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Protecting Consumers in the Financial Marketplace: Thinking Outside the Boxes

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Abstract: *Do consumers need a new regulatory agency to protect them in the financial marketplace? The question has been at the center of the ongoing congressional debate over financial services reform. But is such an agency really necessary, or will it do more harm than good? And if it is created, where should it be located, and—most critically—what powers should it have? A panel of experts discusses these and other questions regarding consumer protection and financial regulation.*

JAMES GATTUSO: Location, location, location: Every real estate agent knows that those are the three most important elements in evaluating a property for sale. Thus, it's not surprising that the debate over financial reform, which has its roots in a real estate crisis, should focus on location. In this case, it's location of a proposed new agency for consumer financial protection.

This idea of creating this agency has gone through a number of permutations. At first—and there's still some support for this—it was supposed to be an independent agency without any oversight by other types of regulators or policymakers. Then it was moved over to the Treasury Department. In its last variation, it's supposedly going to be created within the Federal Reserve.

This last idea is clearly controversial. There is one Member of Congress who pointed out, "We saw over the last number of years when they took on consumer protection responsibilities"—"they" being the Fed—

Talking Points

- The proposed Consumer Financial Protection Agency would unhook consumer protection from safety and soundness, competition, and all the other economic dynamics that are necessary for the market to work properly. That would merely lay the seeds for the next crisis.
- The term "disclosure" implies that there's a scheme the consumer is trying to discover. What we really should be concerned about is making sure that consumers understand essential information about the credit commitments that borrowers are making.
- Where the proposed CFPA is housed is important, but it would be a mistake to be distracted by that question alone. The details of how its powers will be set up, what kind of interaction it will have with the prudential regulator, are far more important than the question of its location.

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“and the regulation of holding companies, it was an abysmal failure.” So, presumably, this Member, Senator Chris Dodd (D-CT), would be against the idea of moving the new agency to the Fed. Yet it looks like that will be proposed in the new bill by Chris Dodd.

Another potential location for this agency, which is my personal favorite, is to move it to the Office of Thrift Supervision, which will itself likely be eliminated and would solve the problem rather neatly.

This debate over location is important, but there’s a danger that it could obscure some even more important questions, particularly what powers would this agency have? It’s less important where it is than what it can do. And powers over whom? Whom will it regulate, and whom will it not be able to regulate?

Perhaps most important at all, would any of this have any impact at all on the likelihood of another financial meltdown? There is precious little evidence that consumer fraud had much, if anything, to do with the crisis of 2008, and there is some argument that perhaps an independent regulatory regime for consumer protection that goes too far could increase the possibility of another meltdown.

So there are lots of interesting issues here, and it’s certainly a timely discussion today with events moving quickly on the Hill toward defining and implementing some of these ideas. We have an excellent lineup today of experts to discuss this issue.

Our first speaker is Todd Zywicki, who is the Foundation Professor of Law at George Mason University. Todd is one of the leading commentators and analysts on the issue of financial consumer protection; he has really been a leader in the debate since it began over a year ago. He came to George Mason from the Mississippi College School of Law and had experience during 2003 and 2004 as Director of the Office of Policy Planning at the Federal Trade Commission. Todd received an M.A. in economics from Clemson University and his J.D. from the University of Virginia.

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TODD ZYWICKI: I want to make three points. First, I want to make an argument for why I don’t think consumer protection issues is what caused the financial crisis, even though that’s the linchpin of the argument for why we need some new government bureaucracy on steroids to deal with this.

Second, I’m going to talk about two different approaches to consumer protection, two paths that sort of diverge in the woods, and urge us to think about this differently from the way it has been thought of.

Third, I want to talk about how making the wrong diagnosis of what caused the crisis and the wrong choice about how to respond to it would likely make matters worse and lay the seeds for the next crisis.

Consumer fraud...is not the financial underpinning of what caused the [financial] crisis. What caused the crisis was consumers rationally responding to misaligned incentives.

Let’s talk about the first point. It surely comes as a surprise to many for me to say that in my view, consumer protection problems did not cause the crisis. I’m not saying that there wasn’t fraud by lenders against borrowers; certainly, in some neighborhoods, there seems to have been fraud. I’m not saying that there wasn’t fraud by borrowers against lenders; there was probably at least as much of that as there was of lenders against borrowers. And I’m not saying that there wasn’t fraud in the securitization market.

What I’m saying is that even if there were issues of consumer fraud, that is not the financial underpinning of what caused the crisis. What caused the crisis was consumers rationally responding to misaligned incentives. When a consumer rationally responds to incentives, that is not a consumer protection problem.

It is unquestionable that the banking industry made a lot of incredibly foolish and stupid loans, but the reason those loans were foolish and stupid was not because they relied on consumers being tricked, but because of the structure of incentives that they set up for consumers, especially when the

housing market went south—in particular, the structure of incentives that they set up for consumers to default on their mortgages and allow foreclosure when their houses fell in price.

The foreclosure and mortgage crisis is really a story about three different ways. The first way has to do with adjustable-rate mortgages (ARMs)—basically, the Federal Reserve's monetary policy over time and, from 2001 to 2004, a downward bulge in what the Federal Reserve did with monetary policy.

What that did was create a strong incentive for consumers to shift from 30-year fixed-rate mortgages to adjustable mortgages by opening up a gap between short-term and long-term interest rates. From about 2001 to 2004, the 30-year fixed-rate mortgage stayed at about the same rate, but what we saw was a dip in the rate for adjustable-rate mortgages.

What this shows is that the idea of adjustable-rate mortgages is not a new idea. Adjustable-rate mortgages go back at least to the mid-1980s, and there were periods in the '80s and '90s when adjustable-rate mortgages were as much as 40 or 50 or 60 percent of the market. In the most recent iteration, it peaked at about 40 percent of the market.

The Fed had artificially reduced short-term interest rates and then artificially brought them back up to where they should be.... [W]hat brought the initial onset of the foreclosure crisis was adjustable-rate mortgages.

Why does that matter? Consumers' use of adjustable-rate mortgages follows the spread between fixed and adjustable-rate mortgages. This is why, if you look back to the 1980s, as the gap between fixed and adjustable-rate mortgages gets larger, people flip over from fixed to adjustable-rate mortgages. They respond to the incentives to do that.

So consumers switched from fixed to adjustable-rate mortgages. What happened next was, the Fed had artificially reduced short-term interest rates and then artificially brought them back up to where they should be. The effect is that what brought the initial onset of the foreclosure crisis was adjustable-rate mortgages.

We've come to think of this as a subprime versus prime issue; I don't think that's right. The initial onset was an adjustable-rate versus fixed-rate issue. If you look at the foreclosure rate on subprime mortgages, subprime fixed-rate mortgages remained at a relatively reasonable level, and it was subprime adjustable-rate mortgages that took off.

But here's where it gets interesting: If you look at prime mortgages, you see the same thing. Prime adjustable-rate mortgages skyrocketed; fixed-rate mortgages stayed constant. Consumers got side-swiped by the Federal Reserve's monetary policy. If they hadn't been so exaggerated in the swings in interest rates, my view is we never would have had this situation to begin with.

The other thing is that creating these very low short-term interest rates is what fueled the speculative fever and sucked investors into the market in a lot of different areas, encouraged by that low access to money.

The second phase was when this led to a fall in housing prices. Over time, when housing prices fall, consumer foreclosures rise. Why is that? Basically, every month when you pay your mortgage, you have an option as to whether or not you want to continue paying the mortgage or stop paying it and basically give the house back to the bank. Economic literature going back 20 years says that consumers act on this option in a rational way, and that's what we've seen: As housing prices have fallen, consumers have used this option to walk away from their houses.

What that leads to is the recognition that there was an underwriting problem. For all the things you've heard about the crazy mortgages that were made, it turns out that one thing matters: whether or not the consumer had a product that caused them to have equity in their house. No-down payment loans, interest-only loans, cash-out refinances—all those things are the core of where the problem arose, whether it was a prime or a subprime mortgage.

What that meant was, if you didn't have equity in your house, you weren't as invested in your house, and those people are more likely to walk away, everything else being equal, but it also means you go into the negative equity territory faster than you otherwise would have. This is especially the case in

states where they have what are called anti-deficiency laws, which allow you to walk away from the loan without the bank being able to sue you for any deficiency. Estimates are that that increases the foreclosure rate by about two to three times whenever house prices fall.

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The third phase we're in now is macroeconomic conditions combined with negative equity. The fastest-rising group of foreclosures now is prime fixed-rate mortgages—what we traditionally thought of as the best mortgages.

So we've got three ways: adjustable-rate mortgages caused by Federal Reserve monetary policy, falling house prices caused by consumers responding to incentives, and now foreclosures rising because of macroeconomic conditions. None of that has anything to do with consumer protection. What that has to do with is consumers rationally responding to the incentives that were presented to them.

Why does that matter, then? Well, it matters for the way we think about consumer protection. We could think about consumer protection in two different ways. We could think about it as what I call market-reinforcing versus market-replacing consumer protection. Market-reinforcing consumer protection basically is focused on the idea of disclosure and competition and consumers being able to shop better. Market-replacing is basically a paternalistic view that says consumers can't be trusted to know what's right for themselves, that they're sort of gullible, hapless saps who get taken advantage of by lenders.

My view is that the first model is the one we need to have for consumer protection. What this means to me is, yes, there are reforms we need to make to consumer protection laws. We need to get rid of what a morass the Truth in Lending Act has become. It went from being a very simple mechanism that

would help consumers shop for things to being a lawyer- and regulator-encrusted mound of paper. If anybody has bought a house, for instance, you know that your disclosures aren't very helpful. We can streamline disclosures, we can make markets work better, and let's focus on doing that.

Instead, the Consumer Financial Protection Agency (CFPA) notion that's been presented by the Obama Administration is based on the idea that paternalism is what matters, that products and consumer choice need to be regulated. I think that's not only incorrect, but also problematic for my third point, which is that I think it could make matters worse. To the extent that we think of this as a consumer protection problem, we could end up enacting regulations that create new perverse incentives for consumers and lenders to lay the foundation for the next crisis.

To give you an example, there are a number of places in the Obama Administration white papers originally introduced about the ways in which the CFPA would ban unfair terms. The legislation itself talks about so-called abusive loans. They would ban pre-payment penalties on mortgages or regulate credit card terms, regulate terms of payday lending and all these sorts of things.

The reality is that a large number of the terms that consumer protection people don't like actually have a risk-based justification in economics. If we ban risk-based pricing in the name of consumer

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protection, obviously, we're going to get less accurate pricing. One of two things is going to happen: Either risk won't be priced accurately or lenders are going to reduce their risk exposure by lending less, further exacerbating the credit crisis that we have.

The final point, then, is that those loans were foolish. The crisis was caused by foolish loans. We might want to say you can't make loans with no

down payment, but that is a safety and soundness issue. It is a safety and soundness issue because of the incentives it set up for consumers. That is not a consumer protection issue.

CFPA is such a bad idea institutionally because it unhooks consumer protection from safety and soundness, competition, and all the other economic dynamics that are necessary for the market to work properly.

I think CFPA is such a bad idea institutionally because it unhooks consumer protection from safety and soundness, competition, and all the other economic dynamics that are necessary for the market to work properly. So the cornerstone, institutionally, needs to be combining consumer protection with a safety and soundness and competition framework and, second, reining in substantive things that could interfere with risk-based pricing. What we've seen so far hasn't done that, and if we don't do that, we're just laying the seeds for the next crisis.

JAMES GATTUSO: Our next speaker is Alex Pollock of the American Enterprise Institute. Alex serves as Resident Fellow at AEI. He joined AEI in 2004 after 35 years in the banking industry, where he was President of the Home Loan Bank of Chicago, President and CEO of Community Federal Savings in St. Louis, and President of Marine Bank in Milwaukee. He certainly comes to the field with ample credentials. He also has credit for developing a one-page mortgage form to help borrowers understand the mortgage system.

Alex has degrees from Princeton University in international relations, a bachelor's degree from Williams College, and, most interestingly, a master's degree from the University of Chicago in philosophy.

ALEX POLLOCK: When I considered the Consumer Financial Protection Agency last spring, I gave some testimony entitled "One Good Idea and a Number of Bad Ones," and that is still my summary of this proposal—except I would add now "and One Possible Compromise."

Starting with the bad ideas, it seems to me that anybody looking at the proposal in its various forms would agree that you would objectively expect a large, very expensive, highly intrusive bureaucracy with rather undefined and probably arbitrarily exercised powers, which would impose heavy costs and requirements likely to conflict with other regulatory agencies.

Where the parties in the debate differ on this proposal is that some people like such bureaucracy and some people don't, like me.

When it comes to fraud, as Todd said, there was of course some fraud against consumers and some fraud by consumers; fraud is known to attend every financial bubble in history. The idea that you can make a lot of money basically for free always gives rise to fraud. But that isn't the main point.

When it comes to this proposed consumer protection function, James mentioned location. Its organizational location is very important, in my view, as Todd also suggested. If this were a stand-alone agency, its inevitable dynamic would be a vast expansion of its regulatory activity: basically, telling people what they can and can't do when it comes to financing.

As context, I'd like to suggest what our fundamental philosophy toward risk in financial activity should be. Needless to say, America is a nation of risk-takers. The risks those of us who have the great advantage of living in this wealthy society take today are nothing compared to those that our ancestors took while they were conquering the frontier, but they're interesting nonetheless.

Should Americans be able to take risk in their financial decisions and, in particular, in financing the buying of a house if they want to? My answer is, of course they should. Should Americans be able to decide, if they want to, that they're going to have to eat oatmeal and hot dogs every day for five years to buy the house of their dreams? Absolutely, but they ought to know what they're doing. Should lenders be able to decide to make risky loans which are likely to have high charge-off rates and heavy losses in bad scenarios? Sure they should, if they know what they're doing.

It occurs to me that the opposite of consumer protection is making people loans that they can't

afford. That's the worst thing you can do, both to yourself as a lender and also to the borrowers.

Both sides of a credit transaction ought to know and understand what it's about and what its risks are. That brings me to the one good idea—and it really is a significant idea—that's embedded in all this discussion, and it's also a nonpartisan idea: clear, simple, straightforward, honest information, generally called “disclosure.”

Just as we ought to get rid of the term “entitlements” when it comes to budgeting because there is no spending of other people's money which you are entitled to, we ought to get rid of the term “disclosure” because disclosure implies that there's a scheme somebody has that you're trying to discover. They may have such schemes, and you ought to discover them, but what we really should be concerned with is key, essential information about the credit commitments that you as a borrower are making and making sure that you understand them.

So what we're really talking about is understanding by the borrower which allows the borrower to exercise personal responsibility in making financial commitments. That, it seems to me, is the fundamental, really good idea which is entangled in all of this debate and which we ought to make progress on.

What we're really talking about is understanding by the borrower which allows the borrower to exercise personal responsibility in making financial commitments.

As James was kind enough to mention, I proposed—it's now almost three years ago—a mortgage key information form. I did it because, as I said to a congressional committee, “You should get everything that a borrower really needs to know onto one page.” Having said that, I needed to create such a form. It's available on the AEI Web site if you want to take a look at it.

I don't insist on that particular form, but on presenting in straightforward language the key information elements so that people can understand in a clear way exactly the commitments they're making and can therefore decide for themselves how much

risk in their financial lives they wish to take. Then we can enable greater personal responsibility in the way the financial system functions. That, it seems to me, is a fundamental and extremely important thing to advance.

We talked about organizational location, and I mentioned a possible compromise. I do think that a stand-alone Consumer Financial Protection Agency, for the reasons discussed a minute ago, is a really bad idea. But, as we all know, the Members of Congress are busy discussing whether you might locate a consolidated consumer financial rules function inside some existing regulatory body—perhaps the Federal Reserve. I think that this location question is very important because if you're going to do this, it is essential to maintain, as many others have said, a balance between the consumer protection functions and the safety and soundness functions.

This is especially important if the bureaucratic behavior of consumer protection evolves as it is almost certain to do. In a stand-alone agency, it is absolutely, with 100 percent probability, going to grow into a credit-promotion as opposed to an information-assuring function. In the original Administration proposal, it was very clear they wanted this organization to promote, as they say, “access” to credit; that is to say, to promote the taking of greater risk by lenders and investors.

If you're going to promote that—I say *if*—you have to have it balanced inside a safety-and-soundness, prudential risk-managing organization, and that organization should be in charge. We have to reject a false compromise which would put such an agency theoretically inside a safety-and-soundness organization but really make it into an independent fiefdom. That is not a compromise and, in my view, is not acceptable.

I do think there is some argument for centralizing the already existing consumer regulation under already existing laws. For example, we have RESPA (the Real Estate Settlement Procedures Act), administered by the Department of Housing and Urban Development. I imagine that in the mid-1970s they had higher hopes for the Department of Housing than one might have today. We have TILA (the Truth in Lending Act), administered by the Fed. Anybody

who follows this knows what a mess of consumer information—so-called disclosures—is made by having these two competing bureaucracies trying to create rules over the same mortgage transaction.

It seems to me there is an argument for consolidating these functions under existing statutes like Truth in Lending and RESPA but making sure that they're inside and subordinate to a financially prudent function. If that happened, by far the most important project that this organization should take on is clear, straightforward, key information—and, of course, honest information—to borrowers about exactly what commitments they're making so they can decide for themselves how much risk they want in their financial lives.

JAMES GATTUSO: Our last panelist for the day is David John, my colleague here at Heritage who serves as Senior Research Fellow covering financial markets and regulation as well as retirement savings issues. David has deep background in financial market issues and is a veteran of many financial legislation wars, having served for some time on the Hill for a number of Members of Congress and also as Vice President of Chase Manhattan Bank in New York covering public policy issues, Director of Legislative Affairs at the National Association of Federal Credit Unions, and more. He is truly an expert on this issue.

If I can add, he has a truly classical education, having received a number of degrees for studies in Athens, the University of Georgia in Athens.

DAVID JOHN: I think there are four main points that need to be made and need to be remembered, especially as we go forward in the discussion here. It appears, according to the latest news—and that may change in the next 15 minutes or so—that the negotiations between Senator Dodd and Senator Bob Corker (R-TN) have foundered, and some of the reports suggest it was because of the CFPA.

It is important not to deny that there were problems with the way consumer regulations were structured, the timing of when they came out, and the way they were applied. Past experience with consumer financial regulations has been far less than perfect. However, we do have the opportunity to make it worse, and I'm afraid that

is the direction that at least the Administration is moving in.

I also have a very strong belief in disclosure, but it has to be, as Alex said, disclosure that you can understand. If you have a credit card, every year you're going to get a disclosure that tells you how your name, address, and other information is going to be used for marketing purposes by the card issuer and its other subsidiaries. The disclosure is usually one large piece of paper that's been folded into four pieces and is filled with tiny type that might be understandable by one of Todd's colleagues at law school, but certainly not by any normal individual.

So meaningful disclosure has to be very simple, and it has to be very carefully displayed. This is important. Those of us who have bought a car on time may have noticed that there was a big bold block in the middle of a long sheet of paper which said basically, "You are going to make X payments of X dollars for X months, which equals X dollars, which is how much you are paying for the car in total. And by the way, this is the effective interest rate that you're going to have."

Disclosure is crucial, but disclosure is not enough. Disclosure has got to be simple...and it has got to be stand-alone.

That is about as simple as you can make it, except for the fact that because it's part of a long form, and because you're writing your signature and/or initials at least half a dozen—and sometimes many more—times, it's very easy for the sales person to point it out and say the proper legal terms, and you'll never notice the disclosure at all. If you buy a house, where you basically spend several hours signing your name and writing a huge check, things become even worse. So disclosure is crucial, but disclosure is not enough. Disclosure has got to be simple, like the one-pager Alex is talking about, and it has got to be stand-alone instead of part of a longer and more complex form.

In the debate about establishing a CFPA, where the agency is housed is important, but it would be a huge mistake to get distracted by just answering that question. As Alex has already said, the last

thing we need is a *de facto* independent agency that is just tucked into another agency. The details on how its powers will be set up, what kind of interaction it will have with the prudential regulators, and the like are, if anything, far more important than the location question. I'm quite concerned that as this debate goes forward, in the effort to present a fairly simple, easily understood argument to people, this is going to be forgotten. There are other ways to protect consumers than just to create a new agency, although Alex gives some very good reasons for consolidating to an extent.

The big argument for a CFPA—especially, ironically, by Chris Dodd and Barney Frank—is that the Fed and other regulators failed to give consumer regulation the proper attention. We've got a paper out that discusses addressing these lapses by using a coordinating council structure instead of a new regulator, one where the different existing regulators would meet on a regular basis. You could have a Senate-confirmed individual who heads this council. Members could include the state regulators in addition to federal regulators so you don't have an all-powerful federal regulator that takes control of everything.

This would solve the problems that supporters of the CFPA have come up with. It would give the consumer regulations more visibility. The coordinating council would have the ability to say this area isn't being handled well enough, and the council could have a small research staff to assist it. But the response to problems with consumer financial regulations doesn't have to be a new agency with the goal of trying to control the universe.

My last point, which I think is actually the most crucial point of all, is that if you look at the newspaper articles that have discussed the Corker–Dodd negotiations, the Shelby–Corker–Dodd negotiations, and others, they all, for the most part, focus on the CFPA. That's an important issue, but it's not the only one contained in a bill of more than 1,000 pages.

What deeply concerns me is that there will be an agreement on the CFPA that somehow or other satisfies everyone, and the conservatives will also get

something—that says in essence, “There will never be another bailout, not now, not ever, absolutely not”—and will treat as minor little issues which actually are going to be far more important in the long run: little things like a resolution authority.

The newspaper yesterday talked about an agreement to create a \$50 billion pre-funded slush fund that would be used to pay for part of the costs of future failures. As we all know, Congress is constitutionally incapable of leaving money alone and not using it for something. So supporters of this new fund can say initially, yes, this will only be for the most ultra-emergencies, but that's not the way it's going to work in the long run. As we've seen in the operation of the federal Flood Insurance Program and so many other federal disaster programs, the definition of “disaster” greatly expands to reach the point of stubbed toes or splinters in your finger, and that's what's going to happen here.

An open-ended regulatory authority is both exceedingly dangerous and a complete dropping of congressional responsibility.

Keep in mind that \$50 billion is only approximately one-third—actually, it's less than that—of the amount that the government sent to AIG alone, and that doesn't count the many other major financial companies out there that also received a federal bailout. There will be some sort of agency on systemic risk, and many of the proposals say that this agency would have the ability to draft an unregulated company into a regulatory system, and hypothetically, regulators at that point would be allowed to tell the company, “I'm sorry, you need to stop certain product lines, you may need to sell off pieces of yourself, or you may need to go out of business.”

An open-ended regulatory authority is both exceedingly dangerous and a complete dropping of congressional responsibility. Congress is supposed to decide on a regular basis which companies are going to be regulated, why, and how and not just simply hand that responsibility over to the regulators and say, “Do what you want guys, but if you fail, we're going to blame you.”

Last but not least, there are additional questions which are going to be answered by the legislation about things like the regulation of derivatives and other types of similar products. The European Union has just sent a rather nasty note to Treasury Secretary Geithner, who has not gone along with some of their proposals to declare that all derivatives are the spawn of Satan and therefore need to be very closely regulated.

These are all key issues. The CFPA is crucial. It's very important, and it will be especially important to consumers, but it's not everything in the bill by a long shot. So dealing with the Dodd draft properly is not just a matter of having a priority list with three items on it and declaring victory and going home. This is a case of legislative language that we don't know or haven't examined in detail and can really hurt us.

ALEX POLLOCK: Congressman Scott Garrett (R-NJ) has a bill to require Fannie Mae and Freddie Mac to be put on budget. That would be another form of truth in legislation which we really need.

Questions & Answers

QUESTION: What is meant by fraud? Is it what a lawyer or prosecutor would say—I can go to court and send somebody to jail—or is it the more colloquial sense of someone taking advantage of a less sophisticated party? On one hand, it's law enforcement, and on the other hand, it is kind of a paternalistic notion. I wonder which it is, or whether it's both.

TODD ZYWICKI: I think it is the kind of thing that the Federal Trade Commission has done forever, which is fraud misrepresentation: basically misleading people about what was in their loan documents, telling people that they had a fixed-rate mortgage when they actually had an adjustable-rate mortgage, or a 2/28 or a 3/27, those sorts of things. It hasn't really been defined very well.

But you put your finger on a more interesting point. I worked at the Federal Trade Commission. I know what fraud and deceptive practices look like. What's interesting about the CFPA is that it's not just talking about fraud and deception; it's also talking about abuse of lending. I have no idea what abuse of lending is. I don't think anybody has any idea what

abuse of lending is, other than it is lending that whoever is the head of this bureaucracy after the fact will decide is too expensive or whatever the case may be.

Regulations are not written for human beings right now. They're written by lawyers and regulators for lawyers and regulators.

Certain types of lending might be called inherently abusive—payday lending, for example. Nobody could possibly know what that means, and I don't see how anybody could possibly be willing to lend money in an environment where, after the fact, the regulators could say that your loan is not just fraudulent or deceptive but abusive, no matter how well you disclose it.

You mentioned the idea about taking advantage of less sophisticated borrowers. A 2007 study done by the Federal Trade Commission asked mortgage consumers about their mortgages. What they found was that neither subprime nor prime borrowers actually understand their mortgages.

That goes back to the point about how bad the disclosures are. The FTC came up with a whole list of very simple things that could be done in the regulatory apparatus that would make it easier for prime and subprime borrowers to understand their mortgages, and it seemingly has gone nowhere. Instead, HUD gets tangled up in all kinds of things involving yield spread premiums on mortgage brokers and all these sorts of sideshow activities.

Regulations are not written for human beings right now. They're written by lawyers and regulators for lawyers and regulators. The FTC study asks, what would happen if we actually wrote disclosures for real human beings? It turns out consumers can understand their products a lot better if you just take that simple step.

ALEX POLLOCK: When it comes to fraud, there are cases which are fraud pure and simple. For example, if a mortgage broker took the loan application and whited out the household income of \$50,000 a year and put in \$90,000 because he knew that's what it would take to get the loan

approved, that's outright fraud on the lender and on the ultimate owner of the mortgage.

It's equally clearly fraud if the borrower said their income was \$90,000 when in fact it was \$50,000. You might say the lender was stupid not to verify it, which is true; nonetheless, lying about your income as a borrower is out-and-out fraud.

Then there are less clear cases, which would be the sort of thing the FTC might get involved in. I've seen these myself in the case of option ARMs, where you're able to make payments of less than the interest on the loan, with the interest rate being added on to your principal. In advertising materials, these would get described as, "I can get you a 1.5 percent loan." What it meant was your initial payment could be as little as 1.5 percent; the actual interest rate might be 5 percent or so, and the other 3.5 percent would be added on to your principal. Of course, they worked on exactly how they said it, and maybe you found an asterisk that said "actual interest may vary" or something. That wouldn't count as clear and straightforward disclosure.

QUESTION: It seems to me that we have social ideals being promoted in order to coerce or manipulate the marketplace. I'm thinking in particular of the Community Reinvestment Act, which offered incentives and disincentives for abiding by these social ideals, and then of course you had Freddie Mac, Fannie Mae really offering implicit coverage for these risky decisions.

Wouldn't truth in lending be a lot more commonsense to business practitioners if there weren't these perverse incentives? Wouldn't it make sense for them to have clearly agreed upon terms in which both lender and borrower were protected if these incentives were not involved?

TODD ZYWICKI: I'm personally not that convinced that the Community Reinvestment Act or Fannie Mae was a big part of this story. The foreclosures and defaults that spawned the financial crisis are not lending to poor-risk and inner-city neighborhoods. What they are is gigantic tracts of brand-new houses built in the suburbs and exurbs of Phoenix, Las Vegas, and the Inland Empire of California.

If you look at FICO scores, for instance, of subprime borrowers over the run of the housing boom, you see they remain the same or perhaps even went up a little; what deteriorated was everything else. In particular, what deteriorated were these requirements of putting money down, put more cash out refinancing, those sorts of things.

Basically, the national banking crisis is really a localized foreclosure crisis in a handful of states, primarily with respect to newer houses and things having to do with real estate markets, exacerbated by things like anti-deficiency laws in states like California and Arizona, which are basically get-out-of-jail-free cards if your bet doesn't pay off.

In my view, Fannie is probably a part of this story because it created a market where these poorly underwritten loans could go. CRA is a very bad idea, and we should get rid of CRA regardless, but I don't think it's necessarily a big part of this story.

ALEX POLLOCK: We had a bubble in house prices and a bubble in credit extension. The question rightly focuses on the political pressure to lower lending standards.

One of the most important parts of that was pressure to reduce down payment requirements. Todd rightly said there are some key regularities in mortgage finance, and one of them is the very strong relationship between down payments, or their inverse, the loan-to-value ratio, and loan performance. The lower the down payment and the higher the loan-to-value ratio, the greater the defaults and delinquencies will be. That's as close to a law of nature as you'll get in finance.

I'd like to contrast this with the ideas of a few generations ago, of the old savings and loan associations. It's very interesting to read how they described what they were doing. They were about improvement in the lives of what we would now call modest- or low-income people, and they said, "Thrift and savings and self-discipline will allow you to better your role in the world." They were clear that they were on a program of social improvement through, in the first place, thrift and, in the second place, becoming a homeowner, a property owner, with a stake in society. So they had savings

and loans, but they never forgot about the savings part of it.

One way to look at the evolution of American mortgage finance is that we completely forgot about the savings part—in fact, politically, purposefully suppressed the savings part, which is the down payment, in favor of all of the emphasis going on the loan. That was a big mistake.

DAVID JOHN: That was a huge mistake. You've got to remember also, CRA has been around for about 30 years or so, and what that means is that most financial institutions found a way to deal with CRA about 25 years ago. I remember going to the American Bankers Association with an idea having to do with small-business retirement savings. We said, "We could give these accounts CRA credit," and they looked at me and said, "Well, that's all very nice, but we figured out how to deal with CRA a dozen years ago. We don't really care if you add it to the definition or don't add it to the definition; it's just not a big deal."

But part of what we forget—and that people over in that domed building and the regulators who try to figure out what those legislators were talking about forget—is that there is a huge difference between what seems like a commonsense idea and actually putting it into regulation and law.

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One that we haven't talked about is the Truth in Savings Act. The Truth in Savings Act came about because a member of the House Banking Committee was walking down K Street one day. It used to be, as you walked by all the different financial institutions, that you'd see a little pressboard in every window showing how much that bank paid on different savings products, and he noticed that there were some differences as they went along. Then he discovered that how the individual financial institution defined a one-year CD might be vastly different from the way another institution did.

So he came back to Congress and started to work on something called the Truth in Savings Act, and by the time it passed, everybody thought, "Oh, that's a really good idea." The final law, as I recall, was somewhere in the 10- to 12-page range—which frankly is nothing, especially given that the financial reform that we're talking about today is going to be somewhere in the neighborhood of 1,000 to 1,500 pages or so—and they sent it to the Federal Reserve and said, "Implement this, please."

What came out of the Federal Reserve was something that was about 1,000 pages thick, and it included a disk, which had the first-ever computer program that was part of a financial regulation. When the Fed attorneys sat down and looked at how savings rates are set, they realized that this subject was vastly complex, and in order to get a legal definition of each savings product, they had to cover every conceivable eventuality, and the result turned out to be a nightmare.

One of the things that you come up with in virtually any law and regulation in financial services is the law of unintended consequences. We've had a tremendous amount of that already, and we're likely to have even more.

TODD ZYWICKI: I want to add one point to Alex's observations, which I thought were very insightful. On the promotion of home ownership, it's a very, very interesting example of the hubris of economic planning. As everybody has remarked, expanding home ownership has been a bipartisan goal for decades.

In retrospect, it seems foolish, and obviously it was foolish, but at the time it actually made sense. There was a huge volume of empirical research that showed that home ownership was correlated with the good things in life—wealth accumulation, better results for kids, better neighborhoods, lower crime, all these sorts of things—and people just assumed that the causal link was that if you bought a home, you became more responsible.

What we've subsequently found out is that responsible people like to buy homes and create good neighborhoods and take care of their kids and that sort of thing. By artificially promoting home ownership, we brought in a new class of people

buying homes for different reasons. It didn't make them more responsible. They were irresponsible people who were coming in to speculate. They were short-term owners; they weren't as invested in the neighborhood. What we found is that these were the people who were much more responsive to the incentives, for instance, to walk away from their

homes when their houses go underwater; they were more likely to take these exotic mortgages and these sorts of things.

It's a very interesting story about how the causation was actually the opposite of what we had understood and had been basing policy on for a long time.