois. He serves on the Board of Directors of the Bill of Rights Institute. From 2005-2009 he served as an elected Alumni Trustee of the Dartmouth College Board of Trustees.

It is my pleasure to testify today on the subject of "Banking Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals." Let me stress at the outset that despite the title of this hearing and my participation in it, I appear in my individual capacity and I am presenting my own perspective on the Obama Administration's financial regulatory reform proposals. I have no affiliation with the "banking industry" except as a customer.

I have studied consumer credit issues for most of my academic career. I have written dozen of articles and opinion pieces on topics related to consumer credit and consumer bankruptcy. In addition to teaching and writing in the area, from 2003-2004 I was the Director of the Office of Policy Planning at the Federal Trade Commission where I participated in the Commission's policy analysis and research on issues of competition and consumer protection.

Today I will focus my remarks primarily on the Obama Administration's proposal to create a new Consumer Financial Protection Agency (CFPA) which would have the authority to issue and enforce new regulations related to consumer lending products.

The creation of a new CFPA is a very bad idea and should be rejected. Nor can the proposal be made tolerable with a few minor tweaks—it is not salvageable and it cannot be improved in substance or in form to be any less of a menace to American consumers and the American economy. It is premised on a fundamental misunderstanding of the causes of the financial crisis: indeed, the Obama Administration's *Financial Regulatory Reform* White Paper offers no evidence—none—to support any of its claims that a meaningful cause of the financial crisis were the result of consumers' inability to understand innovative financial products or that the existence

of the CFPA would have or could have averted the financial crisis. Let me repeat that to make clear—there is *no* evidence that consumer ignorance was a substantial cause of the crisis or that the existence of a CFPA could have prevented the problems that occurred. More importantly, as will be discussed below, no such evidence *could* be produced because no such evidence exists.

Certainly there were incidents of fraud and abuse by lenders during the housing boom that led to subsequent problems and consumers who misunderstood their lending products. And certainly there also were incidents of fraud and abuse by borrowers who defrauded lenders. But there is no evidence that the financial crisis was spawned by a systematic lack of understanding by consumers of the loans into which they were entering. The consumer side of the financial crisis, by which I refer to problems of high levels of default (on mortgages and credit cards) and foreclosure (on mortgages), was caused not by consumer ignorance but misaligned incentives and rational consumer response to them.

It is true that lenders made a huge number of loans that were foolish in retrospect and perhaps should have been recognized as foolish at the time. And these unwise loans presented, and continue to present, major problems for the safety and soundness of the American banking sector. But these loans were foolish *not* because consumers did not understand them. They were foolish because lenders failed to appreciate the incentives that rational, fully-informed consumers would have to default on these loans if circumstances changed.

Consider an extreme, but not unrealistic scenario: a California borrower took a nothing-down, interest-only, adjustable-rate mortgage to buy a new home in the far-flung

exurbs of Northern California, planning to live in the house for a few years and then resell it for a profit. Assume further that the borrower could continue to make his mortgage payment if he chose to do so. Instead, the house plunged in value so that it is worth much less than the outstanding mortgage and with widespread oversupply of housing there is no reasonable likelihood that it will come back above water in the near future. Under California's defaulter-friendly anti-deficiency laws the lender is limited to foreclosing on the house and cannot sue the borrower for the difference between the value of the house and the amount owed on the mortgage. As a result of all of this, the homeowner crunches the number, consults his lawyer, and decides to walk away from the house and allow foreclosure.

This scenario raises substantial concerns about the safety and soundness of such loans. One can ask whether banks should be permitted to make loans that provide such strong incentives for a borrower to default when the loan falls in value. In fact, empirical evidence suggests that many of the terms that have drawn much criticism (such as low-documentation loans) proved to be problematic only when combined with other provisions that reduced borrower equity, such as nothing-down.[1] But while this scenario presents major concerns about the safety and soundness of such a loan, it does *not* present a consumer protection issue. The end result of foreclosure results from the set of incentives confronting the borrower and the borrower's rational response to them—empirical research indicates that loans with no downpayment or which otherwise cause borrowers to have low or no equity in their homes (including interest-only, home equity loans, and cash-out refinances) have proven to be especially prone to foreclosure in the

[1] KRISTOPHER GERARDI, ANDREAS LEHNERT, SHANE SHERLUND, & PAUL WILLEN, MAKING SENSE OF THE SUBPRIME CRISIS, BROOKINGS PAPERS ON ECONOMIC ACTIVITY (Douglas W. Elmendorf, N. Gregory Mankiw, and Lawrence Summers eds., Fall 2008).

recent crisis as stripping equity out of ones' house makes it more likely that a price drop will push the house into negative equity territory thereby providing incentives to default on the loan.

Rather than recognizing the financial crisis as the product of misaligned incentives that has created major safety and soundness issues, the Obama Administration's proposal for a CFPA rests on the assumption that the financial crisis was produced by hapless consumer victims being exploited and defrauded by unscrupulous lenders. This misdiagnosis of the problem to be addressed has produced a proposal that is fraught with a risk of negative unintended consequences for consumers and which could actually exacerbate the structural incentives that produced the current crisis, thereby making such problems more likely rather than less likely in the future.

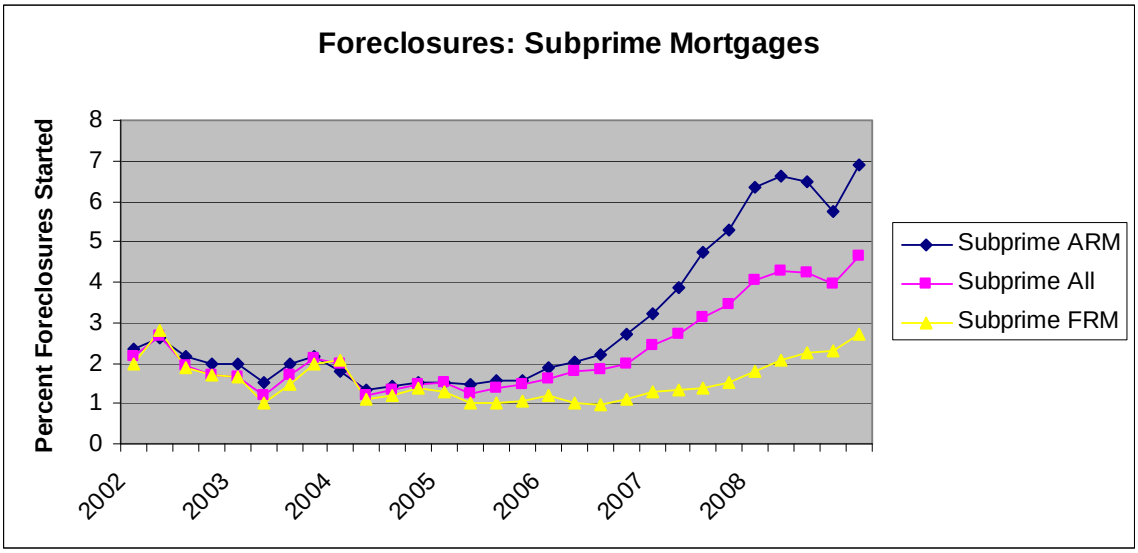
The proposal for a new CFPA is misguided for three reasons. First, it rests on misguided paternalism, and in so doing would likely prove counterproductive to consumer welfare overall. Second, by failing to recognize that the financial crisis primarily resulted from rational consumer responses to misaligned incentives (rather than failures of consumer protection) it offers solutions that could have the unintended consequence of exacerbating the very problems it purports to address, such as the issue of rising foreclosures. Third, by creating a new bureaucracy with defined scope, expertise, and mission, separate from other consumer protection agencies and safety and soundness regulators, it will promote the very bureaucratic balkanization and inconsistency that it aspires to address.

Misplaced Paternalism

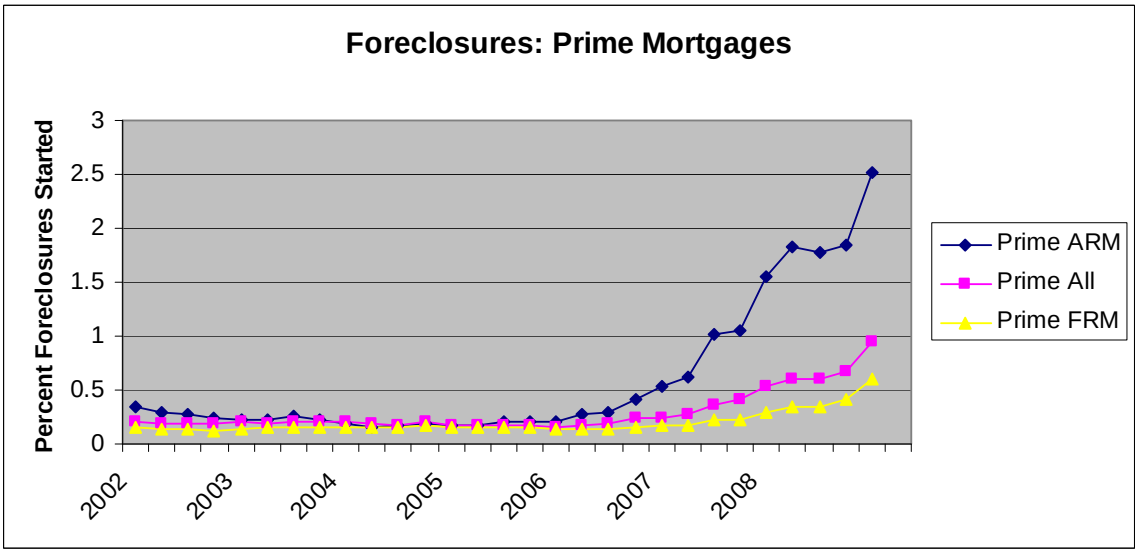
The first problem with the CFPA is its basis in misplaced paternalism about consumers. As noted above, while there was undoubtedly fraud during the housing boom (both by borrowers and lenders) the problems that have been seen in the mortgage market are the result of rational consumer responses to incentives, not a problem of fraud or consumer confusion. The housing crisis—referring specifically to the problem of foreclosures—has little to do with the issues identified by the White Paper and thus an entity such as the CFPA would make little difference in averting a similar problem in the future.

The Mortgage Crisis

The initial wave of foreclosures was triggered by interest-rate resets on adjustable-rate mortgages (ARMs). Consider the following charts, drawn from my forthcoming book, *Bankruptcy and Personal Responsibility: Bankruptcy Law and Policy in the Twenty-First Century* (Yale U. Press, 2010). As is evident, the initial wave of foreclosures was triggered by interest rate resets on adjustable-rate mortgages. First consider subprime mortgages (all data from the Mortgage Bankers Association):

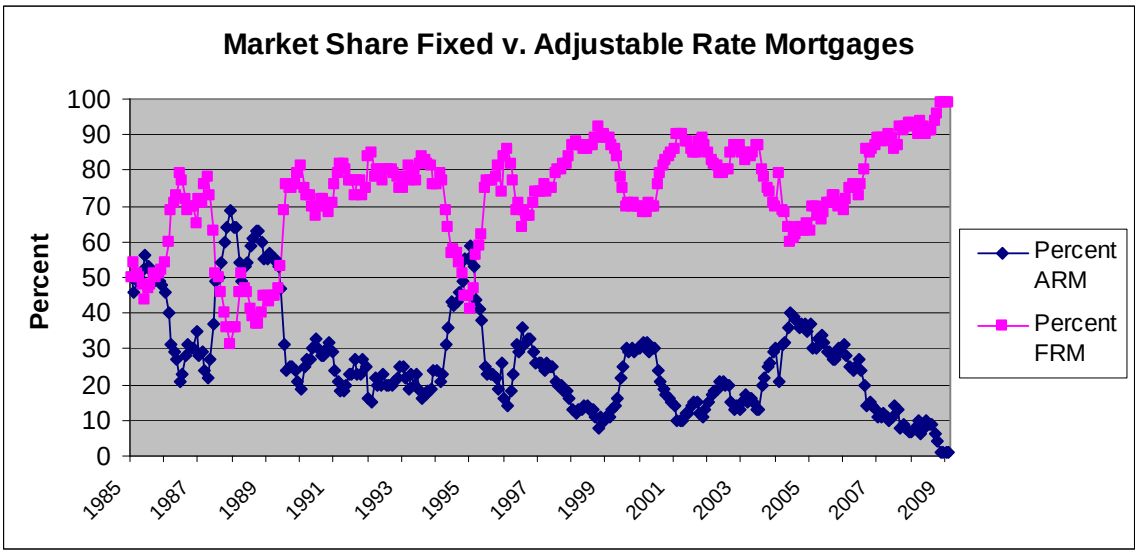


Next compare Prime Mortgages:

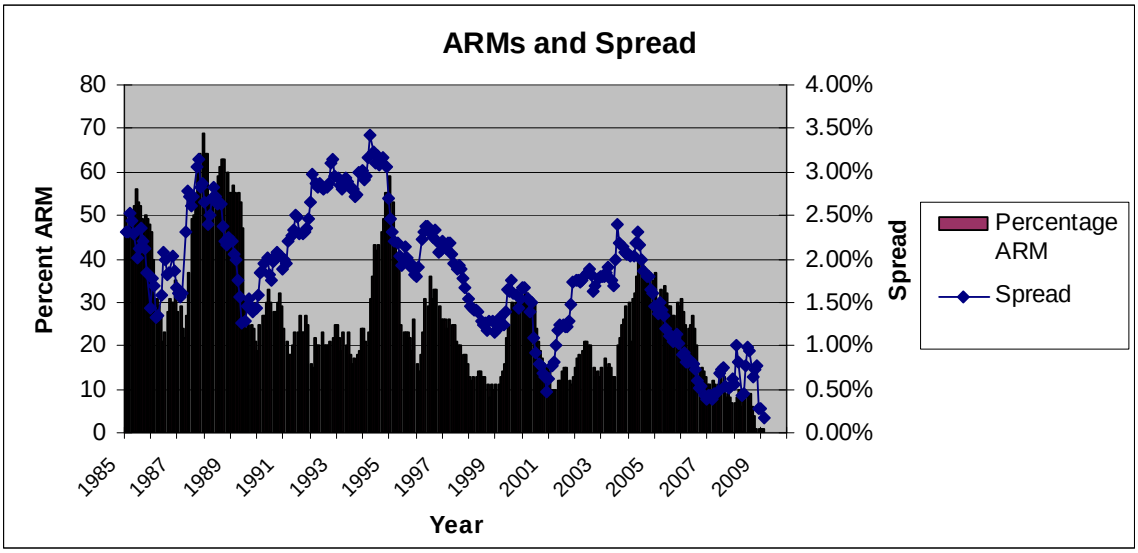


As can readily be seen, the initial surge in foreclosures for *both* prime and subprime mortgages were a manifestation of ARMs, not of subprime lending. In fact, foreclosure rates on fixed-rate subprime loans remained at relatively low levels. By contrast, in percentage terms, foreclosure rates on prime ARMs actually rose faster than for subprime ARMs (starting from a much lower base, of course).

Does this suggest that ARMs are unreasonably dangerous products? Of course not—in fact, even the White Paper does not go so far as to suggest this. In fact, ARMs have been a part of American consumer lending scene for decades. At times in recent decades ARMs have constituted 50 percent, 60 percent, or even more of the market for new mortgages:



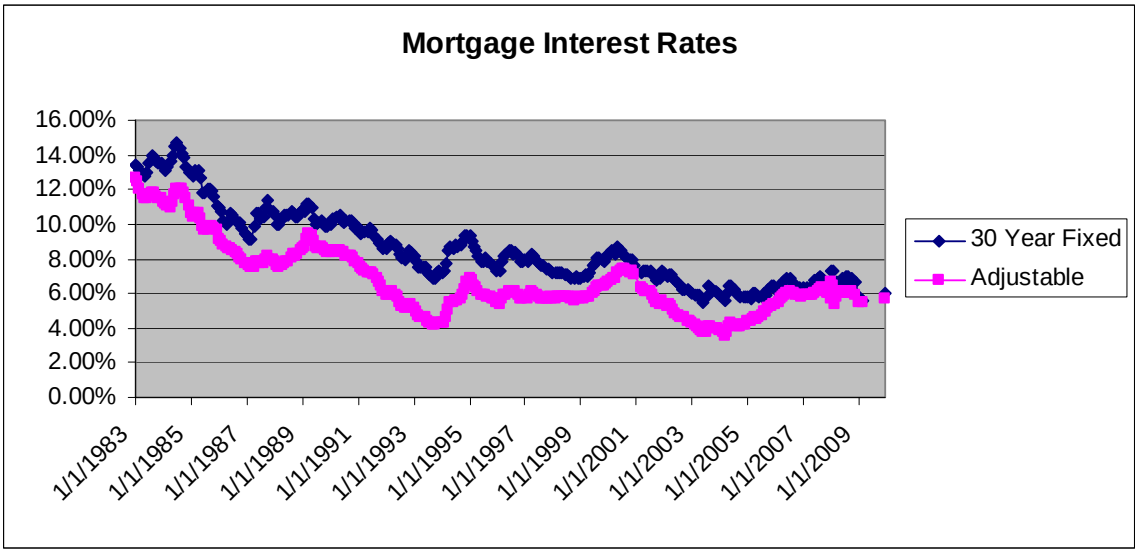
What explains the varying percentage of ARMs versus FRMs over time? It turns out that the determining factor is the spread between the prevailing interest rates on ARM versus FRM. On average, consumers pay a premium of about 100 to 150 basis points o get a fixed-rate mortgage, that premium being what is necessary to compensate the bank for holding the risk of interest rate fluctuations. This spread, however, is not constant over time. When the spread gets larger consumers substitute from FRMs to ARMs and when the spread narrows consumers switch to FRMs:



At the height of the housing boom in 2004, the spread between FRM and FRM was about two percentage points and about forty percent of the mortgages that were written were ARMs.

As can be readily seen, however, the percentage of ARMs was even higher at times in the past, yet this did not lead to a financial calamity. This strongly suggests that ARMs are not inherently dangerous. Further evidence is provided by the fact that virtually all mortgages in Europe are ARMs.

A final ingredient was necessary to make ARMs into a major problem in the United States in recent years: erratic Federal Reserve monetary policy. In the period from 2001-2004, the Federal Reserve drove down short-term interest rates to extremely low levels while FRM interest rates remained essentially constant. This created the observed spread between ARMs and FRMs that encouraged consumers to shift from FRM to ARM, whether for new purchases or to refinance. Then, the Federal Reserve rapidly raised short-term interest rates, creating the interest-rate reset problem described above. Consider the following chart of ARM and FRM interest rates over the past three decades:



The problem, as can readily be seen, was the Federal Reserve's erratic monetary policy, not ARMs per se. In fact, consumers who held ARMs during the 2001-2004 period experienced a major boon as their mortgage payments dropped dramatically without the cost and hassle of refinancing. Consumers simply responded to the incentives presented by the Federal Reserve's monetary policy—as they have regularly in the past. This time, however, the Federal Reserve temporarily pushed short-term rates to an unsustainably low level then whipsawed consumers when it raised rates. I am not aware of any provision in the White Paper that would ensure that the Federal Reserve will not make such catastrophic monetary policy blunders in the future. Nor is it reasonable to think that even the most well-informed consumers about the terms of their mortgages could have understood and anticipated market responses to the Federal Reserve's unprecedented monetary policy decisions when the Federal Reserve itself did not realize what it is doing.

It should be stressed in this context that economic research has overwhelmingly concluded that one factor that was *not* important were so-called "teaser rates" on

subprime mortgages. A "hybrid" mortgage is one with an initial fixed interest rate at the beginning of the loan (usually for two or three years), often termed a "teaser" rate, followed by an adjustable rate for the duration of the loan with the rate set at some spread above an easily-established market rate (such as LIBOR). Critics have claimed that these hybrid mortgages were "exploding" mortgages in that the initial teaser rate was set excessively low and that there would be a dramatic upward shot in interest rates after the interest rate reset that would surprise borrowers with high interest rates and that this has helped to generate rising foreclosure rates. Although often-cited, this theory appears to lack any empirical foundation.

One estimate of subprime loans facing foreclosure in the early wave of foreclosures found that 36% were for hybrid loans, fixed-rate loans account for 31%, and adjustable-rate loans for 26%.[2] Of hybrid loans in foreclosure, the overwhelming majority entered foreclosure *before* there was an upward reset of the interest rate.[3] Most defaults on subprime hybrid loans occurred within the first 12 months of the loan, well before any interest adjustment.[4] For those borrowers who actually underwent an interest-rate reset, the new rate is higher, but not dramatically so when compared to the original

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[2] James R. Barth et al., *Mortgage Market Turmoil: The Role of Interest-Rate Resets*, *in* SUBPRIME MORTGAGE DATA SERIES (Milken Inst.) (2007); C.L. Foote, K. Gerardi, L. Goette, & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007); C. Mayer, K. Pence, & S.M. Sherlund, *The Rise in Mortgage Defaults: Facts and Myths*, J. ECON. PERSPECTIVES (Forthcoming 2008).

[3] Barth, *supra* note. Of those subprime loans in foreclosure at the time of his study, 57 percent of 2/28 hybrids and 83 percent of 3/27 hybrids "had not yet undergone any upward reset of the interest rate."

[4] Mayer, Pence, & Sherlund, *The Rise in Mortgage Defaults* at 11; Shane Sherlund, *The Past, Present, and Future of Subprime Mortgages*, Federal Reserve Board (Sept. 2008); Kristopher Gerardi, Adam Hale Shapiro, & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures*, Federal Reserve Bank of Boston Working Paper No. 07-15. Mayer, Pence, and Sherlund find a dramatic rise in "early payment defaults" well before any interest rate adjustment takes place.

rate.[5] On average, the rate for subprime borrowers from the period 2003-2007 adjusted from an initial rate of about 8 percent to about 11 percent a substantial adjustment, but not one that can fairly be characterized as "exploding." Moreover, mortgage interest rates generally were increasing during this period (the spread between the initial and reset rates generally narrowed during this period), so the higher rate on reset also might have reflected a general rise in ARM interest rates, not the hybrid nature of the loan. Economists Anthony Pennington-Cross and Giang Ho find that the transition in a hybrid loan from an initial fixed period to the adjustable rate period results in heightened rates of prepayment but *not* default.[6] They also find that the termination rate for subprime hybrid loans (whether by prepayment or default) was comparable to that for prime hybrid loans. Other studies documented a dramatic rise in early payment defaults, an absence of rising defaults at the time of interest-rate adjustments, a tendency toward prepayment rather than default around the time of reset, and a lack of evidence of "exploding" interest rates. In light of these facts, economists have almost universally concluded that hybrid mortgages (at least alone) cannot explain the rise in foreclosures. After examining the evidence, several economists from the Boston Federal Reserve flatly stated last year, "Interest-rate resets are not the main problem in the subprime market."[7] I am aware of no evidence that contradicts that conclusion.

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[5] *See* C.L. Foote, K. Gerardi, L. Goette, & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007).

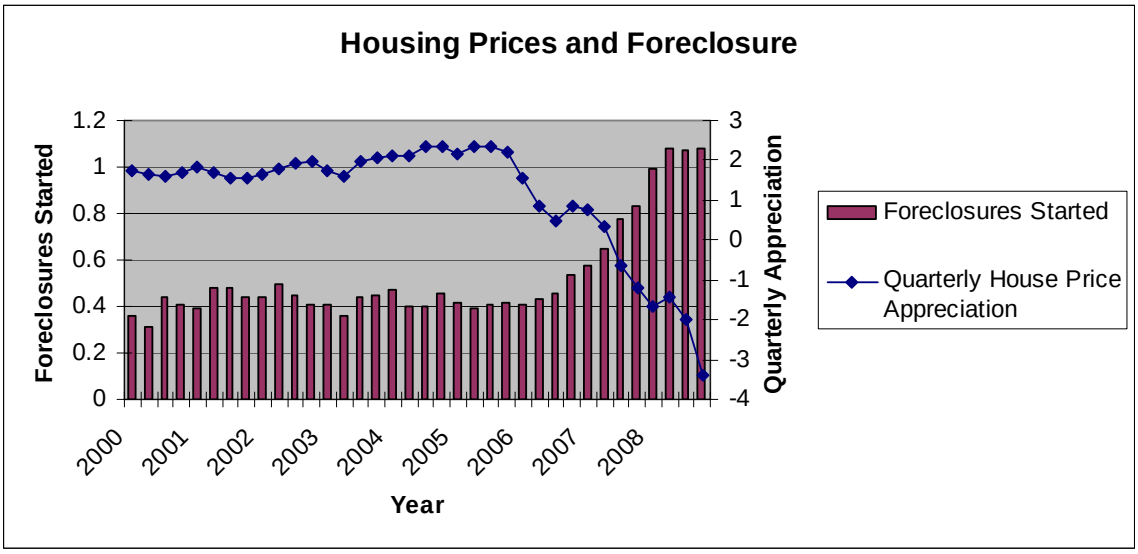
[6] *See* Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 18 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006).

[7] Christopher L. Foote, Kristopher Gerardi, Lorenz Goette, and Paul S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't*, FED. REs. BANK OF BOSTON PUBLIC POLICY DISCUSSION PAPERS 2 (May 30, 2008).

Whatever the cause of the mortgage crisis, there is no foundation for the belief that "exploding" interest-rate resets on subprime mortgages is a substantial part of the problem nor that consumers would be benefited by eliminating this mortgage option.

More generally, as one might expect, those borrowers who initiate hybrid loans tend to have borrower characteristics that place them in an intermediate position between borrowers who initiate fixed-rate mortgages and those who initiate adjustable-rate mortgages in a variety of characteristics, including income, FICO score, and likelihood of moving within the near future.[8]

Foreclosures in the second phase of the housing crisis have been driven by declining home values and the incentives of consumers to walk away from houses that are underwater. As can plainly be seen, there is a clear inverse relationship between declining home prices and rising foreclosures:



Again, consumers are rationally responding to the incentives provided by declining home prices. Not coincidentally, foreclosures have been most severe where

[8] Gregory Elliehausen, Min Hwang, & Jeehon Park, *Hybrid Interest Rate Choice in the Subprime Mortgage Market: An Analysis of Borrower Decisions* (working paper May 2008).

home-price declines have been most dramatic, such as Las Vegas, Miami, Phoenix, and the Inland Empire region of California. The rational decision of consumers to walk away from underwater mortgages does not present any sort of consumer protection issue—although as noted above, it does present severe safety and soundness issues.

Moreover, some apparently risky attributes of loans are also only potentially problematic when combined with other features of the mortgage regulatory regime. Perhaps most important is the presence in several states of so-called antideficiency or "non-recourse" lending laws that limit the remedies available to lenders upon a borrower's default to foreclosure on the home without the right to sue the borrower personally for any remaining deficiency.

Empirical evidence indicates that foreclosure default and foreclosure rates are higher where law limits lender recourse through antideficiency laws. In a study of the neighboring provinces of Alberta and British Columbia in Canada, Lawrence Jones found that "in a period of sizable house-price declines, the prohibition of deficiency judgments can increase the incidence of default by two or three times over a period of several years."[9] Similarly-situated borrowers with negative home equity (that is, where they owe more than the value of the house) "will be observed defaulting in antideficiency jurisdictions but not where deficiencies are truly collectible."[10] Other researchers have also found that prohibitions on deficiency judgments tend to produce higher delinquency[11] and default rates.[12] The higher risk associated with the presence of

[9] Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & ECON. 115, 135 (1993).
[10] *Id.*
[11] Brent W. Ambrose & Richard J. Buttimer, Jr., *Embedded Options in the Mortgage Contract*, 21 J. REAL ESTATE FIN. AND ECON. 95, 105 (2000).
[12] Brent W. Ambrose, Charles A. Capone, Jr. & Yongheng Deng, *Optimal Put Exercise: An Empirical Examination of Conditions for Mortgage Foreclosure*, 23 J. REAL EST. FIN. & ECON. 213, 220(2001) .

antideficiency laws is also reflected in higher interest rates, thus increasing the risk of default for some marginal consumers as well.[13]

A recent study also found that antideficiency law produce increased foreclosures when home prices fall and that the effect is concentrated among wealthier homeowners with more expensive homes.[14] This differential impact is to be expected—wealthier homeowners would be expected to gain a greater benefit from a non-recourse law because they have more assets and income to seize in a lawsuit. Poorer homeowners, by contrast, are likely to have little wealth beyond the home itself. Thus, they gain little benefit from the protection of an antideficiency law.

This also suggests that in many situations the cause of foreclosure is the *interaction* of certain mortgage innovations (such as no-downpayment loans) with preexisting aspects of the legal environment (such as the presence of an antideficiency law). In such situations, loan terms that might prove to be inappropriate in a state with extreme pro-debtor laws (such as an antideficiency law) may be perfectly appropriate in states with more moderate laws that do not provide debtors with such strong incentives to default when their house falls in value. Because these laws governing foreclosure and creditors' rights differ across the country it is difficult to generalize as to whether certain

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[13] *See* Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mort-gage Credit*, 88 REV. ECON. & STAT. 177 (2006) (finding that average loan size is smaller in states with defaulter-friendly foreclosure laws); Jones, *supra* note 137 (higher downpayments in states with antideficiency laws); Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143, 146 (1982) (estimating 13.87 basis point increase in interest rates as a result of antideficiency laws); Brent W. Ambrose & Anthony B. Sanders, *Legal Restrictions in Personal Loan Markets*, 30 J. REAL ESTATE FIN. & ECON. 133, 147–48 (2005) (higher interest rate spreads in states that prohibit deficiency judgments and require judicial foreclosure procedures); SUSAN E. WOODWARD, U.S. DEP'T OF HOUS. & URBAN DEV., A STUDY OF CLOSING COSTS FOR FHA MORTGAGES 50 (2008), *available at* http://www.huduser .org/Publications/pdf/FHA_closing_cost.pdf (finding that presence of antideficiency laws raises costs of loan). *But see* Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 512 (1991) (finding mixed results for impact of antideficiency laws on foreclosure rates depending on specification of regression).

[14] Andra C. Ghent & Marianna Kudlyak, *Recourse and Residential Mortgage Default: Theory and Evidence from US States* (working paper, June 3, 2009).

loan terms are inherently dangerous—as opposed to certain idiosyncratic state laws that render lending more risky in some states than others. Moreover, when foreclosure results because consumers rationally respond to the incentives created by an antideficiency law and allow foreclosure it is impossible to see how this can be considered a consumer protection issue. The White Paper, of course, makes no acknowledgement of the moral hazard problem created by antideficiency laws that spur foreclosures.

Note also, that there are dramatic regional differences in foreclosure rates. While foreclosures have risen nationwide, there are only a handful of areas that face a true foreclosure crisis, such as Phoenix, Las Vegas, Miami, and regions of California, where foreclosure rates are five or ten times the national average. Are we to believe that borrowers in those areas are five to ten times dumber than borrowers elsewhere or five to ten times more likely to have been misled? Of course not. These markets have turned catastrophic because of conscious speculation by short-term investors who knew precisely what risks they were taking, not because hapless consumers were victimized by overly-complex mortgage products.

Finally, foreclosures have continued today, as this foreclosure impetus from underwater mortgages has been combined with the factor that traditionally drove changes in the foreclosure rate, rising unemployment. Again, to the extent that foreclosures remain high because of rising unemployment, this is a macroeconomic problem, not a consumer protection issue.

Despite the lack of *any* evidence that the financial crisis was caused by overly-complicated consumer financial products, the White Paper nonetheless recommends a radical revamp the entire market for consumer lending products. In particular, the White

Paper contemplates that the CFPA would bless a category of "plain-vanilla" mortgages, credit cards, and other consumer credit products that would be provided with an elevated status. How the CFPA would make this determination is unclear from the White Paper as is the criteria that would need to be met to qualify.

In Europe, for instance, the standard mortgage product in many countries is a 10 or 15-year ARM with a balloon payment and no right to prepay.[15] By contrast, in the United States, the plain vanilla mortgage apparently would be a 30-year self-amortizing FRM with an unlimited right to prepay. Add to this the fact that consumers in the United States pay a hidden premium for FRM of about 100-150 basis points and about another 20-50 basis point premium for the right to prepay the mortgage. On average, these two factors combined add almost two percentage points to the interest rate of American mortgages as compared to mortgages without those features, thus making mortgages more expensive and more financially burdensome to households. Moreover, even though many areas in Europe have suffered home price declines comparable the largest drops here in the United States, foreclosure rates remain well-below the highest foreclosure rates in the United States. If anything, this suggests that the apparently "more complicated" European standard mortgage is a much safer product than the American mortgage.

The CFPA, however, provides no criteria for deciding what the "right" premium a borrower should be forced to pay for a fixed-rate or a right to prepay. Traditionally—and correctly—the American regulatory system has not tried to make this choice for consumers, but instead to encourage disclosure to consumers so that they can make the

[15] Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP., Fall 2005, at 93, 107–08 (2005).

best tradeoff of price and other contract terms that is suitable for their situation, budget, and level of risk tolerance. By elevating certain cookie-cutter "plain vanilla" loan products above others, the White Paper would instead seek to substitute its own biased assessment of the "appropriate" terms for a consumer, notwithstanding the fact that in doing so, the regulator would also be dramatically impacting the price that the borrower will have to pay for the loan as well. In so doing, the CFPA could very well force borrowers into more expensive loans that could turn out to be financially unsustainable or deny them the opportunity of home ownership, whereas a different loan with a different package of terms could have been more affordable and better-tailored to the borrowers' personal needs.

The premise that certain lending products can be classified as "risky" to borrowers is implicitly premised on the idea that the traditional American mortgage is not risky. That, of course, is simply incorrect. Principal is paid more slowly than for a shorter mortgage and equity accumulates more slowly. The mortgage interest rate includes a variety of risk premia in it, such as the risk of expected inflation rates, the risk that the borrower will prepay, and the risk of the change in the underlying value of the home as opposed to other investments. Thus, if inflation or market interest rates are lower than expected, then the borrower will have overpaid for the mortgage. If alternative investments (such as investing in the stock market) would have generated a greater return for the money spent on mortgage payments, then the risk of a fixed-rate mortgage is the foregone return on that money. These various risks associated with the traditional American mortgage may explain in part why efforts to introduce the traditional American mortgage have failed in other countries.

Credit Cards

With respect to credit cards, singled out for special criticism in the Obama Administration's White Paper (the "White Paper"), there is scant evidence that borrowers are unable to meaningfully understand their credit cards or shop effectively for credit cards. According to a survey by former Federal Reserve economist Thomas Durkin, 90% of consumers report that they are "Very" or "Somewhat Satisfied" with their credit cards.[16] Durkin also found that two-thirds of credit card owners find it "very easy" or "somewhat easy" to find out information about their credit card terms, and only six percent believed that obtaining this information was "very difficult." Two-thirds of respondents also reported that credit card companies usually provide enough information to enable them to use credit cards wisely. In an ideal world, these figures might be even higher, but the White Paper does a great disservice to American consumers when it implies that consumers are unable comprehend their credit cards or to acquire the information that then need to make reasonable choices.

More importantly, consumers pay attention to and understand the credit card terms that matter most *to them* personally. Consumers who revolve credit card balances are extremely likely to be aware of the interest rate on their credit cards and to comparison shop among cards on that basis, and those who carry larger balances are even more likely to be aware of and comparison shop on this term than those who revolve smaller balances.[17] By contrast, those who do not revolve balances tend to focus on other

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[16] Thomas Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, FEDERAL RESERVE BULLETIN (April 2002).

[17] *See* Thomas A. Durkin, *Credit Card Disclosures, Solicitations, and Privacy Notices: Survey Results of Consumer Knowledge and Behavior*, FEDERAL RESERVE BULLETIN p. A 109 (2006).

aspects of credit card contracts, such as whether there is an annual fee, the grace period for payment, or benefits such as frequent flier miles. In fact, consistent with the observation of more aggressive interest rate shopping by revolvers, those who revolve balances are charged *lower* interest rates on average than those who do not.[18] American consumers are not passive sheep timidly waiting to be shorn, as implied by the White Paper.

Elevating certain "plain vanilla" loans for exalted status also poses a risk of chilling vigorous competition and innovation in lending products. Consider the dramatic innovations and improvements in credit cards over the past several decades.[19] Thirty years ago credit cards were an immensely simple product—a high annual fee, a high fixed interest-rate, and no benefits such as cash-back, frequent-flyer miles, purchase-price protection, etc. Bank cards were available only to a lucky few. The remainder of middle-class consumers who needed credit were forced to rely on credit from local department stores or appliance stores, thereby obliging them to shop at those stores. These cards were simple—but lousy. The simplicity and uniformity of pricing stifled innovation and, some have alleged, made it easier for credit card issuers to collude to fix prices and stifle competition.

The effective deregulation of the credit card market by the Supreme Court's decision in *Marquette National Bank* set off a process of competition and innovation that continues to this day. Annual fees have disappeared on all "plain vanilla" credit cards, remaining only for those cards that provide frequent flyer miles and the like. Virtually all

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[18] Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHICAGO L. REV. 63 (2006).

[19] For a discussion of this history see Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).

credit cards have variable interest rates. And there is a much greater reliance on behavior-based fees, such as over-the-limit fees, late fees, and the like. The combination of these innovations has resulted in more accurate risk-based pricing for cards and less cross-subsidization by low-risk users of higher-risk users of credit cards. True, credit card pricing has become more complicated—but that is largely because consumer use of credit cards is so much more complicated and varied than in the past.

More fundamentally, the deregulation of credit card terms eliminated arbitrary barriers to competition. Annual fees had been imposed by credit card issuers as a mechanism to evade state ceilings on interest rates. The elimination of those legislative price caps enabled interest rates to meet their market rates—but importantly, also led to the rapid elimination of annual fees. The presence of annual fees was very harmful to consumers because an annual fee acted a "tax" on consumers holding more than one credit card. Once a consumer paid his $40 annual fee, he was unlikely to switch to another card (and pay another annual fee) or to carry another card. This dramatically dampened competition. The elimination of annual fees enabled consumers to hold multiple credit cards, essentially forcing credit card issuers to compete every time the cardholder opens his wallet. Moreover, these cards compete on a number of different margins, permitting consumers to choose the best deal available to him at any given time.

It would be extremely unwise for a hypothetical CFPA to try elevate simplicity above all else without considering the impact of its actions on competition, innovation, and consumer choice. The parable of credit card innovation provides a warning lesson about a narrow fixation on simplicity.

Unintended Consequences

A second major problem with the concept of the CFPA is the high likelihood of unintended consequences that will result from its actions. Consider just two areas identified by the White House as possible areas of action by the CFPA: a proposal to ban (or strongly discourage) prepayment penalties and banning "yield spread premiums" in mortgage products. Both of these actions would likely prove counterproductive and harmful to consumers.

Prepayment penalties are a common term in many subprime mortgages, although they remain uncommon in most prime mortgages in the United States. Prepayment penalties are also included in most commercial loans and are present in virtually all European mortgages. Yet the White Paper contemplates banning prepayment penalties in mortgages. This reasoning is based on faulty economic logic and fails to recognize the overwhelming economic evidence supporting the efficiency of prepayment penalties.

The traditional American right to prepay and refinance a mortgage is relatively unique in the world. Available empirical evidence indicates that American consumers pay a substantial premium for this unlimited prepayment right. Borrowers pay a premium for the unlimited right to prepay of approximately 20 to 50 basis points (.2 to .5 percentage points) with subprime borrowers generally paying a higher premium for the right to prepay than prime borrowers because of the increased risk of subprime borrower prepayment.[20] Borrowers pay this premium to compensate lenders for the risk of having

[20] *See* Todd J. Zywicki and Joseph Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 18-20 (2009) (summarizing studies); Gregory Elliehausen, Michael E. Staten & Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages*, 60 J. ECON. & BUS. 33, 34 (2008) (reviewing studies); Chris Mayer, Tomasz Piskorski & Alexei Tchistyi, The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers (Apr. 28, 2008). Term sheets offered to mortgage brokers similarly quoted interest-rate increases of approximately 50 basis points in those states that prohibited prepayment penalties.

to reinvest funds at lower market interest rates when interest rate falls. Where prepayment penalties are banned lenders also take other precautions to guard against the risk of prepayment, such as charging increased points or upfront fees at the time of the loan, which raise the initial cost of the loan.

Nor is there any evidence that prepayment penalties are excessively risky for consumers. Empirical evidence indicates that prepayment penalties do not increase the risk of borrower default. In fact, subprime loans that contain prepayment penalty clauses are less likely to default than those without such clauses, perhaps because of the lower interest rate on loans with prepayment penalties or perhaps because the acceptance of a prepayment penalty provides a valuable and accurate signal of the borrower's intentions.[21] Acceptance by a borrower of a prepayment penalty may also provide a credible signal by the borrower of his intent not to prepay the loan, thus overcoming an adverse selection in the marketplace and permitting a reduction in interest rates. Borrowers obviously have greater knowledge than lenders about the relative likelihood that the borrower will prepay the mortgage, especially in the subprime market where prepayment tends to be highly idiosyncratic and borrower-specific.[22]

The White Paper's approach to prepayment penalties is also internally illogical, stating that prepayment penalties "should be banned for certain types of products, such as subprime or nontraditional mortgages, or for all products, because the penalties make loans too complex for the least sophisticated consumers to shop effectively."[23] This

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[21] Christopher Mayer, Tomasz Piskorski, and Alexei Tchistyi, *The Inefficiency of Refinancing: Why Prepayment Penalties are Good for Risky Borrowers*, Working Paper (Apr. 28, 2008); Sherlund also finds that the presence of prepayment penalties does not raise the propensity for default. Sherlund, *The Past, Present, and Future*.
[22] *See* Zywicki & Adamson, *supra*.
[23] White Paper at 68.

statement is confused in two respects. First, it conflates two different concepts—the complexity of prepayment terms on one hand and the ability of consumers shop effectively on the other. If the concern is the ability to shop effectively, such as being able to compare competing offers, then the White Paper's concern could be met equally well by *mandating* prepayment penalties in every mortgage, thereby standardizing this term. In which case, it would no longer be a term on which consumers would need to compare across mortgages thereby rendering moot the question of the complexity of the term. Second, the statement refers to the inability of the "least sophisticated consumers" to be able to shop effectively. According to research by the Federal Trade Commission, however, those who have subprime mortgages are just as capable of understanding their mortgage terms as prime borrowers (or more accurately, neither groups understands their loan terms very well).[24] In still other cases the White Paper fails to consider the sophistication of the covered group at all. For instance, it identifies negative amortization loans as being especially complex and subject to particular scrutiny.[25] Mayer et al., find that negative amortization and interest only loans were present in a significant minority of alt-A mortgages, but virtually nonexistent in subprime mortgages.[26] Yet although alt-A and subprime loans are often lumped together, there is reason to believe that many alt-A borrowers were highly-sophisticated borrowers who fully understood the risks of those products and alt-A mortgages were often used precisely to purchase larger and more

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[24] JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007), http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.

[25] White Paper at 66.

[26] Chris Mayer, Karen Pence, and Shane M. Sherlund, *The Rise in Mortgage Defaults* (working paper). Mayer, et al., find that 40 percent of Alt-A mortgages had interest-only features, compared to 10 percent of subprime; 30 percent of Alt-A mortgages permitted negative amortization, subprime loans did not have these features.

expensive houses. More generally, negative amortization features do not appear to have been common in loans to ordinary borrowers or to subprime borrowers, but were limited to a particular subset of borrowers who often were highly-sophisticated and fully understood the risk of the loan and consciously chose to speculate that the home price would increase. I am aware of no evidence that those who held negative amortization loans failed to recognize or understand this term or the risks it entailed. Nor does the White Paper present any such evidence.

Finally, the ability of American consumers to freely prepay and refinance their mortgages may have exacerbated the current mortgage crisis—and banning prepayment penalties might thus exacerbate a similar situation in the future. When home prices were rising, many consumers refinanced their mortgages to withdraw equity from their homes. These "cash-out" refinancings became increasingly common during the duration of the housing boom—from 2003 to 2006 the percentage of refinances that involved cash-out rose doubled from under 40 percent to over 80 percent[27] and among subprime refinanced loans in the 2006-2007 period around 90 percent involved some cash out[28]. In fact, even though there was a documented rise in LTV ratios between 2003-2007, even that may underestimate the true increase in the LTV ratio if appraisals for refinance purposes were inflated (either intentionally or unintentionally), as appraisals are a less-accurate measure of value than actual sales.[29] The ability to freely prepay and refinance one's mortgage may help to explain the higher propensity for American consumers to default than in

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[27] Luci Ellis, *The Housing Meltdown: Why Did it Happen in the United States*, BANK FOR INTERNATIONAL SETTLEMENTS BIS WORKING PAPER 259 at 22 and Fig. 9 (Sept. 2008), *available in* http://www.bis.org/publ/work259.pdf.

[28] C J Mayer & Karen Pence, *Subprime Mortgages: What, Where, and To Whom*, NBER Working Paper no. 14083.

[29] Ellis, *The Housing Meltdown*, at 22; Chris Mayer, Karen Pence, and Shane M. Sherlund, *The Rise in Mortgage Defaults* at 6.

comparably-situated countries where prepayment is more difficult and thus cash-out refinancings are not as common.

This suggests that a ban or limitation on contractual agreements for prepayment penalties would encourage even more refinancing activity and further equity depletion that would otherwise be the case—thereby having the unintended consequence of *increasing* the number of foreclosures.

New restrictions on mortgage brokers would also likely be counterproductive for consumers. First, it should be noted that the fixation on the "yield-spread premium" for mortgage brokers is obviously misplaced: this is nothing more than the difference between the wholesale and retail cost of funds. Every loan from a depository lender also has an implicit yield-spread premium embedded in it.

More fundamentally, the White Paper's apparent hostility to mortgage brokers fundamentally misunderstands the nature of competition and consumer choice in this market. New regulations that might result in a reduction in the number of mortgage brokers, and thus an attenuation of competition, will likely result in harm to consumers. Both economic theory and empirical evidence in this area strongly suggest that greater competition among mortgage brokers results in better loan terms for consumers.

Mortgage brokers are confronted with two distinct incentives. First, mortgage brokers have an incentive to maximize the "spread" between the rate at which they can acquire funds to lend to consumers (essentially the wholesale rate) and the rate at which they can lend to borrowers (the retail price). But second, mortgage brokers face competition from other brokers trying to get a borrower to borrow from them. The net

result of these two factors—one pushing toward higher rates and one pushing toward lower rates—is ambiguous as an *a priori* matter.

Early studies have found various different results, some finding that brokers offer better terms on average than depository lenders and others finding that brokers charge higher prices on at least some elements of the transaction.[30] The explanation for these differing results appears to result from differences in the number of mortgage brokers competing in a given market.[31] Where mortgage brokers are numerous and thus competition and consumer choice is greater, consumers generally receive lower interest rates from brokers (the competition effect predominates); but where there are a smaller number of brokers and less competition, consumers typically pay higher interest rates (the broker interest effect predominates). Empirical studies indicate that overly-restrictive broker regulations may also lead to a higher number of foreclosures overall.[32] The lesson seems to be clear—regulators should be wary of adopting overly-stringent regulations that will substantially reduce the number of mortgage brokers in a given market. Similar findings characterize many industries where overly-stringent regulations result in higher prices and other welfare losses for consumers.

Finally, any regulations imposed by the CFPA are likely to be a very blunt instrument for addressing the suitability of various lending products for consumers. "Low

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[30] *Compare* Amany El Anshasy, Gregory Elliehausen & Yoshiaki Shimazaki, The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders (July 2005) (working paper, *available at* http://www.chicagofed.org/cedric/files/2005).
conf_paper_session1_elliehausen.pdf); *see also* Gregory Elliehausen, The Pricing of Subprime Mortgages at Mortgage Brokers and Lenders (Feb. 2008) (working paper) (updated results confirming the initial findings) *with*.WOODWARD, *supra* note 143, at ix (concluding that loans made by mortgage brokers have higher costs of $300 to $425).

[31] M. Cary Colins & Keith D. Harvey, *Mortgage Brokers and Mortgage Rate Spreads: Their Pricing Influence Depends on Neighborhood Type*, J. REAL ESTATE FIN. & ECON. (Forthcoming 2009).

[32] Morris M. Kleiner & Richard M. Todd, *Mortgage Broker Regulations That Matter: Analyzing Earnings, Employment, and Outcomes for Consumers* (working paper Nov. 2008).

documentation" or "no documentation" mortgages (sometimes called "liar's loans") have also come in for criticism. As noted above, the performance of these mortgages has depended to some degree on whether they are refinance or purchase-money loans. Other researchers have found that low-documentation mortgages perform as well as other loans except when the loans combine other risk-increasing terms, such as no downpayment (a practice known as "risk-layering").

More generally, low-documentation loans appear to be extremely reasonable in some circumstances if not others. Low-documentation mortgages are safe and appropriate for many refinancing transactions, such as a borrower with a high credit score, a long track-record of timely payment and equity in his home. For such a borrower, a low-documentation loan may provide an opportunity to refinance at a lower interest rate without the substantial cost, delay, and inconvenience of a full-blown refinancing process that would add little valuable information. By contrast, a low-documentation loan makes little sense for a purchase-money loan to a new borrower with no equity in the home. Prohibiting low-documentation loans in the former situation because of fear that it will be misused in the latter will raise the cost of refinancing for many borrowers and thereby make it more difficult for them to take advantage of lower interest rates. Even more importantly, questions regarding the proper role of low-documentation loans—whether refinance or purchase money—again raise safety and soundness issues, not consumer protection questions.

But this distinction between the appropriateness of low documentation loans in different contexts simply highlights a more fundamental problem: the CFPA's inability to engage in the sort of fine-grained regulatory analysis that is necessary to try to implement

its charge. For instance, empirical studies have found dramatic differences in the performance of subprime loans with different terms depending on whether they are purchase-money or refinance. Economist Morgan Rose found, for instance, that while a three-year prepayment penalty is associated with a higher probability of foreclosure for purchase-money fixed-rate mortgages and refinance adjustable-rate mortgages, that same provision has no impact on increased foreclosures for refinance fixed-rate mortgages.[33] Danis and Pennington-Cross found that low documentation loans increase the probability of delinquency and the intensity of delinquency, but they decrease the probability of default and prepayment.[34] If this is true, which is the proper measure of the suitability of such a mortgage—the higher delinquency rate or the lower default rate?

More importantly, what matters is the suitability of the entire terms of a given loan *as a whole*, not the complexity or "riskiness" of particular terms standing alone. It is frankly absurd for regulators to try to single out particular terms standing alone as being inherently dangerous or inappropriately complex, noting that whether a particular term leads to a higher risk that a given loan will default depends very little on the presence of any given loan term but depends greatly on the type of loan—refinance versus purchase-money, adjustable-rate versus fixed—and the presence of other non-traditional loan terms. Rose summarizes his findings, "In most instances, a given combination of loan features is associated with a greater increase in the predicted probability of foreclosure than the sum of the relevant individual loan feature impacts. For purchase FRMs with reduced documentation combined with either a long prepayment penalty period or a

[33] Morgan J. Rose, *Predatory Lending Practices and Subprime Foreclosures: Distinguishing Impacts by Loan Category*, 60 J. ECON. & BUS. 13 (2008).
[34] Michelle A. Danis & Anthony Pennington-Cross, *A Dynamic Look at Sub-prime Loan Performance* 12 (Fed. Res. Bank of St. Louis, Working Paper 2005-029A, May 2005), *available at* http://research.stlouisfed.org/wp/2005/2005-029.pdf.

balloon payment (but not both), the reverse holds—those combinations are associated with substantial falls in the predicted probability of foreclosure beyond the sum of the relevant individual loan feature impacts."

As Rose concludes:

> With regard to the implications of these results for potential federal predatory lending regulation, the overall pattern of results is of greater import than the individual estimates. That pattern illustrates that the magnitude, and even the direction, of the impact of a long prepayment penalty period, a balloon payment, or low- or no-documentation on the probability of foreclosure depends significantly on (a) the category of the loan under consideration, and (b) the presence or absence of the other two loan features. This suggests that relationships among predatory loan features and fore-closures are much more complex than previous analyses portray, casting doubt on regulators' and legislators' current ability to confidently discern abusive versus non-abusive lending. In particular, broad federal prohibitions or restrictions of these loan features that do not distinguish among loan categories, especially between refinances and purchases, and that do not recognize that loans with multiple loan features may require different treatment than loans with only one, are likely to be quite prone to causing unintended and undesired consequences.

Thus, even if we assume that these issues can be considered consumer protection issues rather than safety and soundness, it is absurd to think that a government bureaucracy can make the sorts of fine-grained distinctions to distinguish appropriate from inappropriate loans. To make data-based decisions a bureaucrat would have to know not only the identity and financial sophistication of the borrower, but also whether the loan is refinance or purchase-money and whether the *combination* of terms in the loan make the loan a likely candidate for default, because there is no sound evidence that particular terms standing alone can be thought of as inherently dangerous. This is not a serious proposition. And it illustrates precisely why the government has eschewed central planning of credit terms in the past—and should continue to do so.

Bureaucratic Inconsistency

A final problem with the CFPA is that it creates a new bureaucracy with a defined scope, expertise, and mission, separate from other consumer protection agencies and safety and soundness regulators. In so doing, it will promote the very bureaucratic balkanization and inconsistency that it aspires to address.

Of primary concern is the distinguishing of the CFPA's consumer protection mission from the Federal Reserve's safety and soundness regulatory authority. Under the White Paper's proposal, the CFPA would have authority to enforce regulations and impose substantial financial penalties. Inevitably, this power to impose financial penalties will threaten the financial condition of banks, thereby bringing the CFPA into conflict with the safety and soundness regulatory authority of the Federal Reserve.

The standard that the CFPA seeks to achieve is also unrealistic and suggests a virtually unlimited scope of authority for its action. The White Paper proposes that CFPA "should be authorized to use a variety of measures to help ensure alternative mortgages were obtained only by consumers who understood the risks and could manage them."[35] This statement fails to recognize, however, that according to a study by James Lacko and Janis Pappalardo of the Federal Trade Commission, very few homeowners understand all of the risks associated with their mortgages—whether traditional or alternative.[36] In this fact, of course, consumer credit products are not unique: consumers routinely purchase complex products and services for which they do not understand all of the nuances and wrinkles of the product, whether automobiles, computers, medical services, legal

[35] White Paper at 66.

[36] JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007), http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.

services, and the like. Citizens routinely vote for politicians without understanding all of the "risks" of voting for one candidate rather than another. To establish such an unrealistic and implausible standard is to open up a capaciousness of regulatory discretion and authority that is simply stunning. This standard of perfect understanding has probably never been met in practice, even for the most simple mortgage and most sophisticated borrower. Yet most mortgages work well for most borrowers without mishap.

Moreover, this standard fails to consider the question of *which* risks are relevant to be understood. For example, must those who enter into a fixed-rate mortgage understand that in doing so they are bearing the risk that market interest rates will fall, thereby forcing them to make higher payments than they would have with an ARM or to undergo a costly and inconvenient refinance process? For instance, during the low interest rate period of 2001-2004, those with fixed rate mortgages could have saved tens of thousands of dollars in lower interest rates if they had an ARM instead.[37] Must lenders insure that borrowers understand this "overpayment" risk? Must lenders make sure that borrowers understand that they pay a premium at the outset of a mortgage in order to have the right to prepay and refinance the mortgage later? What if the buyer only intends to own a given house for a few years?

Life, and credit, is full of risk: instead of acknowledging this, the CFPA apparently assumes away the existence of some sorts of risk, such as the risk of overpaying on a fixed-rate mortgage, and simply assumes that it is not actually a risk that

[37] Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the Credit Un-ion National Association Governmental Affairs Conference: Understanding Household Debt Obligations (Feb. 23, 2004), *available at* http://www.federal reserve.gov/boardDocs/speeches/2004/20040223/default.htm.

matters to consumers. The CFPA substitutes vague and empty aspirational statements for serious analysis of the challenges of trying to establish coherent and rule-bound standards for assessing the propriety of different loan products. These empty generalities provide a recipe for overzealous, incoherent, and contradictory regulatory action. Although consumers will occasionally err in making this evaluation, who is in a better position to evaluate this panoply of risks—consumers with the knowledge of their particular situations and needs or governmental bureaucrats seeking to lay down blunt rules for what sorts of risks are acceptable for different buyers.

The CFPA would attempt to carve off the regulation of consumer financial products from all other consumer protection agencies. Scholars and policy-makers have long recognized that governmental bureaucracies are prone to "tunnel vision," especially those bureaucracies defined by the substantive sector that they regulate rather than by their function. Such agencies are prone to interest-group capture that undermines their effectiveness.

Finally, the CFPA's limited substantive scope and responsibility is likely to cause it to undervalue the importance of competition and innovation in financial services. As noted above, the White Paper's emphasis on the value of simplicity in "plain vanilla" financial products fails to appreciate the value of innovation and competition in financial services.

Instead of creating a new bureaucracy, Congress instead should consider expanding the jurisdiction of the Federal Trade Commission and strengthen the Federal Reserve to meet the discrete categories of true consumer protection issues that arise under current law. Alternatively, this Committee should consider the Republican proposal to

streamline regulatory authority into a new consolidated agency that might perform the Federal Reserve's traditional oversight function more effectively. The FTC has longstanding expertise in consumer financial protection issues as well as related areas of consumer information, labeling, and advertising. In particular, this Committee should review the FTC's study of consumer disclosure regulations which provides numerous useful recommendations for improving consumer disclosures in a more user-friendly (and less lawyer-friendly) manner.