REGULATORY RESTRUCTURING: SAFEGUARDING CONSUMER PROTECTION AND THE ROLE OF THE FEDERAL RESERVE

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BEFORE THE

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DOMESTIC MONETARY POLICY
AND TECHNOLOGY

OF THE

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REGULATORY RESTRUCTURING: SAFEGUARDING CONSUMER PROTECTION AND THE ROLE OF THE FEDERAL RESERVE

Thursday, July 16, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Melvin L. Watt [chairman of the subcommittee] presiding.

Members present: Representatives Watt, Meeks, Sherman, Green, Cleaver, Ellison, Adler, Kosmas; Paul and Posey.

Ex officio present: Representative Bachus.

Chairman WATT. This hearing of the Subcommittee on Domestic Monetary Policy and Technology will come to order. We will proceed with opening statements up to 10 minutes per side, and I will recognize myself for a brief opening statement.

This hearing is entitled, "Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve." This is the second in a series of hearings about financial regulatory reform and the role of the Federal Reserve, the second in this subcommittee, that is. The first hearing, held on July 9th, examined how to balance the Federal Reserve's existing role as the independent authority on monetary policy with its proposed role as systemic risk regulator under the Administration's financial regulatory reform proposal.

Today's hearing examines a different aspect of the Administration's regulatory reform proposal, the proposed Consumer Financial Protection Agency (CFPA). While the full Financial Services Committee has held a hearing—or a series of hearings, for that matter—on the CFPA, this hearing will drill down further and examine some of the public policy and operational considerations related to the proposed CFPA, including whether the Federal Reserve should maintain a role in consumer protection, given its current responsibilities for writing rules, supervising institutions, and enforcing the Nation's consumer protection laws, and if so, what that role should be and how it might be coordinated with, supportive of, or at least not in conflict with the new CFPA.

Although no witnesses from other Federal banking agencies are testifying today, this hearing may also touch upon how the same set of questions should be answered with respect to their consumer protection roles and their interactions with the CFPA.

Today there is no single agency focused solely on protecting consumers from products and services that could be detrimental to their financial health. Since the idea of having a single Consumer Financial Protection Agency was advanced by Harvard Law School Professor Elizabeth Warren, other academics, commentators, Members of Congress, and regular citizens have embraced the idea. They have witnessed the way that our fragmented regulatory system produced serious gaps in regulation and oversight and failed to have anyone whose highest priority was protecting consumers, that is, someone who goes to work every day with that as their single most important objective.

Others, of course, criticize the idea of a single consumer protection agency as adding another layer of regulation.

There can be no doubt that regulatory gaps helped create an environment for toxic financial products such as predatory mortgages and other abuses that helped cause the current financial crisis. To remedy this, the Administration has proposed placing focused authority in the proposed CFPA to administer the Nation's consumer protection laws. As Congress and President Obama work to enact financial regulatory reform, it is critical for us to examine the public policy rationale for vesting virtually all authority for consumer protection of financial products in a single agency. Also, as a matter of public policy, we will examine whether and how the Federal Reserve can effectively balance its responsibilities to execute monetary policy, take on a new role in systemic regulation, and if it continued to have this role, protect consumers effectively.

For far too long, consumer protection has been an afterthought. I hope that the record developed at today's hearing will offer further support for the elevation of consumer protection to be on equal footing with prudential and safety and soundness regulation.

We also hope that today's hearing testimony will begin to address some of the questions surrounding the operational details of the proposed consumer protection agency, including coordination between and among Federal regulators and State regulators so that there is effective and efficient regulation of the Nation's consumer protection laws in the financial services area, as many believe we have in the food and product safety area.

With that, I will recognize the gentleman from Texas, the ranking member of the subcommittee, Mr. Ron Paul, for, I guess, up to 10 minutes or as much time as—I guess, 6 minutes; 6 minutes is what I have been told.

Dr. PAUL. Thank you, Mr. Chairman. I want to thank you for holding these hearings because I think they are very important. The subject of consumer protection and the role of the Federal Reserve is, to me, a very important issue.

I look at this somewhat differently than others because they talk about consumer protection, and they are thinking about financial products and services, credit cards and gift cards and that if there is any harm done to the consumer, that just additional regulation will handle this. But I think there is a much bigger issue related to the consumer and the Federal Reserve, something I think is neglected in a serious manner.

For instance, the Federal Reserve has something to do with the value of our money, and the Federal Reserve has been around since 1913 and now we are working on a 4-cent dollar. So the systematic destruction of the value of our money has not helped our consumers; our consumers are destroyed by the loss of their purchasing power.

The fact that the Federal Reserve regulates interest rates and gets them down to 1 or 2 percent, so if you happen to be a saver and you are in retirement and you put money away, you get punished. Maybe the market would say that the interest rates ought to be 5 percent or 6 percent or 7 percent, if you are a saver. But we punish them, and this has to do with the regulations and manipulations going on with the Federal Reserve.

So the Federal Reserve is hardly a protector of the consumer when it distorts the interest rate that is paid to the savers, and they are the consumers.

Think about how the consumer was protected with the collapse of the financial bubble. The financial bubble—it is well-known the financial bubbles come from inflating the money supply, lower interest rates, malinvestment, too much debt. The source of all this mischief comes from the Federal Reserve, and who suffers? The consumer.

Who benefits? The people who had been making bundles on Wall Street and the bankers, for years when the bubble is being built, and then all of the sudden the bubble bursts, and who gets punished? The little guy gets punished. He loses trillions and trillions of dollars in value.

Who gets bailed out? Goldman Sachs.

And we pretend that the Federal Reserve is going to protect the consumer when the consumer is being destroyed under these conditions.

Think about the consequence of the collapse of the bubble that has been artificially created. Who suffers? It is the consumer, the people who lose their jobs, the poor people, the middle class.

This type of system that we have today, historically it is well-known if we pursue it, and we are pursuing it, because the middle class gets wiped out. Look at all of the inflations throughout history, all of the paper moneys of history. The middle class eventually gets wiped out because the value goes down. And the people who suffer the most aren't the people on Wall Street; the people who suffer the most are the middle class. They lose their jobs. They lose their houses.

And I just think that as well intended as this is, to have more regulations to protect the consumer with their financial products and their other services—maybe it will help a little, but if you don't address the subject of how the consumer is destroyed, it won't help.

Mexico has gone through this quite a few times with the destruction of currency. Who gets wiped out? The middle class. They are all holding pesos. The peso goes to the dogs. The middle class gets wiped out.

Now, and I have had correspondence and meetings with members of congress from Mexico, and now they have a savings account in Mexico where if you are frightened about the destruction of currency, you can actually go in and have a savings account in silver. That is—they are trying to help protect the consumer.

But here in this country, if you happen to want to use silver and gold as legal tender, you go to jail, even though the Constitution tells us exactly what to say.

So, ultimately, these—this process will work its way through the progress and there will be another consumer protection agency, but it is not going to do a whole lot until we address the subject of how do you protect the little guy, the middle class, by having honest money and not allowing the monetary system to inflate at will behind closed doors and to benefit special interests. This is what has been happening for a long time.

Some day, we are going to have a revelation and find out that when we open up the books and find out every agreement that was ever made between the Federal Reserve and Goldman Sachs and have it on the record, maybe then we will find out how we can protect the consumer and not have a system that protects all the wealthy on Wall Street as well as those individuals who happen to work for Goldman Sachs.

I yield back the balance of my time.

Chairman WATT. The gentleman yields back the balance of his time.

The gentleman from California, Mr. Sherman, a member of the subcommittee, is recognized for 3 minutes.

Mr. SHERMAN. The Federal Reserve is a very powerful government agency exercising government power. The proposal now is to give them a lot more power.

In a constitutional democracy we have one person, one vote. The executive branch is headed by the President and all important executive branch appointees are appointed by the President or appointed by the President's appointees.

There is one incredible and offensive exception. That is the Federal Reserve where, at the regional bank, a majority are selected and, ultimately, on the Federal Open Market Committee, perhaps the most important government agency we have, a majority of the power is in the hands of one bank, one vote. Or should I say, "one big bank, one big vote;" "one small bank, one small vote?"

This is an affront to the Constitution which will be exacerbated if we transfer more power to the Federal Reserve without mandating that all its Governors be appointees of those who are elected by the voters. It is a testament to the power of the banks that such incredible governmental power is invested in agencies where the voters don't decide who are the Governors. I realize the Federal Reserve Board of Governors is appointed, but those regional slots and the Open Market Committee are very important centers of government power.

Second, the ranking member on this committee has a bill which I have cosponsored to audit the Federal Reserve. It is absurd to have a government agency with this kind of power be the agency immune from such audits.

And finally, there is the idea of, where do we put consumer protection? Right now, we have a Federal Reserve where the banks choose the majority of those on the regional boards and on the Federal Open Market Committee, and then we are told that is the agency that will protect consumers from the banks. No other industry has that much power to select its regulators.

Finally, if the Fed is going to be the systemic risk regulator, we have to recognize that ripping off consumers is one way to ameliorate systemic risk because if you can double-cycle bill, you can get the banks a little bit more healthy, and maybe they will survive their stress tests. We can't put those responsible for the stress test on the one hand with the responsibility for protecting consumers on the other. And I don't care how healthy you can make the banks with credit card rip-offs, we ought to prevent those credit card rip-offs, we ought to prevent those credit card rip-offs because ripping off the consumer is not the best way to make the banks healthy.

I yield back.

Chairman WATT. The gentleman yields back the balance of his time.

The ranking member of the full committee, Mr. Bachus from Alabama, is recognized for 4 minutes.

Mr. BACHUS. I thank the chairman. I thank you for convening this hearing on consumer protection and the role of the Federal Reserve. And I would like to personally welcome Governor Elizabeth Duke.

I guess "welcome" is a good word. You are welcome. Obviously, you have a difficult task any time you face a subcommittee. And I am not sure who selected you as the one to come up here, but I think it was a very capable decision.

At one point in her distinguished career, she was the head of the community banking for one of our long-based Birmingham banks. And I thank you for being here.

As we heard in this morning's hearing, and it is likely to come out in this hearing, proponents of the Administration's proposal to create a Consumer Financial Protection Agency are contending that there was a massive failure in consumer protection on the part of the Federal Reserve, and that failure led to the collapse of the global economy. I think that is an oversimplification and unduly unjust criticism. And there is lots to criticize about the Fed's response to the growth and the collapse of the subprime mortgage market, as well as the agency's handling of the credit crisis and the turmoil in the financial markets.

In addition, we all agree that comprehensive reform of our financial regulatory system is needed. But I think it is, or should be, clear to all of us that last September, the challenges that the central bank faced were without precedent and that Chairman Bernanke and the Federal Reserve, in combination with the other regulators, the Administration, and the Congress acted with good intentions, and I believe averted a much more catastrophic economic collapse.

I am not sure this Congress and the people we represent fully realize that they did some very good work.

Both the Democrats' regulatory reform proposal and a plan we have put forth strips the Federal Reserve of its consumer protection mandate. And it does that although—with both the subprime lending regulations in 2007, and the credit card regulations of the Fed advanced in 2008 were very good. In fact, in a bipartisan way, both the chairman of the full committee and I as ranking member and most of the members complimented you on that work and, I think, had—I think they were very good.

The difference in the Republican plan is that it streamlines and consolidates the functions of the four bank regulators, including consumer protection, into a single umbrella agency; and this creates clear lines of accountability and prevents regulatory authorities from passing the buck.

In contrast, the Democrats' plan adds a massive new layer of bureaucracy with broad undefined and arbitrary powers to a brand-new agency with absolutely no experience. It is a plan that continues the kind of turf battles that undermine rather than promote effective consumer protection.

In closing, let me say that I understand that Governor Duke will be suggesting some other approaches and I think other approaches probably will carry the day, given the Fed's extensive regulatory expertise and their recent successes in this regard, we have a responsibility to carefully consider them and judge them on the merits.

Thank you, Mr. Chairman.

Chairman WATT. I thank the gentleman for his statement.

The gentleman from Texas, Mr. Green, is recognized for 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. And I do want to associate myself with some of the comments made by the ranking member of the full committee.

I appreciate what you said about averting the catastrophe that the country was facing and that we did some good here in Congress by working with the Fed and helping. I think that was important.

And I think that Mr. Bernanke has done a good job, an outstanding job, and I salute him for what he has done. He has been very much amiable and amicable in terms of working with the Congress, to the extent that he can without surrendering his autonomy, and I don't expect him to do this.

I think the Fed has an awesome task. Right now we are talking about systemic risk regulation. You currently deal with setting and executing monetary policy, and now we are looking at the possibility of adding consumer protection.

With reference to your consumer protection function currently, you deal with supervision and enforcement, complaint investigation, rule-making, consumer education, as well as community development.

You did promulgate some rules that were, I think, of benefit with reference to dealing with credit card practices; the rule that relates to the 45-day notice, I thought was of benefit; prohibiting double-cycle billing was beneficial; and I think that the way that you have put in place the allocation of payments with reference to interest rates, when the interest rates can vary, I think that is a benefit too.

But my concern is, candidly speaking, that these things are done in a reactive way. Congress was about to do something, and I think the Fed judiciously and prudently gave us a very good reaction to what was about to become congressional action. And I am concerned that we don't—we won't have a proactive entity if we have this in the hands of the Fed.

So I welcome your comments later to help me to understand better how this will become a proactive initiative, if you have it, as opposed to reactive.

I thank you, Mr. Chairman, and I yield back.

Chairman WATT. I thank the gentleman for his opening statement.

Without objection, all members' opening statements will be made a part of the record.

And now, I will proceed with the introduction of our witnesses. Our first witness, the only witness on this panel, is the Honorable Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System.

Without objection, of course, Ms. Duke, your written statement will be made a part of the record, and you will be recognized for a 5-minute summary of your testimony. There is a lighting system that you are very familiar with; you have been here before. When it goes to yellow, you will have 1 more minute; and then we will—I am pretty generous in trying to hear our witnesses, because I think that is more important than hearing ourselves sometimes. So we will give you a little slack if you run over.

So you are recognized for 5 minutes, and you may proceed with your testimony.

STATEMENT OF THE HONORABLE ELIZABETH A. DUKE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. DUKE. Thank you, Mr. Chairman. And I will try to be mindful of my time.

Chairman Watt, Ranking Member Paul, and members of the subcommittee, I appreciate the opportunity to appear today to discuss regulatory restructuring and the role of the Federal Reserve Board in consumer protection.

The members of the Federal Reserve Board are in strong agreement with the Administration that a fundamental lesson of the financial crisis is that we need to do a better job for consumers of financial products.

While arguments for consolidating consumer protection functions may be compelling, it is important to also consider the substantial opportunities presented by existing arrangements. In our view, the Federal Reserve has the resources and the experience to execute an ongoing, comprehensive program for effective consumer protection in financial services. Our team of seasoned professionals and specialists focus exclusively on the panoply of activities that, taken together, can most effectively protect consumers; however, their work is augmented by supplemental expertise in market research and supervision from within the Board and the 12 regional Reserve Banks.

We believe that replicating in another agency the full array of functions that support our consumer protection program would be enormously challenging. A report outlining our extensive program and recent actions is provided to my written testimony.

We also view consumer protection as complementary to, rather than in conflict with, the other functions of the Federal Reserve, such as prudential supervision and financial stability. These missions enforce one another. For example, sound underwriting benefits consumers as well as institutions, and strong consumer protections can add certainty to the markets and reduce risk to the financial system.

We have demonstrated, particularly in the recent years with which I am most familiar, our commitment and capacity to effectively execute our congressionally assigned consumer protection responsibilities. The Board is also concerned that removing consumer protection responsibilities from the Federal Reserve would weaken the consumer perspective that currently exists in our monetary and supervisory policy discussions.

It is appropriate and beneficial that the central bank has a mission that includes an analytical and nuanced understanding of developments in the consumer marketplace.

For these reasons, we stand ready to work with this subcommittee and others in Congress to help identify ways to further strengthen our consumer protection program institutionally.

As Congress considers regulatory reform, one option that might be considered would be to retain the Federal Reserve's consumer protection responsibilities and consider additional policies to strengthen and further reinforce our commitment going forward. Along these lines, I would like to offer some suggestions for how this could be accomplished.

First, we believe that enhanced accountability could be achieved by codifying or otherwise institutionalizing consumer protection as a core mission or responsibility for the Federal Reserve, just like monetary policy in bank supervisions. This would provide a clear and ongoing understanding that consumer protection matters are an integral part of the Federal Reserve's overall mission.

Second, Congress could require the Chairman of the Federal Reserve Board to annually report regarding the state of consumer protection, similar to the semiannual monetary policy reports to the Congress. Such reporting could include a comprehensive review of the Federal Reserve's actions taken to strengthen consumer protection, planned future actions to address potentially unfair and deceptive acts and practices, a review of enforcement actions, studies of consumer finances, availability of financial services, especially in underserved areas or other matters as requested by the Congress.

Third, we plan to conduct periodic sufficiency reviews of consumer regulations and policies. These reviews will consider emerging trends in consumer financial services, whether existing regulations are adequate for protecting consumers, and identify those areas in which new consumer protection measures are needed. We will develop a process that includes regular public hearings in Washington and regional locations around the country similar to the process required by the Credit Card Act of 2009. These findings and recommendations could then be reported to Congress as part of the annual testimony and report discussed previously.

Strong, timely and thoughtful consumer protection is critical for the economic health and vitality for our country. We at the Federal Reserve Board remain strongly committed to effectively protecting consumers, and we look forward to continuing to work with Congress on these critical issues.

Thank you, Mr. Chairman.

[The prepared statement of Governor Duke can be found on page 72 of the appendix.]

Chairman WATT. I thank you for your testimony.

And I now recognize the members for questioning and I recognize myself for 5 minutes.

Ms. Duke, I learn something new in this job every day; and reading your testimony, I learned something new. Both on page 2 and page 17 of your testimony, you indicate that consumer protection was never at the core mission statutorily of your agency. You say, correcting that would help you do consumer protection more. I mean, I am reading it here.

I thought you said we should codify consumer protection as a core mission along with our other responsibilities. On page 17, you say, "codify consumer protection as a core mission or responsibility"—"similar to monetary policy in banking supervision and regulation."

I didn't realize that consumer protection was dealt with differently than—certainly not banking supervision and regulation; maybe monetary policy, I recognize, is pretty carefully statutorily outlined.

Are you saying to me that the Fed has viewed this as a secondary role?

Ms. DUKE. The monetary policy targets that we have are in the statute. I think the reason that I would suggest that be put into statute, that this be codified, is that there is a perception, whether true or untrue, that consumer protection has taken a lower priority than some of the other functions of the Federal Reserve.

At times in our history—

Chairman WATT. I can certainly understand the perception, but according to this, it is a reality.

Is there something more explicit about banking supervision and regulation and the responsibilities the Fed has for that than there is about consumer protection?

Ms. DUKE. Mr. Chairman, since I have been with the Federal Reserve, it has been my observation that the three are all important in the Federal Reserve. However, over time, the codification of that would simply make it—we would ensure that it remains.

Chairman WATT. Would you argue with the notion that somebody in our government ought to show up every day with the prime responsibility for protecting or dealing with the issues of consumers in their financial matters?

Ms. DUKE. I wouldn't argue with that at all. In fact, I would hope there is more than one somebody.

Chairman WATT. Okay. All right.

Now, some of the people in the industry have said that if we leave part of this responsibility in the Fed and create this new consumer protection agency, that will lead to conflicts. And I think I started to understand that yesterday, so I am prepared maybe to move it all out of the Fed. That is one possibility of resolving conflicts. Or leave it all in the Fed.

But this is all over the place now: It is in the Fed; it is in OTC; it is in a number of different regulatory agencies. And while you have been pretty aggressive about saying that you think that the Fed can do it, I am wondering if you have the same level of confidence in the other regulators who are doing it. Or should we—are you saying that we should continue to leave consumer protection in the Fed, in the OTC, in the other regulators as an alternative for the new agency?

Ms. DUKE. I am assuming that your question refers to the examination responsibilities, the supervision responsibilities.

Chairman WATT. I am talking about protecting consumers, not the examination responsibilities. Do you have to examine an institution to protect consumers?

Ms. DUKE. There are actually two parts to the consumer protection. One part is the rule-writing and the other part is the inspection within the institutions to ensure that all of the rules are being followed.

So within the banks, within the banking industry, there are onsite examinations similar to prudential supervision examination, but focused entirely on consumer issues. So to the extent that there would be any conflict between the prudential supervision, the safety and soundness side and the consumer compliance side, as a matter of practice right now within the agencies, because of the day-to-day contact, those are usually resolved in the ordinary course of business.

Chairman WATT. I think that is another question that I have, but my time has run out and I don't want to abuse it.

I actually think this may be a panel that we do a second round of questions, so as not to put the other members at a disadvantage.

Let me proceed with recognizing the ranking member for 5 minutes for his questions.

Dr. PAUL. Thank you, Mr. Chairman.

And welcome, Governor Duke, to our hearing.

I find it rather fascinating that we are talking about where the regulations will go, whether it is going to be in the Fed or a new agency. From my viewpoint, I am not sure it makes a whole lot of difference. I think it is the principle of regulation, whether it will work or not.

But it is rather ironic that a lot of people are talking about putting them in the Fed with the amount of failure of the Federal Reserve and the amount of noncompliance or at least, an observation by the Congress, its inability to audit makes it sort of ironic that we might give the Federal Reserve even more power.

I am concerned about the history of regulation. We don't have a real good record that regulations prevent problems. We have had the SEC around for a long time, and the SEC didn't prevent Enron and so many other bankruptcies and big problems. Then, of course, when we had that failure, we had Sarbanes-Oxley and that hasn't prevented much either. We had a lot of housing regulations. It didn't prevent the housing bubble. It goes on and on.

A lot of people think, if you are not a strong endorser of all these regulations, therefore, you think it runs free and there is no regulation. But the regulations come differently; it comes through the marketplace. If you do badly, and you don't serve the consumer, you go bankrupt.

But when you prop-up policies that are bad, ultimately the consumer is hurt by these regulations because the market doesn't hold them in check, and I see that as a bigger problem.

The question is, though, do you think that with additional regulations, more rules and—it might not hurt the consumer in the sense that it is going to be difficult to come up with a new package for the consumer. People might just say, "To heck with gift cards and other things; I am not going to mess with this."

And then there is a cost; there is a cost always, and it is always borne by the consumer. Any time you have a regulation, you say, I am going to regulate the businessman, that is a fallacy. All regulations are a tax, and they are a tax that is passed on to consumers.

Could you address that, on how you can regulate without putting a tax on the consumer?

Ms. DUKE. I think all consumer regulation—and I frankly do think there needs to be some, that it needs to be informed by a deep understanding—an understanding of the market, an understanding of financial institutions, an understanding of the way financial markets operate and the way transactions operate—in order to avoid adding excessive costs; and that such regulations have to be done with an eye toward the availability of financial services.

So it is a balance between the quality and the quantity of financial services.

Dr. PAUL. Right now, there is a big grass-roots effort by consumers, who are saying that the Congress has not fulfilled its responsibility in knowing exactly what the Federal Reserve does—what kind of agreements they make with international banks, other governments, international financial organizations, what kinds of conversations they have had with companies like Goldman Sachs.

And because of this consumer concern, they have asked for more oversight of the Federal Reserve, and there are now 277 Members of Congress who think that should be the case.

Why do you think it would hurt consumers for us to know more about what the Federal Reserve is doing, which may well be hurting the consumer if we knew more about it? How can this information be harmful?

Ms. DUKE. Congressman, we are making quite a bit of information available now.

We have a weekly report of our balance sheet. We have a monthly report which is submitted to Congress. We have a great deal of information on our Web site. And we also are subject to quite a bit of GAO oversight.

The one place, the one exception to that oversight, is in monetary policy; and what research has shown with monetary policy is that the independence of monetary policy is important for expectations of—

Dr. PAUL. May I interrupt, because this bill would have nothing to do with monetary policy. They might find out what has been done, but it wouldn't interfere at all with monetary policy.

And I would beg to disagree. There is more than one issue. It is not monetary policy. If you look at the code, it exempts about five categories; one is, all relationships and transactions with foreign governments, foreign central banks, international financial institutions, private corporations. So those are exempt, too, and I think those are pretty important.

In a way, if the Federal Reserve can have an agreement with another government, that is like a treaty. And surely it isn't exactly what the founders intended when they wrote the Constitution.

I see my time has expired.

Chairman WATT. The gentleman's time has expired.

The gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. And I thank the witness, Ms. Duke, for appearing today.

It is an honor to have you with us, Ms. Duke. My concern has to do with what I called to your attention earlier about being proactive as opposed to reactive. And while I appreciate much of what was done in December of last year, it appeared to be reactive, and I am interested in how do you move from that level of engagement, such that you start to look for ways to protect the consumer, which is what I think most people assume that a consumer protection agency would do.

Let me just give you an example. My suspicion is that a consumer protection agency would have, or a consumer protector would have, looked at the yield spread premium, an undisclosed yield spread premium, and probably have concluded that there is something wrong this as it relates to the consumer, the one who actually received it.

And I said "undisclosed," wherein you qualify the buyer for 5 percent, and you don't tell the buyer that you qualified for 5 percent; and you give them a loan for 8 or 10 percent, and he or she never knows that he or she qualified for prime and was pushed into the subprime market.

How would you do this? How would you become proactive on an issue like this?

Ms. DUKE. I appreciate that question.

We have actually talked about this quite a bit and have recognized the need to be proactive, and I think, at least in recent years, have become quite proactive. The regulations that I appreciate you mentioning, the regulations governing both mortgages and credit cards that we recently passed are one example of that.

A second example that you may not be as much aware of is the review of disclosures that we have done, the review of disclosures under truth in lending, and we have finalized new disclosure rules for credit cards.

We will this week be unveiling new disclosures for mortgage loans, as well as home equity, which will address exactly the yield spread premium that you are talking about. As part of doing that, we have instituted consumer testing, and we have spent quite a bit of time testing disclosures with consumers to make sure we understand how they make decisions and what information is meaningful to them. And what we are finding is that, in some cases, there are some practices that you just plain can't explain with a disclosure, no matter how hard you try, and those are the practices we elect to prohibit.

Mr. GREEN. It seems to me—and I appreciate what you are doing. It seems to me that if we have this located in the Fed, the consumer protection agency, that you have a balance that you have to achieve and that is safety and soundness. You obviously always want to have that in mind and then you want to protect the consumer. I don't think that either agency should lean one way or the other, assuming that this consumer protection agency is separate and apart from the Fed.

I think it should be concerned about safety and soundness as well. But your perch tends to dictate what your view is. You can go to Mount Rushmore, and if you are standing on the wrong side, you won't see all of these pictures, these carvings of Presidents.

And if you are a consumer protection agent, it just seems to me that you would be more focused on the recipient and how the consumer will benefit than you will—than a person who is in banking and is concerned about the product. I think that concern about the product is what actually caused us to have problems with protecting the consumer.

So how do you reconcile this, if you have it?

Ms. DUKE. I understand what you are saying. And, frankly, a lot of these discussions talk about prudential supervision and the good of the institutions versus the consumers, if they are two different things. And that might have been a reasonable perception a couple of years ago.

Given what we have come through recently, I don't think anybody can argue that what is important, as far as consumers understanding the products they are buying, is absolutely important also for the workings of our economy in addition to the financial institutions; and that what is good for one is good for the others, and that each of those perspectives gives you another window into ferreting potential problems.

Mr. GREEN. My concern is that the enlightenment came after a certain degree of friction, if you will. And I think that a consumer protector being proactive would have picked up on some of these things a little bit sooner because that is the job of the consumer protector.

And my time is up, so I will have to yield back and wait for a second round.

Thank you, Mr. Chairman.

Chairman WATT. The gentleman from Alabama is recognized for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman.

Governor Duke, you noted in your written testimony, "We believe that replicating in another agency the deep expertise and full array of functions embedded within the Federal Reserve and used to support our consumer protection program would be enormously challenging."

Can you elaborate on that? What challenges do you think we would face in setting up a brand-new agency?

Ms. DUKE. Our Consumer Affairs Division draws frequently and deeply on the researcher, the economic researchers that we have. We do regular studies of 3-year—every 3 years a study of consumer finances. We have numerous studies going—on markets for consumer credit, on debt markets. We are closely entwined with the securitization markets and, in addition, all of the supervision people that we have.

So having all of that, those resources which are core competencies of the Federal Reserve, for the consumer protection group to draw on is something that I think informs their policymaking in a very positive way.

Mr. BACHUS. And that new agency wouldn't have that expertise or that resource?

Ms. DUKE. I believe that the proposal calls for the new agency to have research capability. But whether it would replicate the entire research capability of the Federal Reserve, I wouldn't think so.

Mr. BACHUS. All right.

You testified—and I think the chairman actually mentioned this—that the Federal Reserve views consumer protection as "complementary to, rather than in conflict with, other responsibilities at the Federal Reserve, such as prudential supervision and fostering financial stability." And, of course, those are both very important to consumers also.

And you say these missions reinforce each other, which—I think that is absolutely true.

What are the dangers of setting up another agency that may view consumer protection as a conflicting mandate with prudential supervision or safety and soundness, rather than a complementary one as the Fed does?

Ms. DUKE. I think probably those risks would have to do with inadvertently adding costs to consumer products through less familiarity, say, with the payment systems and the way those work, or the way the markets work, the way financial institutions are structured, and so mandating protections that are simply more expensive to comply with, or in some cases, that might cause financial institution providers not to offer the product and reduce availability.

Mr. BACHUS. Thank you.

Let me say this: I think you suggested two, I think, beneficial changes. I think this Congress, particularly if we leave consumer protection at the Fed and that codifies consumer protection as a core mission, I think that would be important.

And another thing you say is, "establish periodic reporting requirements for consumer protection similar to the Federal Reserve's semiannual monetary policy report." Of course, you do it twice a year, your Chairman comes before the Congress to talk about monetary policy. That is very helpful. And I think it would be invaluable in us overseeing—and you actually, the Federal Reserve, discharging its duties in consumer protection—to have a similar hearing once a year, or semiannually, to have a progress report on consumer protection and answer questions from the members because markets change, as you said in your statement or in the statement on the Fed's role in consumer protection. Markets change and products evolve. I think that would be an important reform that the Congress could make.

Thank you.

Chairman WATT. The gentleman yields back.

The gentleman from Missouri, Mr. Cleaver, is recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Governor Duke, thank you for being here. I represent the Fifth District of Missouri, primarily Kansas City, Missouri, and of course, we have a regional Federal Reserve office.

It is a cute building, too, incidentally. It is a brand-new building. Have you seen it yet?

Ms. DUKE. Yes, I have.

Mr. CLEAVER. Don't you think it is cute?

Thank you for—

Ms. DUKE. I have never discussed that subject, if a building is cute, but—

Mr. CLEAVER. It is.

The thing that strikes me about the regional office in Kansas City is that it is the center for all of the national complaints. The complaints that would occur in New Jersey end up being routed to the call center in our Federal Reserve office; and they report that there is about one complaint per bank per year, one complaint per bank per year, which would suggest, I think, that—that is a pretty good average.

I mean, that is unbelievable. Churches get more complaints than that on a Sunday. So I think that is pretty good.

And while I do agree that Sarbanes-Oxley didn't live up to what it was intended or certainly by those who promoted it, that the truth of the matter is, I think one of our problems is that we don't have an opportunity for people to understand what is going on.

I don't know—have you ever seen "Jaywalking?"

Ms. DUKE. Yes.

Mr. CLEAVER. Isn't it amazing, people can't tell you who the Vice President of the United States is? So how would they know, the people on the street, even know what the Federal Reserve is?

You start asking questions—I bet if they asked questions on the street, most people wouldn't have any idea what the Federal Reserve is. So most people I would think, and maybe you would agree, if they had a complaint against a bank, they wouldn't know where to take it. Would you agree?

Ms. DUKE. Yes.

Mr. CLEAVER. Now, stay with me.

Ms. DUKE. I am with you.

Mr. CLEAVER. Burger King—I used to be on the board; our goal was to always have free-standing Burger Kings as opposed to having them in buildings because our research showed that we did infinitely more business if we had free-standing Burger King stores. Are you still with me?

Ms. DUKE. I am still with you.

Mr. CLEAVER. Do you agree then that if we had a free-standing agency to handle consumer complaints that we might get more than one a year?

Ms. DUKE. Yes. I think if you consolidate the complaints and do a good job of publishing and publicizing the place to go with those complaints, you will get more complaints.

Mr. CLEAVER. Thank you.

Chairman WATT. The gentleman—I am going to give him a law license, I think, after the end of this hearing.

The gentleman from California is recognized for 5 minutes.

Mr. SHERMAN. I have a law license. I made sure they shredded it. I disclaim it.

Whenever I have a member of the Board of Governors here, and I don't think I have had a chance to examine you yet, I ask about just your personal legal interpretation of section 133. You will remember this is the code section that says that that in times of emergency and after proper consultation, the Fed can basically extend credit so long as it is secured.

And your Chairman has taken the position, what does that security mean? To him, it means the equivalent of AAA.

Do you agree with that?

Ms. DUKE. Yes, sir, and you have asked me that question before.

Mr. SHERMAN. As the chairman of the full committee says, duplication is often a very good thing.

I am concerned about form shopping, not just on prudential regulation, but consumer regulation. If we bring together all of the consumer regulation, then it doesn't matter whether you are subject to Fed regulation or not. You are going to have the same consumer regulation.

Do you think it makes sense to have the Fed provide borrower protection to those who borrow from, say, banks but then have a different consumer regulator define what it takes to protect consumers if they are borrowing from a nonbank?

Ms. DUKE. I think there are two pieces to that. One is the rules which should, and in most cases do, cover all lenders who are offering the same product.

The other piece, and the really important piece here, is the supervision—the level of supervision and enforcement, which has been uneven, and I think that is one of—

Mr. SHERMAN. Are you saying that the Fed has the power to turn to some guy in my District who offers a friend a mortgage, that you have regulatory power over the terms of that mortgage?

Ms. DUKE. We have power over the terms of the mortgage. We don't have the authority or the mandate to go in and examine whether or not the guy actually complied with the regulations.

Mr. SHERMAN. So Fed regulations apply even to the most private loans. If I loan money to my brother-in-law, I had better check Federal regulations?

Ms. DUKE. I am not a lawyer, and I cannot tell you that.

But they do apply to lenders generally—commercial lenders, bank and nonbank.

Mr. SHERMAN. Bank and nonbank.

Now there are those who say there would be a conflict if you had the safety and soundness regulator and the consumer protection regulator separated. And yet lenders today have to deal with IRS rules and they have to deal with environmental rules, they have to deal with State consumer regulation, they have to deal with prudential regulation, they have to deal with the FDIC. Somehow we work it all out.

Do you see it as somehow impossible for the prudential regulators to work—to avoid conflicts with the consumer regulator?

Ms. DUKE. I do not. And as a matter of fact, we do work it out with other regulators all the time.

Mr. SHERMAN. I would like to return to the governance issues I brought up in my opening statement.

How much power do the members of the regional Board of Governors have in dealing with consumer protection in prudential regulation?

Ms. DUKE. Very little. The regional boards are focused primarily on economic matters and the operation of the Reserve Banks themselves and not on supervision or consumer protection.

Mr. SHERMAN. Can you identify any harm there would be if we had, as Presidential appointees, all the members of the Board of Governors of all of the regional banks?

Ms. DUKE. I think that the system that we have with the separate Reserve Banks who are—who have separate boards of directors are important for our independence and monetary policy, that they perform a critical role in monetary policy.

Mr. SHERMAN. So you think it is critical that monetary policy be determined in large part by those voted on by bankers, rather than reflect the outcome of elections?

Ms. DUKE. It is not exactly that directly. And the number of votes on the Open Market Committee—there are seven for the governors and five voting members from the Reserve Banks.

Mr. SHERMAN. That is still an important number, 5 out of 12. And it is not like the meatball industry gets representation; it is not like the lawyers, the accountants or the shoemakers get representation. They are all affected by the Federal Open Market Committee as well.

And why bankers would have such tremendous power over government, over the most famous of all Federal Government decisions. There is nothing the Federal Government does that is watched more intently than the Federal Open Market Committee.

Ms. DUKE. Actually, two-thirds of the boards of each of the Reserve Banks are made up of members of industry, not from—

Mr. SHERMAN. So if you had—the industry dominates the regional; the regional has five-twelfths of the Open Market Committee, and that is not democracy.

Ms. DUKE. Not the banking industry, but from manufacturing, commerce, retail, labor, consumer.

Chairman WATT. The gentleman's time has expired. I announced earlier that we may go a second round if the gentleman is prepared to stay for that.

Mr. Ellison is recognized for 5 minutes.

Mr. ELLISON. Thank you, Mr. Chairman. And I also thank you, Governor Duke. It is good it see you again. I appreciate the time you have taken to help us understand the issues today and yesterday. It is a pleasure to see you here.

In your view, is consumer protection from the view of the Fed an equal partner to potential regulation?

Ms. DUKE. It is today.

Mr. ELLISON. How do you feel that we got to the point we are at now over the course of the last 8 years? Do you think it has been historically?

Ms. DUKE. I think when you look back, we absolutely could have and should have taken action earlier than we did. It is hard for me to determine why not. But what I can tell you is that in the time that I have been there, and actually when I arrived there, there is quite a bit of focus on both supervision and consumer protection.

Mr. ELLISON. Do other central banks around the world have consumer protection within their portfolio?

Ms. DUKE. It is not a typical central bank function. Although I would point out that after 40 years, we have quite a bit of institutional experience and knowledge and memory and that, as an overall matter, our consumer structure and availability in the United States is the envy of the world.

Mr. ELLISON. Yes. Thanks for talking about the Consumer Advisory Council in your testimony. I know they play an important role in advising the Board on consumer regulatory matters. But as I was looking at the membership of the committee, it sort of looked to me like there are a lot of people from the banking industry on the Consumer Advisory Council. Has that ever come to your attention?

Ms. DUKE. That is actually required by statute.

Mr. ELLISON. I see.

Now is there a similar board that advises the Fed on banking issues?

Ms. DUKE. There is also within the statute the Federal Advisory Commission which is made up entirely of the banks.

Mr. ELLISON. Are consumer advocates on that board?

Ms. DUKE. They are not.

Mr. ELLISON. The bankers have their own board and part of another one. That is a good deal.

Ms. DUKE. Again, it is statutory.

Mr. ELLISON. And I think it is important to point out that Congress had its own role to play in all of this. I think that is what it means when it is statutory.

Ms. DUKE. Excuse me. If I could, though, we do meet quite regularly with numerous consumer groups as well as industry groups in our boardroom with the entire Board.

Mr. ELLISON. Right. As I went through here, I looked for people who were bankers. There are some nonprofits. But if you look on—just from my look at what was printed on the Board's Web site the Consumer Advisory Council, it is at last half representation by the banking industry or credit score agency or real estate.

That is not a critique of you, Governor, it is just an observation. And I think it is something we need to look at when we talk about issues of governances. Issues around this have already been raised.

Let me kind of paint a scenario for you. Let's just say that banks are reaping a lot of their profits from, say, overdraft fees, and we have a safety and soundness regulator who says, great, you are making money, you have an income stream. And then you have a consumer regulator who says, that is a problem, this person had a 35-cent overdraft and has a $35 fee.

Now under the present system, that problem will be resolved. Somebody will, someone will make a decision and say the prudential matters are of greater importance than the consumer. Or it could happen the other way, although I doubt it. Isn't that true? Somebody right now is resolving these conflicts that could arise between the prudential regulation and consumer regulation. That is happening now; isn't that right?

Ms. DUKE. Well, if I could come back to, in particular, overdrafts. What we have found, again, particularly in the most recent crisis, the important thing—we talk a lot about the conflict, but there is also the benefit of having the consumer regulation inform safety and soundness and say this may be a short-term source of profitability, but it may not be a reliable long-term source of profitability, and to sound a warning on the prudential side that products that are not well understood and not used well by consumers can actually, as we have seen, come back and endanger the very institution itself.

Mr. ELLISON. And we could have joint examination even if the function were separated.

Ms. DUKE. Conceivably.

Mr. ELLISON. I guess my main point is that there has been some dialogue around the conflict, not raised by you but by members of our committee, and they seem to say there is a conflict and the bill doesn't clearly spell out what to do in the case of a conflict. But my point is, there already is a potential for a conflict and probably already have had those kind of conflicts resolved. But now there is just collapse within one entity, and the public really never knows how these things are resolved; is that right?

Ms. DUKE. There are possible conflicts. Although I think the complementarities are stronger even than the conflicts.

Mr. ELLISON. And would you agree that you could have complementarity even from agencies that are not under the same roof?

Ms. DUKE. Yes, I would.

Mr. ELLISON. I think that means I am done.

Chairman WATT. The gentleman's time has expired. We are at this juncture. I don't want to be unfair to the second panel, but I think there is some benefit to be gained by going at least some more with this witness.

I have a few more questions. So I am thinking that maybe if we did a second round of 3 minutes each, and if somebody really needed more than that, we can do it by unanimous consent. Would that be satisfactory to everybody?

In that case, I recognize myself for 3 minutes. And I start by acknowledging the testimony that you gave about the expertise that is on your staff at the Fed and let you know that Ms. Braunstein, who is sitting behind you, is one of my favorite people. So I recognize that there is substantial expertise at the Fed in the consumer and consumer outreach area, and I respect that.

The question I have is, though, I presume that expertise, whether it is Ms. Braunstein or members of her staff or others, could be transferred to a separate agency if they were not doing consumer protection inside the Fed; and perhaps do that with reference to all of the consumer regulation in this area as opposed to just for the Fed. Am I missing something here?

Ms. DUKE. I am not sure—first of all, I thank you for recognizing Ms. Braunstein and her staff, because they are outstanding.

Chairman WATT. I wouldn't think of doing otherwise.

Ms. DUKE. They are outstanding public servants and they bring not only knowledge and experience to the job, but a passion for consumer protection.

Chairman WATT. You have a reasonably good legislative affairs guy there too. I didn't want him to feel like he was being left out.

Ms. DUKE. I will use your time to praise all of our staff. But I think that one of the things to consider would be that in the rule-writing area in particular, that as good as they are, they might find it more difficult to write their rules without the support of the research staff, the market staff and the supervision staff.

Chairman WATT. All right.

Let me go to the real question, because I noticed the real complaint from the panel we had here from the industry yesterday was that there was this big conflict or potential for conflict if we created this agency. And I dealt with the part of the conflicts between consumer and consumer. I recognize that possibility exists.

I notice you didn't say anything in your testimony about the potential conflict that they kept talking to me about, that nobody was able to identify for me, the conflict that they have said exists between your prudential regulation and the consumer part. There is nothing in your testimony that I could identify.

Is there such a conflict between the consumer side of your operation and the regulatory or monetary policy side of your operation?

Ms. DUKE. There is probably—

Chairman WATT. Maybe just give me one example. I asked a witness this morning, on the panel that we had this morning, to give me one example of a potential conflict between consumer protection and regulation, and he wasn't able to do it.

I am just having trouble figuring out what that conflict is.

Ms. DUKE. There are probably conflicts in a number of different senses. I am trying to sort through them pretty quickly in my mind. There is a potential for conflict between agencies. Any time you have agencies—

Chairman WATT. I understand that. I am talking about policy conflicts. I am talking about policy conflicts between a consumer representative, whether it is in your agency or outside your agency, and the responsibilities you have as regulator of banks and/or monitor policy.

Ms. DUKE. There are a couple of different pieces. There is probably a perceived conflict between, for instance—

Chairman WATT. I am talking about real conflict.

Ms. DUKE. Well, a conflict in perception between a consumer protection proposal that might have the potential to increase cost or reduce availability. So you might have that weighing of those two considerations.

Chairman WATT. All right, okay. Let me go one step further. Suppose we just assumed that there is that conflict, and the consumer side of your operation says, this is a real problem for consumers; and the regulatory side of your operation says, this is a real problem for regulators. How does that get resolved? Who has the final word on that now? Is it the consumer's interest that is being driven or is it the bank's interest that is being driven?

Ms. DUKE. From the standpoint of within an agency or even between agencies, it is a policy balance and ultimately that is what a policymaker has to do, has to make the call balancing those two interests.

From an industry standpoint, if I could reach back into my industry days, I think what that might mean is if you have one set of regulators telling you one thing and another set of regulators telling you something else, the question of which one do you pay the most attention to, which possibly gives rise in a difference in intensity from one or the other.

Chairman WATT. All right, my time has run out, unfortunately, and I am well over the 3 minutes that I said I was going to try to hold people to.

The gentleman from Texas is recognized for 3 minutes.

Dr. PAUL. Thank you, Mr. Chairman. I want to follow up on my question about whether or not current Federal Reserve policy is fair to the consumer. I argue there is a real challenge to the consumer in two points. One, the consumer is always losing purchasing power, and only the Federal Reserve can undo the purchasing power of a dollar. And also the low interest rates which are artificial, because the Fed is involved in interest rates and it really hurts the innocent consumer.

As a matter of fact, the people who are more frugal, the people who borrow against mortgages, they don't care that much. But the frugal people who are doing what a lot of people think they should do, they get penalized. And I know the answer so often that comes back is—I always get the quotes back of what the CPI is doing, and there is really no inflation so don't worry about it. Inflation is a monetary issue and we just doubled the money supply in a short period of time. And I would also argue that prices are going up significantly in certain areas.

One thing characteristic about inflation, all prices don't go up uniformly. If they did and wages went up uniformly, inflation would be no problem. But we have educational costs, they go up disproportionately. Just think about how military equipment goes up and how the military industrial complex gets served with this system. And then also the people who participate in the financial bubbles, and if they are able to get out they benefit tremendously.

But also today in medicine, today we are facing this medicine crisis. Not that the care isn't there. We can get good care, but it costs too much. That is an inflationary problem as much as anything else, because those places where government gets involved, like these three things I mentioned, that is where the money goes and that is where the prices get pushed up. You don't get better service, because you don't get better education or medical care, you get higher prices.

So what is your defense of this position that the Fed isn't a very good protector of the consumer because it undermines the value of a dollar? We have lost 96 percent of the value of our dollar since the Fed has been in existence, and also this low interest rate issue that I bring up.

Ms. DUKE. We are conducting monetary policy to achieve our dual mandate, which is low inflation and steady prices and economic growth. And the inflation rate right now, the core consumer inflation is about 1.8 percent.

Dr. PAUL. According to government statistics, but not according to the consumers. Private sources say that the consumer price index is much higher than what the government reports. So it is in the interest of the government and the Federal Reserve to say that there is no erosion. But whether or not it is today or next year, we know the history.

But what justification is it? Doesn't this seem to be unfair? If you had a CD in the bank, or your parents had a CD in the bank and they were making 1 percent instead of 5 percent, is that fair or unfair?

Ms. DUKE. The interest rates are set and are managed, again, to meet our mandate. And right now rates are particularly low in order to support economic activity, particularly funds' availability to borrowers.

Dr. PAUL. I think the consumer loses on that deal. Thank you.

Chairman WATT. The gentleman's time has expired.

The gentleman from New York is recognized for 3 minutes. I am recognizing him for 3 minutes because we are on the second round of questions with an understanding that if people need more than 3 minutes, they can get it by unanimous consent. The gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman. And thank you, Ms. Duke.

Let me ask you, we had a panel here earlier before the full committee, and what I was trying to figure out and what a number of individuals are talking about is the fact that some are questioning whether the systemic risk regulator should be the Fed. The Fed has been—they have talked about giving the Fed a lot more jurisdiction, a lot more responsibility. And some are concerned about—and I think that based upon the White Paper that the President has put out, that there is going to be tremendous responsibility that is going to cause a lot more work.

Now we want to make sure, because we are looking forward to put some legislation that we think is going to take place and survive for 70, 80, 100 years. What is wrong with letting the Fed focus as a systemic risk regulator and doing what it has to do in maintaining this whole spectrum of responsibilities, and then having another agency whose primary focus is on consumer protection? It seems to me to make sense so that we are not overburdening the Fed. What is wrong with that?

Ms. DUKE. If the question is the overburdening of the Fed, the first thing I would say about the systemic risk responsibility that is in the proposal from the Administration is actually not an incrementally large increase in the activities we have today. The systemically important institutions, the vast majority of them were not necessarily bank holding companies last Fall, but through the crisis became bank holding companies. And I am not aware of very many institutions that would be considered systemically important that we don't supervise today.

I think the difference would be probably in the focus of that supervision which would look not just to the individual institutions themselves, but also to the impact of their activities across the financial system.

Mr. MEEKS. But the problem is that it seems no one picked up. We are in this crisis now. There is enough blame to go around. I am not blaming just the Fed. And no one seemed to pick up the problems that we were having, and the Fed is the one that is supposed to be the independent authority on monetary policy; now we get the systemic risk on top of that.

Then what concerns many individuals is the fact that the Fed had authority, for example, to issue rules implementing the Home Ownership and Equity Protection Act beginning in 1994, yet it chose not to do anything or issue any rules until 2008, which would be important to the consumer. Why is that? Can you explain that?

Ms. DUKE. Again, in hindsight, we could have and should have acted faster on that. Since that time, however, the Fed has been very proactive in the areas of regulations governing mortgages and credit cards, in consumer testing and issuing new consumer disclosures which would be much more helpful to consumers, and also in community outreach for foreclosure prevention and neighborhood stabilization.

I would say since learning that lesson, the Fed has been extremely proactive.

Mr. MEEKS. I see my time has expired.

Chairman WATT. Thank you. And I am squeezing people a little bit, because we do have to be out of the room by 4:30 and we have another panel. So be cognizant of that.

The gentleman from Alabama is recognized for 3 minutes.

Mr. BACHUS. Thank you.

Governor Duke, as I think someone else said, the Fed has had the right to regulate unfair and deceptive loans since, I guess, 1994. Is that correct?

Ms. DUKE. I think so.

Mr. BACHUS. Now it really took until 2007 or 2008 for them to do that; is that correct?

Ms. DUKE. 2008.

Mr. BACHUS. 2008? I think maybe if we had had something where you came up every year and explained your progress. On occasions members did write and say, what are you doing?

Let me ask you this. Even on the lending underwriting standards, I think at the same time or around that same period of time, you were given the jurisdiction on all loan underwriting standards; is that correct?

Ms. DUKE. I believe, and I am not certain on this, so if I get too deep into it, I may have to respond in writing. But I believe that we issued guidance to those institutions that we supervised on underwriting, but then afterwards when we came out with regulations, those regulations would have governed both bank and nonbank lenders.

Mr. BACHUS. You know, there was no going into the banks and examining anything. But I know the State charter banks were examined for underwriting standards. One thing I ran into when I was advocating for subprime lending legislation in 2005, I would talk to some of the banks, the big banks, bank holding companies, and they would say, we don't do these subprime loans. And I found out later that was somewhat half true in that they all had nonbank affiliates who were making those loans hand over fist. But I don't think that the Fed did any audits or supervision of those nonbank affiliates, did they?

Ms. DUKE. I think the authority to do that kind of examination was a little unclear under Gramm-Leach-Bliley. However, we did conduct a pilot program within the last year where we went into nonbank subsidiaries jointly with the FTC, with the OTS, with State regulators, and did full compliance exams on those. And as a result of what we learned there, we are going to continue those examinations.

Mr. BACHUS. Will you enforce the hope of regulations as well?

Ms. DUKE. We will enforce all consumer regulations.

Mr. BACHUS. Will that be just on subprime loans or—

Ms. DUKE. It will be on every kind of loan.

Mr. BACHUS. Thank you.

Chairman WATT. The gentleman's time has expired. The gentleman from California is recognized for 3 minutes.

Mr. SHERMAN. I want to return to the issue of governance at the regional board level. Who has the power to select those members at the regional level, not selected by the President? When I say this, I mean even if bankers are doing the selecting, but have to select a former union leader, that person is a bank selectee. You can always find a former union leader that will reflect the interest of those appointing. How are these slots filled? Who has the power to fill them?

Ms. DUKE. I assume you are talking about the Reserve Bank presidents?

Mr. SHERMAN. And their boards, yes.

Ms. DUKE. Let me back up. The boards of directors of the Reserve banks, there are nine members of the board of directors, A, B, and C directors. The A directors generally are officers or directors of banks and they are elected by the member banks.

Mr. SHERMAN. Okay.

Ms. DUKE. The B directors generally come from and there is a list of 6, and I am not sure I can name them all. It is commerce, manufacturing, labor, retail, agriculture—and I am missing one.

Mr. SHERMAN. All right.

Ms. DUKE. And those are elected by the banks. But that is where they come from, and they are not permitted to be affiliated with a bank.

Mr. SHERMAN. But you are free to find the retailer who is most bank-friendly and appoint that person, elect that person?

Ms. DUKE. In theory. But in practice, that is not the case. And I can actually send a breakdown of what they are. And the C directors are appointed by the Board of Governors, and again from that same group.

Mr. SHERMAN. You have two-thirds selected by the banks. They can't select bankers, but there are literally millions of people that they can turn to, and they just have to find a business person or whatever who meets their interest.

Trust me, if only bald people got to vote, but we had to vote for people with hair, there would be no taxes on bald people. We would find some—some would go get the Bosley thing and sneak in. But that is a little off point.

Now, our friend Mr. Paul has a bill to audit the Federal Reserve. Obviously I don't think there is anything in that bill that says that an audit means you have a stenographer at the Open Markets Committee, and that is immediately published. What is the problem with auditing such a powerful government agency the way other government agencies are audited?

Ms. DUKE. As I understand it, GAO does audit many parts of the Federal Reserve, and that there are 20-some audits underway right now. They have been specifically asked to audit the 13(3) facilities and to audit the specific loans to individual institutions. The concern with having them audit the open market, the FLMC operations, has to do with—as I understand the way those audits go, it is a review of policy decisions, and it would be some perception of a reduction in the independence with respect to policy.

Mr. SHERMAN. Why would you lose—

Chairman WATT. The gentleman's time has expired.

The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, I was so impressed with the questioning of the gentleman next to me, I would like to ask the Chair for some guidance. Do I refer to him henceforth as Reverend, or Doctor, or Attorney, or Reverend Doctor Attorney?

Chairman WATT. I think the latter would be appropriate.

Mr. GREEN. Attorney Doctor. But I do appreciate his questions and I would like to do a quick follow-up. I thought it was a fantastic point that you make.

Quick follow-up, with reference to the complaints that you receive, how many complaints have actually gone from complaint to a case that was referred to the Justice Department with reference to your mission to deal with patterns on practices of discrimination?

Ms. DUKE. In terms of numbers of complaints received or otherwise, I would have to get back to you in writing on that. I do know that we investigate every complaint that we receive on our member banks that we actually supervise. And with respect to referrals to the Justice Department, they primarily come from reviews of fair lending in the institutions. And to the extent that we find discrimination, we do refer those to the Department of Justice.

Mr. GREEN. Have you had occasion to have any bank, as a result of the Justice Department's action, respond and take corrective action?

Ms. DUKE. I believe so. But if I could follow up in writing with specifics.

Mr. GREEN. Okay.

The reason I am asking is because every survey indicates that African Americans, minorities who apply for loans, are less likely to get the same treatment as equally qualified persons who are not minorities. And I am concerned that, given the history of this, and the lack of what I see as affirmative action to correct it, what will happen if we leave it there? It seems to me that a consumer protection agency would probably look at these things a little bit closer and see it as a greater mission than it has been accorded where it is currently.

Ms. DUKE. I would just say that our examiners take this very seriously. And there really are two parts to the examination process. Sometimes they may find a practice that is not in itself discrimination but looks suspect or looks dangerous, and they will talk with the bank and maybe take informal action to get that practice stopped. In those cases, the practice does stop. In cases where either that is not an option or the practice does not stop, those cases are referred to Justice.

Mr. GREEN. Thank you, Mr. Chairman. I will yield the balance of my time to the attorney from Missouri.

Chairman WATT. The gentleman from Missouri.

Mr. CLEAVER. No questions, Mr. Chairman.

Chairman WATT. The gentleman from Minnesota, then, is recognized for 3 minutes.

Mr. ELLISON. Thank you again for your patience, Governor. You have been great this afternoon.

You know, I read an article which says that banks and credit unions collect about $17.5 billion, with a "B" in overdraft fees per year. How does this overdraft issue play in terms of the safety and soundness of banks? Is it, I guess, a good thing from their perspective, because it is a stream of income; or does it indicate something we should be concerned about?

Ms. DUKE. It is a stream of income. However, there are also some issues with overdraft protection or with overdraft fees. We have actually already published, for comment, rules governing overdrafts. Those rules have both an opt-in and an opt-out alternative, and we are now testing disclosures of those alternatives. And we will issue some final rules this year. And so to the extent that banks are overly reliant on overdraft income, that would in the short term. That would be a risk in the long term.

Mr. ELLISON. I am speaking only from a prudential regulator standpoint. What sort of things might a regulator who might go to a particular individual bank, who sees that a significant portion of their profitability based on these overdraft fees—what does that conversation kind of go like, if you understand what I am saying? Is it like you are relying on us too much or you need to develop other products? Because I would imagine a safety and soundness conversation going like this: You have to have more capital, you have to develop more ways to have income streams.

And so I was curious to know, how does the regulator approach the bank if they are excessively relying on overdraft fees?

Ms. DUKE. I am not quite sure with respect to the overdraft fees. But if I could, let me go to a different example. And that would be: Suppose you had an institution that was generating very strong fees from the origination and sale of subprime mortgages. Then certainly the fact it has the income stream is one possibility. But one risk is that if something should go wrong in that marketplace, that that revenue source will dry up. So I think from the prudential side, you would look for—

Mr. ELLISON. In your example, the prudential issues are clear because it represents the possibility of default, right? But not with overdraft fees. This is a just a stream of income. They are not going to default by having too many overdraft fees. But it is just them getting money from a consumer, that I think most people, if you bring specific examples forward, would say the consumer is getting taken advantage of here. And yet the only person whom I think is really going to raise a stink is someone who has a view of the consumer in mind.

So I am just curious to know—I guess we have been beating this horse pretty thoroughly—but I am still curious to know. I think that these two points of view are somewhat in conflict. I think that is a good thing.

Ms. DUKE. To your point, though, it was the Consumer Affairs Division that actually has initiated and completed the rulemaking proposal on overdrafts this year.

Mr. ELLISON. Thirty seconds? I just want to say for anyone who is interested in getting comments to the Fed about this overdraft issue, they have to get their comments there by July 18th. So, if anybody is interested.

Chairman WATT. The gentleman's time has expired. The gentlelady from Florida, Ms. Kosmas.

Ms. KOSMAS. I don't have any questions.

Chairman WATT. In that case, the Chair notes that some members may have additional questions for this witness that they may wish to submit in writing. It seems like there are a number of questions still outstanding here.

Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place her responses in the record.

We thank you so much, Governor Duke, for being with us this afternoon. And we thank your trusted people, whom we have praised behind you, for being with us. And you are excused, and the second panel is officially requested to come forward.

While the witnesses are coming forward I ask unanimous consent that an article from USA Today entitled, "Banks raise penalty fees for customers' overdrafts" be submitted for the record. That is the article that Mr. Ellison has requested be submitted. Without objection, it is so ordered.

Now I will introduce briefly the witnesses on the second panel. The first witness is Ms. Patricia McCoy. She is the director of the Insurance Law Center, and the George J. and Helen M. England Professor of Law at University of Connecticut School of Law.

Our second witness on this panel is Ms. Lauren Saunders, managing attorney at the National Consumer Law Center.

And our third witness on this panel is Mr. Jim Carr, the chief operating officer at the National Community Reinvestment Coalition.

We had a fourth witness, but he turned out to be on the earlier panel, at a hearing earlier today, and I think he had heard enough from me for one day, so he decided he wouldn't come for this one.

Each of you will be recognized for 5 minutes. Your full written statements and any supporting materials, of course, will be made a part of the record. And we would ask you to summarize your testimony in approximately 5 minutes. There is a lighting system in front of you there. The green light stays on for 4 minutes, the yellow light comes on for 1 minute, and the red light means you have hit 5 minutes. We are not religious about that in my subcommittee, but we do ask you to stay reasonably close to that

Ms. McCoy, Professor McCoy, you are recognized for your testimony.

STATEMENT OF PATRICIA A. McCOY, DIRECTOR, INSURANCE LAW CENTER, AND GEORGE J. AND HELEN M. ENGLAND PROFESSOR OF LAW, UNIVERSITY OF CONNECTICUT SCHOOL OF LAW

Ms. MCCOY. Chairman Watt, Ranking Member Paul—

Chairman WATT. Press that button and pull it close to you.

Ms. MCCOY. Chairman Watt, Ranking Member Paul, and members of the subcommittee, thank you for inviting me here today to discuss restructuring financial regulation. Today I will testify in support of the Consumer Financial Protection Agency Act of 2009.

This bill would transfer consumer protection and financial services from Federal banking regulators to one agency dedicated to consumer protection. We need this to fix two problems: first, during the housing bubble, fragmented regulation encouraged lenders to shop for the easiest regulators and laws; and second, banking regulators often dismiss consumer protection in favor of the short-term profitability of banks.

Under our fragmented system of credit regulation, lenders could and did shop for the easiest laws and regulators. One set of laws applies to federally chartered banks and thrifts and their operating subsidiaries. Another set of laws applies to independent nonbank lenders and mortgage brokers.

Because lenders could threaten to change charters, they were able to play regulators off one another. This put pressure on regulators, both State and Federal, to relax their standards and enforcement.

Countrywide, for example, turned in its charters in early 2007 in order to drop the OCC and Federal Reserve regulators and to switch to the OTS. The result was a regulatory race to the bottom that only the Fed had the power to stop.

During the housing bubble, three of the four Federal banking regulators—the Federal Reserve, the OCC, and the OTS—succumbed to pressure to loosen loan underwriting standards and safeguards for consumers.

Today I will focus on the Fed. Under Chairman Alan Greenspan, the Federal Reserve Board failed to stop the mortgage crisis in thee crucial ways:

First, the Federal Reserve was the only agency that could have stopped the race to the bottom. That was because it had the ability to prohibit unfair and deceptive lending for all lenders nationwide under the Home Ownership Equity Protection Act. But Chairman Greenspan refused to exercise that authority. The Fed did not change its mind until last summer when it finally issued such a rule. At that point, the horse was out of the barn.

Second, the Fed as a matter of policy did not do regular examinations of the nonbank subprime lenders under its jurisdiction. These included the biggest subprime lender in 2006, HSBC Finance, and Countrywide ranked number three.

Finally, the last time the Fed did a major overhaul of its Truth in Lending Act mortgage disclosures was 28 years ago, in 1981. With the rise in subprime loans and nontraditional ARMs, those disclosures became solely obsolete. Nevertheless, the Fed did not even open a full review of its mortgage disclosure rules until 2007, and it still has not completed that review.

So why did the Federal Reserve drop the ball? One reason was its overriding belief in deregulation. Another, however, was an attitude that a good way to improve bank safety and soundness was to bolster fee income at banks. We still see that today with respect to rate hikes with credit cards still going on.

This focus on short-term profits not only hurt consumers, it undermined our Nation's financial system. The Act would fix these problems in three ways: first, it would stop shopping by providing one set of consumer protection rules for all providers nationwide; second, the Act puts the authority for administering those standards in one Federal agency whose sole mission is consumer protection. We are asking the Fed to do too much when we ask it to excel at four things: monetary policy; systemic risk regulation; bank safety and soundness; and consumer protection.

Housing consumer protection in a separate agency in fact will provide a healthy check on the tendency of Federal banking regulators to underestimate risk at the top of the business cycle.

Finally, to avoid any risk of future inaction by the new agency, the Act gives backup enforcement authority to the Fed and other Federal banking regulators in the States.

My time is up. Thank you and I will welcome any questions.

[The prepared statement of Professor McCoy can be found on page 161 of the appendix.]

Chairman WATT. Thank you so much.

Ms. Saunders, you are recognized for 5 minutes.

STATEMENT OF LAUREN K. SAUNDERS, MANAGING ATTORNEY, NATIONAL CONSUMER LAW CENTER, ON BEHALF OF AMERICANS FOR FINANCIAL REFORM

Ms. SAUNDERS. Thank you, Chairman Watt, Ranking Member Paul, and members of the subcommittee. Thank you for the opportunity to testify today on behalf of Americans for Financial Reform and many of its individual organizational members. We believe that better consumer protection demands more than modest changes to the existing structure. The structure itself is the problem.

I am Lauren Saunders with the National Consumer Law Center. We at the National Consumer Law Center have a long and deep history of working with the banking agencies. We publish an 18-volume set of consumer law treatises, write hundreds of pages of comments every year on proposed regulations, and have participated on the Fed's Consumer Advisory Council and have otherwise interacted regularly with the banking agencies for decades.

We have found the Fed staff and the Governors to be intelligent, knowledgeable, and respectful of our views. One of the strengths of the proposal to create the new agency is that it will consolidate entire divisions and will retain their experience and knowledge.

There have been successes over the years, but as Congressman Green pointed out, they have tended more to be reactive than proactive measures. At the end of the day, in example after example described in my written testimony, at the Fed and the other agencies, consumers have usually come up short, trumped by an excessive faith in the free market, an overreliance on more disclosures, and an antipathy to taking measures opposed by industry.

This is ironic because listening seriously to consumer concerns can help bolster safety and soundness. It was consumer advocates who pointed out that credit card debt was wreaking havoc on family finances and was unsustainable. It was the consumer advocates, not the banking agencies, who complained repeatedly about mortgages that people could not afford to pay, again and again, year in and year out, and nobody was listening. It is just one of many similar warnings. In 2003, a New York attorney, Ruhi Maker, vented her frustration at the Fed's Consumer Advisory Council: "Consumer advocates are from Mars and bankers are from Venus. I sometimes feel that way. There are parts of the country where I really feel it is going to be a nightmare." This was in 2003.

"I think the horse is out the barn door and, you know, I hope I am wrong, I really hope I am wrong, but I think it's in the interest of the financial institutions to figure out how to fix this problem which some unregulated institutions created, but which then the financial institutions went and purchased." But those concerns and many like them year in, year out went unheeded.

Mars and Venus, men and women, consumers and bankers. We think about things differently. We focus on different problems.

As former Federal Governor Mishkin testified last week in saying he believed the Fed should give up its role as the consumer protection regulator, "The skills and mind-set required to operate as a consumer protection regulator are fundamentally different from those required by a systemic regulator." I would say the same is also true of the mind-set of a prudential regulator. Precisely because consumer protection is complementary to safety and soundness, we need a new agency that will focus on the individual, asking questions from their perspective, about whether products are fair and contribute to or harm family financial stability. It will spot problems early, before they present safety and soundness concerns for an entire portfolio or an entire institution.

The balanced proposal for a consumer financial protection agency ensures that the agency will consider real safety and soundness concerns.

First, and most importantly, one of the five commissioners will be a prudential regulator. That commissioner, present at the creation, will ensure that prudential concerns are integrated into the fabric of the agency's work.

Second, the agency has a statutory mandate to coordinate with the banking agencies. Not every disagreement is a serious conflict, but the agency will have every reason to listen to legitimate prudential concerns like fraud, money laundering, or operational issues.

Third, the proposal requires the Consumer Financial Protection Agency and banking agencies to share confidential examination materials so that each can see the concerns that have been raised from the other's perspective.

Finally, Congress will be exercising oversight. With the history of the Federal Trade Commission in mind, and a prudential regulator on the board, the agency will do everything in its power to minimize conflicts.

Change is always difficult. There are always reasons for tinkering and not making important structural changes. Our coalition firmly believes that we will all be better off with a system that takes consumer protection seriously, that listens fully to both Mars and Venus.

Thank you for this opportunity to testify and I welcome your questions.

[The prepared statement of Ms. Saunders can be found on page 183 of the appendix.]

Chairman WATT. Thank you for your testimony, Ms. Saunders.

Mr. Carr, you are recognized for 5 minutes.

STATEMENT OF JAMES H. CARR, CHIEF OPERATING OFFICER, NATIONAL COMMUNITY REINVESTMENT COALITION (NCRC)

Mr. CARR. Good afternoon, Chairman Watt, Ranking Member Paul, and other distinguished members of the subcommittee. My name is James H. Carr, National Community Reinvestment Coalition. On behalf of the Coalition, I am honored to speak with you today.

NCRC is an organization of more than 600 community-based associations that promote access to basic financial services across the country for working families. NCRC is also pleased to be a member of the new coalition, Americans for Financial Reform, that is working to cultivate integrity and accountability within the financial system.

Members of the committee, the collapse of the U.S. financial system represents a massive failure of financial regulation that suffered from a host of problems, including regulatory system design flaws, gaps in oversight, conflicts of interest, weaknesses in enforcement, failed philosophical perspectives on the self-regulatory functioning of the markets, and inadequate resolution authority to deal with problems after they have occurred.

At the request of the committee, I will devote my time today to one issue, and that is consumer protection. Safety and soundness and consumer protection are often discussed as separate issues, yet the safety and soundness of the financial system begins with and relies on the safety and soundness of the products that are extended to the public.

If the extension of credit by a financial firm promotes the economic wellbeing and financial security of the consumer, the system is at reduced risk of failure. If the financial products exploit consumers, even if they are highly profitable to financial institutions, the system is in jeopardy of failure.

Unfortunately, for more than a decade, financial institutions have increasingly engaged in practices intended to mislead, confuse, or otherwise limit a consumer's ability to judge the appropriateness of financial products offered in the market and make informed decisions. In fact, the proliferation of unfair and deceptive mortgage products led directly to the current foreclosue crisis and massive destruction of U.S. household wealth, which currently stands at about $13 trillion.

The tricks and traps, as it has been described by Elizabeth Warren, used to trap consumers into high-cost abusive financial products, greatly complicated if not impaired the ability of a consumer to make an informed financial decision about the most appropriate product for their financial circumstances.

Nowhere was this irresponsible and reckless behavior by financial institutions more prevalent than in communities of color. For more than a decade, Federal agencies, independent research institutes, and nonprofit organizations have described and discussed the multiple ways in which people of color have been exploited financially within the mortgage market.

The result today, the foreclosure crisis is having its most damaging impact on communities of color in two ways: first, people of color are experiencing a disproportionate level of foreclosures; and second, they are most negatively harmed by rising unemployment.

The Obama Administration recently proposed a sweeping reform of the financial system. A core element of the President's plan is the establishment of the Consumer Financial Protection Agency. House Financial Services Chairman Frank has proposed a similar agency in his legislation, H.R. 3126. A consumer protection agency is long overdue.

Currently, the financial regulatory agencies compete with one another for fees paid by institutions that they are entrusted to regulate. The winning bid is the regulator that promises the least amount of consumer protection.

Although competition is an essential element in a free market, oversight and enforcement of the law is not, nor should it be, available for purchase in a free market. In fact, regulation is one of the few instances in which a monopoly market will result in the most efficient and desired result. A consumer financial agency, as outlined by both the President and the Chairman, would achieve a commonsense goal, and that is to provide standard products to eliminate unnecessary confusion for consumers on routine transactions.

The concept of a standard product seems to be an anathema to some observers, but it is worth remembering that a 30-year fixed rate mortgage has been for more than half a century, and remains today, the gold standard loan product. It was created to help the Nation recover from the collapse of the previous major fall of the housing and credit markets during the Great Depression. In short, sometimes a good standard is the best innovation.

In order to be most effective, the new consumer financial protection agency must examine lending at a community level as well. Highly segregated communities of color are the primary targets for unfair, deceptive, and predatory lending. As a result, the agency must have the knowledge, experience, and resources to address this critical reality.

Moreover, prohibiting reckless and irresponsible products is only half the challenge in making sure there is equal access to reliable financial services. Many financial firms simply deny access to financial services completely. America has a long, unfortunate history of redlining.

The Act that most significantly can address that issue at a community level is the Community Reinvestment Act. That law was included in the consumer protection agency proposed by the President, and we recommend that it be included in the bill that is being considered by this House.

In conclusion, there has and will continue to be considerable pushback against the idea of a consumer financial protection agency, primarily from financial institutions. Their argument is that such an agency will stifle innovation, limit access to credit, and discourage lending to families most in need.

These arguments should be considered as having the same merit as the declaration that the markets are self-regulating. We have seen the folly of self-regulated markets, and the American people are paying an extraordinary price for failed consumer protection.

Thank you very much. I look forward to your questions.

[The prepared statement of Mr. Carr can be found on page 48 of the appendix.]

Chairman WATT. Thank you so much for all of your testimony.

And we will now go to questioning by the members. It is my policy to go last on the last panel, since I have to be here anyway. So with that in mind—before I do that, though, I did want to commend to the members' attention the historical analysis that Professor McCoy has done. You would do well to read her entire testimony, not just the 5 minutes that she abbreviated here. It is about the best analysis of how we got here that I have seen floating around.

So the gentleman from New York, Mr. Meeks, is recognized for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman, and thank you for your testimony here today.

You know, my district in New York is the number one in foreclosures in the City of New York. I am noticing a certain trend, and I am wondering if you can tell me your opinion on this and whether a consumer agency would be able to intersect.

Here is what I am finding: number one, that individuals who have taken out mortgages—and some of the financial institutions had skin in the game, they didn't just take it and securitize it away—that those individuals' incomes and the credit they received seemed to match more or less the mortgages that they were receiving. Those who went to mortgage brokers or some others and their incomes did not match, those were simply sold away, because they weren't going to keep them, so it didn't matter.

And so there are two things that are happening. Either individuals are now in upside-down mortgages, and the banks are not refinancing them; or they just simply—if they had adjustable rates, and they adjusted, they can't afford them and they are thrown out of their homes.

So what I am concerned with in your vision when we move forward with a consumer financial protection agency, that this would be an area of which they could specialize and look in to see if, in fact—or tracking, if you will—to see if in fact there is a pattern.

I mean, for years we have been talking here about predatory lending. And there has been no one that I know of that we could go to, to focus on, to stop predatory lending. I can recall on this committee we could go—we would be talking time after time after time to a person, at the person, but yet no result.

So in your mind's eye, would a consumer financial protection agency also be an adequate agency to look at issues such as predatory lending and put an end to it?

That would be my first question.

Ms. MCCOY. It would be a very important piece of the puzzle.

What we need to stop is this two-tier system where the sensible loans are the ones held in portfolio and the reckless, dangerous loans are the ones sold through securitization. Having one uniform standard for all loans, whether they are securitized or not, would definitely help that problem. But here the bank regulators would continue to have a role even if the agency is created, because the bank regulators can make sure that banks are not rewarded with lower capital requirements for securitizing bad loans. So they can partially buttress safety through capital treatment, and they should.

Mr. CARR. I would agree with that.

I would add, however, that the first step in enforcement is actually knowing there is a problem. And one of the great opportunities of this new agency is to have a staff steeped in the ability and understanding of consumer issues such that they can examine the trends and practices, and patterns and practices, to bring forth really powerful studies with a Federal imprimatur.

Mr. MEEKS. Before I run out of time, refute this argument for me. Some have said that with the agency, we would need to look at a vanilla product, we would have to put 20 to 25 percent down; and as a result, I know, therefore the availability of credit, and particularly in minority communities, to own a home—which I still believe is the way we create wealth—would become smaller and thereby the gap between the haves and have-nots would become greater.

How would you answer that?

Mr. CARR. It is a frivolous argument, the idea that somehow every single consumer is different from one another.

There is a difference to offering one product to every single consumer in the market as opposed to having standard products that are based on individuals' income, their wealth, and certain other types of financial circumstances to create classes of standard products.

And one can be very nimble, very innovative, with standard products. In fact, there are a lot of them that actually exist. The problem was they could not compete with the reckless subprime loans that were actually priced at a much higher premium by the investment banks.

So the idea that somehow you lose innovation because you introduce standards is a frivolous argument.

Chairman WATT. The gentleman's time has expired. The gentleman from Texas is recognized for 5 minutes.

Dr. PAUL. I thank you, Mr. Chairman. I have a question for Mr. Carr on how optimistic he might be about what we are trying to do.

I tend toward pessimism at times; and I think the problem is almost bigger than what we are dealing with here, and we are just dealing on the edge of the basic problem. So the system that we have had has been around a long time. We have had a system—some people refer to it as capitalism that was unregulated.

I happen to think that it doesn't have much to do with capitalism; it has to do with corporatism, where corporations seem to get the benefits of some of the programs that are designed to help the poor. We have multiple programs that have been going on for a long time designed to help the poor, and yet sometimes I think that is so superficial. The poor seem to become more numerous and the poor—especially since the crisis has hit; but it is always on a pretense to help the poor, and yet the corporations stand to make the money.

So they make the money and they have the power and they have the insight with some of our financial institutions, including the Federal Reserve; and when the bubble forms, they benefit, and nobody complains too much if it seems to satisfy a lot of people.

But when the bust comes, then we have a bailout. Who does the bailout serve? Do we immediately go out and bail out the people that we tried to get houses for? No. We immediately go out and bail out the system. So—the system is so deeply flawed, so they make the money when the bubble is being formed and they get bailed out when the bubble bursts.

We come along with a new system that we hope will work. But for housing programs, for instance, you know, we want houses for the poor people, but developers make a lot of money, builders make a lot of money, mortgage companies make a lot of money, the banks make a lot of money. And all of a sudden the system doesn't work very well and the poor get wiped out and they lose their houses.

So if we don't address that major problem, the structure of the system, this corporatism which has invaded us, how can this idea that, well, we will regulate a little bit in order to protect the consumer—I guess I am rather cynical, and I want you to tell me whether you share any of that concern, whether my cynicism sometimes is justified or not.

Mr. CARR. Congressman, I appreciate the question because I agree with much of what you have just said.

One of the problems that we have in this country is that we have the financial system operating on one side of the ledger and we have special programs for the poor on the other. The way the poor became solid middle class in this country was by having a financial system that built their wealth and public policies working with that financial system, coming largely out of the Great Depression, that built the vast majority of our middle class.

We do not have that now. Instead, we have a banking system that looks at consumers and says, how can we exploit them? And that is problematic, and until we change that system such that when a bank and our financial institution is reaching to a consumer specifically to promote the economic mobility of that consumer and build their wealth—if that is not their goal, if that is not what is going to be accomplished by their product, the poor will remain poor and all the Federal subsidies in the world won't help them.

That is why it is so critical to put into place an agency that actually combines the knowledge, the collective wisdom of people who actually understand the banking system, the financial system, and understand it is their mission to promote the economic mobility of this country. Because once they are working together, there will be no conflicts of promoting wealth and stability within working families, with safety and soundness of the financial system.

And then, Congressman, the other programs that you have talked about, that have failed so miserably so often, those programs will now have a foundation by which they can actually enhance what is happening. But if the markets don't work for the general public, poverty will never be resolved.

Dr. PAUL. One other quick question. Would you have any objection, personally, to us knowing what is going on at the Federal Reserve and have an audit of the Federal Reserve?

Mr. CARR. I am not familiar with the Federal Reserve's audit.

Dr. PAUL. I am finished. I yield back.

Chairman WATT. The gentleman's time has expired.

The gentleman from Texas, Mr. Green, is recognized.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing.

I have a question with reference to the Fed continuing to perform the function of consumer protection. And I would like for each of you to give me a reason why the Fed should not—this consumer protection agency should not be in the Fed. And I would like for you to discount—it is exceedingly important that you do this—discount past performance. Do not let that be your reason, discounting past performance.

Why would we not want the Fed to have custody, care, and control of this agency? Ms. McCoy, we will start with you.

Ms. MCCOY. Thank you, Congressman Green.

The reason why the Fed would not do as good a job as the agency is that it approaches safety and soundness issues, which is one of its core concerns, through the vantage point of banks. It is concerned about their solvency. The banks, in turn, report quarterly profits, and that tends to produce a short-term vantage that the Federal Reserve often shares.

And that is true not only for the Federal Reserve. It is true for the Comptroller of the Currency and the Office of Thrift Supervision. And this is a structural and cultural mind-set that will not change.

Mr. GREEN. Thank you.

Ms. Saunders?

Ms. SAUNDERS. I was basically going to say the same thing. I think the questioning here today has pointed out how many people coming from consumer organizations sit on the Board of Governors, have ever sat on the Board of Governors, even have had a significant role on the Consumer Advisory Council.

I actually drafted a section of my testimony focused on the CAC and how it promotes industry views more than consumers'. It just pervades the agency. Whether we add the words "consumer protection" to the line in the statute or not, it is always going to be a small part of the overall function of the Federal Reserve, and it is so dominated by bankers and focused on banking and those concerns that it is going to look at things from that perspective and miss important questions if you look at it—focus solely on the consumer.

Mr. GREEN. Mr. Carr?

Mr. CARR. I would just reinforce the past two comments, that it is just a structure that does not and will not work. In fact, you said, without looking in hindsight or retrospectively, it is really hard to do that.

You just asked a question right in the depths of the greatest recession we have had in a half century. We know that much of the damage was brought to Black and Latino communities. How many civil rights actions are currently active by the Fed? And the answer was, we are not sure.

I can't look backward, but can I look back just an hour?

I think we need an agency that understands that economic opportunity and economic mobility is imperative for this country; and that if you can't respond to that in the depth of this crisis, how can you be given the mantle to make sure that those rights are ensured?

Mr. GREEN. Thank you, Mr. Chairman. I yield back.

Chairman WATT. I thank the gentleman.

The gentleman from Missouri is recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. It won't take the entire 5 minutes.

This is for the three of you, or either of the three of you. My assumption—well, I don't want to assume.

Do you believe that we absolutely must include the Community Reinvestment Act in this legislation, assuming of course that we can somehow prevent illegal immigrants who work for ACORN from benefiting, do you think that this has to be an inseparable part of this new consumer protection agency?

Ms. MCCOY. Congressman, by the way, Kansas City was my "big city" when I grew up.

Mr. CLEAVER. Where are you from?

Ms. MCCOY. Lawrence.

Mr. CLEAVER. Lord help us.

Ms. MCCOY. Exactly.

I think it makes sense for the Community Reinvestment Act to be part of the new agency because the agency is so concerned with access to credit and credit quality. And those two things are at the core of CRA.

Ms. SAUNDERS. My organization does not really work on CRA issues. But I can tell you that as I was writing my testimony and the particular history on Rent-a-Bank, payday lending where the banks are lending their preemption rights to the payday lenders, I was struck—I had help on the testimony from Jean Ann Fox at the Consumer Federation. I was struck by the important role that CRA played in eventually bringing—eventually, it was one of the rare successes, all four of the banking agencies, to realize that this was not appropriate and shutting it down.

Mr. CLEAVER. Mr. Carr.

Mr. CARR. Yes.

First of all, I am on the executive committee of Americans for Financial Reform. It is the official position of the organization that CRA should and must be included in the new consumer protection agency.

Second of all, I will go back to something I said in my opening comments. The goal of that agency is to ensure access to safe and sound products, and it can't do so to minority communities if it is only looking at individuals, because the financial system doesn't treat individuals the same in minority communities. They treat them as markets.

And so getting at systemic issues of failing to lend—failing to lend, as opposed to using exploitive products—the Community Reinvestment Act is the only real act that really promotes and holds banks and other financial institutions—well, banks now, hopefully other financial institutions—accountable for proactively lending in communities and not ignoring the legitimate credit needs.

So if it is not in that agency, we have left a major piece of support for minority communities out.

The second thing is that we should understand that that agency will have that accumulated knowledge and expertise of researchers, data—how will it in any way enhance their jobs to have the people who look at things at a geographic and at a market's level—systemic market level not part of those daily conversations, sharing of information and, ultimately, the creation of products and the enforcement of the law?

It must be in order for that agency to work as it is designed. It must be able to look at broad-based community lending.

Mr. CLEAVER. You don't all have to answer. Just give me some signal.

Based on your answer, then, you would support a civil rights division of the financial consumer protection agency?

Ms. MCCOY. I would.

Ms. SAUNDERS. That is also part of, I think, an official position of Americans for Financial Reform, which we—

Mr. CLEAVER. Yes. I know yours. Thank you very much.

I yield back the balance of my time, Mr. Chairman.

Chairman WATT. The gentleman from Minnesota is recognized.

Mr. ELLISON. Thank you, Mr. Chairman.

And also I want to thank all the panelists. You all have done a remarkably excellent job, and I appreciate the time you have taken.

Let me get right to my point. One of the things I have been trying to focus on yesterday and today is to ask some of the people who represent the Fed—and even yesterday, the bankers—about this issue of what takes precedence—what will take precedence, what has taken precedence—prudential regulation or consumer interests?

Based on the long amount of time that has transpired between the Fed having the authority to make rules regarding good mortgages and the time they actually came up with something—credit cards, overdrafts, all of this stuff—does the length of time that has transpired give us any indication as to how the Fed has grappled with these two conflicting portfolios and which one has prevailed?

Do you understand my question?

Ms. MCCOY. I do, Congressman.

I want to relate a personal experience that—I was on the Consumer Advisory Council of the Fed from 2002 to 2004, and this was exactly the period when we—consumer advocates were urging the Fed to adopt the unfair and deceptive rules that it delayed until 2008.

We pressed for 3 years with no success to have that rule adopted. We were told endlessly why the Fed could not do it, would not do it; and I have to say, I was so frustrated because we were not listened to.

Subsequently, a Fed staffer said, "You were right, we were wrong, but we didn't listen to you because you only told stories of individual consumers."

Mr. CARR. Congressman, if I could just—

Mr. ELLISON. Mr. Carr, please.

Mr. CARR. I think we should recognize that it took until the middle of 2008 to actually release final regs on HOEPA to deal with this issue. And even at that time, some of the most egregious predatory practices still weren't purged.

For example, yield spread premiums, which are basically kickbacks, were still allowable, as well as weaknesses on issues such as assignee liability, prepayment penalties. And this is knee deep into the crisis. Those issues have now only recently been taken on again.

Mr. ELLISON. Ms. Saunders?

Ms. SAUNDERS. If I could just add, in addition to the length of time which, of course, says something about priorities, what triggered the action? It wasn't just how long it took, it is that nothing happened until Chairman Frank and others said, "Use it or lose it." And they were under threat of losing that authority and Congress was considering credit card bills and predatory lending bills and it was clear that they were under the gun and they had to do it. And in the end, you know, that is what it took, a threat, an ultimatum to get action.

Mr. ELLISON. Thank you for elaborating on that.

Do you see any reason why there couldn't be joint exams with prudential and consumer regulators? Because some people seem to be really concerned about a potential conflict between the two.

I mean, I don't see it as a huge problem. I see it—first of all, I see conflicts as having happened already; they just were resolved in the way you all just described in favor of the prudential regulator, in favor of the industry. So now there might be a fair chance for the consumer, and that might somehow manifest into a conflict that we can see.

But I guess my question is, if there is a potential conflict, can you envision a few ways in which these things might be worked out?

Ms. MCCOY. I can.

First of all, I think joint examinations are entirely feasible. There are other parts of financial services regulation where it happens very well, such as an insurance regulation.

But let me suggest this. We know on very rare occasions that agencies do have irreconcilable conflicts. For example, under Gramm-Leach-Bliley, the SEC and the Federal banking regulators couldn't agree on the push-out provisions. And a way to resolve that is to allow them, the agency, to refer the matter to GAO. It does a report to Congress, and Congress is advised of the issue and if GAO's recommendation is to the resolution. I think that is a great tiebreaker.

Mr. CARR. Congressman, if I could just say for 5 seconds, I think the absence of conflict would be a failure of mission, which is exactly what we have right now.

One would expect that given the types of deceptive and exploited practices happening, you would be having lots of conflicts for the last decade. The absence is a problem.

Mr. ELLISON. Thirty seconds, Mr. Chairman, or no?

Chairman WATT. Yes.

Mr. ELLISON. Just to sort of wrap up, have you all thought about how we might fund the agency?

Ms. MCCOY. I was saying before the hearing that funding is a really hard issue to figure out, and I don't have a good solution except to say that the agency needs adequate funding, which the SEC has not had. And the funding system needs to make certain that the agency does not become captive to large financial services providers. Those, to me, are the two overriding goals.

Mr. ELLISON. And if we cannot get this independent regulatory board, which I believe we need and I support fully, can we at least change the situation so that the bankers don't have their advisory board at the Fed and then have half an advisory board on the consumers?

Chairman WATT. I take it that is a rhetorical question of this panel?

Ms. MCCOY. Even if the consumers have their own board and there are no bankers on it, that will not solve the problem. It is just not enough.

Mr. ELLISON. Thank you.

Chairman WATT. The gentleman's time has expired.

I will recognize myself for 5 minutes to conclude this.

Ms. Saunders, I think you may have addressed some of the concerns that I was beginning to feel about the potential for conflict between a new consumer regulatory agency and leaving some consumer responsibilities, consumer protection responsibilities. You pointed out some things in the legislation that—I am a cosponsor of that—I was not aware of. It would be helpful, I think, if you—all three of you—looked closer at that because what we do not need is conflict between consumer regulation in one place and consumer regulation in the other place.

And I think we may have addressed it appropriately in the statute. Ms. Saunders seems to suggest that in her testimony. I take it you stand by that?

Ms. SAUNDERS. I do.

I would also like to point out, though, that the proposal is basically to remove pretty much all of it into the new agency. The Fed would retain backup enforcement authority.

Chairman WATT. But then I am thinking that maybe if there is a potential for conflict, we may need to be removing even more of it. That was the conflict that I—now, the second question that the industry has raised over and over again, this potential for conflict between consumer and prudential. I keep having trouble identifying even what that is all about.

The regulator, Ms. Duke, didn't suggest that that potential existed today, but the industry keeps telling me that there is a conflict between consumer regulation and prudential regulation.

And is anybody able to tell me one instance where that would raise its head?

Ms. SAUNDERS. I was actually looking for those examples in industry testimony yesterday as I was preparing, and the ones that I came up with from their examples—interesting that Mr. Ireland did not repeat them this morning when you challenged him—one was check hold times.

Now, the Expedited Funds Act actually is not one of the ones being proposed and given to the new agency. It would stay with the Fed. But let's assume that it was going.

The idea is that the banks say, "We have operational issues on how we clear checks and we have fraud issues and we just can't speed it up." And of course the consumer is saying, "We want our money now."

Why couldn't this agency take that into consideration? Nobody wants fraudulent checks cleared. Like any other agency, it is going to balance the issues.

Chairman WATT. If you really got to a fork in the road where you had a real conflict, which nobody has really been able to identify to me—it is even hard for me to imagine who would—I guess then the question becomes, who takes precedence, the consumer or the bank?

How would you resolve that?

Ms. SAUNDERS. In the end, somebody has to decide; and the structure of this agency is that the agency decides. But it has a regulator on the board and Congress looking over its shoulder, and I am confident that it is not going to ignore serious safety and soundness issues.

Chairman WATT. Final point and final question, because I do confess to a level of ambivalence on this CRA issue that Representative Cleaver raised. I am still somewhat ambivalent.

I understand your position that an integral part of CRA should be in this consumer agency, but I would hate to think of a scenario in which CRA responsibility and duties don't continue to reside over on the regulatory side also, because I would hate for them to say, you know—that is not our thing anymore to oversee that.

So let me get you all to just think about that a little bit. Not that I am—the legislation that we introduced kept it where it is in the existing regulators. There may be some way to accomplish what you all have suggested would be the legitimate consumer regulatory part of it through some language to make sure that they are monitoring it, and still give the primary responsibility to the regulators who are out there pushing the banks and financial institutions regularly through their examination process. But that is—I am—my jury is still out on that; and I would love to hear more.

But we have run out of time, unfortunately, and my time has expired.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing or which maybe have been raised today; and we would welcome your written responses to—such as the last one that I raised. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

We thank you all so much. All of you were just outstanding witnesses, and your written testimony was outstanding also. I have commended it—put Ms. McCoy's testimony, in fact, in the hearing record of the full committee this morning; and we will make sure that the other two written testimonies get circulated widely also.

We thank you for your participation, and with that—with nothing further for the good of the cause, as they say in my church—the hearing is adjourned.

[Whereupon, at 4:27 p.m., the hearing was adjourned.]

A P P E N D I X

July 16, 2009

OPENING STATEMENT OF REP. MELVIN WATT

Hearing Entitled, "Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve"

Thursday July 16, 2009

This is the second in a series of hearings about financial regulatory reform and the role of the Federal Reserve. The first hearing, held on July 9, examined how to balance the Federal Reserve's existing role as the independent authority on monetary policy with its proposed role as systemic risk regulator under the Administration's financial regulatory reform proposal.

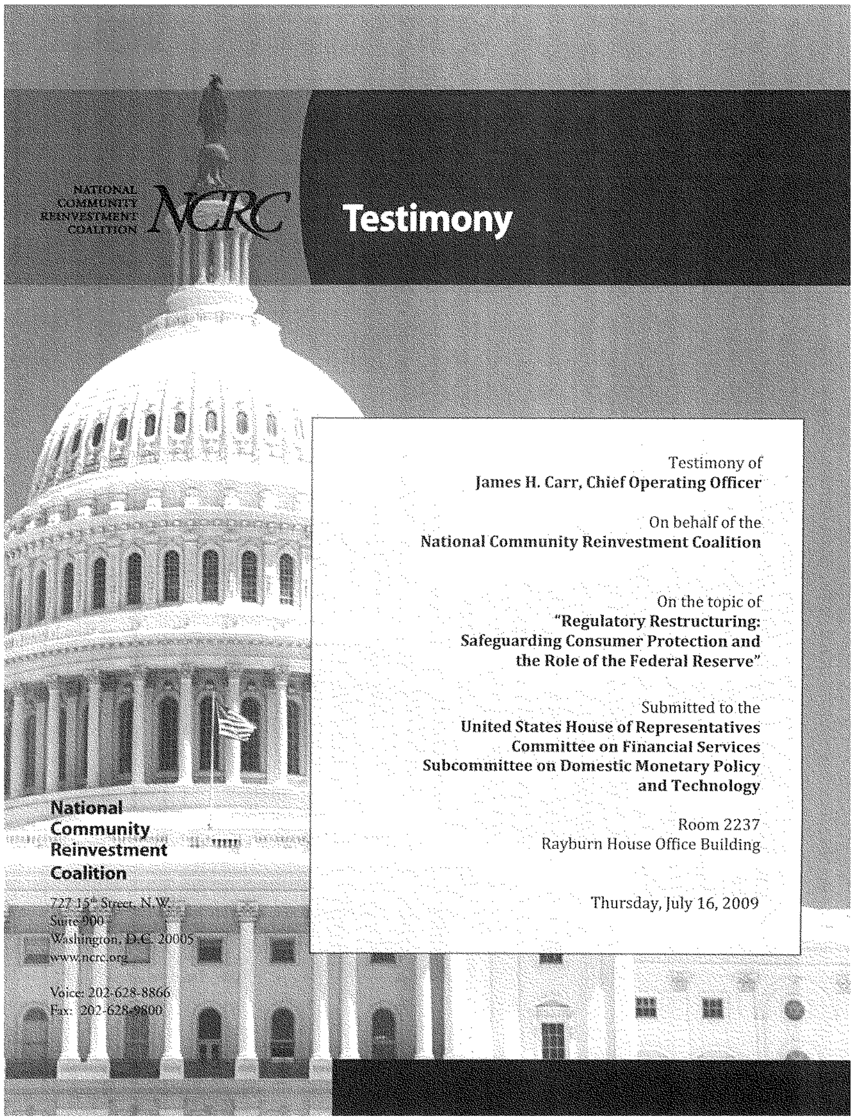
Today's hearing examines a different aspect of the Administration's regulatory reform plan – the proposed Consumer Financial Protection Agency (CFPA). While the full Financial Services Committee has held a hearing on the CFPA, this hearing will drill down further and examine some of the public policy and operational considerations related to the proposed CFPA, including whether the Federal Reserve should maintain a role in consumer protection given its current responsibilities for writing rules, supervising institutions and enforcing the nation's consumer protection laws and, if so, what that role should be and how it might be coordinated with, supportive of or, at least, not in conflict with the new CFPA. Although no witnesses from other federal banking agencies are testifying today, this hearing may also touch upon how the same set of questions should be answered with respect to their consumer protection roles and their interactions with the CFPA.

Today, there is no single agency focused solely on protecting consumers from financial products and services that could be detrimental to their financial health. Since the idea of having a single consumer financial protection agency was advanced by Harvard Law School Professor Elizabeth Warren, other academics, commentators, Members of Congress and regular citizens have embraced the idea. They have witnessed the way that our fragmented regulatory system produced serious gaps in regulation and oversight and failed to have anyone whose highest priority was protecting consumers -- someone who goes to work everyday with that as their single most important objective. Others, of course, criticize the idea of a single consumer protection agency as adding another layer of regulation.

There can be no doubt that regulatory gaps helped create an environment for toxic financial products such as predatory mortgages and other abuses that helped cause the current financial crisis. To remedy this, the Administration has proposed placing focused authority in the proposed CFPA to administer the nation's consumer protection laws.

As Congress and President Obama work to enact financial regulatory reform, it is critical for us to examine the public policy rationale for vesting virtually all authority for consumer protection of financial products in a single agency. Also, as a matter of public policy, we will examine whether and how the Federal Reserve can effectively balance its responsibility to execute monetary policy, take on a new role in systemic regulation *and*, if it continued to have this role, protect consumers effectively.

For far too long, consumer protection has been an afterthought. I hope that the record developed at today's hearing will offer further support for the elevation of consumer protection to be on equal footing with prudential and "safety and soundness" regulation. We also hope that today's testimony will begin to address some of the questions surrounding the operational details of the proposed Consumer Financial Protection Agency, including coordination between and among federal regulators and state regulators, so that there is effective and efficient regulation of the nation's consumer protection laws in the financial services area as many believe we have in the food and product safety area.



Testimony of
James H. Carr, Chief Operating Officer

On behalf of the
National Community Reinvestment Coalition

On the topic of
**"Regulatory Restructuring:
Safeguarding Consumer Protection and
the Role of the Federal Reserve"**

Submitted to the
**United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy
and Technology**

Room 2237
Rayburn House Office Building

Thursday, July 16, 2009

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Good afternoon Chairman Watt, Ranking Member Paul, and other distinguished Members of the Committee. I am James H. Carr and I am the Chief Operating Officer at the National Community Reinvestment Coalition (NCRC). On behalf of our coalition, I am honored to speak with you today on the topic of "Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve."

NCRC is an association of more than 600 community-based organizations that promotes access to basic banking services for America's working families. NCRC is also pleased to be a member of a new coalition of more than 200 consumer, civic, labor, and civil rights organizations – Americans for Financial Reform – that is working to cultivate integrity and accountability within the US financial system.

I. Introduction

Members of the Committee, financial regulatory system design flaws, gaps in oversight, conflicts of interest, weaknesses in enforcement, and failed philosophical perspectives on the functioning of the markets combined to lead to the virtual implosion of the credit markets and collapse of the US economy.

In assessing the key problems leading to the crisis, considerable attention has been focused on issues such as excessive investment leverage ratios and institutions perceived as being too big to fail, complex financial instruments and vehicles, unregulated financial entities, and perverse pay incentives to executives who engaged in risky lending and reckless financial practices.

These problems are critical to understanding the current situation that is increasingly destabilizing the housing and credit markets. But they constitute only one of three issues that together explain the financial system's meltdown, the extraordinary costs to American tax payers, and the contagion effects on the broader economy. The other two key issues are 1) failure to protect consumers from unfair and deceptive financial products and practices, and 2) inadequate resolution authority to manage insolvent financial institutions.

At the request of the Committee, I will devote my time today to the issue of consumer protection. In my written testimony, I expand on my consumer protection comments and touch briefly on the other two pieces of the regulatory failure puzzle.

The Role of Consumer Protection in the Financial System

Financial safety and soundness and adequate consumer protection are most often discussed as wholly separate issues. Yet, the safety and soundness of the financial system begins with and relies heavily on the safety and soundness of the products offered to the public.

If the extension of credit by a financial firm promotes the economic wellbeing and financial security of the consumer, the system is at reduced risk of failure. If, however, financial products exploit consumers – even if they are highly profitable – the financial system is in jeopardy. The most meaningful way to manage systemic risk is to better protect the public from unfair, deceptive, fraudulent, and otherwise predatory policies and practices in the financial services industry.

The Systemic Business Model of Deception

For more than a decade, financial institutions have increasingly engaged in practices intended to mislead, confound, and otherwise limit a consumer's ability to judge the value of financial products offered in the market and make informed decisions.

Elizabeth Warren, a Professor of Law at Harvard University and Chair of the Congressional Oversight Panel on the Troubled Asset Relief Program, has developed a detailed list of the "tricks and traps" that financial institutions, particularly consumer credit lenders, use to make unsafe financial products appear attractive to consumers. She also adds that these financial institutions build unjustified and unethical fees and penalties into the terms and conditions of such products to turn a profit at the expense of trusting borrowers.

For example, only a few years ago, the typical terms and conditions statement for a credit card was only a single page. Today, terms and conditions sheets are steeped in complex legal jargon and can number at least 30 pages. In response to this, Congress has had to mandate a minimum type size because credit card companies were sending their required disclosures to consumers with such small print that a magnifying glass was required to read them.

Outside of the consumer credit arena, the proliferation of unfair and deceptive mortgage products led directly to the current foreclosure crisis and massive destruction of US household wealth. The "tricks and traps" used to market these high-cost, unsustainable home loans greatly complicated, if not impaired, the ability of a consumer to make an informed decision about the most appropriate mortgage product for his or her individual need and financial circumstances.

To quote Professor Warren in the Congressional Oversight Panel's "Special Report on Regulatory Reform," "the available evidence suggests that the costs of deceptive financial products are high, [and] quickly climbing into the billions of dollars" per year.

Not an Equal Opportunity Economic Crisis

Financial institutions targeted their toxic products of communities of color in particular. For more than a decade, federal agencies, independent research institutes, and nonprofit organizations described and discussed the multiple ways in which people of color were being financially exploited in the housing and credit markets.

Unfortunately, nothing substantial has been done to address these growing concerns. The result today is that the foreclosure crisis is having a disproportionately devastating effect on communities of color in two ways. First, communities of color are experiencing higher levels of foreclosures than their white counterparts; and second, they are most negatively impacted by rising unemployment.

Since the beginning of this year alone, more than 3 million jobs have been cut, bringing the national unemployment rate to an uncomfortable 9.5 percent (as of June 2009). While of great concern, the rate of job loss for African Americans exceeds 15 percent, and for Latinos, approaches 13 percent.

Because African Americans and Latinos have comparatively few savings, they are poorly positioned to survive a lengthy period of unemployment. As a result, potentially millions of African-American and Latino households could find themselves falling out of the middle class by the time the economy recovers.

The steering of African Americans and Latinos into deceptive mortgage loans has also contributed to these communities being over-represented in foreclosure statistics. African Americans, for example, have experienced a full three-percentage point drop in their homeownership rate since the foreclosure crisis began.

Banks, independent mortgage companies, and non-bank financial institutions routinely pushed substandard, poorly underwritten, over-appraised, and unsustainable loans at African-American and Latino consumers in violation of federal fair housing and fair lending laws. Subprime loans, particularly subprime adjustable rate mortgage (ARM) loans, have significantly higher default and delinquency rates than prime loans.

According to a study by the US Department of Housing and Urban Development, subprime loans are five times more likely in African-American households than in white, and homeowners in high-income African-American areas are twice as likely as borrowers in lower-income white communities to receive subprime loans. Further, NCRC's report "Broken Credit System" studied high-cost lending in ten large metropolitan areas across the country. After controlling for risk and housing market conditions, that report cites that the racial composition of a neighborhood had an independent and strong effect on lending outcomes. The findings in this report are consistent with other studies of subprime lending and race.

Paul Calem of the Federal Reserve, and Kevin Gillen and Susan Wachter of the Wharton School also used credit-scoring data to conduct econometric analysis. They found that after controlling for creditworthiness and housing market conditions, the level of subprime refinance and home purchase loans increased in a statistically significant manner as the portion of African Americans increased on a census tract level in Philadelphia and Chicago. The Center for Responsible Lending also used the 2004 Home Mortgage Disclosure Act data with pricing information to reach the same troubling conclusions.

Lenders also steered minority borrowers who qualified for prime loans into high-cost loans, resulting in equity stripping and contributing to wealth inequalities. A 2008 study by the *Wall Street Journal* found that more than 60 percent of borrowers with high-cost subprime loans had credit scores sufficient for them to have qualified for a prime market home loan.

Over the past three years, NCRC has released a series of studies titled "Income is No Shield against Racial Disparities in Lending," which documents that racial/ethnic disparities in lending increase when comparing middle- and upper-income minorities against middle- and upper-income whites. The most recent study ("Income Is No Shield, Part III: Assessing the Double Burden: Examining Racial and Gender Disparities in Lending, June 2009) highlights the prevalence of high-cost lending and its devastating consequences for women of color, particularly African-American women of all income levels. And, because African-American children are more likely to reside in female-headed households, black children are also disproportionately harmed as a result of the foreclosure crisis and its attendant stresses.

If a black family lost their home to foreclosure and could not find a suitable apartment in the neighborhood from which they were evicted, black children may be forced to leave their school, social networks, and familiar community surroundings, all of which can hinder their educational performance and long-term socio-economic wellbeing.

The situation is so dire within the African-American community that United for a Fair Economy, a Boston-based policy group, estimates that 41 percent of African Americans are at risk of falling into poverty, and that African Americans could experience the greatest loss of wealth since Reconstruction.

II. Goals and Purposes for the Proposed Consumer Financial Protection Agency

The Obama Administration notes in its paper "Financial Regulatory Reform: A New Foundation," that "consumer protection is a critical foundation for our financial system. It gives the public confidence that the financial markets are fair and enables policy makers and regulators to maintain stability in regulation." In order to elevate the importance of consumer protection as a core element of the new regulatory regime, the President proposes the establishment of a Consumer Financial Protection Agency. That new institution would consolidate a highly fragmented system of consumer financial protection laws currently enforced by six separate agencies.

CFPA would consolidate experts who share both expertise in consumer protection laws and practices and a commitment to protecting the public. This mission and synergy of expertise would greatly enhance the effectiveness of regulators seeking to employ best-practices related to measuring and monitoring institution behavior, and enforcing the nation's consumer protection laws. There would also be better understanding of the intersections and overlaps of potentially conflicting or mutually reinforcing consumer protection law and regulations. CFPA would have broad authority to oversee products like home mortgages and credit cards, and services including real estate appraisals, tax preparation, and debt collection. It would promote clear and understandable terms in contracts, and fair, safe, and reliable financial products and services.

Finally, rather than hampering states' efforts to protect their own citizens (which was the approach of the Office of the Comptroller of Currency and the Office of Thrift Supervision), CFPA would create a federal floor of financial protection and encourage greater state involvement in financial regulatory oversight.

Recently, the House Financial Services Committee Chairman Barney Frank proposed a similar agency. That bill, the Consumer Financial Protection Agency Act of 2009 (H.R. 3126), reinforces the President's proposal in many key areas. First, a proposed CFPA would not be susceptible to the same regulatory arbitrage that has characterized the current regulatory regime. Currently, four federal banking agencies—the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC)—compete against one another for fees paid by the institutions they are supposed to regulate. Competition is an essential element of a free market, but oversight and enforcement of the law is not, nor should it be, available for purchase in a free market. In fact, regulation is one of the few instances in which a monopoly market will most efficiently deliver the desired results. Second, a proposed CFPA would be the best-positioned agency with regulatory authority for consumer protection because it would be independent of the financial institutions that bank agencies regulate.

This crisis has taught us that unless we explicitly devote specific resources to consumer protection, the public's wellbeing will take a backseat to the demands of the financial services industry. Placing federal fair lending laws and all aspects of consumer protection under the jurisdiction of CFPA would maximize the agency's ability to monitor and enforce the law. Because fair lending laws and consumer protection laws often reference each other, a violation of one constitutes a violation of the other(s). If multiple regulatory agencies continue to enforce different aspects of different fair lending and consumer protection laws without a coordinated strategy, effective enforcement opportunities will continue to be missed and vulnerable communities will continue to suffer.

III. The Challenges of Community Lending

Some have argued that CRA should not be included in a proposed CFPA. They assert that requiring CFPA to expand its staff capacity to address broad-based community reinvestment and serving populations as borrower groups rather than solely as individuals will dilute the agency's mission.

Prohibiting is only half the problem. A major exception between H.R. 3126 and the President's recommendation is that H.R. 3126 proposes to leave regulatory oversight for CRA under the purview of the Federal Reserve. As previously discussed, NCRC believes that this aspect of the bill should be amended to reflect the President's proposal to shift regulatory oversight of CRA to the proposed CFPA. First, for more than a decade, the Federal Reserve has increasingly limited the effectiveness of CRA. As with all other consumer protections under its jurisdiction, CRA has been the neglected "stepchild" of the quarterly earnings reports from financial firms. Retaining CRA at the Federal Reserve would greatly limit its effectiveness to channel much-needed dollars into communities with mounting foreclosures and rising job loss.

Moreover, a long and troubling history of discrimination for communities of color has made the need for CRA enforcement critical to the long-term economic performance and overall strength of the US economy. CRA is an effective tool for building wealth at the community level and ensuring that all Americans, regardless of race/ethnicity, are able to be active and contributing members to the national economy. CFPA should also be tasked with prohibiting reckless and irresponsible products targeted overwhelmingly to communities of color. For example, many financial firms deny access to responsible financial services simply by not lending to certain communities. This practice breeds a lack of competition for prime loans in "excluded" (usually communities of color) and leads to a disproportionate exploitation of consumers within these markets.

More must be done to achieve an inclusive financial system. A recent report by the Center for Financial Services Innovation estimates that there are 40 million under-banked households in the

United States. And nearly 10 million households have no relationship with a mainstream financial institution. As such, NCRC believes that CRA is the best tool to adequately address these concerns and put the US economy on the road to recovery.

Since its enactment in 1977, the Community Reinvestment Act (CRA) has been vital to building communities through safe and sound financial products and investments. Fragmented regulatory authority of CRA has resulted in inconsistent enforcement that has reduced CRA's ability to revitalize working communities hardest hit by the current economic crisis.

Under CRA regulation, a violation of fair lending and anti-predatory lending laws can penalize a bank with a lower CRA rating if the violation is widespread and substantial. Yet, if the current bank agencies retain the authority to conduct CRA exams, it is not guaranteed (nor given the agencies past performance, expected) that bank agencies would regularly consult with CFPA to determine whether or not fair lending or anti-predatory violations have occurred that should impact the CRA rating.

Therefore, NCRC recommends that bank agencies be coordinated by CFPA to ensure that their fair lending reviews allow for the development of a full understanding of the lending practices and patterns of the banks they are examining. The best way to ensure adequate consultation and collaboration across banking agencies is to consolidate enforcement authority for both fair lending and CRA examination authority within CFPA's jurisdiction.

Some stakeholders have recently testified before this Committee against repositioning CRA under CFPA. These arguments involve the issues of safety and soundness, community development, and consumer protection. Each of these arguments is not convincing and can be easily addressed and rebutted.

Industry trade associations have asserted that placing CRA under the jurisdiction of the CFPA would divorce CRA enforcement from the examination of safety and soundness, which would remain with the federal bank agencies. The safety and soundness exams result in a CAMELS rating being issued to a bank, which is a rating from 1 to 5 of the overall condition of a bank. CAMELS is an acronym describing the exam elements: C- Capital Adequacy, A – Asset Management, M – Management, E- Earnings, L- Liquidity, and S – Sensitivity to Market Risks. Exams resulting in CAMELS ratings are currently conducted separately from CRA exams and are confidential (the public does not see the rating which is shared between the regulatory agency and the bank).

CRA exams also consider safety and soundness issues but the consideration focuses on lending practices instead of the overall financial condition of the bank. If lending practices are abusive, illegal, and unsafe, the CRA exam is supposed to penalize a bank through a lower rating. An example of this is the FDIC's exam of CIT Bank of May 12, 2008. The FDIC failed this Utah-based industrial bank based on its purchases of predatory loans.

Quoting from the FDIC's exam, "CIT Bank engaged in an unsafe and unsound practice by purchasing $3.1 billion in subprime nontraditional mortgage pools with predatory characteristics that resulted in a significant negative impact on the institution's overall CRA performance rating. The subprime nontraditional mortgage loans had undesirable characteristics including pre-payment penalties; stated income loans; and qualifying borrowers at a teaser rate, resulting in payment shock when scheduled resets ultimately occur. The characteristics of the underlying mortgage loans greatly increased the risk that the borrowers would default, or otherwise be in a worse financial position than they were previous to accepting the loan. CIT's purchase of the subprime mortgage pools was made in an unsafe and unsound manner that caused harm to consumers. In doing so, CIT failed in its responsibility to meet a basic tenet of CRA."

As this example illustrates, transferring CRA, fair lending, and consumer protection oversight to CFPA would provide CFPA with the necessary examination tools to conduct similar analyses and ensure that CRA activities are conducted in a safe and sound manner. This skill set is distinct from those necessary to execute overall safety and soundness reviews that generate CAMELS ratings.

Arguments against a CFPA include the notion that product innovation would be stifled and that consumers would lack access to financial services that meet their unique consumer needs. These propositions are without merit. CFPA, as conceived in H.R. 3126 or by the President, seeks commonsense regulation. Its goal is to provide consumers with relevant and understandable information that will enable them to better financial decisions in their best interests. It also proposes the increased use of standard products to eliminate confusion for consumers who need standard financial products.

Standard products were the hallmark of the housing industry prior to the "product innovation" that detonated the system. The 30-year fixed-rate mortgage was, for decades, the gold standard of mortgage products, and was responsible for America's extraordinarily high rate of sustainable homeownership. And, homeownership anchored by the 30-year fixed-rate mortgage was the cornerstone of wealth attainment for the typical American household. In short, sometimes the best "product innovation" is a good standard product.

A final argument against a proposed CFPA is that it might cost the American taxpayer too much capital. However, the current economic crisis demonstrates that a failure to adequately regulate the financial marketplace has already cost the American taxpayer too much in capital. To date, American taxpayers have spent almost $13 trillion to prop up the US economy and save struggling banks.

IV. CRA Modernization Is Vital to CFPA's Mission

NCRC's support for the creation of a CFPA that would be responsible for enforcing CRA is critical to promoting the economic wellbeing of America's working families and communities. In addition, CFPA's effectiveness would be further increased with a modernized CRA. Modernizing CRA and strengthening how it applies to banks and non-bank financial institutions would allow CFPA to better leverage increases in responsible loans and investments in low- to moderate-income areas. Enhanced CRA data disclosure on lending, investing, and services would also support CFPA's overall mission and goals.

The President's proposal and H.R. 3126 are particularly strong on data disclosure. They recognize that data enhancements are critical to promoting access to responsible credit and other financial services, identifying business and community development opportunities, and promoting adherence to fair lending and consumer protection laws. The President's proposal and H.R. 3126 include the following enhancements to data disclosure:

Collection of Deposit Account Data

Banks and credit unions would be required to maintain and disseminate data on their branches, ATMs, and other depository facilities, as well as maintain and disseminate the census tract locations of their depository facilities. (Note: Deposit accounts include checking, savings, credit union share accounts and other types of account as defined by CFPA.) The number and dollar amount of deposit accounts for the residential and commercial customers for each deposit facility would also be collected. The place of residence/business of bank/credit union customers would be provided on a census tract basis, making it possible to analyze the income level and race/ethnicity percentage of the census tracts of these customers. These data should be used as part of CRA exam analysis as proposed by the Administration.

Small Business Loan Data Collection

Financial institutions would be required to collect Home Mortgage Disclosure Act (HMDA)-like data on small businesses to determine whether a business is minority- and/or women-owned. In addition to collecting race and gender data, the financial institution would be required to collect the type and purpose of the loan for which the business is applying, the type of action taken with respect to the application, the gross annual revenue of the small business, the census tract location of the business, and any other information CFPA deems appropriate.

Financial institutions that would be required to collect and report these data include any partnership, company, corporation, and cooperative organization. This requirement extends beyond banks that have a current obligation to report small business loan data under CRA. CFPA does, however, reserve the right to exempt any class of financial institutions from this reporting requirement.

The importance of this data cannot be understated. The addition of race and gender data in HMDA facilitated a dramatic expansion of prime lending to minorities and women in the 1990s before the explosion of subprime lending from 2003-2007. For example, home lending to African Americans and Hispanics increased 79.5 percent and 185.8 percent, respectively, compared with 51.4 for middle- and upper-income borrowers between 1993 and 2002. In contrast, a well-developed literature based on national surveys indicates the likely possibility of discrimination against women- and minority-owned small businesses. A lack of publicly available data on small business lending by race and gender has inhibited lending to women- and minority-owned businesses by preventing stakeholders from identifying missed opportunities to serve minority- and women-owned businesses and by enabling discriminating lenders to remain undetected when violating the fair lending laws.

The Federal Reserve Board has inhibited rather than facilitated the promotion of additional data collection of small business lending. The Federal Reserve has prevented lenders from voluntarily collecting race and gender data for small business borrowers by failing to lift the current prohibition in Regulation B (that implements the Equal Credit Opportunity Act) against collecting this data. In addition, the Federal Reserve discontinued the periodic national survey that enabled researchers to document disparities and likely discrimination in small business lending. In total, the Federal Reserve's actions discouraged debate and discussion on small business data disclosure, which is inconsistent for an agency that has been responsible for enforcing CRA and the fair lending laws.

Enhancements to Home Mortgage Disclosure Act (HMDA) Data

In addition to the demographic characteristics they already collect in HMDA data, financial institutions would be required to collect the age of the borrower under the Administration's proposal and H.R. 3126. NCRC and others have found that elderly borrowers experience lending disparities; this additional data element will allow for a more systematic investigation of these disparities. Several loan terms and conditions would also be collected, including total points and fees, the difference between the annual percentage rate and a benchmark rate for all loans, prepayment penalties, the value of the real property pledged as collateral, whether the loan is a hybrid loan with a lower teaser rate, whether the loan is a negative amortization loan, whether the application was received by a broker or other retail channel, and the credit score of the borrower.

V. Distribute Consumer Protection Responsibilities

Role of the Federal Reserve

Once established, CFPA would become the primary agency responsible for coordinating consumer protection at the federal level, monitoring the financial industry's consumer protection activities, interpreting the consumer protection laws through issuing rules, and enforcing consumer protection laws. Because CFPA would take the lead role in consumer protection does not mean that the Federal Reserve should abdicate its needed role in consumer protection. As the central bank of the United States, part of its mandate is to ensure that the financial services sector serves as an engine of growth for the entire economy, which in turn requires ensuring positive consumer outcomes.

The Federal Reserve's consumer protection role should be subordinate to that of CFPA's: it should retain oversight over the institutions for which it is the primary regulator, and retain authority to investigate potential consumer abuse and refer violations of consumer protection laws to CFPA. The Federal Reserve's consumer protection role should also be more limited in the future because it has proven to be unwilling or unable to adequately monitor and effectively enforce the laws. The Federal Reserve's track record on lack of regard for the American consumer ranges from its involvement in the Community Reinvestment Act, to the mortgage lending markets, and to alternative consumer credit products.

Perhaps the most egregious instance in which the Federal Reserve protected the interests of financial institutions at the expense of consumers is in the mortgage lending markets. With the passage of the Home Ownership and Equity Protection Act (HOEPA) in 1994, the Federal Reserve was granted extraordinary powers to prevent predatory lending and punish predatory lenders who engaged in these practices. Not only did the Federal Reserve not make full use of its new authority, it declined to issue final HOEPA guidelines. HOEPA created a critical opportunity to purge predatory lending from the markets, but the lack of oversight and enforcement undermined the ability of banks and mortgage companies to comply fully with fair lending regulations. It was not until July 2008, after the housing bubble had burst and begun to wreak havoc on the financial services sector and the economy as a whole, that the Federal Reserve finally issued revisions to its HOEPA guidelines.

Inconceivably, the Federal Reserve has supported unfair and unnecessarily high-cost alternative financial products as they were becoming more pervasive over the past decade. For example, although the Truth in Lending Act (TILA) requires banks to notify account holders before extending a fee-based "courtesy loan" to cover overdrafts, the Federal Reserve has refused to enforce this requirement. According to the FDIC, banks with automatic overdraft loans earned $1.77 billion in fees on those loans in 2006. The Federal Reserve has not addressed this practice, and has declined even require banks to allow consumers to opt out of automatic overdraft loan programs.

The Federal Reserve also engaged in the "race to the bottom" of regulatory enforcement as financial institutions took advantage of their ability to "charter shop" and choose the federal regulatory agency that best fit their needs. That race was so competitive that it plunged the entire financial system into a ditch.

Although the leader in promoting poor lending enforcement was the Office of Thrift Supervision (OTS), the Federal Reserve followed OTS's lead along with the other banking agencies. This was particularly harmful to low- and moderate-income communities and minority consumers, as years of regulatory competition for financial industry business led to the weakening of CRA provisions and enforcement. Moreover, the Federal Reserve also failed to use the most critical enforcement tool of CRA: the law's requirement of public meetings at the time of proposed mergers. In Congressional testimony in 2007, an official representing the Federal Reserve testified that the Federal Reserve had held only 13 public meetings on mergers since 1990. This is less than one meeting per year in an era in which consolidations have profoundly changed the banking industry. In addition, of the 13,500 applications for the formation of banks or the merger of institutions that the Federal Reserve has received since 1988, only 25 applications were denied.

More recently, the federal banking agencies declined to solicit the public's input regarding the emergency mergers involving JP Morgan Chase/Washington Mutual and Wells Fargo/Wachovia. If the agencies believed that the usual application process and public comment period was not possible in those cases, they could have held post-merger meetings and public hearings, as requested by NCRC member organizations. None of the agencies has scheduled post-merger meetings.

The Federal Reserve also failed in its duty to enforce fair lending and non-discrimination. Between 2004 and 2006, the Federal Reserve identified approximately 470 lenders whose practices were possibly in violation of civil rights and fair lending laws. Instead of investigating the lenders to determine the presence and extent of actual violations, the Federal Reserve referred all 470 cases to other regulatory agencies, and did not follow up when the other agencies similarly declined to investigate.

In particular, the Federal Reserve should maintain its Office of Civil Rights and Fair Lending Compliance. This office should work to ensure that the Federal Reserve's own activities affirmatively promote fair housing. It should be responsible for monitoring the civil rights dimensions of consumers' experiences with financial institutions under its regulatory purview. The Federal Reserve's Office of Civil Rights and Fair Lending Compliance should also retain its power to encourage compliance by denying non-compliant institutions the ability to participate in economic recovery programs. This would require the Federal Reserve to cooperate more amiably and openly with other banking agencies, HUD, DOJ, and CFPA to enforce non-discrimination and ensure fairness.

The Federal Reserve should also retain limited consumer protection rule making authority over institutions for which it is the primary regulator, but its authority ought to be subordinate to the rule making authority of the CFPA and should not preempt states from instituting more rigorous consumer protection policies. Any time that CFPA issues a ruling or guidelines on consumer protection, the Federal Reserve should immediately communicate its intent to align its policies with CFPA's judgment and take steps to adjust its implementation to align with CFPA's requirements.

VI. The Role of Other Federal Banking Regulatory Agencies

While the Federal Reserve is the primary focus of today's hearing, it is important not to lose sight of the other Federal banking regulatory agencies, particularly the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and the Federal Insurance Deposit Corporation (FDIC). Currently, these agencies all share responsibility among themselves and the Federal Reserve for oversight, implementation, and enforcement of consumer protection laws.

Like the Federal Reserve, the other banking agencies have routinely failed to look out for consumers' interests in order to champion financial institutions. For that reason, these other banking agencies should also have limits placed on their roles in consumer protection once CFPA is established. They should be subordinate to CFPA on all matters related to consumer financial products and services. Each agency should retain oversight over the institutions for which it is the primary regulator and retain authority to investigate potential consumer abuse and refer violations of consumer protection laws to the CFPA.

There is ample evidence that the other federal banking regulatory agencies were derelict in their duties to ensure that financial institutions operated responsibly and ethically. Regarding CRA requirements and exams in particular, the federal regulatory agencies chose which regulator would best meets their needs with lax enforcement. In fact, OTS, which aggressively promoted itself as a "lax" regulator, implemented in 2004 exceptionally lenient CRA exams. In response to this, the other agencies were compelled to relax their CRA enforcement for mid-size institutions in order to compete with OTS.

Even in the depths of this current credit market and economic crisis, the federal banking agencies have actively worked to weaken consumer protection laws. As Congress considered sweeping credit card reform legislation earlier this year, for example, the OCC lobbied for additional loopholes to limit disclosure requirements.

The banking agencies priorities are perhaps most clearly demonstrated through their activities related to preemption of state laws. In 2003, the OCC preempted Georgia's newly enacted comprehensive anti-predatory lending law. The law would have curtailed many of the predatory practices that allowed lenders to saddle consumers with unsustainable home mortgages without suffering losses when the loans went bad- a major contributing factor in the foreclosure crisis. OCC preempted the law because it would have been expensive for banks to implement and would have required secondary market participants to conduct more due diligence to ensure that they did not purchase loans with predatory features.

Preemption efforts by OCC, OTS, and the National Credit Union Association have prevented states from implementing more rigorous consumer protection laws to benefit their residents. Preempted policies include banning ATM fees, expanding regulation of insurance policies, requiring enhanced disclosure of terms and conditions, and capping interest rates.

Finally, none of the federal banking agencies have been supportive of minority consumers and have generally ignored financial institutions' practices that violated civil rights and fair lending legislation. Forty years after the first fair housing and fair lending laws were enacted, minority borrowers continue to be harmed by unfair practices and unequal treatment within the financial system.

As with the Federal Reserve, the other banking agencies should maintain their Offices of Civil Rights and Fair Lending Compliance. These offices should work to ensure that the agencies' activities affirmatively promote fair housing. They should also actively collaborate among each other to monitor the civil rights dimensions of the products and services offered by financial institutions, and follow up with one another in investigating potential civil rights violations.

Each banking agency should also retain rule making authority over the institutions for which it is the primary regulator, but its authority ought to be subordinate to the rule making authority of the CFPA and should in no way preempt states from instituting more rigorous consumer protection policies. Any time that CFPA issues a ruling or guidelines on consumer protection, all federal banking regulatory agencies should immediately communicate their intent to align their policies with CFPA's judgment.

VII. Balance Consumer Protection, Systemic Risk, and Monetary Policy

As of today, the creation of a CFPA remains a proposal. Its failure to be enacted would mean that regulatory agencies would maintain their current authority over consumer protection, systemic risk and monetary policy. Even if that is the case, the public must nevertheless expect, demand, and receive improved performance from those agencies.

If the Consumer Financial Protection Act is not passed, it would be imperative that the Federal Reserve recognize that safety and soundness are two sides of the same coin. Judging from the Federal Reserve's own leadership, this will be a difficult hill to climb. Testifying to this subcommittee on July 9, 2009, former Federal Reserve Governor Frederic Mishkin stated that "the skills and mindset required to operate as a consumer protection regulator [are] fundamentally different from those required by a systemic regulator."

Also testifying to this committee last week, former Federal Reserve Governor Lawrence Meyer said that if the Federal Reserve is to give anything up, "the most obvious choice is consumer protection and community affairs [because]....These are not seen around the world as core responsibilities of central banks."

If the Federal Reserve is to balance consumer protection, monetary policy, and systemic risk responsibilities, it would have to take its consumer protection rule writing authority more seriously to create uniform standards across the financial industry. It would then need more effectively to enforce those protections. And, based on the statements of its own leadership, it should hire new staff and reorganize its leadership in a manner that advances those within the institution who understand and appreciate more fully the imperative of consumer protection.

Moreover, the reformed role that banks currently play in determining Federal Reserve makeup and policy needs to be curtailed. Local banks have a large say in picking the presidents of each of the 12 district banks, who sit on the Open Market Committee that creates monetary policy and wields other significant regulatory powers. As long as the Federal Reserve, by design, overwhelmingly prioritizes the interests of banks, consumer protection will lose when it comes into conflict with other concerns, such as short-term profits or bank solvency.

Ultimately, Federal Reserve policies need to take a long-term view of the financial industry in order to recognize that consumer protection, sound monetary policy, and limiting financial risk are aligned interests. The Federal Reserve should clearly articulate what systemic healthiness of the financial system ideally looks like; enumerate the activities and analysis it will use to measure system-wide health, including examining consumer risks; develop rigorous processes to address systemic risks when they are identified; and tailor those processes to meet the demands of different types of risks, including behaviors, products, and institutional size and complexity.

Greater resolution authority over non-bank financial institutions is essential. This power would augment its ability to create industry-wide uniform standards. It would also provide the necessary authority to take non-bank financial institutions into receivership when they are in danger of failing, to ensure that, unlike AIG, future failed firms are unwound in a manner that is timely, responsible, and less expensive for taxpayers.

Because the Federal Reserve has supervisory authority for bank holding companies and other types of non-depositor firms, it may be the agency that is best positioned to be given resolution authority for non-banks. However, more research and analysis of the Federal Reserve's and others' institutional capacity to handle complex unwinding and liquidation processes is necessary before a final determination is made.

Recommendations for General Federal Reserve Reform

As a member of the Americans for Financial Reform, NCRC supports the coalition's recommendations to create a more neutral Federal Reserve that better balances its sometimes conflicting duties of consumer protection, systemic risk regulation, and monetary policy. Those recommendations include:

- Make all of the district bank presidents appointees of the President, subject to congressional approval. The current practice of appointing Federal Reserve governors to very long terms (14 years) should preserve the necessary degree of independence.

- The Federal Reserve should move away from the "disclosure-based consumer protection" to the creation and enforcement of industry-wide uniform standards that prohibit harmful or abusive products and require that loans be made based on reasonably established ability to repay.

- The rules and regulations established by the Federal Reserve should not preempt state laws, but provide a floor upon which states can add extra protections for institutions under their jurisdiction.

- Monetary policy should be designed to address the concerns of ordinary workers instead of the banks. This would mean more emphasis on maintaining high levels of employment and less concern about modest rates of inflation.

- The Federal Reserve should be required to be more open in its proceedings. As it stands now, the Federal Reserve provides summary minutes of the meetings of the Open Market Committee with a six-week lag. Full transcripts are made available with a 5-year lag. There is no reason that these lags cannot be reduced. In principle, the meetings could be televised live so that the public could immediately understand the factors underlying the Federal Reserve's decisions on monetary policy.

- The Federal Reserve should establish a Consumer Advocate which reports to Congress regularly on agency effectiveness.

- A council made up of the heads of the major federal financial regulatory agencies – including the Federal Reserve – should monitor and manage systemic risk, as no single agency or institution can effectively monitor and prevent or resolve systemic risks. This council should be fully accountable and transparent to the public and have a dedicated staff and sufficient resources. The council should also have the power to preempt consumer and investor protections.

Conclusion

In response to the idea of a separate consumer protection agency, there has been considerable push back, primarily from financial institutions, that such an agency would limit access to credit and discourage lending to families most in need of access. That argument should be considered as having the same merit as the declaration that the markets are self-regulating. We have seen the folly of self-regulated markets and the American people are feeling the pain of failed consumer protection.

To date, more than $12.8 trillion of financial support in the form of investments, loans, and guarantees, has been advanced to prop up the financial system -- but this approach has had limited effectiveness because consumers continue to struggle in a virtual sea of deceptive debt and a financial system that remains unaccountable to the American public.

At the end of the day, the effectiveness of consumer protections – whether they be located in their current regulatory agencies or consolidated in a new CFPA – will depend largely on how those institutions are staffed going forward, the transparency in their work, lack of conflicts in their decision making authority, and the manner and extent of their funding.

Simply consolidating the existing consumer regulatory infrastructure to another building in Washington but leaving these critical issues of structure, authority, and autonomy unaddressed will not have a meaningful impact on protecting the public. And failure to place the appropriate regulatory structure in place at this time, could ultimately lead to another crisis in the future for which recovery may be even more protracted and painful.
Now is the time to enact strong legislation that establishes the financial health of the American public as the first priority of the financial system. When the public benefits from their engagements with the financial system, everyone – borrowers, communities, financial firms, and the nation as a whole – wins.

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Statement of

Elizabeth A. Duke

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy and Technology

Committee on Financial Services

U.S. House of Representatives

July 16, 2009

Chairman Watt, Ranking Member Paul, and members of the Subcommittee, I appreciate the opportunity to appear today to discuss regulatory restructuring and the role of the Federal Reserve Board in consumer protection.

Today, I would like to discuss why the Federal Reserve Board believes there is a compelling case for leaving consumer protection rule writing functions within the Federal Reserve and supervision with the agencies responsible for prudential supervision. While arguments for consolidating functions can themselves be compelling, it is important to also consider the substantial opportunities presented by existing arrangements.

I and other members of the Board are in strong agreement with the Administration that a fundamental lesson of the financial crisis is that we need to do a better job for consumers of financial products. In our view, the Federal Reserve has the resources, the structure, and the experience to execute an ongoing comprehensive program for effective consumer protection in financial services. First, we believe that replicating in another agency the deep expertise and full array of functions embedded within the Federal Reserve and used to support our consumer protection program would be enormously challenging.

We also view consumer protection as complementary to, rather than in conflict with, other responsibilities at the Federal Reserve, such as prudential supervision and fostering financial stability. These missions reinforce one another. For example, sound underwriting benefits consumers as well as the institution, and strong consumer protections can add certainty to the markets and reduce risks to the institutions. We have demonstrated, particularly in recent years with which I am most familiar, our strong ability to effectively execute our congressionally assigned consumer protection responsibilities. In this context, it is important to note that the Board is concerned about the loss of the strong consumer protection perspective that currently exists in our supervisory and other policy discussions. It is appropriate and beneficial that the central bank has a mission that includes an analytical and nuanced understanding of developments in the consumer marketplace.

For these reasons, we stand ready to work with this subcommittee and others in Congress to help identify ways to further strengthen our program institutionally. I will discuss today some of the Board's important consumer protection initiatives and explore several ideas for increasing regulatory accountability for consumer protection, institutionalizing today's commitment to aggressive, effective programs, and maintaining the benefits inherent in current structures. One way to preserve the strengths of our program while reinforcing the requisite level of commitment and focus would be to codify consumer protection as a core mission along with our other responsibilities. Another would be for Congress to establish periodic reporting requirements for consumer protection similar to the Federal Reserve semiannual monetary policy report.

Current Consumer Protection Initiatives of the Board

In order to provide a picture of consumer protection activities of the Board, I would like to briefly note some recent initiatives. A much more extensive report by the Board's staff is provided as an attachment, titled *The Federal Reserve's Role in Protecting Consumer.* I recommend it to you.

It has become standard practice at the Board to make extensive use of consumer testing to improve disclosures to consumers and to highlight practices that simply cannot be understood by consumers even with the best disclosures. In such cases we elected to prohibit the practices.

The Federal Reserve has written strong consumer protection rules for mortgages and credit cards. In fact, our credit card rules served as the basis for recent Congressional legislation.

Next week, we anticipate issuing a comprehensive proposal under our Truth in Lending authority that includes re-designed, consumer-tested disclosures and rule changes for closed-end mortgages and home equity lines of credit. The proposal will include new rules governing mortgage originator compensation. I would add that discussions with our colleagues at the Department of Housing and Urban Development (HUD) about using this same consumer testing protocol for combined Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) disclosures are underway.

This past year, we completed a pilot examination program of nonbank subsidiaries of bank holding companies, and, based on the results of this initiative, we are instituting an ongoing program for supervision of these entities.

We are also active "on the ground" with consumers and groups who represent consumers' interests. We have established a centralized call center and 800 telephone number for receiving consumer complaints. Community affairs and Board research staff have assisted organizations specializing in foreclosure mitigation. And we have worked with nonprofits, financial institutions, and local leaders to advance strategies for neighborhood stabilization.

We have increased staff resources to speed our response time for drafting new rules to address emerging trends that may pose new risks for consumers. We also have created a specialized unit and cross-function process that is devoted to the identification and analysis of these trends to provide early warnings on emerging consumer problems for our examination team, and enhance our messaging to consumers and nonprofit support organizations.

Additionally, we are leading a robust and informed dialogue among community and financial industry stakeholders on ways to modernize the 1977 Community Reinvestment Act (CRA) to reflect changes to the financial landscape and new delivery mechanisms for financial products.

How We Function

The Board's Division of Consumer and Community Affairs (DCCA) has primary staff responsibility for carrying out our consumer protection program. But the Division draws substantially on resources and expertise from other functions of the Board and the Federal Reserve System. The Board's experience is that the most effective programs require a multi-disciplinary approach that draws on a deep understanding of consumer behaviors and interests, as well as financial markets and industry operations. Recognizing that, key elements of the division's program include:

- Rulemaking as a pillar of our consumer protection program that utilizes a team of attorneys to write implementing legislation, update regulations, respond to a changing marketplace, put useful and effective disclosures in place, and prohibit unfair and deceptive acts and practices;
- Consumer testing to develop effective disclosures that are meaningful to consumers;
- Supervision and enforcement of state member banks and bank holding companies and their nonbank affiliates to ensure that consumer protection rules are being followed;
- Consumer complaint and inquiry processes to assist consumers in resolving grievances with their financial institutions and to answer their questions;
- Consumer education to inform consumers about what they need to know when making decisions about their financial services options;
- Research to understand the implications of policy on consumer financial markets;
- Outreach to national and local government agencies, consumer and community groups, academia, and industry to gain a broad range of perspectives, and to inform policy decisions and effective practices;
- Support for national and local agencies and organizations that work to protect and promote community development and economic empowerment to historically underserved communities.

Interconnections Between Consumer Protection and Prudential Supervision

As early as the 1970s, the Board recognized the need for dedicated experts to conduct consumer compliance examinations. Since that time, the Board has had a separate examination force, specially trained in the intricacies of consumer compliance laws and regulations. At the same time, there is recognition that consumer protection supervision is connected in important ways to prudential supervision. As a result, the Board's separate divisions for consumer protection and prudential supervision work closely in developing examination policy and industry guidance. Further, the two functions are housed under the same management structure at the Reserve Banks, where policy is implemented through examinations, applications processing, and complaint resolution. This structure ensures a comprehensive picture through the lens of both safety and soundness and consumer protection for the institutions that are supervised by the Federal Reserve.

We strongly believe that these two responsibilities should remain closely linked. Both sides benefit from a broader perspective of management and risks in a financial organization, and from a close coordination of supervisory actions. Placing consumer compliance examinations activities in a separate organization, apart from other supervisory responsibilities, would adversely affect the complementary nature of these two necessary functions and could reduce the effectiveness of both programs over time.

Interconnections Between Consumer Protection and other Important Central Bank Functions

Perhaps less well understood are the interconnections between our consumer mission and the functions of the Federal Reserve to promote economic and financial stability. Consumer protections are important in creating consumer and investor confidence in the financial marketplace and avoiding negative spillover effects to the broader community. As the current crisis illustrates, loss of confidence and disruptions in consumer credit markets can erode economic performance and, ultimately, the financial stability of national and international markets.

In recent years, we have seen tangible evidence of the importance of household credit to economic performance. Consumer spending makes up roughly 70 percent of gross domestic product (GDP), and, thus, is an important factor to achieving sustainable economic growth. Many staff throughout the Federal Reserve System routinely analyze data and track trends for consumer credit, spending levels, and consumer attitudes to monitor this important market segment.

Our responsibilities for consumer protection and community affairs programs have provided the Federal Reserve, as the nation's central bank, with a valuable view of the economy and financial system through the lens of individual households and communities at a retail level. The more granular view from Main Street is consistent with our regional presence and important to providing a view of economic and financial activity from multiple perspectives. We also believe that consumers benefit from having key economic policymakers who are familiar with the issues affecting individual consumers and communities.

Recent Actions to Expand Consumer Protections and in Support of Consumers and Communities

We believe that the recent actions taken on behalf of consumers represent important advancements in support of consumer protection. They also demonstrate the Board's ability to fulfill these functions. The accompanying report describes these activities, but I would like to highlight several that are particularly relevant to the subject of today's hearing.

Over the course of the past forty years, Congress has assigned the Federal Reserve primary rulewriting responsibilities for many consumer protection and fair lending laws. The provisions of these laws are intended to help inform consumers about financial products, to facilitate their ability to make good choices when selecting these products, to promote fairness in the marketplace, and to protect consumers against unfair and deceptive practices. Thus, we have primary responsibilities for writing rules under authority provided by the Truth in Lending Act, the Home Ownership and Equity Protection Act (HOEPA), which amended TILA, and the Equal Credit Opportunity Act (ECOA), among others. In addition, we share rulewriting with other federal agencies under certain laws, such as the Community Reinvestment Act and Fair Credit Reporting Act (FCRA). Supplement A of the accompanying report provides a complete listing of the statutes for which the Federal Reserve has rulewriting authority.

The Federal Reserve last year issued sweeping new mortgage and credit card rules that significantly expand protections for consumers of these credit products.

Mortgage Credit Rules

The Board used its authority under TILA and HOEPA to revise Regulation Z, which implements these statutes, by issuing final rules to establish comprehensive new regulatory protections for consumers in the residential mortgage market. Importantly, the Board's new rules apply to all mortgage lenders, not just the depository institutions that are supervised by the federal banking and thrift agencies.

The rules are designed to provide transaction-specific disclosures early enough to facilitate shopping and to protect consumers from unfair or deceptive acts or practices in mortgage lending, while supporting sustainable home ownership. They are intended to respond to the most troublesome practices in the mortgage industry that contributed to the recent subprime market meltdown. The Board also adopted rules governing mortgage advertisements to ensure that they provide accurate and balanced information and do not contain misleading or deceptive representations.

As I mentioned earlier, next week we plan to issue a comprehensive rule proposal that includes re-designed, consumer-tested disclosures and rule changes for closed-end mortgages and home equity lines of credit. We also anticipate as part of this same rulemaking to propose new rules to address mortgage originator compensation.

Credit Card Rules

In December 2008, the Federal Reserve issued far-reaching rules to enhance protections for consumer credit card accounts. These rules are the most comprehensive changes to regulations that govern consumer credit cards ever adopted by the Board. They affect nearly all aspects of consumer credit card accounts, including marketing and advertising, disclosures given with applications and at account opening, billing statements, and issuers' ability to change account terms. These rules formed the basis for the recently enacted Credit CARD Act of 2009. Yesterday, we issued an interim final rule amending Regulation Z to implement those provisions of the new credit card law that are effective in August.

Consumer Testing, our Consumer Advisory Council, and Extensive Outreach Further Inform our Consumer Protection Program

Importantly, in developing the credit card rule, as we had with the mortgage rules, we conducted extensive consumer testing, using focus groups and one-on-one interviews with consumers, as well as the more traditional avenues for receiving input.[1] The testing first identified what information consumers currently use in making decisions about their credit card accounts, and how useful they found existing disclosures. The Board used these insights to develop revised credit card disclosures, which also were tested with consumers for comprehension and utility.

[1] See *Design and Testing of Effective Truth in Lending Disclosures: Findings from Qualitative Consumer Testing Research*, submitted to the Federal Reserve Board of Governors by Macro International, Inc. (December 15, 2008), www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a7.pdf, and *Design and Testing of Effective Truth in Lending Disclosures: Findings from Experimental Study*, submitted to the Federal Reserve Board by Macro International, Inc. (December 15, 2008), www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a8.pdf.

We have found consumer testing to be increasingly integral to the consumer protection rules we write, as well as in the development of our consumer education materials. Since 1996, the Board has engaged in extensive consumer surveys and testing to bring critical insight about consumers' understanding of financial products and their decisionmaking for selecting these products. The increasing complexity of certain consumer financial products can pose information overload problems for consumers and thus impair their decisionmaking. We find that consumer testing benefits us in developing well-designed consumer disclosures that convey essential information to consumers in an effective manner. Consumer testing can also reveal those instances in which disclosures are unable to convey adequate information to facilitate consumer choice and help highlight those areas where rules are warranted to safeguard consumers and to prevent unfair and deceptive practices.

Consumer testing is used to supplement our other means for gathering input from consumers, the financial-services industry, and the general public on pending rules and other consumer-related policies. For example, the Federal Reserve's Consumer Advisory Council, a 30-member body representing consumer and community organizations, the financial industry, academics, and state agencies, provides invaluable perspectives on policy matters pertaining to our consumer protection responsibilities. We also actively consider the views of the broad range of consumer and community organizations and financial services industry representatives we meet with or otherwise hear from to inform our views on consumer policies.

Pilot Review of Targeted Nonbank Mortgage Subsidiaries

The recent problems in the subprime mortgage market revealed gaps in supervision and enforcement with respect to nonbank mortgage lenders. Most subprime loans were issued by entities outside the supervisory jurisdiction of the Federal Reserve and other federal bank regulators, and consequently, these entities were not subject to examinations to assess compliance with federal consumer protection laws. We believe, therefore, that it is appropriate for Congress to consider, as part of regulatory reform, a strengthened supervisory and enforcement scheme, in partnership with state regulators and enforcement officials, for closing the regulatory gap with respect to independent nonbank lenders.

Recognizing the critical need to conduct on-site reviews of credit practices of nonbank lenders, the Board, in July 2007, initiated a multiagency partnership to conduct targeted consumer compliance reviews of selected nonbank lenders that had significant subprime mortgage operations. The joint effort is the first time multiple agencies have collaborated to plan and conduct consumer compliance reviews of independent mortgage lenders and nonbank subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities.

The agencies involved--the Federal Reserve, the Office of Thrift Supervision (OTS), the Federal Trade Commission (FTC), and state agencies represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators--developed detailed work plans for the targeted consumer compliance reviews. The pilot program has been completed and the Federal Reserve is fully committed to implementing its own program of supervision of nonbank subsidiaries of holding companies on an ongoing basis. As with the pilot, we will continue to work cooperatively and share information with other agencies with overlapping jurisdictions.

Promoting Consumer Awareness

The Federal Reserve has a long history of providing useful consumer information and promoting awareness of emerging financial market trends and how those trends will affect consumers. Our Consumer Information website (www.federalreserve.gov/consumerinfo) includes 23 consumer topics, providing useful information on bank accounts, consumer credit, and home mortgages. We have also developed calculators to help consumers explore mortgage choices and mortgage financing. We recently launched English and Spanish versions of our credit card repayment calculator, which allows consumers to estimate how long it will take to pay off their credit card bills if they make only minimum payments. The calculators are available on our website.

In response to increasing reports of foreclosure rescue scams, we launched a coordinated effort to warn homeowners already struggling to pay their mortgages. A new informational piece, *5 Tips for Avoiding Foreclosure Scams*, is the latest in our ongoing "5 Tips" plain-language consumer information series. The rapid growth of this problem led us to purchase 30-second spot advertisements in movie theaters in 18 cities experiencing high foreclosure rates. The advertisements were intended to raise public awareness about these scams. The Federal Reserve expects to do more of this type of innovative outreach to consumers.

Collaboration across the Federal Reserve System in Response to the Home Mortgage Crisis

The Federal Reserve System's unique ability to respond at both a national and regional level allowed the Federal Reserve to take an active leadership role in shaping a public policy response as the mortgage crisis deepened.

For example, we created the Homeownership and Mortgage Initiative (HMI). Using economists and community development experts from across the system, the Federal Reserve developed a comprehensive strategy to provide information, data, and solutions that respond to the challenges of preventing unnecessary foreclosures and stabilizing communities that are adversely affected by large clusters of foreclosures. Additionally, the Federal Reserve System is providing online data about subprime lending patterns and performance. The data are available on the Federal Reserve Bank of New York's website.[2] These dynamic maps and data illustrate subprime and alt-A mortgage loan conditions that may assist community groups, policymakers, and local governments as they prioritize the use of their resources and develop plans to lessen the impacts that delinquencies and foreclosures may have on local economies.

We have worked with the Federal Reserve Banks to convene a series of regional conferences: *Recovery, Renewal, Rebuilding: A Federal Reserve Foreclosure Series*, to clarify the challenges and the strategies for moving toward solutions by examining effective practices, creative solutions, and innovative ways to prepare for the future.[3] And we have forged a partnership with NeighborWorks America, a congressionally chartered nonprofit corporation, to identify strategies to address the challenges that foreclosed homes can present, such as decreased home values and vacant properties that can deteriorate from neglect. This collaboration is focused on finding ways to mitigate the impact of foreclosures and vacant homes across the country and to help stabilize neighborhoods.[4]

Recent Actions Taken to Strengthen our Consumer Protection Program

We believe that an effective consumer protection program requires an ability to detect and respond to changing and emerging markets and products, particularly for those that pose risks to consumers. Along these lines, we have taken a number of specific actions and initiatives to strengthen our consumer protection program in ways that enhance our ability to proactively respond to changing markets.

The Federal Reserve staff continues to expand our use of consumer testing for the development of more effective consumer disclosures and other rules. We have created a special

[2] See "Dynamic Maps of Nonprime Mortgage Conditions in the United States," www.newyorkfed.org/mortgagemaps/.
[3] See additional information on the conferences, http://stlouisfed.org/RRRseries/ and www.clevelandfed.org/Our_Region/Community_Development/Events/Seminars/2008/20080827/Overview_4Forums.pdf.
[4] See http://www.stablecommunities.org/.

unit to oversee consumer protections issues in the subsidiaries of the largest financial institutions that are active in consumer credit and payment services, instituted a new program for on-site examinations of nonbank consumer lending affiliates and have expanded our complaint resolution program to include these institutions. We also streamlined access for consumers to file complaints and centralized our complaint and inquiry system using a single 800 complaint telephone number and a new website.

Synergies and Inputs from other Federal Reserve Functions

An important advantage that the Federal Reserve brings to performing its consumer protection mission is our ability to draw on other sources of expertise that exist at the Board and within the Federal Reserve System. Our consumer specialists frequently capitalize on the vast range of expertise of System economists, market specialists, consumer compliance and prudential examiners, and other specialists in banking, economic analysis, and the payments systems. We have found that this array of skills and knowledge, in many respects unique to the Federal Reserve, is invaluable for crafting rules and policies aimed at achieving a proper balance between promoting a fair playing field for consumers while also allowing for market innovations that benefit consumers. The results, we believe, are more informed and thoughtful policies and activities that protect and educate consumers, expand knowledge in the marketplace, and support the important work of consumer and community groups.

Research Activities Support Consumer and Community Affairs Functions

The expertise provided by the research divisions of the Federal Reserve Board and the Reserve Banks is one example of the ancillary, but, nonetheless, vital expertise that our consumer protection staff utilizes in carrying out its responsibilities. The Board's economists conduct research and data collection and perform analyses of developments in the marketplace that may have implications for consumers. For example, economists reviewed available data on market mortgage pricing and performance to help the Board determine the appropriate metric and threshold to be used in defining which home loans would be subject to the Home Ownership and Equity Protection Act rules.

Research economists also play a central role in assuring the integrity of data made available to the public by the Federal Financial Institutions Examination Council (FFIEC)[5] under the Home Mortgage Disclosure Act (HMDA) and the regulations that implement the Community Reinvestment Act. Economists review the data for quality assurance and provide analytic assessments of the data each year. The economists further support fair lending enforcement activities by providing other federal and state regulators with an assessment of possible fair lending issues as revealed through this analysis. Beyond activities that support enforcement of consumer protection rules with respect to individual institutions, economists conduct basic research to learn more about CRA, fair lending and related matters. Past research on these topics has included an examination of the effects of CRA on local communities and on the performance and profitability of CRA-related lending. More recently, economists at the Board conducted an assessment of the relationship between the CRA and the subprime mortgage crisis.

Every three years, the Board sponsors the Survey of Consumer Finances (SCF) that is used to gather unique data on the financial and other circumstances of a nationally representative sample of U.S. households. One of the synergies provided by the Federal Reserve's consumer protection function is that it has direct access to Board economists who design and interpret the results of the SCF. A similar benefit is achieved with respect to the Federal Reserve activities in connection with assessing credit record data and how they are used in the marketplace. Economists have conducted extensive research on the content and quality of credit records, and

[5] The FFIEC is comprised of representatives of the federal financial supervisory agencies: the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Association.

on the use of credit scoring and the effects of scoring on the availability and affordability of credit for the population at large and for different population segments. This, in turn, informs our rulemaking and other policy decisions.

Federal Reserve Bank Activities

The Federal Reserve's twelve regional banks monitor the status of the regions' economies, financial institutions, and communities. The Reserve Banks are tasked with studying their District's economy. Their research factors into monetary and other policy decisions. They also implement the Board's supervisory policies under delegated authority, examining banks within their jurisdiction, and engaging in community economic development activities. Specific activities vary from District to District due to the specific circumstances of their regions. Examples of these specialized activities include the following:

Federal Reserve Bank of Boston[6]

Research Center for Behavioral Economics and Decisionmaking

The Federal Reserve Bank of Boston established the Research Center for Behavioral Economics and Decisionmaking to explore the field of behavioral economics, which attempts to integrate insights from across the social sciences into standard economic research. This research program produces research with the hope of applying its lessons into more effective economic policy. Such research can have important implications when developing consumer protection rules and supervisory policies, as well as informing financial education efforts. The Center also analyzes and interprets outside research that may bear on the Board's consumer protection policy responsibilities.

[6] For more information, see www.bos.frb.org

Federal Reserve Bank of Philadelphia [7]

Payment Cards Center

The Payment Cards Center provides meaningful insights into developments in consumer credit and payments that are of interest not only to the Federal Reserve but also to the industry, other businesses, academia, policymakers, and the public at large. The Center carries out its work through an agenda of research and analysis as well as forums and conferences that encourage dialogue incorporating industry, academic, and public-sector perspectives.

Federal Reserve Bank of San Francisco

The Center for Community Development Investments[8]

The Center for Community Development Investments is an online clearinghouse of investment resources that also encourages collaboration, innovation, and research in the community development investment industry. The Center is sponsored and staffed by the Community Development Unit of the Federal Reserve Bank of San Francisco with direction from an Advisory Committee of industry practitioners and researchers. The activities of this center support our ability to implement CRA and respond to emerging community issues.

Suggestions for Further Reinforcing the Federal Reserve's Consumer Protection Mission

The Federal Reserve Board believes that that consumer protection is vitally important to the strength of the economy and to maintaining financial stability. Our four decades of experience have provided us with a core competency in this area. We are proud of our many significant accomplishments, which attest to the importance that the Board attaches to its consumer protection mission. Accordingly, as Congress considers legislation to reorganize agency functions with regard to consumer protection, one option that might be considered would be to retain the Federal Reserve's consumer protection responsibilities, and consider additional

[7] For more information, see www.phil.frb.org
[8] For more information, see www.sf.frb.org/cdinvestments

policies to strengthen and further reinforce our accountability going forward. Along these lines, I would like to offer some suggestions for how this could be accomplished.

First, as I mentioned previously, Congress could formally codify consumer protection as a core mission or responsibility for the Federal Reserve, similar to monetary policy and banking supervision and regulation. This would provide a clear and ongoing understanding that consumer protection matters should be viewed as an integral part of the Federal Reserve's overall mission.

Second, Congress could require the Chairman of the Federal Reserve Board to report periodically regarding the "state of consumer protection," in the financial services industry, similar to the semiannual monetary policy report to the Congress. Such reporting could include a comprehensive review of the Federal Reserve's actions taken to strengthen consumer protection, the results of regulatory sufficiency reviews (as described below) and planned future actions to address potentially unfair and deceptive acts and practices, a review of enforcement actions, studies of consumer finances, availability of financial services especially in underserved areas, or other matters as requested by the Congress.

Third, we plan to conduct periodic sufficiency reviews of consumer regulations and policies. These reviews will consider emerging trends in consumer financial services, whether existing regulations are adequate for protecting consumers, and will identify those areas in which new consumer protection measures are needed. We will develop a process that includes regional public hearings in Washington, D.C. and at several of the Federal Reserve Banks. The hearings will be held every two years to gather information on consumer issues and risks--similar to the process required by the Credit CARD Act of 2009. As we envision this process, the Federal Reserve's Consumer Advisory Council would assist in preparing the agenda, and its members would participate in the hearings, as appropriate. The findings and recommendations would be reported to Congress.

These are very important matters. Strong, timely, and thoughtful consumer protection is vital for the economic health and vitality of our country. We at the Federal Reserve Board remain strongly committed to strengthening this function. We look forward to continuing to work with Congress on these critical issues.

The Federal Reserve System's Role in Protecting Consumers
July 16, 2009

Overview of the Federal Reserve's Consumer Protection Philosophy

The Board of Governors of the Federal Reserve System (Board) and the Federal Reserve Banks, collectively referred to as the Federal Reserve System (Federal Reserve), have demonstrated a strong dedication to consumer protection. They have worked collaboratively for decades for the benefit of consumers—writing rules to provide consumer protections, supervising and enforcing these regulations in state-member banks, and leading community economic development and consumer education programs throughout the country. These consumer protection roles are bolstered by the organization's unique structure, which enables the Board's dedicated consumer protection division to conduct its responsibilities by tapping a broad range of expertise available across the Federal Reserve in financial law, economics, prudential and consumer compliance examinations, payment systems, and other areas. Such connections provide strategic insight into the implications of policy decisions on consumers, the financial industry, and the broader economy. A detailed discussion of the Federal Reserve's extensive consumer protection program and how its various functions have expanded and adapted to meet the challenges presented by a rapidly-changing financial market place is provided in Appendix A.[1]

The Federal Reserve's Consumer Protection Program

The Board's Division of Consumer and Community Affairs (DCCA) has primary responsibility for developing consumer protection policy for the Federal Reserve. Recognizing the importance of strong rules and rigorous supervision and enforcement of consumer protection regulations, the Board established its consumer protection function and staffed it with specially trained experts who focus exclusively on consumer protection issues. The division applies a multi-disciplinary approach to achieve its mission "to develop regulations, policies, and programs designed to inform and protect consumers, to enforce federal consumer protection laws, to strengthen market competition, and to promote access to banking services in historically underserved markets," including:

- Rule-writing to implement legislation, update regulations to respond to the changing marketplace, and prohibit unfair or deceptive acts and practices;
- Consumer testing to develop effective disclosures that are meaningful to consumers;
- Supervision and enforcement to ensure that consumer protection rules are being followed;

[1] The detailed discussion of the Federal Reserve's consumer protection roles begins on page 16.

- Consumer complaint processing to assist consumers in resolving grievances with their financial institutions;
- Research to understand the implications of policy choices on consumer financial markets and unique regional differences in markets;
- Outreach to national and local government agencies, consumer and community groups, academia, and industry to gain a broad range of perspectives and to inform policy decisions and best practices;
- Consumer education to inform consumers about what they need to know when making decisions about their financial services options.

Contributions from Other Federal Reserve Functions

A more comprehensive consumer protection program is achieved from the strategic positioning of DCCA within the central bank. DCCA draws on extensive resources and expertise to gain understanding of consumer behaviors and interests, as well as banking markets and operations. Staff tap the expertise of their colleagues in research and prudential supervision functions and share their perspectives and expertise to increase understanding of how consumer protection matters impact safety and soundness supervision and national and regional economic issues. This dialogue across the organization contributes to informed, well-researched policy and activities that protect and educate consumers and expand knowledge in the marketplace.

Research Activities to Support Consumer Protection

The research divisions of the Board and the Reserve Banks conduct research, data collection and analysis that support the consumer and community affairs functions. Some activities are focused on the implementation of consumer protection rules and statutes, such as those pertaining to fair lending and substantive protections and disclosures in the areas of consumer and mortgage credit. Other activities are aimed at learning about market circumstances as they pertain to consumer finances, including the use of credit and wealth building. Economists throughout the Federal Reserve routinely monitor and assess data to learn about changing conditions that affect consumers, local communities and businesses. It is through this extensive process that the Board gains a nuanced understanding of the state of the economy as it considers policy actions.

Research contributes to the Board's rulemaking in the consumer arena by gathering and analyzing relevant data and considering the effects on consumers, and the market more generally, of alternative options in proposed and final rules. For example, economists reviewed available data on mortgage pricing to help the Board determine the appropriate metric and threshold to be used in defining which loans in the higher-priced segment of the mortgage market should be subject to new rules concerning underwriting practices. These rules were issued using the Board's authority in the Home Ownership and Equity Protection Act to prohibit unfair practices in connection with mortgage loans.

Research economists also play a central role in assuring the integrity of data made available to the public by the Federal Financial Institutions Examination Council (FFIEC) under the Home Mortgage Disclosure Act (HMDA) and the regulations that implement the Community Reinvestment Act (CRA). Economists review the data for quality assurance and provide analytic assessments of the data each year. The economists further support fair lending enforcement activities by analyzing HMDA data and identifying lenders that may warrant supervisory follow up. This HMDA analysis is used within the Federal Reserve and shared with other state and federal regulators.

Economic research activities in support of the consumer and community affairs functions go beyond fair lending and related matters.[2] Economists routinely conduct research to learn more about the affect of various policies and market changes on consumers. Most recently, Federal Reserve economists conducted studies on various aspects of subprime lending, including research on gaps in mortgage servicers' capacity and incentives to conduct mortgage workouts[3] and an assessment of the relationship between the CRA and the subprime mortgage crisis.

Board researchers also collect and analyze data that help reveal trends in consumer financial matters that are important to policy-making decisions. In particular, the Board sponsors the Survey of Consumer Finances to gather unique data on the financial and other circumstances of a nationally representative sample of U.S. households. The results of this research provide one of the most important sources of information on the assets, debts and wealth of American consumers. The Federal Reserve also has gained great expertise in assessing how credit record data are used in the marketplace. For example, economists have conducted extensive research on the content and quality of credit records. The research includes the use and predictability of credit scoring and the effects of scoring on the availability and affordability of credit for the population at large and for different population segments.

The Nexus Between Consumer Protection and Safety and Soundness Supervision

The Federal Reserve has demonstrated its commitment to consumer protection oversight by establishing a team of dedicated examiners to conduct consumer compliance examinations, including fair lending reviews and institutions' performance under the Community Reinvestment Act. This team of professionals executes the Board's examination procedures to ensure that institutions are complying with consumer protection laws and regulations.

Given the interconnection between consumer protection and prudential supervision, staff in DCCA and the Board's Division of Banking Supervision and Regulation (BS&R) work closely in developing examination policy and industry guidance. In its supervision governance structure, the Board's directors of BS&R and DCCA have co-chaired the Supervision Committee, which consists of the heads of supervision from the twelve Reserve Banks. In

[2] See Supplement E for a list of more than 175 studies on financial issues related to consumers and small businesses conducted by Federal Reserve researchers since 2004.

[3] Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, *The Incentives of Mortgage Servicers: Myths and Realities*, 2008, http://www.federalreserve.gov/pubs/feds/2008/200846/200846abs.html.

addition, every three years, DCCA and BS&R staff conduct a coordinated operations review of a Reserve Bank's supervision function.

In the Reserve Banks, the two examination functions are housed under the same management structure, enabling coordination of the policies implemented through examinations, applications processing, and complaint resolution. This structure ensures that information about an institution's issues is shared and evaluated though the lens of both safety and soundness and consumer protection for the institutions supervised by the Federal Reserve. As one way to stay on top of emerging supervisory issues, Board staff and Reserve Bank leadership have regularly scheduled discussions of both prudential and consumer compliance supervisory matters. With their regional perspectives, the Reserve Banks provide a valuable early-warning system for emerging local risks that may have national implications.

In addition, to keep pace with regulatory changes and the changing complexity of the financial services industry, the Board has a supervisory program dedicated to consumer compliance at large financial institutions and large complex banking organizations, including large regional banks, bank holding companies, and nonbank subsidiaries of holding companies. Oversight of these companies is tightly coordinated with the Board's safety and soundness supervision for these companies. Each year, staff from the Reserve Banks develop a risk assessment for each of the institutions in the large bank portfolio that is used to plan the supervisory strategy, including consumer compliance. DCCA staff review the risk assessments to ensure that the documents appropriately capture the consumer compliance risk in each company and to ensure that consumer compliance examinations are sufficient both within each company and across the portfolio.

Federal Reserve Bank Activities

The Federal Reserve's twelve regional banks monitor the status of their region's economy, financial institutions, and communities. The Reserve Banks set their research priorities, with economists studying their District's markets to understand regional dynamics and to contribute to monetary policy. A cadre of specialized consumer compliance examiners implements the Board's supervisory policies under delegated authority, examining banks in their jurisdiction. Reserve Banks also conduct specific community development activities and research activities, which vary from District to District to respond to the unique circumstances of low- and moderate-income communities in its region. The following are a few examples of how specialized programs at the Reserve Banks contribute to informed, thoughtful consumer protection policy.

Federal Reserve Bank of Boston[4]

<u>Research Center for Behavioral Economics and Decisionmaking</u>

[4] For more information, see www.bos.frb.org

The Federal Reserve Bank of Boston established the Research Center for Behavioral Economics and Decisionmaking, which works to integrate insights from across the social sciences into standard economic research. This program produces research in this specialized discipline, with the objective of developing more effective economic policy. Such research can have important implications for consumer protection rules and supervisory policies, as well as financial education efforts. The Center also analyzes and interprets outside research that may bear on the Board's consumer protection policy responsibilities. These studies and analyses help inform Board research on issues related to how consumers manage and make decisions about their finances.

Federal Reserve Bank of Philadelphia [5]

Payment Card Center

The Payment Card Center provides meaningful insights into developments in consumer credit and payments that are of interest not only to the Federal Reserve but also to the industry, other businesses, academia, policymakers, and the public at large. The center was developed in response to the recent developments in payment options and helps inform policy in this rapidly-evolving area. It carries out its work through an agenda of research and analysis as well as forums and conferences that encourage dialogue incorporating industry, academic, and public-sector perspectives. Staff from the payment card center provided valuable input for the Board's recent credit card rulemakings and are involved in current efforts to develop rules on stored-value cards.

Reserve Bank of San Francisco

Community Development Investment Center[6]

The Center for Community Development Investments is an online clearinghouse of investment resources that also encourages collaboration, innovation and research in the community development investment industry. With the mission to support the long-term growth of the community development investment industry, the Center serves as a national center for research, training, pilot initiatives, and policy-making discussions. The Center is sponsored and staffed by the Community Development unit of the Federal Reserve Bank of San Francisco with direction from an Advisory Committee of industry practitioners and researchers. It has produced several key publications that have served as a catalyst for further discussion of emerging issues and trends in the community development industry.

Delivering Results: The Federal Reserve's Comprehensive Approach to Consumer Protection

[5] For more information, see www.phil.frb.org

[6] See www.sf.frb.org/cdinvestments

With this multi-faceted, multi-disciplinary approach to consumer protection, the Board can respond effectively to consumer protection issues in the marketplace. The following section highlights recent examples of important new policies and program enhancements by DCCA that were developed with input from experts throughout the Federal Reserve System.

Mortgage Credit

HOEPA Rule-writing

The Federal Reserve has primary rulewriting responsibility for many consumer protection laws, including the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA), which amended TILA. The Board recently revised Regulation Z, which implements these statutes by issuing final rules to establish sweeping new regulatory protections for consumers in the residential mortgage market. Importantly, the Board's HOEPA rules apply to all mortgage lenders, not just the depository institutions that are supervised by the federal banking and thrift agencies.

The rules are designed to protect consumers from unfair or deceptive acts or practices in mortgage lending, while supporting sustainable home ownership. The rules respond to some of the most troublesome practices in the mortgage industry that contributed to the recent subprime market meltdown. In response to specific problems, some restrictions in the final rules apply only to higher-priced mortgage loans. Other provisions apply to all mortgage loans secured by a consumer's principal dwelling. The Board also adopted rules governing mortgage advertisements to ensure they provide accurate and balanced information and do not contain misleading or deceptive representations.

The Board's final rules resulted from a process that involved extensive research and outreach to consumer groups, industry representatives, and other government agencies at the state and federal levels. The Board held a series of public hearings on consumer protection in the mortgage market in four cities across the country during the summer of 2006. In light of the information received at the 2006 hearings and the rise in defaults that began soon after, the Board held an additional hearing in June 2007 to explore how it could use its authority under HOEPA to prevent abusive lending practices without unduly constricting credit. At the 2007 hearing, and in hearing-related public comments, the Board received input from individual consumers, lenders, mortgage brokers, state government officials, and academicians. The Board's rulemaking was also informed by the comments received in connection with the development of interagency supervisory guidance on nontraditional mortgage products issued in September 2006 and interagency guidance on subprime lending that was issued in June 2007. These guidance pieces addressed both consumer protection and prudential supervision matters. Throughout the process, Board staff also drew upon the expertise and perspectives resident in the members of the Board's Consumer Advisory Council.[7] Moreover, Board's economists and prudential supervision personnel were involved in developing and implementing policy options for the Board's consideration for the HOEPA rules, drawing on numerous data and their understanding of mortgage markets.

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[7] The Board's Consumer Advisory Council meets with the Board members three times each year to provide advice about emerging risks and solutions for consumer protection issues.

In response to the proposed rules that were issued in December 2007, the Board received and considered approximately 4,700 comment letters that represented a broad spectrum of views. After listening carefully to commenters, collecting and analyzing data, and undertaking consumer testing, the Board issued more effective and improved final rules that include the following restrictions for "higher-priced mortgage loans" mortgages:

- Prohibiting a lender from making a loan without regard to the borrower's ability to repay the loan from income and assets other than the home's value.
- Requiring creditors to verify the income and assets they rely upon to determine repayment ability.
- Banning any prepayment penalty if the payment can change in the initial four years. For other higher-priced loans, a prepayment penalty period cannot last for more than two years.
- Requiring creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

For all mortgage loans secured by a borrower's principal dwelling, the rules establish that:

- Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value.
- Companies that service mortgage loans are prohibited from engaging in certain practices, such as pyramiding late fees. In addition, servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request.
- Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days after a consumer applies for any mortgage loan secured by a consumer's principal dwelling, such as a home improvement loan or a loan to refinance an existing loan.

The rules also set additional advertising standards that apply to all mortgages, requiring additional information about rates, monthly payments, and other loan features. Further, the final rules ban seven deceptive or misleading advertising practices, including representing that a rate or payment is "fixed" when it can change.

Pilot Review of Targeted Non-bank Mortgage Subsidiaries

The recent problems in the subprime mortgage market revealed gaps in the federal agencies' supervisory authority. While supervisory guidance was issued in 2005 and 2006 to address areas of concern in the mortgage industry, the Board had limited authority to conduct loan file reviews in segments of the industry where the loans were being made to verify adherence to the guidance. The Boards' authority to conduct examinations of state-member banks is clear. However, the Federal Reserve's authority to examine non-bank subsidiaries of bank holding companies was made less clear by the passage of the Gramm-Leach-Bliley Act of 1999, which vested clear enforcement authority for these entities to their primary functional regulators (the Federal Trade Commission and the States). This represented a challenge because the vast majority of subprime lending was undertaken by independent brokers and mortgage banks, supervised by state banking agencies, and non-bank subsidiaries of banks and bank holding companies.

Recognizing the critical need to conduct on-site reviews of credit practices of non-bank lenders, in July 2007, the Board initiated a multiagency partnership to conduct targeted consumer compliance reviews of selected non-bank lenders that had significant subprime mortgage operations. The joint effort is the first time multiple agencies have collaborated to plan and conduct consumer compliance reviews of independent mortgage lenders and non-bank subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities.

The agencies involved—the Federal Reserve, the Office of Thrift Supervision (OTS), the Federal Trade Commission (FTC), state agencies represented by the Conference of State Bank Supervisors, and the American Association of Residential Mortgage Regulators—developed detailed work plans for the targeted consumer compliance reviews. Federal Reserve consumer compliance examiners, assisted by representatives from the FTC and the states, led reviews of entities supervised by the Federal Reserve System. The consumer compliance examiners also received assistance from Federal Reserve credit risk subject matter experts to ensure a broad understanding of the companies that were reviewed. At the same time, state regulators conducted a coordinated review of an independent state-licensed subprime lender and associated mortgage brokers, and the OTS conducted a review of a mortgage subsidiary of a thrift holding company.

The reviews evaluated the companies' underwriting standards, as well as senior management's oversight of the risk-management practices the companies used to ensure compliance with state and federal consumer protection regulations and laws, including the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Federal Trade Commission Act, and the Home Ownership and Equity Protection Act. The agencies shared information about the reviews and investigations to ensure that similar issues were treated consistently.

In addition, the Federal Reserve System sent surveys to the consumers whose loan files were analyzed during the on-site reviews. The surveys were designed to learn how well consumers understood the terms of their mortgage loans. While the survey responses did not indicate that violations of the relevant consumer protection laws and regulations had occurred, the responses confirmed information that DCCA obtained through consumer testing – that disclosure alone is not enough to explain complex loan products to consumers.

As a result of this pilot, the Board is introducing a framework for routine consumer compliance supervision of non-bank subsidiaries of the largest bank holding companies. These supervisory activities will be risk-focused and done in coordination with the prudential supervision program for these entities. They will include continuous monitoring, discovery reviews, examinations with transaction testing, as appropriate, and the investigation of consumer complaints. As the program is implemented the effectiveness of the framework will be assessed and adjusted as necessary.

Responding to the Home Mortgage Crisis – Collaboration, Local Solutions and National Policy Outcomes

While implementing regulatory and supervisory actions to address issues in the mortgage market, the Federal Reserve also mobilized to respond to the alarming rate of foreclosure throughout the country. As foreclosures mounted and projections worsened throughout 2008, nonprofit organizations, governments, lenders, and mortgage servicers worked to respond to the needs of borrowers and communities confronting defaulting mortgages and foreclosures. The Federal Reserve System's unique ability to respond at both a national and regional level allowed the Federal Reserve to take an active leadership role in shaping a public policy response as the crisis deepened. The Federal Reserve responded by hosting policy forums, conducting extensive outreach, filling a critical information gap and acting as a central source of accurate, timely data on foreclosures nationwide.

In doing so, the Federal Reserve tapped its extensive resources throughout the country – twelve regional banks and twenty of their branch offices and the Board of Governors in Washington, D.C. – to apply research, supervision, and community development expertise in identifying strategic inputs for informing local and regional responses to economic conditions. The Federal Reserve coalesced these resources and created the Homeownership and Mortgage Initiative (HMI), a comprehensive strategy to provide information and solutions toward helping to stem unnecessary foreclosures and to help stabilize communities and prevent negative spillovers at the neighborhood level. The HMI coordinated the various functional areas of the System to improve access to data, information, and policy relating to foreclosures. This strategy capitalized on the following areas of expertise:

- *Research and Analysis* to provide community groups, counseling agencies, regulators, financial institutions, and others with detailed analysis to support efforts to help troubled borrowers and communities.
- *Supporting Informed Public Policy* to bring experts together to discuss the deepening foreclosure crisis and pose policy responses to prevent unnecessary foreclosures and address community stabilization efforts.
- *Financial Education* to help consumers make informed personal financial decisions, including those about home ownership.

With respect to research and analysis, the Federal Reserve has provided community coalitions, counseling agencies, fellow regulators, financial institutions, and others with detailed analyses identifying neighborhoods at high risk of foreclosures. By understanding those areas with concentrations of subprime mortgages, delinquencies, and foreclosures, community leaders, local and state governments can better target their scarce resources to borrowers in need of counseling and other interventions that may help forestall foreclosure.

To support needed research and analysis, the Federal Reserve System launched several initiatives to provide studies, data, and other resources related to foreclosures. With access to reliable data being a significant challenge to communities grappling with foreclosures, the Federal Reserve System provided online data concerning subprime lending patterns and performance, posted on the Federal Reserve Bank of New York's website. [8] These dynamic maps and data illustrate subprime and alt-A mortgage loan conditions that can assist community groups, policymakers, and local governments as they prioritize the use of their resources for these efforts and develop plans to lessen the impacts that delinquencies and foreclosures may have on local economies. In addition, a Federal Reserve System workgroup, consisting of some of the System's top economists and community development experts, have prepared overviews of the current state of knowledge about housing and mortgage markets, as well as about foreclosures. The System continues to conduct research on a wide range of topics to fill analytical gaps and better understand the effects of foreclosure on neighborhoods, the economy, and the housing and mortgage markets.

As the crisis unfolded, housing experts began identifying critical issues that needed immediate attention. The Federal Reserve hosted a series of policy forums in five different cities to explore the impact of the foreclosure crisis on different real estate markets; develop strategies that address both the negative impact of foreclosures in high-cost markets and the challenge of strengthening neighborhoods in weak-market communities; and how recent research on foreclosure and vacancy and abandonment might be actualized as public policy. Through this series, "Recovery, Renewal, Rebuilding: A Federal Reserve Foreclosure Series," attendees in Atlanta; Los Angeles; Columbus, Ohio; St. Louis, and Washington, D.C., worked to clarify the challenges and the strategies for moving toward solutions by examining best practices, creative solutions, and innovative ways to prepare for the future.[9] The Community Affairs Offices at each of the twelve Reserve Banks filled an information gap by launching online Foreclosure Resource Centers, which include a Community Foreclosure Mitigation Toolkit, to provide information to homeowners, prospective home buyers, and community groups on preventing foreclosures and lessen their negative influence on neighborhoods.[10]

In the interest of supporting borrowers experiencing difficulty in meeting their mortgage obligations, the Board has provided outlets for mortgage-related consumer financial education materials. In addition, through the HMI, the Federal Reserve has posted internal and external resources on each of the 13 Federal Reserve websites to help improve consumers' access to information that can assist them as they work to address their mortgage challenges.[11] Staff also revised *Consumer's Guide to Mortgage Refinancing*, providing a link to a to a mortgage refinancing calculator.[12] For consumers who have questions about banking procedures and rules, or feel they may have been unfairly treated by their bank, the Federal Reserve Consumer Help

[8] See "Dynamic Maps of Nonprime Mortgage Conditions in the United States," www.newyorkfed.org/mortgagemaps/.

[9] See additional information on the conferences, http://stlouisfed.org/RRRseries/ and www.clevelandfed.org/Our_Region/Community_Development/Events/Seminars/2008/20080827/Overview_4Forums.pdf.

[10] See Mortgage Foreclosure Resources at www.federalreserve.gov/consumerinfo/foreclosure.htm.

[11] See Mortgage Resources for Consumers, www.federalreserve.gov/consumerinfo/foreclosure_consumers.htm.

[12] See "5 Tips for Protecting Your Home from Foreclosure," www.federalreserve.gov/pubs/foreclosuretips/default.htm and www.federalreserve.gov/consumerinfo/mortgages.htm.

Center feeds queries directly into the various regulatory agencies so that a consumer has only one stop to make to ask questions or file complaints.[13]

With the completion of the HMI in March 2009, the Federal Reserve System launched the Mortgage Outreach and Research Efforts (MORE) initiative in May 2009 that builds on the knowledge and experiences from the HMI. MORE is coordinating and facilitating the Federal Reserve System's response to mortgage delinquencies and foreclosures with the goal of: 1) mitigating the impact of the mortgage crisis on individuals and communities; 2) deepening understanding of the incidence, causes, and impact of foreclosures; and 3) enhancing communications strategy on mortgage-related issues. Knowledge acquired through the HMI helped to refine the scope of MORE's objectives, which focuses primarily on: 1) reducing preventable foreclosures; 2) promoting effective neighborhood stabilization; and 3) enhancing consumer protection efforts. Anticipating the development of germane ideas and analysis that would contribute to policy makers and local stakeholders, MORE includes a strategic approach to enhancing external outreach and messaging such as effective dissemination of maps, analysis, reports; convening public forums for researchers, policy analysts, and practitioners; and creating and disseminating toolkits for local stakeholders.

To support neighborhood stabilization efforts, the Federal Reserve forged a partnership with NeighborWorks America, a national nonprofit, to identify strategies to address the challenges that foreclosed homes can present, such as decreased home values and vacant properties that can deteriorate from neglect. This collaboration is focused on finding ways to mitigate the impact of foreclosures and vacant homes across the country and help stabilize neighborhoods. As a result of this partnership, information on community stabilization best practices, new resources, and strategies has reached thousands of community development practitioners. Impacts of this effort include:

- the development of the first national neighborhood stabilization curriculum which resulted in the training of 640 community development professionals nationwide;
- 22,400 professionals who have benefitted from the information on a newly created neighborhood stabilization web-site[14];
- twelve workshops across the country highlighting neighborhood stabilization best practices that reached 820 practitioners.

The partnership, which included personnel, analytical, and financial support by the Federal Reserve, included the development and deployment of training resources, the development of web-based materials for the benefit of local leaders, convening various key actors, and the provision of data and analysis to inform intervention strategies. When Congress approved funding for HUD's National Stabilization Program (NSP), the Board assisted HUD in the development of allocation formulas and qualifying criteria, and is conducting a series of case studies using the first wave of NSP grants to identify promising approaches and to assist HUD in targeting future rounds of awards. The Federal Reserve has also hosted or co-hosted a number of

[13] See www.federalreserveconsumerhelp.gov.

[14] See http://www.stablecommunities.org/.

training events for local leaders pursuing community stabilization efforts in general, and NSP funding in particular.

Policy Analysis, Emerging Risk Monitoring, and Community Reinvestment Activities

Recognizing the critical need to analyze and understand the broad range of policy that affects consumers' economic and financial well-being, DCCA created a policy analysis group in 2007. This unit gathers, creates, and interprets a range of information relevant to current and emerging public policy issues relevant to consumer protection and community development. In particular, the policy analysis group systematically scans information from across the Federal Reserve System, including such disparate sources as trends in consumer complaints, analysis from research economists, warning signs from bank examiners, new developments for Reserve Banks, and state-level legal changes to anticipate and analyze upcoming issues. It uses this information and analysis to advise Board members, DCCA staff, and other stakeholders on appropriate courses of action as warranted.

This function has been fully integrated into the Board's response to the recent wave of foreclosures. In addition to assisting the attorneys, examiners, and community development teams in responding to the crisis, staff has worked across sectors and agencies to collect relevant data and understand the concerns of various stakeholders. As part of this effort, DCCA engages regularly with a diverse group of stakeholders, including consumer groups, housing counselors, nonprofit intermediaries, lenders, loan servicers, mortgage insurers, investor groups, elected officials, and other federal and state agencies. This interaction has informed the Board as it has advised regulated institutions on dealing with delinquencies, developed tools for consumers, worked with the HOPE NOW Alliance and other industry efforts, collaborated with the Department of Housing and Urban Development (HUD) on the implementation of "Hope for Homeowners" and with the Department of Treasury on "Making Home Affordable" programs, and generally leveraged public and private sector resources where possible to inform public policy decisions.

To stay ahead of the curve on new policies and practices as they emerge, DCCA has established a committee to actively assess emerging risks and issues affecting consumers and communities, and identify possible responses. This cross-disciplinary group includes attorneys, economists, consumer compliance managers, data specialists, policy analysts, and others, and draws information from across the Federal Reserve System. This early warning system researches a range of budding topics of potential concern and assesses their impact on consumers. The committee has vetted, and provided policy recommendations, on a diverse set of issues. For instance, this group identified the need for additional attention to be paid to reverse mortgages, likely to increase in scale due to demographic trends and other factors, and mobile banking, growing in size due to recent technological advancement; these issues are now staffed with multidisciplinary teams monitoring trends and recommending courses of action.[15] The

[15] This group has also analyzed possible consumer concerns related to such varied topics as auto loans, overdraft protection, debit cards, fallout from mortgage delinquencies, life settlement transactions, foreclosures, mortgage rescue scams, loan servicing abuses, remotely created checks, rental housing, retirement annuities, stored value cards, student loans, transactional mortgages, 401(k) debit cards, and home equity lines of credit.

intent of the effort is to continuously scan the horizon for potential threats or concerns for the economic well-being of consumers and the communities in which they live, and take effective steps to anticipate problems before they emerge.

One result of this work has been new consumer education and awareness campaigns around foreclosure assistance and scams. In the spring of 2009, in response to the increasing number of foreclosure rescue scams identified by non-profits, lenders, and others, the Federal Reserve Board took the proactive step to purchase 30-second advertisements in movie theaters to raise awareness of these scams and other fraudulent schemes aimed at consumers. The advertisements, which played before movie previews in 18 cities with high foreclosure rates, warn consumers about foreclosure scams and direct them to the Board's website for tips on avoiding fraud and for information about other resources available to them through the Federal Reserve System. Perhaps even more effective than the advertisements themselves was the broader media coverage on this effort. Several major newspapers, wire services, and radio and television news programs reported on the movie theater strategy, further extending the reach of the message and raising public awareness of this critical issue.[16] The campaign has been further leveraged through the Federal Reserve Banks, which plan to air, and in some cases, locally tailor, the PSA at additional theaters in their markets. Posters derived from the PSA campaign, as well as the Board's consumer education publication, *5 Tips to Avoiding Foreclosure*, are being used by the National Association of Realtors and mortgage servicers.

To further support policy evaluation regarding community development and financial services to traditionally underserved consumers, the Federal Reserve is leading a robust discussion on Community Reinvestment Act (CRA) modernization. The Boston and San Francisco Federal Reserve Banks earlier this year published *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act,* in which some twenty experts shared their ideas, opinions and research regarding CRA's history and possible areas in need of reform.[17] The publication was rolled out at a Washington, D.C. policy forum, co-sponsored by the Board and keynoted by Federal Reserve Governor Elizabeth Duke. CRA was also the principal focus of the Cleveland Federal Reserve Bank's policy summit. As part of this process, the Board has solicited views on CRA reform from a wide range of stakeholders, including financial services industry representatives, community organizations, non-profit community development practitioners, and other experts.

Credit Card Rules

As the most common consumer financial services credit product, credit cards represent an important tool for facilitating transactions for both consumers and businesses. Advances in technology (such as credit scoring) and the expansion of the financial services marketplace have contributed to a significant increase in competition in the credit card market over the last decade.

[16] Additional information is provided in Supplement C.

[17] Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, http://www.frbsf.org/publications/comm.unity/cra/index.html.

However, in recent years, as credit card terms and features have become more complex, the risk that consumers will not understand or notice key terms that affect a plan's cost has increased. In addition, over time, lenders began employing aggressive, and sometimes deceptive, marketing, pricing, and billing practices. These abuses elevated concerns about the transparency and adequacy of consumer disclosures for credit cards.

The Federal Reserve is committed to enhancing consumers' ability to use credit cards in a responsible and informed manner. In December 2008, the Board issued sweeping rules to enhance protections for consumer credit card accounts. These rules are the most comprehensive changes to regulations that govern consumer credit cards ever adopted by the Board. These rules affect nearly all aspects of consumer credit card accounts, including marketing and advertising, disclosures given with applications and at account opening, billing statements, and issuers' ability to change account terms. In fashioning these rules, Board staff drew upon extensive data about credit card usage, including the use of so-called "teaser" rates, balance transfer programs, penalty pricing, and other practices. Board economists and others were involved with this effort to seek to ensure that issues about access to credit, innovations, and new products were carefully considered along with card issuer practices and policies.

The Board drew on several sources of data and information in developing improved disclosures to communicate key information to consumers in ways that they would be more likely to pay attention to, understand, and use in their decisionmaking. Board economists and attorneys used the services of a professional consumer testing firm to conduct extensive consumer testing, using focus groups and several dozen one-on-one interviews with consumers.[18] The testing first identified what information consumers currently use in making decisions about their credit card accounts, and how they use existing disclosures. The Board used these insights to develop revised credit card disclosures, which also were tested with consumers. Prior to issuing final rules, the Board conducted quantitative testing with over 1,000 consumers nationwide to gauge consumers' comprehension of the newly developed disclosures compared to existing disclosures and formats. In addition, in response to proposed revisions to Regulation Z issued in June 2007 and May 2008, the Board received and considered over 60,000 comment letters representing a broad spectrum of views. The Board used lessons learned from testing and input from those commenting in order to develop a final rule and model disclosures that would enhance consumer understanding of credit card terms.

Conclusion

These are but a few examples of the Federal Reserve's commitment to consumer protection and its ability to apply a comprehensive approach to improving disclosures, imposing substantive consumer protections, banning unfair and deceptive practices, and addressing consumer education needs. This work is designed to ensure that families are well served by

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[18] See *Design and Testing of Effective Truth in Lending Disclosures: Findings from Qualitative Consumer Testing Research*, submitted to the Federal Reserve Board of Governors by Macro International, Inc. (December 15, 2008), www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a7.pdf, and *Design and Testing of Effective Truth in Lending Disclosures: Findings from Experimental Study*, submitted to the Federal Reserve Board by Macro International, Inc. (December 15, 2008), www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a8.pdf.

financial services products to the betterment of their individual goals and to the ultimate benefit of the broader economy.

Given today's difficult economic times and complex consumer financial marketplace, consumers and communities require unprecedented protection. The Federal Reserve is an institution that is well positioned to respond vigorously and swiftly to the issues that require immediate remedy. Further discussion of the Federal Reserve's consumer protection program is provided in Appendix A.

Appendix A

Federal Reserve Roles in Consumer Protection and Community Development

Rulewriting Responsibilities

The Board has sole responsibility for issuing rules to implement a number of consumer financial services and fair lending laws, including the Truth in Lending Act (TILA), Truth in Savings Act (TISA), Electronic Fund Transfer Act (EFTA), Consumer Leasing Act, Equal Credit Opportunity Act (ECOA), and Home Mortgage Disclosure Act (HMDA). In addition to the statutes for which the Board has exclusive rulewriting responsibility, the Board shares rulewriting responsibility with other agencies under certain laws, such as the Community Reinvestment Act (CRA) and the Fair Credit Reporting Act (FCRA).[19] The Board and other federal financial regulators sometimes lend expertise by serving in a consulting role in the development of consumer regulations issued by other agencies such as the Department of Housing and Urban Development, and the FTC. For example, most recently, the Board has consulted with the Department of Defense (DOD), with respect to DOD's development of regulations governing loans to members of the armed services and their families.

The Board has a committed team of attorneys within DCCA who are solely dedicated to fulfilling these responsibilities. These professionals possess the specific legal expertise and experience for interpreting legislation and crafting consumer regulations that strive to provide meaningful consumer protection without impeding the innovation that improves consumer choice, convenience, and service in financial products. With this knowledge, these attorneys effectively tap information resources within the Federal Reserve, such as market information from economists and business practices data from prudential and consumer compliance examiners. In addition to these valuable inputs, the DCCA attorneys also review consumer complaints, examination reports, and public comment letters and solicit the views of other federal and state regulators who have valuable insights based on their own experience and expertise in supervising financial institutions and protecting consumers. The views of state agencies through such organizations as the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Attorneys General (NAAG), as well as from individual state regulatory agencies are also sought in order to gain a broad perspective to inform the rulewriting process.

In addition to its rulemakings to implement statutory changes, the Board updates its regulations in response to the changing marketplace and emerging issues. As markets change and products evolve, questions arise about how existing rules apply in new circumstances. These matters are often addressed through amendments that specifically target a particular issue, or by updating the interpretations published in the commentaries to our regulations. As a matter of policy, the Board periodically conducts a comprehensive review of each regulation. For the

[19] See Supplement A.

consumer financial services laws, one goal of these regulatory reviews is to develop more effective consumer disclosures. Writing regulations always involves the challenge of crafting rules that are, on the one hand, clear and specific enough to facilitate compliance and promote consistency among financial institutions but, on the other hand, flexible enough to accommodate market developments. By balancing these interests, the Board seeks to avoid imposing undue regulatory burdens that could hinder innovation and raise costs without producing offsetting benefits in consumer protection. Toward this end, the Board actively seeks the input of a wide range of stakeholders through various processes that are elemental to the rule-writing effort, including conducting consumer testing, soliciting public comment, and enlisting the Board's Consumer Advisory Council.

Consumer Testing

Many of the consumer protection laws for which the Board writes regulations are based on ensuring that consumers receive adequate information in the form of disclosures about the features and risks of a particular product. When consumers are well informed, they are in a better position to make decisions that are in their best interest. Information helps and empowers individual consumers by improving their ability to compare products and to choose those that will help them meet their personal goals.

Since 1996 the Board has engaged in extensive consumer surveys and testing to assess consumers' needs and develop effective disclosures for regulatory proposals using the services of a professional testing firm. Consumer testing provides critical insight into consumers' understanding of financial products and their decision-making process. Given the complexity of certain products, such as credit card products with multiple features and nontraditional mortgages, there is significant danger of information overload that can undermine consumers' decision-making processes. Comprehensive consumer testing enables the Board to design disclosures that are articulated and presented in a manner that conveys essential information to consumers.

Consumer testing provides insights that are vital to learning more about how consumers use information and how disclosures can be simplified to enhance consumers' understanding. The Board made a valuable investment in developing and testing revised credit card disclosures and is currently engaged in testing mortgage disclosures to make them more effective. Through the consumer testing process, staff gained valuable insight in three key areas: 1) what information consumers find useful when making credit decisions and what information they ignore, 2) what information consumers comprehend and what information they do not, and 3) the impact that different formats and presentation can have on consumers' ability to notice and use the information.

To ensure that new disclosures are useful to consumers, the Board has increased its use of consumer testing. Exploring how consumers process information and come to understand--or sometimes misunderstand--important features of financial products has proven eye-opening. The lessons learned from consumer testing have resulted in improved required disclosures. For example, the Board's new rules on credit card disclosures require certain key terms to be included in a conspicuous table provided at account opening because field testing indicated that consumers were often already familiar with and able to interpret such tables on applications and solicitations, but were unlikely to read densely written account agreements.

The Board will continue to use qualitative cognitive testing with individuals to help develop clear disclosures and quantitative validation testing to ensure the new disclosures represent an improvement over those currently in the marketplace. Currently, the Board is conducting extensive consumer testing for disclosures for mortgages, home equity lines of credit and overdraft protection products. Additional insights are also gained from the field of behavioral economics and consumer testing as the Board continues to explore ways to provide disclosures that consumers will pay attention to, comprehend, and use in their decision making.

Consumer testing efforts have also revealed that even the best disclosures do not offer the best protection to consumers in all cases. Some aspects of increasingly complex products simply cannot be fully understood or evaluated by consumers, no matter how well-educated the consumer or how clear the disclosure. Because of the complexity of certain products and terms, it may be difficult for consumers to weigh their costs and benefits or make informed choices. Some products posing a high degree of risk to consumers, especially those targeted at vulnerable populations, are often offered through aggressive or misleading marketing. Thus, there remains a need for effective regulation and enforcement that are responsive to market changes and that protect consumers from practices that are unfair and detrimental to consumers. In those cases, direct regulation, including the prohibition of certain practices, is necessary. In these cases, the Board has limited the discretion of lenders or prohibited certain practices. For example, the failure to require escrow accounts for homeowners' insurance and property taxes led borrowers to underestimate the costs of homeownership. The Federal Reserve restricted this practice and others through new mortgage rules adopted in July 2008. Similarly, the Board's credit card rules issued in December 2008 will protect consumers from unexpected interest charges, including increases in the interest rate during the first year after account opening and increases in the rate charged on pre-existing credit card balances.

Public Comment and Outreach

Each regulatory proposal is submitted to the public for critique and comment. This process provides the opportunity for all stakeholders—from large, well-organized interest groups to individual consumers—to offer their perspectives on the impact of the proposal. As concern over consumer protection has gained considerable attention by lawmakers, media, and individuals in recent years, participation in the public comment process has increased, particularly in the areas of mortgage lending and credit cards. For example, the Board's proposal to amend rules related to mortgage credit under its authority granted by Home Ownership and Equity Protection Act, issued in December 2007, generated approximately 4,700 comment letters. The Board's proposal on credit cards, published in May 2008, yielded more than 60,000 comment letters from the public, most of which were from individual consumers in addition to trade associations, financial institutions, and consumer and community groups. These comment letters were reviewed and their issues considered in drafting the final rules.

In addition to the public comment process, the Board also actively seeks input from a range of leaders in the consumer finance industry, including lenders, advocates, researchers, government officials and other regulators. To gather input from these stakeholders, the Board convenes hearings or special forums on the issues. The Board's mortgage rulemaking was also informed by the comments received in connection with the development of interagency supervisory guidance on nontraditional mortgage products issued in September 2006 and interagency guidance on subprime lending that was issued in June 2007.

With respect to drafting rules for credit cards, the Board convened a forum of lenders, consumer advocates, and researchers to discuss issues relating to industry practices on loss mitigation and pricing and consumer financial education. The forum provided valuable insights into the issues and impacts of various credit card practices and changes in the Federal Reserve's proposed regulations. These perspectives augmented the information gathered through consumer testing and focus groups, the Board's Consumer Advisory Council, and the public comment process and contributed to a final rule that will enhance consumer understanding of credit card terms.

Consumer Advisory Council

The Consumer Advisory Council (CAC), whose thirty members represent consumer and community organizations, the financial services industry, academic institutions, and state agencies, advises the Board on matters concerning laws and regulations that the Board administers and on other issues related to consumer financial services. In considering potential members, the Board seeks individuals with significant knowledge of various aspects of consumer financial services and products, consumer regulations, the Community Reinvestment Act, affordable housing, and community development. The Board also seeks individuals with backgrounds that complement those of returning Council members in terms of experience, affiliation, and geographic representation.[20] Meetings are held three times a year, in March, June, and October, and are open to the public.

The CAC provides the Board with diverse viewpoints about its administration of the consumer financial protection laws and regulations. For example, the CAC has considered the Board's rule-writing authority for laws such as the Community Reinvestment Act, the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, the Truth in Lending Act, and the Home Ownership and Equity Protection Act. Among the consumer-protection issues that the CAC has discussed recently are:

- the Board's rules to prohibit unfair or deceptive acts or practices by banks in connection with credit card accounts;
- the Board's proposed amendments to Regulation E relating to the use of overdraft services and the assessment of overdraft fees;
- possible changes to the Community Reinvestment Act in light of developments in the financial services industry;
- the availability and quality of credit for consumers and small businesses; and
- proposed regulations relating to risk-based pricing notices that are provided to consumers under the Fair and Accurate Credit Transactions Act.

[20] See Supplement B for a current list of members.

The Council has found that committees are an effective way to facilitate full consideration of complex issues. The three standing CAC committees and their areas of coverage are:

- **Consumer Credit Committee** -- All forms of credit and related issues, such as credit cards, mortgages, home equity loans and lines of credit, auto loans, student loans, consumer leasing, TILA, RESPA, consumer credit reporting, and consumer debt.
- **Depository and Delivery Systems Committee** -- Banking services, products, and fees, electronic and mobile banking, electronic fund transfers, expedited funds availability, financial privacy, and Truth in Savings.
- **Housing and Community Development Committee** -- Affordable housing and community development finance, foreclosures, community stabilization, CRA, mortgage lending discrimination and red-lining, fair housing, HMDA, and financial literacy.

In 2009, the CAC also established a Special Issues Working Group, which provides an opportunity for members to focus in an in-depth, comprehensive way on topics that may cut across the various committees.

Supervisory Responsibilities

The Federal Reserve System's supervision responsibilities related to consumer protection are carried out by DCCA staff and the Federal Reserve Banks through several inter-related programs. These include: (1) program administration, oversight, and policy development; (2) consumer compliance examinations of state member banks; (3) supervision of large banking organizations and nonbank subsidiaries of bank holding companies; (4) fair lending enforcement; (5) administration of the Community Reinvestment Act; (6) consumer complaint processing and resolution; and, (7) examiner training.

The consumer compliance supervision program has evolved a great deal over the years, with today's program being a comprehensive approach to supervision structured to further DCCA's mission to develop regulations, policies, and programs designed to inform and protect consumers, to enforce federal consumer protection laws, to strengthen market competition, and to promote access to banking services in historically underserved markets."

1. Program Administration, Oversight and Policy Development

The Board has staff in DCCA dedicated to ensuring that supervisory procedures and policies are regularly updated to reflect changes in laws and regulations, as well as to address variations in the state member bank portfolio as they relate to asset size, product innovations, and organization structures. To ensure timely, appropriate, and consistent implementation of the Board's consumer compliance examination program, the Board conducts vigorous oversight of Reserve Bank work products, and annually assesses the Reserve Banks' performance. Oversight activities include on-site visits to Reserve Banks, participating with examiners on consumer compliance examinations, and conducting horizontal reviews of subject matter areas.

The Division also has a comprehensive oversight program related to the large banking organization portfolio. As is the case with oversight of state member banks, staff in DCCA with particular expertise in large complex financial services organizations review Reserve Bank work products and recommend changes as needed. These staff also participate in consumer compliance reviews of the companies in their portfolios and provide input into the Division's annual assessment of the Reserve Banks' performance.

In addition, every three years, DCCA staff conduct, together with the Board's Division of Banking Supervision and Regulation (BS&R), an operations review of a Reserve Bank's supervision function. The Reserve Banks also have formalized quality assurance programs to self-assess the strength of their programs.

The work done by DCCA staff compliments that done by prudential supervisors in BS&R. The recognition of the close relationship between consumer compliance and prudential supervision is not a recent phenomenon for the Board. Over the years, the Board has coordinated and integrated supervisory policy development related to state member banks as well as the largest and most complex banking organizations. In its supervision governance structure, for many years the Board's directors of BS&R and DCCA have co-chaired the Supervision Committee, which consists of the heads of supervision from the twelve Reserve Banks.

2. Consumer Compliance Examinations of State Member Banks

The Federal Reserve's consumer compliance examination program is implemented by a team of specially trained examiners. These examiners are responsible for examining state member banks for compliance with consumer protection laws, including the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Equal Opportunity Act (ECOA), the Community Reinvestment Act, and more than 20 other federal consumer protection laws and regulations.[21] Federal Reserve consumer compliance examiners are required to complete a comprehensive training program prior to being eligible to lead a consumer compliance examination. Examiners are provided ongoing training on consumer protection laws and regulations, emerging products and issues, as well as supervisory trends and related matters.

Consumer compliance examinations conducted by the Federal Reserve follow a risk-focused approach. This approach directs resources to banks and to the activities within those banks, commensurate with the level of risk to both the bank and to consumers. The approach is designed to reasonably ensure that all banks supervised by the Federal Reserve comply with consumer protection laws and regulations. It is founded on the expectation that consumer compliance risk management is an integral part of the corporate-wide risk management function of each state member bank.

The frequency of consumer compliance examinations follows an established schedule. Adherence to this schedule is continuously monitored by both Reserve Bank and Board staff.

[21] See Supplement A for a listing of all the laws and regulations that are reviewed by Federal Reserve examiners as part of consumer compliance examinations.

The length of the examination interval is based on the consumer compliance examination rating of the bank; those with satisfactory or better ratings are examined less frequently than those that exhibit poor performance. Examination frequencies can be accelerated when offsite monitoring, the review of Home Mortgage Disclosure Act (HMDA) data, emerging issues, or consumer complaints, for example, indicate a need for supervisory intervention.

Examination findings are communicated to a bank's Board of Directors through a separate report of examination. This report contains a supervisory rating that assesses the bank's compliance performance and the level of supervisory concern represented by that performance on a scale of "1" to "5" with "1" representing an outstanding performance level, and a "5" indicating significantly poor performance. When examiners identify violations of law or weaknesses in a bank's compliance management program, the bank is required to take swift and appropriate corrective action. When necessary, enforcement actions, both formal (e.g., cease and desist orders, civil money penalties) and informal (e.g., memoranda of understanding), are imposed to compel needed corrective actions. Further, referrals to the U.S. Department of Justice are made by the Federal Reserve, as required by law, when examinations reveal a pattern or practice of lending discrimination.

3. *Supervision of Large Banking Organizations and Nonbank Subsidiaries of Bank Holding Companies*

To keep pace with regulatory changes and the changing complexity of the financial services industry, the Board has a supervisory program dedicated to consumer compliance at large financial institutions and large complex banking organizations, including large regional banks, bank holding companies, and nonbank subsidiaries of holding companies. There are 25 companies in the large bank portfolio, many of which have substantial consumer lending operations, and therefore, substantial consumer protection risks.

Because of the close relationship between consumer compliance and prudential supervision, the Board's consumer compliance supervision of these large companies is tightly coordinated with the Board's safety and soundness supervision for these companies. For example, each year the Reserve Banks develop a risk assessment for each of the companies in the large bank portfolio. The risk assessments are used to plan the supervisory strategy for each company, including work related to consumer compliance. DCCA staff review the risk assessments to ensure that the documents appropriately capture the consumer compliance risk in each company. In addition, DCCA staff review the supervisory plans to ensure that planned consumer compliance examinations are sufficient both within each company and across the portfolio.

As a result of the pilot program targeting the subprime mortgage lending subsidiaries of bank holding companies, which is discussed on page 7 of this document, the Board introduced a program to conduct routine consumer compliance examinations of nonbank subsidiaries of those entities that are subject to the consumer protection laws that the Board has the authority to enforce (such as the Truth in Lending Act, the HMDA, and the Equal Credit Opportunity Act). This program will result in specially trained consumer compliance examiners conducting on-site reviews of the operations of the nonbank subsidiaries of the largest bank holding companies. These examinations will be planned based on the results of the risk assessments.

4. Fair Lending Enforcement

The Board's longstanding commitment to the enforcement of the fair lending laws, namely the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act, is reflected in DCCA's organizational structure which includes a specialized Fair Lending Enforcement Section. This section was recently expanded to include economists, as well as fair lending attorneys. In addition to its resource commitment to fair lending, the Federal Reserve expects banks to devote significant resources to fair lending and examines them routinely for fair lending compliance.

Fair lending is an integral part of supervisory regimen. For example, Federal Reserve examiners begin every consumer compliance examination by evaluating the bank's fair lending risk across all business lines, using Interagency Fair Lending Examination Procedures. Examiners have long analyzed HMDA data as part of this process. Based on this evaluation, examiners identify specific business lines on which to focus, and in every examination at least one product or class of products is evaluated in detail. Additionally, examiners conduct fair lending reviews outside the usual examination cycle when warranted by heightened fair lending risk at both state member banks and bank holding company subsidiaries.

When conducting fair lending examinations, consumer compliance examiners perform two distinct functions. First, examiners evaluate the institution's overall fair lending compliance program. In essence, examiners make sure that management is committed to fair lending and has put in place the appropriate systems, policies, and staff to prevent violations. Examiners assess whether the institution devotes a level of resources to consumer compliance that is commensurate with its size, the complexity of its business lines, and the fair lending risk of its business practices. Of course, the level of resources dedicated to fair lending will vary across institutions, but examiners require that every institution make fair lending a high priority, from the loan officer to the board of directors. If an institution's staff or systems fall short, examiners direct the institution to take corrective action.

Second, examiners determine if the bank has violated the fair lending laws. To that end, they review lending policies and practices to make sure they are not discriminatory. Examiners also test the institution's actual lending record for specific types of discrimination, such as underwriting discrimination in consumer loans, or pricing discrimination in mortgage or automobile lending. This testing for discrimination may use statistical techniques, manual reviews of loan files, or both. When examiners find evidence of potential discrimination, they coordinate closely with the Board's Fair Lending Enforcement Section, which brings additional legal and statistical expertise to the examination and ensures that fair lending laws are enforced consistently and rigorously throughout the Federal Reserve System.

Because the Federal Reserve expects institutions to devote significant resources to fair lending and examines them routinely for fair lending compliance, fair lending violations--especially those involving a pattern or practice of discrimination—tend to be rare among the banks it supervises. However, when violations do occur, strong action is taken. If there is reason to believe that there is a pattern or practice of discrimination under ECOA, the Board, like the other federal banking agencies, has a statutory responsibility under that Act to refer the matter to the Department of Justice (DOJ), which reviews the referral and decides if further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. DOJ may decide instead to return the matter to the Federal Reserve for administrative enforcement to correct the problems and make amends to the victims. During 2006-08, the Board referred fifteen institutions to the Department of Justice for a wide range of issues after concluding that they had engaged in a pattern or practice of discrimination in violation of the ECOA. These issues included mortgage pricing discrimination, auto pricing discrimination, redlining, underwriting discrimination, and discrimination based on marital status.

Most lenders readily agree to correct fair lending violations. In fact, lenders often take corrective steps as soon as they become aware of a problem. Thus, the Federal Reserve generally uses informal supervisory tools, such as Memoranda of Understanding between the bank's Board of Directors and the Reserve Bank, or Board Resolutions, to ensure that violations are corrected. If necessary to protect consumers, however, the Federal Reserve can and does bring public enforcement actions. For example, in 2004, we publicly assessed a $70 million civil money penalty against CitiFinancial Credit Company and also ordered restitution to borrowers.

5. Administration of the Community Reinvestment Act (CRA)

Enacted in 1977, the CRA states that federally insured banks and thrifts have an obligation to help meet the credit needs of the communities in which they are chartered, including low- and moderate-income neighborhoods, consistent with safe and sound operations. The act also directs the federal bank and thrift regulatory agencies, including the Federal Reserve, to implement the CRA through regulations, to assess during examinations the records of federally insured depository institutions in meeting their obligation under the law, and to take those records into account when evaluating proposals for expansion.

<u>CRA Examinations</u>

CRA examinations have been at the core of the Federal Reserve's efforts to encourage state member banks to help meet the credit needs of their communities since the first set of CRA regulations was adopted in 1978. The agencies have adjusted the CRA examination process over the years on their own initiative and in response to statutory changes, some of which have been significant.

The 1978 CRA regulations focused CRA examinations on factors related to the process used by institutions to determine the credit needs of their community and to their responses to those needs. The evaluation of an institution's performance was based on the application of twelve assessment factors, including the ascertainment of community credit needs, marketing and the types of credit offered, the geographic distribution of loans, the record of opening and closing branches and providing services, participation in local community development projects, and the financial and legal capability of the institution.

Until the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, CRA examinations culminated in a confidential examination report and rating that was provided only to the bank or thrift. FIRREA amended the CRA to require the agencies to issue public CRA ratings and written performance evaluations describing institutions' CRA performance using facts and data to support the agencies' conclusions. This requirement makes CRA examinations unique among other supervisory activities, which are otherwise confidential matters. In the absence of any statutory authority for the agencies to address poor CRA performance through enforcement actions, public disclosure of CRA ratings and evaluations may well serve to motivate an institution to improve a weak CRA record, or encourage an institution to maintain an otherwise favorable record.

Also in FIRREA, Congress amended the CRA to require the current four-tiered CRA examination rating system with descriptive performance levels of Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance in place of the five-tiered system in use by the agencies at the time. In response to these statutory changes, the agencies amended the CRA regulations and examination procedures accordingly to prescribe the method for assigning an institution's rating, and preparing and issuing public evaluations. Each rating encompasses a wide range of potential performance outcomes.

The CRA regulations were substantially revised again in 1995, in response to a directive to the agencies from President Clinton to review and revise the CRA regulations to make them more performance-based, and to make examinations more consistent, clarify performance standards, and reduce cost and compliance burden. This directive addressed criticisms that the regulations, and the agencies' implementation of them through the examination process, were too process-oriented, burdensome, and not sufficiently focused on actual results. The agencies also changed the CRA examination process to incorporate these revisions.

Since 1995, the agencies' CRA regulations have tailored the examination approach to the institution's size or its business operations. Currently, for depository institutions with assets greater than $1.061 billion, CRA performance is evaluated based on a lending test, an investment test, and a service test. Institutions with assets between $265 million and $1.061 billion are designated as "intermediate small institutions" and are evaluated on their record of lending in low- and moderate-income areas and to lower-income people in the institutions' assessment areas. A community development test is also included in the review of these institutions. This test encourages institutions to engage in a range of community development lending, investment, and services but provides the flexibility to target their resources where they will produce the most community benefit. Currently, institutions with assets less than $265 million are evaluated primarily on their lending performance in their communities, including low- and moderate-income areas and populations. Given their more limited capacity and resources, small institutions are not expected to engage in more complex community development activities.

The regulations also provide a different evaluation method for institutions designated as "wholesale" or "limited purpose." This examination method focuses on evaluating an institution's community development lending, services, and investments. In addition, any institution can opt to develop a CRA "strategic plan" and be evaluated under that plan, if it is approved.

The frequency of CRA examinations is determined by, and in some cases limited by, an institution's size and prior CRA rating. The Federal Reserve conducts CRA examinations of state member banks with assets greater than $250 million and favorable ratings on a two-year cycle; a one-year cycle applies if the rating is less than satisfactory. By statute, the examination cycle is significantly longer for banks with assets less than $250 million and ratings of Satisfactory or Outstanding. Under the CRA, the agencies are prohibited from examining these entities for CRA purposes any more frequently than every four or five years if the bank is rated Satisfactory or Outstanding, respectively, for CRA. Congress added this limitation to the statute as part of the Gramm-Leach-Bliley Act in 1999 as a way to reduce regulatory burden. We may, however, examine these banks on shorter cycles if the rating is below satisfactory, and under other very narrow and limited exceptions.

During the CRA examination, examiners assess an institution's performance within the context of all relevant factors, such as its business strategy, capacity and constraints, the overall economic conditions and credit needs in its assessment area, and the availability of community development activities appropriate to the institution. This performance context recognizes that while insured depository institutions have an affirmative obligation to meet the credit needs of the communities in which they are chartered, they must engage only in activities that are safe and sound.

To ensure a broad and balanced CRA assessment, examiners routinely conduct interviews with local business people, government officials, housing and consumer advocates, realtors, trade association representatives, and many others. The purpose of these interviews is to obtain information about, among other things, general credit needs of the community, the availability or the lack of availability of credit, and how different institutions respond to those credit needs. The comments of these individuals are factored into the examiners' CRA rating.

The community also has other opportunities to participate in the CRA evaluation process. The public can offer comments on an institution's CRA performance and those comments are publicly available. Examiners review the institution's public comment file and take comments into account when evaluating an institution's overall CRA performance. To assist the public, and to encourage public comments, the agencies inform the public every calendar quarter of upcoming CRA examinations.

Under the CRA regulations, the Federal Reserve's evaluation of a bank's CRA performance takes into account evidence of illegal lending discrimination or other illegal credit practices. Federal Reserve examiners conduct a fair lending review concurrently with, or close in time to each CRA evaluation, and the findings from that review are factored into the CRA evaluation.

CRA and the Applications Process

As directed by the Bank Merger Act and the Bank Holding Company Act, the Federal Reserve takes into account a number of factors when it reviews applications for expansion from financial institutions. These include the competitive effects of the proposal in the relevant markets; the financial and managerial resources and future prospects of the bank holding company and its banking subsidiaries; and the convenience and needs of the communities affected.

When an application is filed, the public is notified and interested parties may comment on any of the statutory factors. It is not uncommon for the Federal Reserve to receive comment letters as part of the application process; most are in protest of the application. For applications involving very large banking organizations, it is not uncommon for the Federal Reserve to receive several hundred comment letters. Substantive comments are always given a high degree of consideration in the evaluation of the application proposal, sometimes resulting in the Federal Reserve holding public meetings to gather additional input from the public when information cannot be effectively obtained from written comments, other sources, or the supervisory processes. The Federal Reserve has held thirteen public meetings since 1990.[22]

When evaluating an application proposal, the Board's approach is very comprehensive. It takes into account the following information:

- CRA and compliance examination reports
- CRA record of lending to small businesses and small farms
- Home Mortgage Disclosure Act data reports by the financial institutions
- Recent actions taken to improve CRA and/or compliance performance weaknesses
- Enforcement actions, and/or any identified fair lending referrals or investigations
- Comments submitted by interested parties and the financial institution's response to those comments and
- Any additional information requested by the Federal Reserve from the applicant to complete the record or to address concerns raised by the public.

Additionally, any commitments that the financial institution makes to the Board for specific actions or improvements are monitored through appropriate supervisory follow-up.

6. Consumer Complaints

The Federal Reserve established a consumer complaint program in 1976. Drawing on the resources of the Federal Reserve Banks, the purposes of the program are to investigate complaints made by consumers against state member banks (those institutions under the Federal Reserve's supervisory authority), answer consumers' questions about banking practices, and refer consumers to other federal or state agencies when appropriate to assist them in getting their issues addressed. In addition, the Board responds to issues raised by congressional representatives on behalf of their constituents. Consumer complaints are an important source of information for the Board because they can reveal emerging consumer-protection issues and trends in banking practices. In addition, complaints often identify areas of concern that the Board considers when writing regulations or preparing supervisory guidance for bank examiners.

Over the last decade, the consumer financial services marketplace has changed dramatically. Technological developments and increased access to technology have also changed both the way institutions operate and how consumers want to communicate with

[22] Transcripts are available for all meetings since 1998 at www.federalreserveboard.gov

financial institutions and others. In response to these changes, in 2007, the Federal Reserve launched its Federal Reserve Consumer Help call center (FRCH). FRCH consolidated the intake of consumer complaints, both written and telephone, by providing a single mailing address, website, and toll-free number for consumers that want to file a complaint against a financial institution or want to inquire about a particular financial service, product, or their consumer protection rights. Complaints against banking institutions supervised by the Federal Reserve continue to be investigated by the Reserve Bank responsible for examining the institution in question. This approach ensures that complaints are investigated by examiners who are knowledgeable about an institution and its regional banking market--and who can leverage the bank-supervisor relationship to resolve an issue. If a consumer has a complaint against an institution not supervised by the Federal Reserve, FRCH can seamlessly connect the consumer with the appropriate agency.

In 2008, the majority of complaints against state member banks concerned checking accounts (28 percent) and credit cards (26 percent). Not surprisingly, the percentage of complaints against state member banks related to real estate loans jumped in 2008 to 18 percent (compared to only 5 percent in 2007). Complaints against state member banks in 2007 were also related primarily to credit cards and deposit accounts, 61 percent and 19 percent, respectively. In 2006, the majority of complaints against state member banks related to credit cards (54 percent) and deposit accounts (28 percent).

All complaints and inquiries received by the Federal Reserve, along with information about how the issue was resolved, are stored in a database. The database is used by: examiners when scoping an examination; rule-writers to get data about practices consumers are complaining about; staff responsible for consumer education to focus their efforts; and policy staff in determining if additional guidance to the industry is required about a particular practice or to identify an emerging issue that may be potentially harmful to consumers.

7. Examiner Training

A well-trained, highly-skilled consumer compliance examination staff is a high priority for the Board, and integral to the ultimate success of our consumer compliance supervisory programs. As such, the Board has had an examiner training curriculum and examiner commissioning process for many years. In 1991, the Board made significant revisions to its training program and commissioning process. In particular, a core curriculum of courses and knowledge was identified that System staff members, training to be commissioned examiners, are expected to master. This mastery is demonstrated through successful completion of a proficiency check at the end of the core curriculum. After assistant examiners successfully completes the proficiency check and demonstrates the ability to apply the learning obtained in the classroom in the field, the Reserve Bank may submit their names to Board staff with a request for them to be commissioned as examiners.

The Board's consumer compliance examiner training curriculum consists of six courses focused on various consumer protection laws, regulations, and examination concepts. Instructors for the training courses are seasoned experts in compliance supervision from across the Federal

Reserve System. In 2008, courses were offered in 12 sessions where nearly 200 consumer compliance examiners, System staff, and state examiners participated.

As with other supervision related programs, the examiner training curriculum and course content are reviewed regularly, with the core curriculum being reviewed every three years for the purpose of updating subject matter and instructional methods, as appropriate. Additionally, when appropriate, the training program takes advantage of alternative methods to classroom training such as offering courses via the Internet or using other distance-learning technologies. For example, with the assistance of the St. Louis Federal Reserve Bank's Center for Online Learning, the program developed several computer-based training modules, with some providing online pre-coursework and others online self-study courses.

It takes more than a predefined course curriculum and online course modules to keep our examiners on top of regulatory changes, updated examination procedures, or newly released interagency guidance. The examiner curriculum emphasizes the importance of continuing professional development. To better meet this need, in 2008 the System initiated a powerful training delivery method, entitled Rapid Response. In contrast to more traditional training development and delivery model, which takes time to develop, technical and instructional content on time-sensitive or emerging topics are designed, developed, and presented to System staff within days or weeks of the perceived need. This "just-in-time" training is invaluable in the current environment; and it is extremely cost effective. To date, the training program has conducted 45 sessions with an average attendance of 149 System staff. Recently, attendance at this training was offered to state examiners. Six sessions have been directly related to consumer compliance issues. The sessions are audio conferences with supporting documentation available on the web; the sessions are recorded and archived for ready access for those unable to attend the live session.

Community Affairs

The Federal Reserve's Community Affairs Offices (CAOs), a function initially established in 1984, were established to assist financial institutions meet their obligations under the Community Reinvestment Act (CRA) by helping them to identify the credit needs and lending opportunities in low- and moderate-income communities in their market areas. Over time, the function has grown considerably, expanding its mission to promote fair and informed access to financial markets for all consumers, recognizing the particular needs of underserved populations. It does this through collaborative work across the Federal Reserve System and through outreach to and partnerships with financial institutions, community development organizations, federal, state and local governments, academic institutions, think tanks, and others interested in promoting community and economic development. Through their outreach, publications, conferences, and research activities, the CAOs provide vital information and technical assistance to lenders, government officials, and community developers at the national, regional and local level. These efforts are designed to inform these institutions and their constituencies of programs and funding strategies that play a vital role in realizing viable community economic development in distressed communities.

Each Reserve Bank and the Board has a Community Affairs function staffed by professionals with a range of experiences including the financial industry, non-profit organizations, as well as urban planning and regulatory agencies. Because of the economic diversity of the various regions, each Reserve Bank program sets its own priorities based on the community development needs of its District. The Federal Reserve Board has an oversight function, and it also promotes more effective communications and collaboration between the programs in the Reserve Banks to address issues of mutual interest and importance.

The objectives of the Board's Community Affairs program are as follows:

- Foster the active engagement of depository institutions in providing credit and other banking services to their entire communities; promote cooperation among community organizations, government agencies, financial institutions, and other community development practitioners to their mutual benefit; and promote better understanding among policymakers, community leaders, and private-sector decision makers of the processes and resources that support successful community development programs;

- Provide educational and technical assistance to financial institutions, government agencies, and community groups on developing and implementing effective community lending programs; represent the Board at conferences dealing with community development, urban lending, and rural investment; and develop and maintain a national network of contacts in the field of community development;

- Participate in outreach programs that provide information to the public on matters relating to community development issues; and produce and distribute brochures, newsletters, and other publications to increase public awareness of the System's Community Affairs program resources;

- Conduct oversight of Reserve Bank Community Affairs activities through ongoing contact with Reserve Bank officials and staff; and conduct operations reviews and annual performance evaluations of Reserve Bank Community Affairs programs;

- Provide technical assistance to financial institutions seeking regulatory approval for bank and bank holding company community development investments; coordinate applications analysis on these issues with appropriate Board divisions; and develop greater public awareness of the risks and benefits of various financial service products that foster community development and increase access to credit;

- Provide ongoing support to the Board on community development issues through advice on related policies, preparation of testimony and speeches, and briefings; support Board member's service on the NeighborWorks America® Board of Directors; and

- Represent the Board on interagency projects and task forces that are related to community development and other pertinent issues; work with other federal agencies including the Department of Housing and Urban Development, Small Business Administration, Government Accountability Office, Department of Treasury, Department of Justice, and Bureau of Indian Affairs; and act as a liaison to national community organizations and financial intermediaries.

One example of how the Federal Reserve fulfills these objectives is a recent research effort that was undertaken in 2006 in partnership with the Brookings Institution to examine the issue of concentrated poverty. The project was motivated by the recognition that the problems faced by many of the poor communities devastated by Hurricane Katrina in 2005 were shared by residents of neighborhoods across the United States. While concentrations of poor people living in poor neighborhoods have been observed in large Midwestern and Northeastern cities, concentrated poverty also exists in smaller cities, immigrant gateways, suburban municipalities and rural counties. The need for a deeper understanding of the relationship between poverty, people, and place led the Federal Reserve to join with the Brookings Institution's Metropolitan Policy Program. The resulting report, *The Enduring Challenge of Concentrated Poverty in America: Case Studies from Communities Across the U.S.,* features case studies, undertaken by the Federal Reserve System's Community Affairs Offices, of 16 high-poverty communities across the country, including immigrant gateway, Native American, urban, and rural communities. Through these case studies, the report contributes to our understanding of the dynamics of poor people living in poor communities, and the policies that will be needed to bring both into the economic mainstream.[23] The report was rolled out in December 2008 at a conference sponsored by the Federal Reserve Board to highlight the findings of the paper and discuss opportunities for policymakers, community developers, lenders, and academics to consider for addressing the issues that contribute to concentrated and enduring poverty. Some Federal Reserve Banks have continued the work in case study cities such as Springfield, Massachusetts, and Fresno, California by expanding the analysis and engaging local stakeholders to develop solutions to the problems highlighted by the report. For example, in Springfield, the Federal Reserve Bank of Boston will publish a series of discussion papers that identifies current and potential employment opportunities; barriers to accessing these opportunities, including barriers to local business formation and entrepreneurship; and successful models of training, job development, and job matching.

Oversight of Reserve Bank Programs

In carrying out its oversight responsibilities, the Board staff conducts annual evaluations of the Reserve Bank Community Affairs programs in addition to operations reviews once every four years. The Board uses the Community Affairs (CA) annual evaluation process to highlight areas of success and potential improvements to improve the capacity of each Reserve Bank to meet the needs of underserved communities and individuals in its region.

This oversight provides a process for identifying issues requiring attention, sharing best practices (outreach/tracking performance, etc), growing the function such as the expansion of the program into research.

[23] *The Enduring Challenge of Concentrated Poverty in America,* The Federal Reserve System Community Affairs Offices and the Brookings Institution, 2006, http://www.frbsf.org/cpreport/index.html.

Research Conference

The Community Affairs Officers of the Federal Reserve System host a biennial research conference to encourage objective research into financial services issues affecting low- and moderate-income individuals, families, and communities. The conference has been held in Washington, DC. This year's conference explored the role, processes, and outcomes of innovation in financial services for low- and moderate-income consumers and underserved populations. Leading researchers presented original and objective research that can inform innovative market and product development through a framework that moved from:

- individual consumer preferences and behaviors with focus on consumer finance products, to
- influences that affect market participation such as financial education and institutional structures, to
- effects of mortgage products on both performance and wealth creation, to
- approaches for shaping market participation.

As with previous conferences, the 2009 System Community Affairs Research Conference succeeded in sharing relevant and timely research related to consumer and community development issues with practitioners in an accessible format, the lessons of which can be easily applied in the field. The conference also provides a valuable catalyst for new research to inform policies that affect low- and moderate-income consumers and communities.[24]

Leadership on Issues Related to Foreclosures and Neighborhood Stabilization:

- **Rental Housing Forums** -- Recognizing that large numbers of renters are impacted by the foreclosure crisis, the Board's Community Affairs staff hosted a series of forums to explore various rental housing issues. The first forum, outlined the rental housing challenges created by the foreclosure crisis and detailed industry-led policy initiatives to address them, including REO rental policies, such as rent-to-own policies, designed by Freddie Mac and Fannie Mae. The second forum focused on issues related to small multifamily properties (less than 50 units) and the third featured a discussion of the challenges of managing scattered-site rental units. Plans are underway for future forums to discuss low-income housing tax credits.

  These forums have focused attention on how the market for affordable rental housing has been affected by the high rates of foreclosure. The forums have helped promote understanding of the policy issues that need to be addressed in order to ensure sufficient supplies of affordable rental housing while also promoting constructive dialogue on possible solutions and best practices.

- **Website Centers**: In 2008, Community Affairs helped lead the effort to develop online foreclosure resource centers for each Reserve Bank and the Board to customize for their various constituents. In addition, the Board launched a page on the Board's public Web site, *Resources for Stabilizing Communities*, which highlights System conferences,

[24] See http://www.chicagofed.org/cedric/cedric_index.cfm for additional information.

discussion papers, and other resources relating to community stabilization. This new page and the Foreclosure Resources for Consumers page are cross-linked. This is part of an ongoing System-wide effort to address and mitigate the impacts of foreclosures on communities. As part of the MORE initiative described above, this year the System will be working to improve the availability and coordination of its data resources and analysis, address the continuing need to improve foreclosure mitigation efforts, and add additional toolkits for post-foreclosure consumer concerns, among other things.[25]

- **New CRA Publication:** The Federal Reserve System's Community Affairs function has been a leader in helping financial institutions to understand and comply with the requirements of the Community Reinvestment Act. In 2009, the Federal Reserve Banks of Boston and San Francisco released a publication, *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, offering a range of perspectives on the past and future of the CRA. The publication provides history, research, and highlights policy options for amending the Act, through articles from academic researchers, current and former regulators, community development practitioners, and financial services representatives that have experience working with the CRA. To launch the publication and foster discussion on the future of CRA, the Federal Reserve Banks of Boston and San Francisco, in partnership with the Board of Governors, hosted a forum, "Revisiting the CRA: A Policy Discussion." At the Board, Community Affairs has held a number of meetings with community organizations and financial institutions to better understand how the CRA is working in practice and gather recommendations for future changes[26].

- **Foreclosure Rescue Scams:** The Community Affairs function has coordinated efforts to warn consumers about the prevalence of foreclosure rescue scams which present a danger to consumers already struggling to pay their mortgages. A new information piece, *5 Tips for Avoiding Foreclosure Scams*, is the latest in the "5 Tips" series of consumer information published by the Board. Reserve Banks developed local and regional communication to complement the Board's messaging on this issue. The Board is also coordinating with NeighborWorks America to learn from their experience with implementing an Ad Council campaign for foreclosure mitigation this year and apply those lessons to this effort.[27]

- **Rapid Response Training**: The Board and FRB-San Francisco teamed up to lead a Rapid Response examiner training on Real Estate Owned (REO) Disposition and Neighborhood Stabilization. In addition to giving examiner's background on the issues involved in dealing with neighborhood stabilization from a financial institution's

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[25] For additional information see http://www.federalreserve.gov/consumerinfo/foreclosure.htm

[26] For additional information see http://www.frbsf.org/publications/community/cra/index.html

[27] For additional information see http://www.federalreserve.gov/pubs/foreclosurescamtips/default.htm

perspective, the session covered how CRA influences a bank's participation in community stabilization efforts.

- **Research Coordination on Neighborhood Stabilization Program (NSP)** – Board Community Affairs leads a System task force that has completed a research protocol to conduct local case studies regarding the implementation of the NSP. Participants will conduct survey research during July and August in selected cities.

- **Collaboration With Consumer Advocacy Groups** – In response to inquiries made by national consumer advocacy groups, the Board has helped to organize collaborative efforts between consumer advocacy groups and their local affiliates and Federal Reserve Banks to address local challenges and identify potential solutions related to the foreclosure crisis. For example, at the request of National People's Action (NPA), the Board is participating in a series of regional public forums with local NPA affiliates and the Federal Reserve Banks. The first of these meetings was held in June 2009 in Richmond, California and included a public meeting, a small group discussion with local leaders, and a property tour of foreclosed properties. Additional regional forums are being planned in several other communities, including Buffalo, New York, Cincinnati, Ohio, and Decatur, Illinois. The Board has also organized efforts in collaboration with the Greenlining Institute around various dimensions of foreclosure challenges, with the most recent meeting held in May at the San Francisco Federal Reserve Bank on the impact of foreclosure on minority communities. The senior research manager presented detailed analysis of the impact of foreclosures in California on the African American, Hispanic, and Asian communities.

Consumer Education and Research

The Federal Reserve has a long history of providing useful consumer information. A major line of defense in consumer protection is self-defense--in other words, a well-informed consumer. Educated consumers can serve as their own advocates and better protect themselves from unnecessarily expensive and abusive financial products, practices, and scams by asking good questions about products and practices, especially those that "seem too good to be true." Consumers look to the Federal Reserve for unbiased, research-based financial information--and it intends to keep it that way. Over the years, the Federal Reserve Board has worked with other agencies and organizations on consumer information resources, both in print and on the Internet.

By using a variety of strategies to address the continuum of consumer needs--from making consumers aware of an issue, to providing reliable information and clear disclosures that allow a meaningful evaluation of financial choices, to prohibiting certain egregious products and practices--the Federal Reserve can empower consumers to make informed financial decisions. We believe that all of these approaches are essential for ensuring that consumers can successfully navigate an increasingly complex financial marketplace. In so doing, we aim to promote the economic well-being of consumers and their families.

Raising Awareness and Providing Tools

One of the most important roles the Federal Reserve plays is to make consumers aware of emerging issues and trends in the financial marketplace and to help them understand how those trends will affect them personally. For example, the Board has a contract with a distributor of brief consumer news stories, in print and radio format, to daily and weekly media subscribers. We have used this approach for several years and have found it to be an effective means of directing consumers to our website (www.federalreserve.gov) for more information and resources. For example, a recent article on tips for protecting homeowners from foreclosure appeared in 398 newspapers in 26 states. Another article on refinancing mortgages appeared in 444 newspapers in 22 states. Audience penetration for these articles is estimated at 44.6 million and 45.4 million, respectively.

The Board also has a history of identifying strategic partnerships to enhance its consumer outreach. For example, it is working to expand consumer awareness of foreclosure scams through a partnership with NeighborWorks America and the Conference of State Bank Supervisors (CSBS). The Federal Reserve Board and the Federal Reserve Banks also continue to partner with the "America Saves" program, the American Savings Education Council, Operation Hope, the "Bank On" program, and the Jump$tart Coalition for Personal Financial Literacy to promote financial education and asset-building strategies.

The Board also participates in outreach events, such as the Congressional Black Caucus, Financial Literacy Day in Washington, D.C., professional development conferences, and similar events to raise awareness of the Board's materials and website, and to direct concerned consumers to Federal Reserve Consumer Help, the System's central consumer complaint and inquiry intake center.

The Board's Consumer Information website (www.federalreserve.gov/consumerinfo) includes 23 consumer topics ranging from bank accounts to consumer credit to mortgages; 13 of these are also available in Spanish. The materials are designed for consumers who prefer varying levels of detail. Using the "layering" that web links offer, resources range from the sound-bite "5 Tips" series to the more comprehensive consumer's guide series.

In addition to the consumer information that Congress has mandated the Federal Reserve to provide to consumers, such as the *Consumer Handbook on Adjustable Rate Mortgages* and *What You Should Know about Home Equity Lines of Credit*, the Board has also developed web-based information such as calculators to help consumers explore mortgage choices and mortgage refinancing and a data base of credit card interest rates and fees. It also provides English and Spanish versions of our credit card repayment calculator, which allows consumers to estimate how long it will take to pay off their credit card bills if they only make minimum payments. Consumers can also estimate the monthly payments needed to pay off a balance in a specific number of years or the amount of time it will take to pay off their balance if they pay a specific amount each month.

Building Capacity in Partnership with Educators and Practitioners

While Board staff work diligently to enhance consumer awareness and provide useful financial tools and information, the Federal Reserve is aware that some consumers would benefit from a more structured approach to learning how to make sound and informed choices in the financial marketplace. And sometimes they need coaching, advice, or counseling to help them develop and implement a personal financial plan. The Federal Reserve is committed to empowering consumers and increasing their financial capability by building the capacity of financial educators in schools and community-based organizations.

Across the country, the Federal Reserve System hosts teacher-education workshops for kindergarten through grade 12 teachers. These efforts focus on activity-based constructivist learning approaches, such as computer games, in contrast to more traditional information transfer education models. The goals are to incorporate more experiential learning and to foster the development of critical thinking and problem-solving skills.

The Federal Reserve also hosts training workshops and conferences for community-based educators working with young adult and adult learners. These events provide updates on emerging issues and resources, as well as ideas for outreach via social media. While many of these are face-to-face sessions, some have also used webinars, online training, and other distance-learning strategies to reach audiences that may not be able to travel to conferences or meetings.

As an example, the Board is actively involved in financial education outreach with the military. Staff attended the first Worldwide Work and Family Life Professional Skills Symposium held by the Navy. The purpose of this symposium was to educate Navy staff - including the Certified Ombudsman Trainers - on the resources available as they work with base personnel. The Board was the only government agency to participate in this event. Staff will also attend and present a workshop in the Department of Defense's Financial Fair as part of its annual Human Resources Worldwide Conference this summer.

The Board's support of education and capacity building goes beyond these train-the-trainer efforts. Many Reserve Bank staff members serve as key members of local Jump$tart coalitions that encourage states and localities to set standards of learning that include financial decision making skills. Board staff also serves on the advisory council for NeighborWorks America's Center for Homeownership Education and Counseling (NCHEC), which has developed industry standards for quality homeownership education and counseling, including foreclosure mitigation counseling. NCHEC certifies nonprofit organizations as well as individual counselors. A more fulsome listing of Reserve System initiatives is attached.[28]

At the same time that Federal Reserve works to make sure that quality financial information reaches consumers, the Federal Reserve System is evaluating the impacts of financial education in an effort to better understand what approaches work the best. For example, Board staff, working with the Department of Defense, Army Emergency Relief, and San Diego City College, conducted a longitudinal study involving two groups of soldiers--one receiving a two-day financial education course as part of their advanced individualized training, and a second comparison group that did not receive any financial education. This addresses two

[28] For a detailed listing relevant research, see Supplement E.

common criticisms of financial education program evaluation literature: lack of a comparison group and documenting changes over time.[29]

Broader Efforts in Support of Financial Education

In addition to the Federal Reserve's efforts to promote consumer education and protection, the Board has supported the Financial Literacy and Education Commission (FLEC) in meeting its mandates and implementing its national strategy. Since its inception in 2004, Board staff has served on the MyMoney.gov website working group and the national strategy working group.

Beyond work with FLEC, Federal Reserve Board staff has also been engaged with colleagues internationally. In particular, the Board has been the only U.S. federal agency to represent U.S. financial education efforts with the International Network for Financial Education sponsored by the Organization for Economic Cooperation and Development (OECD). Federal Reserve Board staff serves on a subcommittee to create research and evaluation criteria that will allow cross-cultural comparisons of the impacts of financial education programs. Since 2002, the Federal Reserve Board has met with other international financial regulators to share best practices with respect to financial consumer protection and education issues. In these international settings, staff have learned that while on the forefront of many consumer education and protection efforts, there is much to learn from others.

Research on Consumer Issues

Over the years, the Board has conducted a wide range of applied, consumer-focused research to inform rule-writing, consumer education, and community affairs functions. In addition, research and community development economists at the Reserve Banks as well as staff at centers, such as the Payment Card Center at the Philadelphia Reserve Bank, provide insight and assistance. The Board funds research via consumer testing and occasional surveys. One of the major consumer data collection efforts is the triennial Survey of Consumer Finances (SCF). The SCF provides detailed information on the finances of U.S. families. No other study for the country collects comparable information. Data from the SCF are widely used, from analysis at the Federal Reserve and other branches of government to scholarly work at the major economic research centers. The study is sponsored by the Federal Reserve Board in cooperation with the Department of the Treasury. Since 1992, data have been collected by the National Organization for Research at the University of Chicago (NORC).

Staff use existing data sets, such as the Board's SCF, and collect primary data (original research) through surveys, focus groups, and interviews. Examples of research conducted and published over the past five years include the following:[30]

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[29] Bell, Catherine; Gorin, Daniel; Hogarth, Jeanne M., "Does Financial Education Affect Soldiers' Financial Behaviors?", Division of Consumer and Community Affairs, Federal Reserve Board of Governors presented at the Federal Reserve Community Affairs Research Conference, April 16-17, 2009, http://www.kansascityfed.org/carc2009/program.cfm.

Electronic banking

2009 U.S. Households Access to and Use of Electronic Banking, 1989-2006
2008 Consumer Payment Choices: Paper, Plastic, or Electrons?
2004 The Adoption of Electronic Banking Technologies by U.S. Consumers
2004 U.S. Consumers and Electronic Banking, 1995 to 2003
2004 Are Families Who Use E-Banking Better Financial Managers?
2004 The Adoption of Electronic Banking Technologies by U.S. Consumers
2004 Closing the Digital Age Divide: Adoption of Electronic Financial Services by Consumers Age 60+

Financial access and inclusion

2006 ¡Cuidado! Remittances and Consumer Protection
2005 Banking on Remittances: Increasing Market Efficiencies for Consumers and Financial Institutions
2005 Who Has a Bank Account? Exploring Changes Over Time, 1989 - 2001
2005 Promise and Potential: The State of Financial Affairs of Hispanic Families
2004 Why Don't Households Have a Checking Account?

Credit and mortgages

2009 Changes in U.S. Home Equity Lending: Evidence from the 1989 through 2007 Survey of Consumer Finances
2007 Unlocking the Risk-Based Pricing Puzzle: Five Keys to Cutting Credit Card Costs
2006 Who Moved the LTV? Examining the Increase in Home Leverage
2006 The Geography of Mortgage Delinquency
2006 Cohort Analysis of Consumer Credit Card Behaviors: Will Consumers Be Ready for Retirement?

Consumer complaining behaviors

2004 Numbers versus Words: Quantitative and Qualitative Satisfaction Data
2004 Consumers' Resolution of Credit Card Problems and Exit Behaviors

Financial education and capability

2009 Does Financial Education Affect Soldiers' Financial Behaviors?
2007 The Federal Reserve System's Role in Economic and Financial Literacy – Rationale, Activities, and Impact
2006 Is More Always Better? Information Search for Financial Products

Community development

2008 Economic Development Incentives: Research Approaches and Current Views
2005 Financial Education and Community Development Finance

In addition, since 1996 the Board has used consumer-testing research to develop disclosures. Within the past five years, disclosure research has included privacy notices, payroll

[30] An additional list of research references is available in Supplement E.

cards, credit cards, mortgages, home equity lines of credit, overdraft protection, and student loans.

Supplement A

Regulatory Responsibilities for the Division of Consumer and Community Affairs

The Federal Reserve Board's Division of Consumer and Community Affairs is primarily responsible for implementing consumer financial services and fair lending laws administered by the Board. Consumer financial services and fair lending laws that are administered by other agencies are enforced by the Board for entities subject to its jurisdiction. The laws for which the Division has responsibility and the implementing regulations are listed below.

Laws for which the Board has sole rule-writing authority

For the following laws, the Board's regulations apply to the particular entities designated in the respective statutes.

o The **Consumer Leasing Act of 1976**, which is implemented by **Regulation M,** requires lessors to provide lessees with standardized disclosures about the cost and terms of consumer leases of personal property with a term of more than four months (such as automobile leases). The disclosures must be given before a consumer becomes obligated for a lease. They also require the uniform disclosure of leasing terms in advertisements.

o The **Electronic Fund Transfer Act of 1978**, which is implemented by **Regulation E,** establishes the rights, liabilities, and responsibilities of consumers who use electronic fund transfer (EFT) services and of financial institutions that offer those services. Among other things, financial institutions must disclose the costs and terms of EFT services and provide documentation of EFTs on periodic statements. The act limits a consumer's liability for the unauthorized use of a debit card, restricts the unsolicited issuance of debit cards by financial institutions, and establishes procedures for error resolution. The act covers transactions at automated teller machines; point-of-sale terminals in stores; phone bill-payment plans; and preauthorized transfers to and from a customer's account, such as direct deposit of salary and Social Security benefits.

o The **Equal Credit Opportunity Act of 1974**, which is implemented by **Regulation B,** prohibits creditors from discriminating in any aspect of a credit transaction on the basis of gender, marital status, age, religion, national origin, race, color, the receipt of public assistance benefits, and the exercise of any right under the Consumer Credit Protection Act. Among other things, the act requires creditors to inform unsuccessful applicants in writing of the reasons that credit was denied and to grant credit to qualified individuals without requiring spouses to co-sign the credit agreement.

o The **Expedited Funds Availability Act of 1987,** which is implemented by **Regulation CC,** specifies how quickly depository institutions must give consumers access to deposited funds. Institutions are required to disclose to their customers their policies on funds availability. Regulation CC also implements the Check Clearing for the 21st Century Act of 2003 ("Check 21"), which authorizes a new negotiable instrument called a "substitute check" to facilitate check truncation and electronic check exchange. Check 21 provides that a properly prepared substitute check is the legal equivalent of the original check for all purposes. The act includes new warranties, an indemnity, and expedited recrediting procedures that protect consumers who receive substitute checks.

o The **Home Mortgage Disclosure Act of 1975,** which is implemented by **Regulation C,** requires mortgage lenders in metropolitan areas to disclose to the public data about the home purchase and home improvement loans (including refinancings) that lenders originate or purchase and about the disposition of applications for those loans. Lenders must provide geographic information about the property to which the loans relate and the income, gender, race, and national origin of applicants and borrowers. Effective in 2004, Regulation C requires lenders to report additional data, including pricing information on loans above certain rate thresholds and whether a loan is subject to the Home Ownership and Equity Protection Act amendments to the Truth in Lending Act.

o The **Truth in Lending Act of 1968,** which is implemented by **Regulation Z,** requires uniform methods for computing the cost of credit and for disclosing terms and conditions on a broad range of credit products: credit cards and other lines of credit, automobile loans, student loans, and home-purchase and other home-secured loans. The act prohibits the unsolicited issuance of credit cards, limits cardholder liability for unauthorized use, and establishes procedures for handling billing error disputes. It also gives borrowers the right to rescind certain loans secured by their principal residence.

The Home Ownership and Equity Protection Act of 1994 (HOEPA) amended the Truth in Lending Act to require additional disclosures and protections for home-secured loans having rates and fees above a specified amount. Under HOEPA, the Board is also responsible for prohibiting acts or practices in connection with mortgage loans that the Board finds to be unfair or deceptive. Rules issued by the Board under HOEPA apply to all mortgage lenders, including independent mortgage companies. However, the Board enforces HOEPA only for the institutions it supervises. The Federal Trade Commission (FTC) enforces HOEPA for independent mortgage companies.

o The **Truth in Savings Act of 1991,** which is implemented by **Regulation DD,** requires depository institutions to provide consumers with information about the fees, interest rates, and other features on their deposit accounts, including savings and checking accounts and certificates of deposit. The act also prohibits certain methods of calculating interest.

Laws for which the Board shares rule-writing authority

For the following laws, the Board's regulations apply only to state-chartered banks that are members of the Federal Reserve System ("state member banks"). Other federal financial agencies have adopted similar regulations for those entities under their jurisdiction.

o The **Community Reinvestment Act of 1977,** which is implemented by **Regulation BB,** is intended to encourage financial institutions to help meet the credit needs of their communities, particularly low- and moderate-income neighborhoods, while preserving the flexibility necessary for the institutions to operate in a safe and sound manner. Institutions are required to specify the services they offer and to identify their lending areas. The Board assesses a bank's performance in meeting its obligations to its community and takes that assessment, along with other factors, into account when considering applications for mergers, acquisitions, and the formation of financial holding companies.

o The **Community Reinvestment Act "sunshine"** provisions of the Gramm-Leach-Bliley Act of 1999 are implemented by **Regulation G.** Annual reporting and public disclosures are required for certain written agreements that are entered into between insured depository institutions (or their affiliates) and non-governmental entities or persons.

o The **Fair Credit Reporting Act of 1970**, which is implemented in part by **Regulation V,** regulates the consumer reporting industry. The act governs the retention, use, and exchange of information about consumers, primarily information about consumers' credit histories. Among other things, it places restrictions on the use of consumer reports and requires credit reporting agencies to allow consumers to correct erroneous reports. The act was substantially amended by the Fair and Accurate Credit Transactions Act of 2003.

o The **Flood Disaster Protection Act of 1973** is implemented by **Regulation H.** The act prohibits federally regulated lending institutions from making any loan secured by improved real estate or a mobile home located or to be located in a flood hazard area of a community participating in the National Flood Insurance Program unless the property securing that loan is covered by flood insurance.

o The **Insurance Sales** provisions of the **Gramm-Leach-Bliley Act of 1999** are implemented by **Regulation H**. The insurance rules require that certain disclosures be made to consumers in connection with the sale of insurance products and annuities by depository institutions. Institutions are prohibited from conditioning an extension of credit on the consumer's purchase of insurance or an annuity from the institution or any of its affiliates.

o The **Privacy of Consumer Financial Information** provisions of the **Gramm-Leach-Bliley Act** are implemented by **Regulation P**. The law requires institutions to disclose their privacy policies and provide consumers with notice and an opportunity to opt out of the sharing of their nonpublic personal financial information with unaffiliated entities, subject to certain exceptions.

o The **Federal Trade Commission Act** authorizes the Board to identify unfair or deceptive acts or practices by banks and to issue regulations to prohibit them. Rules issued by the Board under **Regulation AA** apply to all banks, but not to thrifts, credit unions, or nonbank lenders. (The Office of Thrift Supervision and National Credit Union Administration are given the same authority with respect to thrifts and credit unions, respectively.) If the FTC issues a rule under the act, the Board is required to issue a substantially similar rule, to the extent applicable.

Regulation AA's Subpart A establishes consumer complaint procedures. Subpart B contains the Credit Practices Rule (CPR), which is the corollary to a rule issued by the FTC in 1985. The CPR restricts certain practices in the collection of delinquent consumer debts (for example, practices related to late charges, the responsibilities of cosigners, and wage assignments). In 2008, the Board amended Regulation AA to prohibit certain credit card practices.

Other consumer financial services laws

The following laws are enforced by the Board for state member banks but do not involve Board regulations.

o The **Fair Debt Collection Practices Act of 1977,** which is administered by the Federal Trade Commission, prohibits abusive debt collection. The act applies to banks that function as debt collectors for other entities, but does not apply to creditors who attempt to collect only debts owed to them. There is no implementing regulation.

o The **Fair Housing Act of 1968** prohibits discrimination on the basis of race, color, gender, religion, national origin, handicap, or familial status, in connection with the sale or rental of housing, including housing finance. The U.S. Department of Housing and Urban Development (HUD) writes the rules for the act. (Note: The Board writes the rules for the Equal Credit Opportunity Act (ECOA), which prohibits credit discrimination in all types of credit transactions, not just housing credit. Also, ECOA prohibits credit discrimination on the basis of age but does not cover handicap or familial status. See above.)

o The **Real Estate Settlement Procedures Act of 1974,** implemented by HUD's **Regulation X,** seeks to protect consumers from unnecessarily high real estate settlement costs by providing them with the cost information required to close a mortgage loan transaction and by prohibiting certain business practices. Under the act, lenders must disclose to borrowers the costs of real estate settlement services (such as points, title insurance, appraisal fees, and other closing costs) in connection with home-mortgage loans. These disclosure requirements are closely related to the Truth in Lending Act disclosures required for home-secured loans. The act also protects borrowers against certain abusive practices, such as kickbacks between settlement service providers, and regulates the use of escrow accounts.

Supplement B

2009 Consumer Advisory Council Members

Chair
Edna Sawady
Consultant
New York, New York
Term expires December 31, 2009

Vice Chair
Michael Calhoun
President,
Center for Responsible Lending
Durham, North Carolina
Term expires December 31, 2010

Paula Bryant-Ellis
Senior Vice President and Manager of the Community Development Banking Group
BOK Financial Corp
Tulsa, Oklahoma Term expires December 31, 20112

Alan Cameron
President and CEO
Idaho Credit Union League
Boise, Idaho
Term expires December 31, 2010

John P. Carey
Executive Vice President and Chief Administrative Officer
Citi Cards, Citigroup, Inc.
Long Island City, New York
Term expires December 31, 2011

Jason Engel
Vice President and Chief Regulatory Counsel
Experian
Costa Mesa, California
Term expires December 31, 2009

Kathleen Engel
Leon M. and Gloria Plevin Associate Professor
Cleveland-Marshall College of Law, Cleveland State University
Cleveland, Ohio
Term expires December 31, 2010

Joe Falk
Consultant
Akerman Senterfitt
Miami, Florida
Term expires December 31, 2009

Carolyn E. "Betsy" Flynn
President and Vice Chairman
Community Financial Services Bank
Benton, Kentucky
Term expires December 31, 2011

Patricia Garcia Duarte
President and CEO
Neighborhood Housing Services (NHS) of Phoenix
Phoenix, Arizona
Term expires December 31, 2011

Louise Gissendaner
Senior Vice President and Director of Community Development
Fifth Third Bank
Cleveland, Ohio
Term expires December 31, 2009

Ira J. Goldstein
Director of Policy and Information Services
The Reinvestment Fund
Philadelphia, Pennsylvania
Term expires December 31, 2011

Greta Harris
Vice President-Southeast Region
Local Initiatives Support Corporation
Richmond, Virginia
Term expires December 31, 2010

Patricia Hasson
President
Consumer Credit Counseling Service of Delaware Valley, Inc
Philadelphia, Pennsylvania
Term expires December 31, 2009

Thomas James
Senior Assistant Attorney General
Office of the Illinois Attorney General
Chicago, Illinois

Term expires December 31, 2009

Kirsten Keefe
Senior Staff Attorney
Consumer, Housing, and Community Economic Development, Empire Justice Center
Albany, New York
Term expires December 31, 2011

Lorenzo Littles
Director
Enterprise Community Partners
Dallas, Texas
Term expires December 31, 2010

Larry B. Litton, Jr.
President and CEO
Litton Loan Servicing LP
Houston, Texas
Term expires December 31, 2011

Saurabh Narain
Chief Fund Advisor
National Community Investment Fund (NCIF)
Senior Managing Director
ShoreBank Corporation
Chicago, Illinois
Term expires December 31, 2010

Andres L. Navarrete
Senior Vice President and Chief Counsel for National Lending and Regulatory
Capital One
McLean, Virginia
Term expires December 31, 2011

Jim Park
President
Asian Real Estate Association of America
CEO
New Vista Asset Management
San Diego, California
Term expires December 31, 2011

Ronald Phillips
President
Coastal Enterprises, Inc.
Wiscasset, Maine

Term expires December 31, 2010

Kevin Rhein
Division President and Business Manager
Wells Fargo Card Services
Minneapolis, Minnesota
Term expires December 31, 2010

Shanna Smith
President and CEO
National Fair Housing Alliance (NFHA
Washington, District of Columbia
Term expires December 31, 2010

H. Cooke Sunoo
Director
Asian Pacific Islander Small Business Program
Los Angeles, California
Term expires December 31, 2009

Jennifer Tescher
Director
Center for Financial Services Innovation
Chicago, Illinois
Term expires December 31, 2010

Stergios "Terry" Theologides
Executive Vice President and General Counsel
Saxon Mortgage Services, Inc.
Irving, Texas
Term expires December 31, 2009

Mary Tingerthal
President, Capital Markets Companies
Housing Partnership Network
Saint Paul, Minnesota
Term expires December 31, 2011

Linda Tinney
Vice President, Community Development-West Metro Region
U.S. Bank
Denver, Colorado
Term expires December 31, 2009

Luz Urrutia
President

El Banco de Nuestra Comunidad,
The Peoples Bank
Roswell, Georgia
Term expires December 31, 2009

Supplement C

Foreclosure Rescue Scam Theatre Ads

PSA Theatre Distribution and timeframe
April 10 through 16:

- AZ - Phoenix -- Ahwatukee 24
- CA - Los Angeles/Riverside -- Temecula 15
- CA - San Francisco -- Daly City 20
- CA - Sacramento -- Sacramento Green 16
- CA - Stockton-San Joaquin -- Stockton City Stadium 16
- CA - Merced -- Hollywood Mainplace Stadium Cinema 1
- CO - Denver -- Pavillions 15
- FL - Ft. Lauderdale -- Sawgrass Stadium 23
- FL - Miami -- Kendall Village 16
- FL - Orlando-Daytona -- Waterford Stadium 20
- GA - Atlanta -- Atlantic Station 16
- MD - Waldorf -- St. Charles Town Center 9
- MD - Largo -- Magic Johnson Capital Center 12
- MI - Detroit -- Livonia 20
- NV - Las Vegas -- Santa Fe Station
- OH - Valley View -- Cinemark 24
- VA - Manassas -- Manassas 14
- VA - Woodbridge -- Potomac Mills 18

Supplement D

COMMUNITY AFFAIRS

PUBLICATIONS AND SIGNATURE CONFERENCES

The following is a list of Federal Reserve publications and signature conferences produced by the Community Affairs Offices to keep financial institutions, community development organizations, state and local governments as well as individual consumers informed of issues and trends important to promoting sustainable communities.

FEDERAL RESERVE SYSTEM:

The Enduring Challenge of Concentrated Poverty in America: Case Studies from Communities Across the U.S., a joint project of the Federal Reserve System and the Brookings Institution, contributes to our understanding of the dynamics of poor people living in poor communities, and the policies that will be needed to bring both into the economic mainstream. http://www.frbsf.org/cpreport/index.html.

BOSTON
Publications:

Communities and Banking
Published four times per year;
Recent issue (Summer 2009): Neighborhood Stabilization and Land Banking, Green Space and Affordable Housing, Financial Burden of Health Care
http://www.bos.frb.org/commdev/c&b/index.htm

New England Community Developments
Published three times per year;
http://www.bos.frb.org/commdev/necd/index.htm

Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act
Joint publication of the Federal Reserve Banks of Boston and San Francisco; Research papers and essays documenting industry changes since the passage of CRA in 1977, including proposals for future CRA reforms.
http://www.bos.frb.org/commdev/cra/index.htm

NEW YORK
Data:

Regional Economic Data on LMI areas
Demographic, housing, social, and economic data for select regions in the Second District provide background information on low- and moderate-income (LMI) areas to

support presentations on the region and community discussions. The library of charts, tables and maps profile conditions in LMI census tracts for:

- New York State
- New York City
- Upstate New York -- defined as the 48 northern and western NYS counties
- Long Island
- Fairfield County, CT
- Greater Newark, NJ -- defined as northern NJ including Essex, Union, Hunterdon, Morris, and Sussex counties

The Facts and Trends Series
Provides analytical summaries intended to present key facts on topical issues to assist governments, community advocates and others to better understand, monitor and address specific economic concerns within the Second District.

Foreclosure Prevention Flyers
Customized by region to help borrowers find free and reliable foreclosure prevention resources. Flyers are currently available for New York State, New York City, Newark, and Connecticut. Available on the Bank's website for consumers to download, print, and distribute as needed.

PHILADELPHIA
Publication:

Cascade
Cascade is a community development publication produced three times a year by the Community Affairs Department. Cascade has a primary readership in financial institutions, nonprofits, and government agencies in the Third Federal Reserve District. http://www.phil.frb.org/community-development/publications/cascade/

Signature Conference:

Reinventing Older Communities – A biennial conference that has become a major meeting ground for policymakers, community developers, lenders, funders, planners, and government representatives who want to learn from leading practitioners and researchers around the country. The 2008 conference theme, *"How Does Place Matter?"* was cosponsored with The Brookings Institution's Metropolitan Policy Center, the William Penn Foundation, the Reinvestment Fund, and LISC. The conference included a research track developed with the University of Pennsylvania's Institute for Urban Research.

CLEVELAND
Publication:

CR Report
Community Affairs Magazine
http://www.clevelandfed.org/Our_Region/Community_Development/Publications/CRReport/CRReport_Winter2008.pdf

Signature Conference:

Annual Policy Summit – The Cleveland Policy Summit is a one-day forum focused on the most relevant community development issues facing the Fourth District. The most recent Summit (June 2009) featured a lively debate over topics as varied as whether the country should promote home ownership as much as it has in the past, whether the Community Reinvestment Act should be expanded to include more organizations or become more limited in scope, and whether there should be more or less government involvement in returning the housing industry to health.

RICHMOND
Publication:

MARKETWISE
Community Affairs magazine; published three times a year
http://www.richmondfed.org/publications/community_development/marketwise/index.cfm

ATLANTA
Publication:

Partners in Community and Economic Development
This magazine, published three times each year, features articles addressing community development trends, issues, and events.
http://www.frbatlanta.org/publica/pubs_pubrouter.cfm?pub_type=PARTNERS%20IN%20COMMUNITY%20AND%20ECONOMIC%20DEVELOPMENT

CHICAGO
Publication:

Profitwise News and Views
Community Affairs Magazine
Published three times per year
http://www.chicagofed.org/community_development/files/PNV_June2009_ReEd_WEB.pdf

ST. LOUIS
Publications:

Bridges is a quarterly review of regional community development issues, projects and regulatory changes for lenders and community groups.
http://www.stlouisfed.org/publications/br/

Regional Economic Development
A journal of local and regional economic development, with particular focus on the Eighth Federal Reserve District.
http://research.stlouisfed.org/publications/red/

Signature Conference:
Exploring Innovations – A biennial conference dedicated to the most innovative trends and developments in community development.

MINNEAPOLIS
Publication:
Community Dividend
Quarterly publication of the Community Affairs department at the Minneapolis Fed.
http://www.minneapolisfed.org/publications_papers/issue.cfm?id=297

KANSAS CITY
Publication:
Subprime Loan Reports: A series of subprime loan reports for selected Tenth District cities.
http://www.kc.frb.org/home/subwebnav.cfm?level=3&theID=10576&SubWeb=3

DALLAS
Publication:
Banking and Community Perspectives
Articles and case studies about community development issues, interviews with policymakers and announcements on related upcoming events.
http://dallasfed.org/ca/bcp/2009/bcp0901.pdf

Building Wealth
A personal finance education resource for schools, nonprofit community organizations, financial services providers and consumers to help young people, adult consumers, families and others develop a plan for building personal wealth. *Building Wealth* presents an overview of personal wealth-building strategies that includes setting financial goals, budgeting, saving and investing, managing debt, and understanding credit reports and credit scores.
http://dallasfed.org/ca/wealth/index.cfm

SAN FRANCISCO
Publications:
Community Development Investments Review

A publication of the Center for Community Development Investment at the FRB-San Francisco created to bridge the gap between theory and practice by bringing experts together to write about various community development investment topics including finance, collaborations, public policy, and best practices.
Current Issue: Real Estate Owned
http://www.frbsf.org/publications/community/review/vol5_issue1/index.html

Community Investments Online
Community Affairs Magazine
Published three times each year
Current Issue: Unemployment in Low Income Communities
http://www.frbsf.org/publications/community/investments/0905/index.html

Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act
Joint publication of the Federal Reserve Banks of Boston and San Francisco; Research papers and essays documenting industry changes since the passage of CRA in 1977, including proposals for future CRA reforms.
http://www.frbsf.org/publications/community/cra/index.html

Signature Conference:

National Interagency Community Reinvestment Conference – This conference provides participants with the unique opportunity to learn about the regulations underpinning the Community Reinvestment Act, as well as to share emerging challenges and best practices in community development with colleagues from across the country. Through interactive panels and plenary sessions, participants learn not only about the nuts and bolts of CRA, but also about other emerging community development issues.

Supplement E

Publications by Board Economists Relating to Consumer Protection, 2004-2009

Aaronson, Stephanie, and Julia Coronado (2005). "Are Firms Or Workers Behind the Shift Away from DB Pension Plan?" Finance and Economics Discussion Series 2005-17. Board of Governors of the Federal Reserve System (U.S.).

Adams, Robert M., and Dean F. Amel (2005). "The Effects of Local Banking Market Structure on the Banking-Lending Channel of Monetary Policy," Finance and Economics Discussion Series 2005-16. Board of Governors of the Federal Reserve System (U.S.).

Adams, Robert M., Paul W. Bauer, and Robin C. Sickles (2004). "Scale Economies, Scope Economies, and Technical Change in Federal Reserve Payment Processing," *Journal of Money, Credit, and Banking,* vol. 36, no. 5, pp. 943-958.

Agarwal, Sumit, John C. Driscoll, Xavier Gabaix, and David Laibson (2008). "Learning in the Credit Card Market," NBER Working Papers 13822. National Bureau of Economic Research, Inc.

Agarwal, Sumit, John C. Driscoll, Xavier Gabaix, and David Laibson (2007). "The Age of Reason: Financial Decisions Over the Lifecycle," NBER Working Papers 13191. National Bureau of Economic Research, Inc.

Agarwal, Sumit, John C. Driscoll, and David Laibson (2007). "Optimal Mortgage Refinancing: A Closed Form Solution," NBER Working Papers 13487. National Bureau of Economic Research, Inc.

Aizcorbe, Ana, Martha Starr, and James T. Hickman (2004). "Vehicle Purchases, Leasing, and Replacement Demand," *Business Economics,* vol. 39, no. 2, pp. 7-17.

Amel, Dean F., and Kenneth P. Brevoort (2005). "The Perceived Size of Small Business Banking Markets " *Journal of Competition Law and Economics,* vol. 1, no. 4, pp. 771-784.

Amel, Dean F., Arthur B. Kennickell, and Kevin B. Moore (2008). "Banking Market Definition: Evidence from the Survey of Consumer Finances," Finance and Economics Discussion Series 2008-35. Board of Governors of the Federal Reserve System (U.S.).

Amromin, Gene (2005). "Precautionary Savings Motives and Tax Efficiency of Household Portfolios: An Empirical Analysis," Finance and Economics Discussion Series 2005-01. Board of Governors of the Federal Reserve System (U.S.).

Amromin, Gene, Jennifer Huang, and Clemens Sialm (2006). "The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings," NBER Working Papers 12502. National Bureau of Economic Research, Inc.

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Hearing on "Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve" before the Subcommittee on Domestic Monetary Policy and Technology of the U.S. House Committee on Financial Services

Prepared Statement of Patricia A. McCoy
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-- and --
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2:00 p.m., Thursday, July 16, 2009 – 2128 Rayburn House Building

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Chairman Watt, Ranking Member Paul, and Members of the Subcommittee: Thank you for inviting me here today to discuss restructuring the financial regulatory system. I applaud the subcommittee for exploring bold new approaches to financial regulation needed to address our nation's economic challenges.

In my remarks today, I testify in support of the Consumer Financial Protection Agency Act of 2009, proposed by the Administration. The Act would transfer many of the consumer financial protection responsibilities of federal banking regulators to a single, dedicated agency whose sole mission is consumer protection. This step is essential for three reasons. First, during the housing bubble, our current system of fragmented regulation drove lenders to shop for the easiest legal regime. Second, the ability of lenders to switch charters put pressure on regulators – both state and federal – to relax credit standards. Finally, federal banking regulators have routinely sacrificed consumer protection for the short-term profitability of banks. Creating one, dedicated regulator charged solely with consumer financial protection would establish uniform standards and enforcement for all lenders and help eliminate another death spiral in lending. Although I examine this issue through the lens of mortgage regulation, my discussion is equally relevant to other forms of consumer credit, such as credit cards and payday loans.

The reasons for the breakdown of the home mortgage market and the private-label market for mortgage-backed securities are well known by now. Our broken system of mortgage finance and the private actors in that system – ranging from mortgage brokers, lenders, and appraisers to the rating agencies and securitizers – bear direct responsibility for this breakdown in standards.

There is more to the story, however. In 2006, depository institutions and their affiliates, which were regulated by federal banking regulators, originated about 54% of all higher-priced home loans. In 2007, that percentage rose to 79.6%.[1] In some states, mortgages originated by state banks and thrifts and independent nonbank lenders were regulated under state anti-predatory lending laws. In other states, however, mortgages had no meaningful state regulation. Consequently, regulatory failure was to blame as well as reckless business practices. That failure was not confined to states, but pervaded federal banking regulation as well.

Neither of these phenomena – the collapse in lending criteria nor the regulatory failure that accompanied it – was an accident. Rather, they occurred because mortgage originators and

[1] Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, *The 2007 HMDA Data*, FED. RES. BULL. A107, A124 (Dec. 2008), available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf.

regulators became locked in a competitive race to the bottom to relax loan underwriting and risk management. The fragmented U.S. system of financial services regulation exacerbated this race to the bottom by allowing lenders to shop for the easiest regulators and laws.

I open by describing how our fragmented regulatory system encouraged lenders to shop for lenient regulators. Then I document regulatory failure by federal banking regulators. Finally, I discuss how the Consumer Financial Protection Agency Act of 2009 solves these problems.

I. The Regulatory Story: Race to the Bottom

It is a basic tenet of banking law that banks should not extend credit without proof of ability to repay. Federal banking regulators[2] had ample authority to enforce principle through safety and soundness and federal consumer protection laws. Nevertheless, they refused to exercise their substantial powers of rule-making, formal enforcement, and sanctions to crack down on poorly underwritten loans until it was too late. Their abdication allowed irresponsible loans to multiply. Furthermore, their green light to banks to invest in investment-grade subprime mortgage-backed securities and CDOs left the nation's largest banks struggling with toxic assets. These problems were a direct result of the country's fragmented system of financial regulation, which caused regulators to compete for turf.

A. The Fragmented U.S. System of Mortgage Regulation

In the United States, the home mortgage industry operates under a fragmented regulatory structure which varies according to entity.[3] Banks and thrift institutions are regulated under federal banking laws and a subset of those institutions – namely, national banks, federal savings associations, and their subsidiaries – are exempt from state anti-predatory lending and credit laws due to federal preemption. In contrast, mortgage brokers and independent non-depository mortgage lenders escape federal banking regulation but have to comply with state laws. Only state banks and thrifts in some states (a dwindling group) are subject to both sets of laws.

Under this dual system of regulation, depository institutions are subject to a variety of federal examinations, including fair lending, Community Reinvestment Act, and safety and soundness examinations, but independent nondepository lenders are not. Similarly, banks and thrifts must comply with other provisions of the Community Reinvestment Act, including reporting requirements and merger review. Federally insured depository institutions must also meet minimum risk-based capital requirements and reserve requirements, unlike their independent non-depository counterparts.

Some federal laws applied to all mortgage originators. Otherwise, lenders could change their charter and form to shop for the friendliest regulatory scheme.

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[2] The four federal banking regulators include the Federal Reserve System, which serves as the central bank and supervises state member banks; the Office of the Comptroller of the Currency, which oversees national banks; the Federal Deposit Insurance Corporation, which operates the Deposit Insurance Fund and regulates state nonmember banks; and the Office of Thrift Supervision, which supervises savings associations.

[3] This discussion is drawn from Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 110 (Nicolas P. Retsinas & Eric S. Belsky eds., Joint Center for Housing Studies of Harvard University & Brookings Institution Press, 2008).

B. Applicable Law

Despite these differences in regulatory regimes, the Federal Reserve Board did have the power to prohibit reckless mortgages across the entire mortgage industry. The Board had this power by virtue of its authority to administer a federal anti-predatory lending law known as "HOEPA."

1. Federal Law

Following deregulation of home mortgages in the early 1980s, disclosure became the prevailing form of federal mortgage regulation. The federal Truth in Lending Act (TILA),[4] passed in 1968, mandates uniform disclosures regarding cost for home loans. Its companion law, the federal Real Estate Settlement Procedures Act of 1974 (RESPA),[5] requires similar standardized disclosures for settlement costs. Congress charged the Federal Reserve with administering TILA and the Department of Housing and Urban Development with administering RESPA.

In 1994, Congress augmented TILA and RESPA by enacting the Home Ownership and Equity Protection Act (HOEPA).[6] HOEPA was an early federal anti-predatory lending law and prohibits specific abuses in the subprime mortgage market. HOEPA applies to all residential mortgage lenders and mortgage brokers, regardless of the type of entity.

HOEPA has two important provisions. The first consists of HOEPA's high-cost loan provision,[7] which regulates the high-cost refinance market. This provision seeks to eliminate abuses consisting of "equity stripping." It is hobbled, however, by its extremely limited reach – covering only the most exorbitant subprime mortgages – and its inapplicability to home purchase loans, reverse mortgages, and open-end home equity lines of credit.[8] Lenders learned to evade the high-cost loan provisions easily by slightly lowering the interest rates and fees on subprime loans below HOEPA's thresholds and by expanding into subprime purchase loans.

HOEPA also has a second major provision, which gives the Federal Reserve Board the authority to prohibit unfair or deceptive lending practices and refinance loans involving practices that are abusive or against the interest of the borrower.[9] This provision is potentially broader than the high-cost loan provision, because it allows regulation of both the purchase and refinance markets, without regard to interest rates or fees. However, it was not self-activating. Instead, it depended on action by the Federal Reserve Board to implement the provision, which the Board did not take until July 2008.

2. State Law

Before 2008, only the high-cost loan provision of HOEPA was in effect as a practical matter. This provision had a serious Achilles heel, consisting of its narrow coverage. Even though the

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4 15 U.S.C. §§ 1601–1693r.

5 12 U.S.C. §§ 2601–2617.

6 15 U.S.C. §§ 1601, 1602(aa), 1639(a)–(b).

7 15 U.S.C. § 1602(aa)(1)–(4); 12 C.F.R. § 226.32(a)(1), (b)(1).

8 15 U.S.C. § 1602(i), (w), (bb); 12 C.F.R. § 226.32(a)(2) (1997); EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).

9 15 U.S.C. § 1639(*l*)(2).

Federal Reserve Board lowered the high-cost triggers of HOEPA effective in 2002, that provision still only applied to 1% of all subprime home loans.[10]

After 1994, it increasingly became evident that HOEPA was incapable of halting equity stripping and other sorts of subprime abuses. By the late 1990s, some cities and states were facing rising foreclosures and some jurisdictions were contemplating regulating subprime loans on their own. Many states already had older statutes on the books regulating prepayment penalties and occasionally balloon clauses. These laws were relatively narrow, however, and did not address other, new abuses that were surfacing in subprime loans.

Consequently, in 1999, North Carolina became the first state to enact a comprehensive anti-predatory lending law.[11] Soon, other states followed suit and passed anti-predatory lending laws of their own. These newer state laws implemented HOEPA's design but frequently expanded coverage or imposed stricter regulation on subprime loans. By year-end 2005, twenty-nine states and the District of Columbia had enacted one of these "mini-HOEPA" laws. Some states also passed stricter disclosure laws or laws regulating mortgage brokers. By the end of 2005, only six states – Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota – lacked laws regulating prepayment penalties, balloon clauses, or mandatory arbitration clauses, all of which were associated with exploitative subprime loans.[12]

Critics, including some federal banking regulators, have blamed the states for igniting the credit crisis through lax regulation. Certainly, there were states that were largely unregulated and there were states with weak mortgage regulation. Mortgage brokers were loosely regulated in too many states. Similarly, the states never agreed on a uniform system of mortgage regulation.

Nevertheless, this criticism of the states disregards the hard-fought efforts by a growing number of states – which eventually grew to include the majority of states – to regulate abusive subprime loans within their borders. State attorneys general and state banking commissioners spearheaded some of the most important enforcement actions against deceptive mortgage lenders.[13]

C. The Ability to Shop For Lax Laws and Regulators

State-chartered banks and thrifts and their subsidiaries had to comply with the state anti-predatory lending laws. So did independent nonbank lenders and mortgage brokers.

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10 EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Urban Institute Press, 2007).

11 N.C. GEN STAT. § 24-1.1E.

12 *See* Raphael Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan Wachter, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47-66 (2008), full working paper version available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005423.

13 For instance, in 2002, state authorities in 44 states struck a settlement with Household Finance Corp. for $484 million in consumer restitution and changes in its lending practices following enforcement actions to redress alleged abusive subprime loans. Iowa Attorney General, *States Settle With Household Finance: Up to $484 Million for Consumers* (Oct. 11, 2002), available at www.iowa.gov/government/ag/latest_news/releases/oct_2002/Household_Chicago.html. In 2006, forty-nine states and the District of Columbia reached a $325 million settlement with Ameriquest Mortgage Company over alleged predatory lending practices. *See, e.g.*, Press Release, Iowa Dep't of Justice, Miller: Ameriquest Will Pay $325 Million and Reform its Lending Practices (Jan. 23, 2006), *available at* http://www.state.ia.us/government/ag/latest_news/releases/jan_2006/Ameriquest_Iowa.html.

For the better part of the housing boom, however, national banks, federal savings associations, and their mortgage lending subsidiaries did not have to comply with the state anti-predatory lending laws due to federal preemption rulings by their federal regulators. This became a problem because federal regulators did not replace the preempted state laws with strong federal underwriting rules.

1. Federal Preemption

The states that enacted anti-predatory lending laws did not legislate in a vacuum. In 1996, the federal regulator for thrift institutions – the Office of Thrift Supervision or OTS – promulgated a sweeping preemption rule declaring that henceforth federal savings associations did not have to observe state lending laws.[14] Initially, this rule had little practical effect because any state anti-predatory lending provisions on the books back then were fairly narrow.[15]

Following adoption of the OTS preemption rule, federal thrift institutions and their subsidiaries were relieved from having to comply with state consumer protection laws. That was not true, however, for national banks, state banks, state thrifts, and independent nonbank mortgage lenders and brokers.

The stakes rose considerably starting in 1999, when North Carolina passed the first comprehensive state anti-predatory lending law. As state mini-HOEPA laws proliferated, national banks lobbied their regulator – a federal agency known as the Office of the Comptroller of the Currency or OCC – to clothe them with the same federal preemption as federal savings associations. They succeeded and, in 2004, the OCC issued its own preemption rule banning the states from enforcing their laws impinging on real estate lending by national banks and their subsidiaries.[16] In a companion rule, the OCC denied permission to the states to enforce their own laws that were *not* federally preempted – state lending discrimination laws are one example – against national banks and their subsidiaries. After a protracted court battle, the controversy ended up in the U.S. Supreme Court, which upheld the OCC preemption rule.[17]

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14 12 C.F.R. §§ 559.3(h), 560.2.

15 Bostic et al., *supra* note 12; Office of Thrift Supervision, *Responsible Alternative Mortgage Lending: Advance notice of proposed rulemaking*, 65 Fed. Reg. 17811, 17814-16 (2000).

16 Office of the Comptroller of the Currency, *Bank Activities and Operations; Final rule*, 69 FED. REG. 1895 (2004) (codified at 12 C.F.R. § 7.4000); Office of the Comptroller of the Currency, *Bank Activities and Operations; Real Estate Lending and Appraisals; Final rule*, 69 FED. REG. 1904 (2004) (codified at 12 C.F.R. §§ 7.4007-7.4009, 34.4). National City Corporation, the parent of National City Bank, N.A., and a major subprime lender, spearheaded the campaign for OCC preemption. *Predatory lending laws neutered*, ATLANTA JOURNAL-CONSTITUTION, Aug. 6, 2003.

17 Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007); Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System*, 23 ANN. REV. BANKING & FINANCE LAW 225 (2004). The Supreme Court later overturned part of the OCC visitorial powers rule. Cuomo v. Clearing House Ass'n, L.L.C., ___ U.S. ___ (2009). The OCC and the OTS left some areas of state law untouched, namely, state criminal law and state law regulating contracts, torts, homestead rights, debt collection, property, taxation, and zoning. Both agencies, though, reserved the right to declare that any state laws in those areas are preempted in the future. For fuller discussion, see. McCoy & Renuart, *supra* note 3.

OTS and the OCC had institutional motives to grant federal preemption to the institutions that they regulated. Both agencies depend almost exclusively on fees from their regulated entities for their operating budgets. Both were also eager to persuade state-chartered depository institutions to convert to a federal charter. In addition, the OCC was aware that if national banks wanted federal preemption badly enough, they might defect to the thrift charter to get it. Thus, the OCC had reason to placate national banks to keep them in its fold. Similarly, the OTS was concerned about the steady decline in thrift institutions. Federal preemption provided an inducement to thrift institutions to retain the federal savings association charter.

2. The Ability to Shop for the Most Permissive Laws

As a result of federal preemption, state anti-predatory lending laws applied to state-chartered depository institutions and independent nonbank lenders, but not to national banks, federal savings associations, or their mortgage lending subsidiaries. The only anti-predatory lending provisions that national banks and federally chartered thrifts had to obey were HOEPA and agency pronouncements on subprime and nontraditional mortgage loans.[18] Of these, HOEPA had extremely narrow scope. Meanwhile, agency guidances lacked the binding effect of rules and their content was not as strict as the stronger state laws.

This dual regulatory system allowed mortgage lender to play regulators off one another by threatening to change charters. Mortgage lenders are free to operate with or without depository institution charters. Similarly, depository institutions can choose between a state and federal charter and between a thrift charter and a commercial bank charter. Each of these choices allows a lender to change regulators.

A lender could escape a strict state law by switching to a federal bank or thrift charter or by shifting its operations to a less regulated state. Similarly, a lender could escape a strict regulator by converting its charter to one with a more accommodating regulator.

Countrywide, the nation's largest mortgage lender and a major subprime presence, took advantage of this system to change its regulator. One of its subsidiaries, Countrywide Home Loans, was supervised by the Federal Reserve. This subsidiary switched and became an OTS-regulated entity as of March 2007. That same month, Countrywide Bank, N.A., converted its charter from a national bank charter under OCC supervision to a federal thrift charter under OTS supervision. Reportedly, OTS promised Countrywide's executives to be a "less antagonistic" regulator if Countrywide switched charters to OTS. Six months later, the regional deputy

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[18] Board of Governors of the Federal Reserve System et al., Interagency Guidance on Subprime Lending (March 1, 1999); OCC, Abusive Lending Practices, Advisory Letter 2000-7 (July 25, 2000); OCC et al., Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001); OCC, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans, Advisory Letter 2003-3 (Feb. 21, 2003); OCC, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, Advisory Letter 2003-2 (Feb. 21, 2003); OCC, OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices, 70 Fed. Reg. 6329 (2005); Department of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Product Risks; Final guidance, 71 Fed. Reg. 58609 (2006); Department of the Treasury et al. Statement on Subprime Mortgage Lending; Final guidance, 72 Fed. Reg. 37569 (2007). Of course, these lenders, like all lenders, are subject to prosecution in cases of fraud. Lenders are also subject to the Federal Trade Commission Act, which prohibits unfair and deceptive acts and practices (UDAPs). However, federal banking regulators were slow to propose rules to define and punish UDAP violations by banking companies in the mortgage lending area.

director of the OTS West Region, where Countrywide was headquartered, was promoted to division director. Some observers considered it a reward.[19]

The result was a system in which lenders could shop for the loosest laws and enforcement. This shopping process, in turn, put pressure on regulators at all levels – state and local – to lower their standards or relax enforcement. What ensued was a regulatory race to the bottom.

II. Regulatory Failure

Federal preemption would not have been such a problem if federal banking regulators had replaced state laws with tough rules and enforcement of their own. Those regulators had ample power to stop the deterioration in underwriting standards that mushroomed into a full-blown crisis. However, they refused to intervene in disastrous lending until it was too late. As a result, federally regulated lenders – as well as all lenders operating in states with weak regulation – received *carte blanche* to loosen their lending standards free from regulatory intervention.

A. The Federal Reserve Board

The Federal Reserve Board had the statutory power, starting in 1994, to curb lax lending not only for depository institutions, but for all lenders across-the-board. It declined to exercise that power in any meaningful respect, however, until after the nonprime mortgage market collapsed.

In the mortgage lending area, the Fed's supervisory process has three major parts and breakdowns were apparent in two out of the three. The only part that appeared to work well was the Fed's role as the primary federal regulator for state-chartered banks that are members of the Federal Reserve System.[20]

As the second part of its supervisory duties, the Fed regulates nonbank mortgage lenders owned by bank holding companies but not owned directly or indirectly by banks or thrifts. During the housing boom, some of the largest subprime and Alt-A lenders were regulated by the Fed, including the top- and third-ranked subprime lenders in 2006, HSBC Finance and Countrywide Financial Corporation, and Wells Fargo Financial, Inc.[21]

The Fed's supervisory record with regard to these lenders was mixed. On one notable occasion, in 2004, the Fed levied a $70 million civil money penalty against CitiFinancial Credit Company

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[19] Richard B. Schmitt, *Regulator takes heat over IndyMac*, LOS ANGELES TIMES, Oct. 6, 2008; see also Binyamin Appelbaum & Ellen Nakashima, *Regulator Played Advocate Over Enforcer*, WASHINGTON POST, November 23, 2008. The official later retired following a capital contribution backdating scandal.

[20] In general, these are community banks on the small side. In 2007 and 2008, only one failed bank – the tiny First Georgia Community Bank in Jackson, Georgia, with only $237.5 million in assets – was regulated by the Federal Reserve System. It is not clear whether the Fed's performance is explained by the strength of its examination process, the limited role of member banks in risky lending, the fact that state banks had to comply with state anti-predatory lending laws, or all three. While more state member banks have since failed, the deepening recession was likely a contributing factor to their failure.

In the following discussion on regulatory failure by the Federal Reserve Board, the OTS, and the OCC, the data regarding failed and near-failed banks and thrifts come from federal bank regulatory and S.E.C. statistics, disclosures, press releases, and orders; rating agency reports; press releases and other web materials by the companies mentioned; statistics compiled by the *American Banker*; and financial press reports.

[21] Data provided by *American Banker*, available at www.americanbanker.com.

and its parent holding company, Citigroup Inc., for subprime lending abuses.[22] Apart from that, the Fed did not take public enforcement action against the nonbank lenders that it regulated. That may be because the Federal Reserve did not routinely examine the nonbank mortgage lending subsidiaries under its jurisdiction. The late Federal Reserve Board Governor Edward Gramlich stated as much in a speech in 2007. Only then did the Fed kick off a "pilot project" to examine the nonbank lenders under its jurisdiction on a routine basis for loose underwriting and compliance with federal consumer protection laws.[23]

Finally, the Board is responsible for administering most federal consumer credit protection laws, including HOEPA. When former Governor Edward Gramlich served on the Fed, he urged then-Chairman Alan Greenspan to exercise the Fed's power to address unfair and deceptive loans under HOEPA. Greenspan refused, preferring instead to rely on non-binding statements and guidances.[24] This reliance on statements and guidances had two disadvantages: one, major lenders routinely dismissed the guidances as mere "suggestions" and, two, guidances did not apply to independent nonbank mortgage lenders.

The Federal Reserve did not relent until July 2008, when under Chairman Ben Bernanke's leadership, it finally promulgated binding HOEPA regulations banning specific types of lax and abusive loans. Even then, the regulations were mostly limited to higher-priced mortgages, which the Board confined to first-lien loans of 1.5 percentage points or more above the average prime offer rate for a comparable transaction, and 3.5 percentage points for second-lien loans. Although shoddy nontraditional mortgages below those triggers had also contributed to the credit crisis, the rule left those loans – plus prime loans – mostly untouched.[25] While badly needed, the rules were too little and too late.

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22 Federal Reserve, Citigroup Inc. New York, New York and Citifinancial Credit Company Baltimore, Maryland: Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent, May 27, 2004.

23 Edward M. Gramlich, Boom and Busts, The Case of Subprime Mortgages, Speech given August 31, 2007, Jackson Hole, Wyo., at symposium titled "Housing, Housing Finance & Monetary Policy," sponsored by the Federal Reserve Bank of Kansas City, pp. 8-9, available at www.kansascityfed.org/publicat/sympos/2007/pdf/2007.09.04.gramlich.pdf; Speech by Governor Randall S. Kroszner At the National Bankers Association 80th Annual convention, Durham, North Carolina, October 11, 2007.

24 House of Representatives, Committee on Oversight and Government Reform, "The Financial Crisis and the Role of Federal Regulators, Preliminary Transcript" 35, 37-38 (Oct. 23, 2008), available at http://oversight.house.gov/documents/20081024163819.pdf. Greenspan told the House Oversight Committee in 2008:

> Well, let's take the issue of unfair and deceptive practices, which is a fundamental concept to the whole predatory lending issue.
>
> The staff of the Federal Reserve . . . say[] how do they determine as a regulatory group what is unfair and deceptive? And the problem that they were concluding . . . was the issue of maybe 10 percent or so are self-evidently unfair and deceptive, but the vast majority would require a jury trial or other means to deal with it . . .

Id. at 89.

25 Federal Reserve System, *Truth in Lending: Final rule; official staff commentary*, 73 FED. REG. 44522, 44536 (July 30, 2008). The Board set those triggers with the intention of covering the subprime market, but not the prime market. *See id.* at 44536-37.

In the home mortgage area, the Board also abdicated its authority to keep Truth-in-Lending Act disclosures up-to-date. The last time the Board did a major overhaul of the TILA rules was in 1981. These TILA disclosures worked tolerably well under the old market conditions featuring fixed-rate mortgages. In the 1990s, however, the market changed with the introduction of risk-based pricing. By that time, the Fed's sorely outdated Truth-in-Lending Act disclosures were not equipped to produce accurate, timely disclosures for subprime loans and exotic adjustable-rate mortgages.[26] Nevertheless, the Fed dragged its feet on issuing new rules. It did not get around to issuing a narrow new rule under TILA on bait-and-switch tactics and payment shock disclosures until July 30, 2008 and when it did, Congress immediately passed legislation declaring the rule insufficient.[27] As for comprehensive reform, the Board did not even initiate a full review of its TILA rules for closed-end mortgages until 2007. It still has not completed that review.[28]

On October 23, 2008, in testimony before the U.S. House of Representatives Oversight Committee, Greenspan admitted that "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief." House Oversight Committee Chairman Henry Waxman asked Greenspan whether "your ideology pushed you to make decisions that you wish you had not made?" Greenspan replied:[29]

> Mr. GREENSPAN. . . . [Y]es, I found a flaw, I don't know how significant or permanent it is, but I have been very distressed by that fact. . . .
>
> Chairman WAXMAN. You found a flaw?
>
> Mr. GREENSPAN. I found a flaw in the model that defines how the world works, so to speak.
>
> Chairman WAXMAN. In other words, you found that your view of the world, your ideology, was not right, it was not working.

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26 As early as 1998, the Federal Reserve Board and the Department of Housing and Urban Development were aware that Truth in Lending Act disclosures did not come early enough in the nonprime market to allow meaningful comparison shopping. That year, the two agencies issued a report diagnosing the problem. In the report, HUD recommended changes to the Truth in Lending Act to require mortgage originators to provide binding price quotes before taking loan applications. The Federal Reserve Board dissented from the proposal, however, and it was never adopted. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & DEP'T OF HOUS. & URBAN DEV., JOINT REPORT TO THE CONGRESS, CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, at 28 - 29, 39 - 42 (1998), *available at* www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

27 *Compare* Federal Reserve System, *Truth in Lending: Final rule; official staff commentary*, 73 Fed. Reg. 44522 (July 30, 2008) *with* Mortgage Disclosure Improvement Act of 2008 (MDIA), Pub. L. No. 110-289, tit. V, § 2502(a)(6), 122 Stat. 2855-2856 (July 30, 2008). In the MDIA, Congress issued a rebuke to the Federal Reserve by mandating stronger payment shock disclosures and notice of any interest rate hikes before the loan closing. Congress further amended these provisions of the MDIA in the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, enacted on October 3, 2008.

28 The Board also seriously delayed revamping TILA disclosures for credit cards, but did issue a comprehensive new final rule on credit card disclosures in January 2009. Federal Reserve System, *Truth in Lending: Final rule*, 74 FR 5244 (Jan. 29, 2009).

29 House of Representatives, Committee on Oversight and Government Reform, "The Financial Crisis and the Role of Federal Regulators, Preliminary Transcript" 36-37 (Oct. 23, 2008), available at http://oversight.house.gov/documents/20081024163819.pdf.

Mr. GREENSPAN. Precisely. That's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well.[30]

B. Regulatory Lapses by the OCC and OTS

Federal preemption might not have devolved into a banking crisis of systemic proportions had OTS and the OCC replaced state regulation for their regulated entities with a comprehensive set of binding rules prohibiting lax underwriting of home mortgages. Instead, federal banking regulators, including the OCC and OTS, issued a series of "soft law" advisory letters and guidelines against predatory or unfair mortgage lending practices by insured depository institutions.[31] Federal regulators disavowed binding rules during the run-up to the subprime crisis saying that guidelines were more flexible and the agencies enforced those guidelines through bank examinations and informal enforcement actions.[32] Informal enforcement was usually limited to negotiated, voluntary agreements between regulators and the entities that they supervised, making it easy for management to drag out negotiations to soften any restrictions and bid for more time. Furthermore, examinations and informal enforcement are highly confidential, making it easy for a lax regulator to hide its tracks.

1. The Office of Thrift Supervision

Although OTS was the first agency to adopt federal preemption, it managed to fly under the radar during the subprime boom, overshadowed by its larger sister agency, the OCC. After 2003, while commentators were busy berating the OCC preemption rule, OTS allowed the largest federal savings associations to embark on an aggressive campaign of expansion through option payment ARMs, subprime loans, and low-documentation and no-documentation loans.

Autopsies of failed depository institutions in 2007 and 2008 show that five of the seven biggest failures were OTS-regulated thrifts. Two other enormous thrifts during that period – Wachovia Mortgage, FSB and Countrywide Bank, FSB -- were forced to arrange hasty takeovers by large bank holding companies to avoid failing. By December 31, 2008, thrifts totaling $355 billion in assets had failed in the previous sixteen months on OTS' watch.

The reasons for these thrift failures evince fundamental regulatory lapses by OTS. Almost all of the thrifts that failed in 2007 and 2008 – and all of the larger ones -- succumbed to massive levels of imprudent home loans. IndyMac Bank, FSB, which became the first major thrift institution to fail during this crisis, in July 2008, manufactured its demise by becoming the top originator of low-documentation and no-documentation loans. These loans, which became known as "liar's loans," infected both the subprime market and credit to borrowers with higher

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30 Testimony of Dr. Alan Greenspan before the House of Representatives Committee of Government Oversight and Reform, October 23, 2008, available at http://oversight.house.gov/documents/20081023100438.pdf.

31 See note 18 *supra*.

32 Office of the Comptroller of the Currency, *Bank Activities and Operations; Real Estate Lending and Appraisals; Final rule*, 69 FED. REG. 1904 (2004).

credit scores. By 2006 and 2007, over half of IndyMac's home purchase loans were subprime loans and IndyMac Bank approved up to half of those loans based on low or no documentation.

Washington Mutual Bank, popularly known as "WaMu," was the nation's largest thrift institution in 2008, with over $300 billion in assets. WaMu became the biggest U.S. depository institution in history to fail on September 25, 2008, in the wake of the Lehman Brothers bankruptcy. WaMu was so large that OTS examiners were stationed there permanently onsite. Nevertheless, from 2004 through 2006, despite the daily presence of the resident OTS inspectors, risky option ARMs, second mortgages, and subprime loans constituted over half of WaMu's real estate loans each year. By June 30, 2008, over one fourth of the subprime loans that WaMu originated in 2006 and 2007 were at least thirty days past due. Eventually, it came to light that WaMu's management had pressured its loan underwriters relentlessly to approve more and more exceptions to WaMu's underwriting standards in order to increase its fee revenue from loans.[33]

Downey Savings & Loan became the third largest depository institution to fail in 2008. Like WaMu, Downey had loaded up on option ARMs and subprime loans. When OTS finally had to put it into receivership, over half of Downey's total assets consisted of option ARMs and nonperforming loans accounted for over 15% of the thrift's total assets.

In short, the three largest depository institution failures in 2007 and 2008 resulted from high concentrations of poorly underwritten loans, including low- and no-documentation ARMs (in the case of IndyMac) and option ARMs (in the case of WaMu and Downey) that were often only underwritten to the introductory rate instead of the fully indexed rate. During the housing bubble, OTS issued no binding rules to halt the proliferation by its largest regulated thrifts of option ARMs, subprime loans, and low- and no-documentation mortgages. Instead, OTS relied on oversight through guidances. IndyMac, WaMu, and Downey apparently treated the guidances as solely advisory, however, as evidenced by the fact that all three made substantial numbers of hazardous loans in late 2006 and in 2007 in direct disregard of an interagency guidance on nontraditional mortgages issued in the fall of 2006 and subscribed to by OTS that prescribed underwriting ARMs to the fully indexed rate.[34]

The fact that all three institutions continued to make loans in violation of the guidance suggests that OTS examinations failed to result in enforcement of the guidance. Similarly, OTS fact sheets on the failures of all three institutions show that the agency consistently declined to institute timely formal enforcement proceedings against those thrifts prohibiting the lending practices that resulted in their demise. In sum, OTS supervision of residential mortgage risks was confined to "light touch" regulation in the form of examinations, nonbinding guidances, and occasional informal agreements that did not work.

2. The Office of the Comptroller of the Currency

The OCC has asserted that national banks made only 10% of subprime loans in 2006. But this assertion fails to mention that national banks moved aggressively into Alt-A low-documentation

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[33] Peter S. Goodman & Gretchen Morgenson, *Saying Yes, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008.

[34] Department of the Treasury et al., *Interagency Guidance on Nontraditional Mortgage Product Risks; Final guidance*, 71 FED. REG. 58609 (2006).

and no-documentation loans during the housing boom.[35] This mattered a lot, because the biggest national banks are considered "too big to fail" and pose systemic risk on a scale unmatched by independent nonbank lenders. We might not be debating bailouts of Citibank and Bank of America today had the OCC stopped them from expanding into toxic mortgages and bonds.

Like OTS, "light touch" regulation was apparent at the OCC. Unlike OTS, the OCC did promulgate one rule, in 2004, prohibiting mortgages to borrower who could not afford to repay. However, the rule was vague in design and execution, allowing lax lending to proliferate at national banks and their mortgage lending subsidiaries through 2007.

In disregard of the 2004 rule, through 2007, large national banks continued to make large quantities of poorly underwritten subprime loans and low- and no-documentation loans. In 2006, for example, fully 62.6% of the first-lien home purchase mortgages made by National City Bank, N.A., and its subsidiary, First Franklin Mortgage, were higher-priced subprime loans. Starting in the third quarter of 2007, National City Corporation reported five straight quarters of net losses, largely due to those subprime loans. Just as with WaMu, the Lehman Brothers bankruptcy ignited a silent run by depositors and pushed National City Bank to the brink of collapse. Only a shotgun marriage with PNC Financial Services Group in October 2008 saved the bank from FDIC receivership.

The five largest U.S. banks in 2005 were all national banks and too big to fail. They too made heavy inroads into low- and no-documentation loans. The top-ranked Bank of America, N.A., had a thriving stated-income and no-documentation loan program which it only halted in August 2007, when the market for private-label mortgage-backed securities dried up. Bank of America securitized most of those loans, which may be why the OCC tolerated such lax underwriting.

Similarly, in 2006, the OCC overrode public protests about a "substantial volume" of no-documentation loans by JPMorgan Chase Bank, N.A., the second largest bank in 2005, on grounds that the bank had adequate "checks and balances" in place to manage those loans.

Citibank, N.A., was the third largest U.S. bank in 2005. In September 2007, the OCC approved Citibank's purchase of the disreputable subprime lender Argent Mortgage, even though subprime securitizations had slowed to a trickle. Citibank thereupon announced to the press that its new subsidiary – christened "Citi Residential Lending" – would specialize in nonprime loans, including reduced documentation loans. But not long after, by early May 2008, after Bear Stearns narrowly escaped failure, Citibank was forced to admit defeat and dismantle Citi Residential's lending operations.

The fourth largest U.S. bank in 2005, Wachovia Bank, N.A., originated low- and no-documentation loans through its two mortgage subsidiaries. Wachovia Bank originated such large quantities of these loans – termed Alt-A loans – that by the first half of 2007, Wachovia Bank was the twelfth largest Alt-A lender. These loans performed so poorly that between December 31, 2006 and September 30, 2008, the bank's ratio of net write-offs on its closed-end home loans to its total outstanding loans jumped 2400%. Concomitantly, the bank's parent company, Wachovia Corporation, was reported its first quarterly loss in years due to rising

[35] Testimony by John C. Dugan, Comptroller, before the Senate Committee on Banking, Housing, and Urban Affairs, March 4, 2008.

defaults on option ARMs made by Wachovia Mortgage, FSB, and its Golden West predecessor. Public concern over Wachovia's loan losses triggered a silent run on Wachovia Bank in late September 2008, following Lehman Brothers' failure. To avoid receivership, the FDIC brokered a hasty sale of Wachovia to Wells Fargo after Wells Fargo outbid Citigroup for the privilege.

Wells Fargo Bank, N.A., was in better financial shape than Wachovia, but it too made large quantities of subprime and reduced documentation loans. In 2006, over 23% of the bank's first-lien refinance mortgages were high-cost subprime loans. Wells Fargo Bank also securitized substantial numbers of low- and no-documentation mortgages in its Alt-A pools. In 2007, a Wells Fargo prospectus for one of those pools stated that Wells Fargo had relaxed its underwriting standards in mid-2005 and did not verify whether the mortgage brokers who had originated the weakest loans in that loan pool complied with its underwriting standards before closing. Not long after, as of July 25, 2008, 22.77% of the loans in that loan pool were past due.

As the Wells Fargo story suggests, the OCC depended on voluntary risk management by national banks, not regulation of loan terms and practices, to contain the risk of improvident loans. A speech by the then-Acting Comptroller, Julie Williams, confirmed as much. In 2005, Comptroller Williams, in a speech to risk managers at banks, coached them on how to "manage" the risks of no-doc loans through debt collection, higher reserves, and prompt loss recognition. Securitization was another risk management device favored by the OCC.

Three years later, in 2008, the Treasury Department's Inspector General issued a report that was critical of the OCC's supervision of risky loans. Among other things, the Inspector General criticized the OCC for not instituting formal enforcement actions while lending problems were still manageable in size. In his written response to the Inspector General, the Comptroller, John Dugan, conceded that "there were shortcomings in our execution of our supervisory process" and ordered OCC examiners to start initiating formal enforcement actions on a timely basis. [36]

The OCC's record of supervision and enforcement during the subprime boom reveals many of the same problems that culminated in regulatory failure by OTS. Like OTS, the OCC usually shunned formal enforcement actions in favor of examinations and informal enforcement. Neither of these supervisory tools obtained compliance with the OCC's 2004 rule prohibiting loans to borrowers who could not repay. Although the OCC supplemented that rule later on with more detailed guidances, some of the largest national banks and their subsidiaries apparently decided that they could ignore the guidances, judging from their lax lending in late 2006 and in 2007. The OCC's emphasis on managing credit risk through securitization, reserves, and loss recognition, instead of through product regulation, likely encouraged that *laissez faire* attitude by national banks.

C. Judging by the Results: Loan Performance By Charter

OCC and OTS regulators have argued that their agencies offer "comprehensive" supervision resulting in lower default rates on residential mortgages. The evidence shows otherwise.

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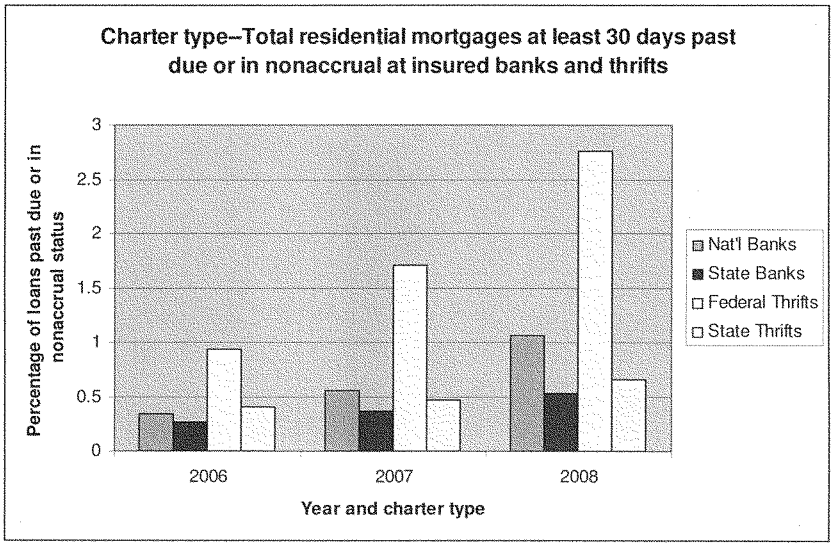
36 Office of Inspector General, Department of the Treasury, "Safety and Soundness: Material Loss Review of ANB Financial, National Association" (OIG-09-013, Nov. 25, 2008).

Data from the Federal Deposit Insurance Corporation show that among depository institutions, federal thrift institutions had the worst default rate for one-to-four family residential mortgages from 2006 through 2008. (See Figure 1).

Figure 1. Total Performance of Residential Mortgages by Depository Institution Charter



Source: FDIC Statistics on Depository Institutions

The second-worst performance record among depository institution lenders went to national banks. State thrifts had better default rates than either type of federally chartered institution in 2007 and 2008. State banks consistently had the lowest default rates of all.

Among these charter types, the only ones that enjoy federal preemption are national banks regulated by the OCC and federal thrift institutions regulated by the OTS. State banks and state thrift institutions do not. Thus it appears, at least among depository institutions, that federal preemption was associated with *higher* default rates, not lower rates, during 2006 through 2008, when credit standards hit bottom and the mortgage market imploded.

These data do not address whether that independent nonbank lenders have even higher default rates in some states and that may in fact be the case. Nevertheless, the data undercut the assertion that federal preemption reduces default rates among mortgages by depository institution lenders. To the contrary, the lowest default rates were at state banks and thrifts, which are subject both to state and federal regulation.

III. The Consumer Financial Protection Agency Act of 2009

Dual regulation and the resulting crazy quilt of laws encouraged lenders to shop for the lightest rules. In turn, this pressured regulators to weaken their standards and to relax enforcement of safety and soundness and consumer protection laws.

Casting underwriting standards to the wind in a seemingly obscure corner of the consumer credit market ended up triggering a global recession. This crisis shows that the United States ignores consumer protection at its peril. If it was not clear before, we now know that systemic stability and consumer protection are inextricably linked.

To correct the regulatory lapses that I have described, our financial regulatory system needs to adopt three reforms:

- *First*, Congress should adopt uniform minimum consumer protection standards for all financial services providers nationwide, regardless of entity, charter, or location.

- *Second,* the authority for administering and enforcing these standards should be housed in one federal agency whose sole mission is consumer protection.

- *Third,* to avoid the risk of agency inaction, Congress should give parallel enforcement authority to federal banking regulators and the states.

The Consumer Financial Protection Agency Act of 2009 accomplishes all three objectives.

A. Uniform Federal Safety Standards For Consumer Credit

The downward spiral in underwriting standards drove home the need for uniform consumer protection standards that apply to all financial services providers. Adopting a uniform federal floor would prevent lenders, brokers and other financial providers from seeking safe havens in legal regimes that do little to protect consumers.

The Consumer Financial Protection Agency Act of 2008 ("the Act") solves this problem by creating one set of uniform federal laws that apply to all financial services providers across the country, regardless of entity, charter, or geographic location. To prevent regulators from competing to relax the interpretation of those laws, furthermore, the Act consolidates the authority to administer those laws in one agency. That agency is the new Consumer Financial Protection Agency ("Agency").

The Act would give the Agency jurisdiction over the following types of consumer financial protection laws and apply almost all of these laws to all financial services providers:

- *Unfair Practices:* First, in Section 1031 of the bill, the Agency would have authority to define and prevent unfair or deceptive acts and practices in consumer financial services. While federal banking regulators have this power, they resisted using it until far too late, after the mortgage market melted down. Section 1031 also represents an improvement over the high-cost loan provisions in HOEPA, which proved too narrow and rigid and failed to address new abuses as they appeared in the mortgage market.

- *Deceptive Marketing*: Second, Section 1033 of the bill would authorize the Agency to write rules banning unfair sales practices in consumer financial services. The bill delegates this responsibility to the Agency, partly due to evidence that the Federal Reserve Board was slow to crack down on deceptive marketing practices during the housing bubble. A related provision, Section 1037, would allow the Agency to set forth the duties of front-line personnel such as loan officers or brokers who deal directly with consumers when providing a consumer financial product and to make sure that their compensation methods do not undermine those duties.

- *Transparency and Disclosure:* Third, Section 1032 would empower the Agency to adopt rules mandating better consumer disclosures. This and other sections of the bill direct the Agency to re-design disclosures based not on speculation, but on empirical tests using real consumers and pilot disclosure forms. The bill would transfer this responsibility to the Agency due to the Federal Reserve Board's protracted hesitation and delay in revamping disclosures. The Agency would also be responsible for producing a badly needed, combined TILA-RESPA mortgage disclosure form.

- *Safer Loans:* Fourth, in the provision on standard consumer financial products found in Section 1035, the bill would allow the Agency to gently "nudge" consumers toward safer financial products, such as fixed-rate mortgages, with easy-to-understand terms. Consumers would be offered a relatively safe, plain-vanilla product first. This would make it easier for consumers to comparison shop and help them avoid "snow jobs" by standardizing the terms of safer products and bringing those products front and center to consumers' attention. At the same time, consumers would remain free to choose different products with other features subject to warnings or other safeguards.

- *Existing Consumer Financial Protection Laws:* Finally, the bill would transfer the authority to administer other existing federal consumer financial protection laws to the Agency. These laws would include the Truth in Lending Act, HOEPA, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Fair Credit Billing Act, and the Home Mortgage Disclosure Act.[37]

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[37] The Agency would also receive responsibility for administering the Consumer Leasing Act, the Electronic Fund Transfer Act, the Truth in Savings Act, the Alternative Mortgage Transaction Parity Act, the S.A.F.E. Mortgage Licensing Act, the Community Reinvestment Act, the privacy provisions in title V of the Gramm-Leach-Bliley Act, and provisions of the Federal Deposit Insurance Act dealing with deposit insurance disclosures.

B. A Dedicated Federal Agency Whose Sole Mission is Consumer Protection

1. Federal Regulators Cannot Serve Two Masters

The housing bubble and hazardous mortgages by federally regulated depository institutions show that we cannot expect consumer protection to be paramount to federal banking regulators when times are good. At the top of the economic cycle, federal banking regulators are prone to interpret their safety and soundness mandate in favor of the short-term profitability of the banks they regulate, to the detriment of the long-term welfare of consumers. For this reason, the consumer protection function should be removed from federal banking regulators and housed in its own agency whose sole mission is consumer protection.

The bank regulatory agencies' own mission statements make it clear that consumer protection is a low priority. For example, the Federal Reserve Board divides its duties into four general areas:[38]

- "conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- "supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- "providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system."

In the Fed's description, monetary policy comes first, followed by banking supervision. Consumer protection does not even merit its own bullet point.

Similarly, safety and soundness regulation is the paramount mission of the OCC and OTS. The OCC describes its mission as having four objectives, with consumer protection coming last:[39]

- "To ensure the safety and soundness of the national banking system.
- "To foster competition by allowing banks to offer new products and services.
- "To improve the efficiency and effectiveness of OCC supervision, including reducing regulatory burden.
- "To ensure fair and equal access to financial services for all Americans."

Like the OCC, OTS describes safety and soundness as its principal job:[40]

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38 THE FEDERAL RESERVE SYSTEM, PURPOSES & FUNCTIONS 1 (9th ed. 2005).

39 Comptroller of the Currency, *About the OCC* (viewed February 28, 2009), available at http://www.occ.treas.gov/aboutocc.htm.

40 Office of Thrift Supervision, *Mission and Goals* (viewed February 28, 2009), available at http://www.ots.treas.gov/?p=MissionGoal.

> "To supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs."

In theory, safety and soundness and consumer protection should normally overlap. In practice, they have not, as recent experience has shown. During the housing boom, federal banking regulators too often equated short-term profitability, including profits from excessive fees on consumers,[41] with safety and soundness. In their effort to protect the short-term profitability of banks and thrifts, federal regulators often dismissed consumer protection as conflicting with that mission. When agencies derive most of their operating budgets from assessments on the entities they regulate – as do the OCC and OTS – the pressure to sacrifice consumer protection for profit maximization by those entities can be overwhelming.[42]

I served on the Federal Reserve Board's Consumer Advisory Council from 2002 through 2004 and saw firsthand how resistant federal banking regulators were to instituting basic consumer protections during the run-up to the current crisis. Repeatedly over that period, I and other members of that Council warned the Federal Reserve's staff and governors about rising foreclosures and other dangers associated with reckless subprime loans. We urged the Board to exercise its powers under HOEPA to strengthen protections for subprime and nontraditional mortgages, but to no avail. During my tenure on the Council, the late Governor Gramlich told me during a break at one of the Council's public meetings that there was not enough support on the Board to expand HOEPA's protections. Governor Gramlich was truly sympathetic to those concerns, but was not able to convince his fellow Board members, including Chairman Greenspan. These experiences confirmed my belief that banking regulators often dismiss the consumer protection piece of their mission.

Some critics argue that removing consumer protection responsibilities from federal banking regulators and housing them in their own dedicated agency would undercut the safety and soundness of banks. As the current crisis shows, however, entrusting consumer protection to the federal banking agencies is no guarantee of bank safety and soundness. Indeed, having a separate federal watchdog for consumer credit would help place healthy, countercyclical constraints on the tendency of federal banking regulators to sacrifice long-term safety for short-term profits at the top of the credit cycle. It would also encourage forward-looking regulation as new problems arise, instead of laggard, backward-looking regulation of the type recently issued by the Federal Reserve.

The Act contains three main safeguards to help ensure that the Agency's actions comport with bank safety and soundness. First, the National Bank Supervisor would be the only permanent member of the Agency's Board. Second, at numerous points throughout the bill, the Act mandates consultation or coordination by the Agency with its fellow federal regulators, including federal banking regulators and the Securities and Exchange Commission and Commodity

41 Examples include regulators' slow response to curtailing large prepayment penalties and their continued indecision on costly overdraft protection on checking accounts.

42 For instance, the OCC derives 95% of its budget from assessments on national banks. The twenty largest national banks contribute almost 60% of those assessments. See, e.g., Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PENN. L. REV. 1, 93-94 (2008); Testimony of Arthur E. Wilmarth, Jr., Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (Apr. 26, 2007).

Futures Trading Commission.[43] Finally, the Agency must file regular reports with Congress to enable Congress to exercise its oversight power.

2. A Separate Federal Consumer Credit Agency Offers Other Strong Advantages

A wide range of experts across the political spectrum, from the Treasury Department under former Secretary Paulson to former Federal Reserve governors and the Congressional Oversight Panel, have recommended housing consumer financial protection in its own agency.[44] A separate federal agency dedicated to consumer protection for all consumer credit would offer several distinct advantages. First, it would rescue consumer financial protection from its current orphan state and make consumers the Agency's top priority. Second, it would consolidate industry-wide enforcement in the Agency, meaning that all financial services providers would be subject to the same level of enforcement.

This latter point is necessary to thwart shopping for the easiest regulator. Under the current regime, consumer compliance examinations and enforcement are divided among federal banking regulators and sometimes other agencies, even though the Federal Reserve Board writes the rules for most federal consumer credit laws. Other federal consumer financial protection laws – such as Section 5 of the Federal Trade Commission Act and the Community Reinvestment Act – are individually implemented by the four federal banking regulators with respect to their regulated entities. Each agency can make its own choice about the extent to which it enforces or does not enforce the law. Ending this fragmentation of enforcement would discourage lenders from switching charters in search of the easiest regulator.

Finally, transferring consumer credit laws to one agency whose sole mission is consumer protection would provide regulators with a complete overview of the entire consumer credit market, its structure, and emerging issues. Right now, consumer financial protection suffers from a silo mentality because it is parceled out among so many agencies. Consolidating it in one agency would overcome this silo mentality. In addition, consolidation would concentrate expertise for consumer financial products in one agency. The provisions of the Act authorizing a research division and periodic reporting requirements are essential to developing and deploying this expertise.

3. How to Avoid Future Agency Inaction

Consolidating oversight in one federal agency poses a final concern about agency capture and inaction. The FTC, for example, had a vigorous enforcement record on mortgage abuses during the Clinton Administration but a lackluster record during the George W. Bush Administration, at least until 2008. During that same period, OCC and OTS preemption raised industry capture concerns. These problems are not unique to those agencies, moreover. Administrations and

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[43] See, e.g., §§ 1016, 1022, 1031 of the Act.

[44] THE DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 170-74 (March 2008) (proposing a Conduct of Business Regulatory Agency), available at www.treasury.gov; CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM 30-37 (Jan. 2009), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf. Just last week, former Federal Reserve governors Laurence H. Meyer and Frederic S. Mishkin testified before this Subcommittee advocating transferring the Federal Reserve's consumer protection functions to the new Agency.

agency chairs come and go, which means that over its lifetime, every agency will have periods of drift and inaction. Not every agency head can be a Ben Bernanke or a Sheila Bair.

The drafters of the Act thought long and hard about this issue and carefully designed the bill to counteract possible agency inaction. The Act takes a two-pronged approach. First, it makes federal consumer financial protection standards a floor, not a ceiling. Second, it vests back-up enforcement authority in fellow federal regulators and in the states.

i. A Minimum Federal Floor

To address the concern that at some point in the future, the Agency, with respect to its rule-making authority, might drag its feet on needed reforms, the Act specifies that federal consumer financial protection standards will operate as a floor. As such, the federal standards will preempt state laws that are weaker. However, states would remain free to enact stricter consumer protections so long as those protections are consistent with the federal statute. The Agency would retain the power to determine whether a state law was consistence. § 1041.

A minimum federal floor, rather than a ceiling, is critical for three reasons. First, that approach provides an important safeguard against the possibility that the Agency might adopt unduly weak rules or fail to update the rules. Second, states are closer to local conditions and often more responsive to emerging problems at home. A federal floor would preserve the states' ability to protect their citizens. Finally, giving latitude to the states to adopt stricter standards would preserve the states' important role as laboratories of experimentation. Enabling individual states to test other approaches would help prevent federal rules from becoming ossified. This dual federal-state approach, in fact, may have resulted in lower default rates on mortgages at state banks and thrifts (Figure 1).

Bankers have voiced fears that a patchwork of state laws will make compliance too costly and complex. Those fears are vastly overstated. In fact, in the past, when Congress has enacted federal consumer legislation as a floor, only a handful of states have passed stronger statutes of their own.[45] Bankers have managed to adjust to those few variations. In all other states, the federal standard prevails standing alone.

[45] For example, in the Depository Institutions Deregulation and Monetary Control Act of 1980, Congress allowed states to opt out of federal deregulation of usury caps on first-lien residential mortgages. Fourteen states originally opted out, although some of those later repealed their usury caps. Similarly, only six states exercised their right to opt out of federal preemption under the Alternative Mortgage Transaction Parity Act. Elizabeth Renuart and Kathleen E. Keest, *The Cost of Credit: Regulation, Preemption, and Industry Abuses* §§ 3.9.4.1, 3.10.1, 3.10.2 (Boston: National Consumer Law Center, 3d ed. 2005 and annual supplement).

ii. Back-up Enforcement Power

In financial services regulation, we have experienced starkly different models of enforcement, depending on the regulatory scheme. For national banks and federal savings associations, especially after 2004, the OCC and OTS invoked their visitorial powers to argue that they had sole enforcement power for any consumer protection abuses by their regulated entities. Then those agencies resisted vigorous enforcement action against abusive mortgages, while continuing to assert that no other agency had authority to act in their stead.

In contrast, when the Securities and Exchange Commission succumbed to lax enforcement in the late 1990s and 2000s, state attorneys general retained the power to prosecute securities fraud on their own. That power resulted in landmark actions by the attorneys general of New York, Massachusetts, and Connecticut, among other states, and lit a fire under the S.E.C. to initiate actions of its own. Similarly, in insurance regulation, the decentralization of enforcement among the fifty states meant that when there were serious market conduct problems, some states were likely to take enforcement even if others were not. The Act incorporates these lessons by giving back-up enforcement authority to other federal regulators and the states to provide a strong antidote to any inaction by the Agency.

Vis-à-vis other federal regulators, to avoid traffic jams, the Act gives primary enforcement to the Agency. Other federal regulators, however, can recommend enforcement to the Agency. Furthermore, if the Agency fails to initiate enforcement within 120 days of a recommendation, then the federal regulator that made the recommendation may take enforcement action of its own.[46]

Vis-à-vis the states, the Act gives state attorneys general the power to enforce the Act upon notice to the Agency. The Agency can intervene as of right if it chooses.

In sum, the Act would put an end to the regulatory arbitrage that fueled the credit crisis and give consumers a needed voice. I would welcome any questions.

[46] Nothing in the Act affects the enforcement authority of the Department of Justice, the S.E.C., or the Commodity Futures Trading Commission.

Testimony of

Lauren Saunders, National Consumer Law Center

On behalf Americans for Financial Reform

And the following AFR members:

ACORN
ACORN Housing
Americans for Fairness in Lending
Consumer Action
Consumer Federation of America
Consumers Union
Demos
National Association of Consumer Advocates
National Consumer Law Center (on behalf of its low-income clients)
National Fair Housing Alliance
National People's Action
Public Citizen
Sargent Shriver National Center on Poverty Law
SEIU
U.S. PIRG

Before the Subcommittee on Monetary Policy
Committee on Financial Services
U.S. House of Representatives
The Honorable Mel Watt, Chairman

Hearing on Regulatory Restructuring:
Safeguarding Consumer Protection and the Role of the Federal Reserve

16 July 2009

I. INTRODUCTION

A. Summary

Thank you Chairman Watt, Ranking Member Paul and members of the committee for inviting me to testify today. I am the Managing Attorney of the National Consumer Law Center's Washington, DC office. I am pleased to offer this testimony on behalf of Americans for Financial Reform[1] and the following AFL members: ACORN,[2] ACORN Housing, Americans for Fairness in Lending,[3] Consumer Action,[4] Consumer Federation of America,[5] Consumers Union,[6] Demos,[7] National Association of Consumer Advocates,[8] National Consumer Law Center (on behalf of its low-income clients),[9] National Fair Housing Alliance,[10] National People's Action,[11] Public Citizen,[12] Sargent Shriver National Center on Poverty Law,[13] SEIU,[14] and U.S. PIRG.[15]

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1 **Americans for Financial Reform** is a coalition of nearly 200 national, state, and local organizations working to reform and restore oversight, accountability, and transparency to the nation's financial system. The coalition represents organizations and members in every state committed to reforming the regulatory system through policy, legislation, communications and field operations around the country.

2 **ACORN**, the **Association of Community Organizations for Reform Now**, is the nation's largest community organization of low- and moderate-income families, working together for social justice and stronger communities.

3 **Americans for Fairness in Lending** works to reform the lending industry to protect Americans' financial assets. AFFIL works with its national Partner organizations, local ally organizations, and individual members to advocate for reform of the lending industry.

4 **Consumer Action**, founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC. For more than two decades, Consumer Action has conducted a survey of credit card rates and charges to track trends in the industry and assist consumers in comparing cards.

5 The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

6 **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

7 **Demos** is a New York City-based non-partisan public policy research and advocacy organization founded in 2000.A multi-issue national organization, Demos combines research, policy development, and advocacy to influence public debates and catalyze change.

8 The **National Association of Consumer Advocates, Inc.** is a nonprofit 501(c) (3) organization founded in 1994. NACA's mission is to provide legal assistance and education to victims of consumer abuse. NACA, through educational programs and outreach initiatives protects consumers, particularly low income consumers, from fraudulent, abusive and predatory business practices. NACA also trains and mentors a national network of over 1400 attorneys in representing consumers' rights.

9 The **National Consumer Law Center**, Inc. is a non-profit corporation, founded in 1969, specializing in

This testimony describes why we recommend that consumer protection for financial products and services be consolidated within a new federal Consumer Financial Protection Agency.

A review of the history of consumer protection by the Federal Reserve and the other banking agencies demonstrates consistent inattention, at best, and opposition, at worst, to the needs of consumers. These failures transcend many years and many different subject areas, and show that the problems are institutional, not occasional lapses that have been corrected by experience or that can be fixed by tinkering with the existing framework.

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low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes and regularly updates a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, Cost of Credit, Consumer Banking and Payments Law, Foreclosures, and Consumer Bankruptcy Law and Practice, as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the federal agencies on the regulations under these laws.

10 Founded in 1988, the **National Fair Housing Alliance** is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. Headquartered in Washington, D.C., the National Fair Housing Alliance, through comprehensive education, advocacy and enforcement programs, provides equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation.

[11] **National People's Action** is a national network of metro and statewide organizations that builds grassroots power to create a society in which racial and economic justice are realized.

12 **Public Citizen** is a national nonprofit membership organization that has advanced consumer rights in administrative agencies, the courts, and the Congress, for thirty-eight years.

[13] Founded by Sargent Shriver in 1967, the mission of the **Sargent Shriver National Center on Poverty Law** is to provide national leadership in identifying, developing, and supporting creative and collaborative approaches to achieve social and economic justice for low-income people. The Community Investment Unit of the Shriver Center advances the mission of the organization through innovative and collaborative public policy advocacy to enable low-income people and communities to move from poverty to prosperity.

[14] With 2 million members in Canada, the United States and Puerto Rico, **SEIU** is the fastest-growing union in the Americas. Focused on uniting workers in healthcare, public services and property services, SEIU members are winning better wages, healthcare and more secure jobs for our communities, while uniting their strength with their counterparts around the world to help ensure that workers—not just corporations and CEOs—benefit from today's global economy.

15 The **U.S. Public Interest Research Group** serves as the federation of and federal advocacy office for the state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of their members.

Our testimony describes why we believe that a new CFPA would do better. First, it will give consumer protection the attention and clear focus it deserves. Second, by consolidating functions that are now in seven different agencies, it will provide consistent protection no matter who offers the product or service, will be able to take a holistic view, and will be able to act quickly to prevent harm. Finally, the agency will be set up to ensure regulatory independence and freedom from regulatory arbitrage.

We also describe the powers that the new agency should have, the role that the Federal Reserve and the other agencies should retain, and how the various agencies will consult and coordinate. In short, we agree with the President and Chairman Frank that, in order to ensure robust consumer protection, the new agency should have the full set of tools to protect consumers: data collection and research, supervision and examination, rule-writing and enforcement. These responsibilities should be moved away from the Federal Reserve and other banking agencies and be given exclusively to the CFPA, in order to ensure effectiveness and avoid conflicts that can paralyze action, though the banking agencies and the Federal Trade Commission should retain backup enforcement powers for their regulated entities.

Properly implemented, a Consumer Financial Protection Agency will encourage innovation by financial actors, increase competition in the marketplace and lead to better and safer choices for consumers.

We look forward to working with you and committee members to enact a strong Consumer Financial Protection Agency bill to restore the faith and confidence of American families that the financial system will protect their homes and their economic security.

B. About Americans for Financial Reform

Americans for Financial Reform is a coalition of nearly 200 national, state, and local organizations working to reform and restore oversight, accountability, and transparency to the nation's financial system. The coalition represents organizations and members in every state committed to reforming the regulatory system through policy, legislation, communications and field operations around the country.

The campaign is organized around the principles originally outlined in the "Special Report on Regulatory Reform," by the Congressional Oversight Panel chaired by Professor Elizabeth Warren to monitor the bailout and to help ensure that aid to the financial sector is accompanied by meaningful market reforms.

The coalition's platform and activities can be seen at www.ourfinancialsecurity.org

C. The Experience of the National Consumer Law Center and Other Consumer Advocates in Working with the Federal Reserve Board and the Other Banking Agencies

This testimony draws on the long experience of the National Consumer Law Center in particular, and consumer advocates in general, in working with the Federal Reserve Board (FRB) and the other banking agencies, and observing their consumer protection activities.

For over 40 years, NCLC has provided a source of consumer law expertise to poverty law programs, consumer advocates, and policymakers around the country working to protect low income consumers.

Of particular note here, we publish an 18-volume series of legal treatises, each of which runs several hundred to 1,000 or more pages, that detail the interpretation, regulations under, and use of most of the "enumerated statutes" that are proposed to be transferred to the Consumer Financial Protection Agency,[16] as well as the federal laws that preempt state consumer protections and the federal and state laws against unfair and deceptive practices.[17] NCLC attorneys and other consumer attorneys who help write these treatises read every single case under each of these statutes, and every volume is updated annually.

Together with many other consumer and civil rights groups, we have commented in excruciating detail in response to requests for comments from the FRB in particular, but other banking agencies as well, virtually every time regulations are proposed. In just the past year, NCLC has filed hundreds and hundreds of pages of comments with the Federal Reserve and other agencies on credit card, mortgages, foreclosure rescue scams, overdraft fees, and many other topics.

For decades, NCLC attorneys and other consumer advocates have also participated on the Federal Reserve's Consumer Advisory Council and have had the opportunity to talk directly to Board Governors about our concerns. We have also met and interacted with Board staff formally and informally in many other settings.

We have uniformly found the Federal Reserve's consumer protection staff, and the Governors, to be intelligent, knowledgeable, experienced, and respectful of our views. Indeed, one of the

[16] We cover the Alternative Mortgage Transaction Parity Act, Electronic Funds Transfer Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, Home Mortgage Disclosure Act, Real Estate Settlement Procedures Act, Secure and Fair Enforcement for Mortgage Licensing Act, Truth in Lending Act, and Truth in Savings Act. The only major statutes that we do not cover in depth are the Community Reinvestment Act and the Gramm-Leach-Bliley Act.

[17] Unfair and Deceptive Acts and Practices (2008 7th ed.); Truth in Lending (2007 6th ed. and 2008 Supp.); The Cost of Credit: Regulation, Preemption, and Industry Abuses (2005 3d ed. and 2008 Supp.); Consumer Banking and Payments Law (2005 3d ed. and 2008 Supp.); Foreclosures (2007 2d ed. and 2008 Supp.); Credit Discrimination (2005 4th ed. and 2008 Supp.); Fair Debt Collection (2008 6th ed.); Student Loan Law (2006 3d ed. and 2008 Supp.); Access to Utility Service (2008 4th ed.); Fair Credit Reporting (2006 6th ed. and 2008 Supp.); Collection Actions (2008 1st ed.); Consumer Class Actions (2006 6th ed. and 2008 Supp.); Consumer Bankruptcy Law and Practice (2006 8th ed. and 2008 Supp.); Consumer Law Pleadings (Website and 2008 Index Guide); Consumer Arbitration Agreements (2007 5th ed. and 2008 Supp.); Automobile Fraud (2007 3d ed. and 2008 Supp.); Repossessions (2005 6th ed. and 2008 Supp.); Consumer Warranty Law (2006 3d ed. and 2008 Supp.).

strengths of the proposal to create a new Consumer Financial Protection Agency is that it will not attempt to re-create divisions that already exist, but will transfer the relevant divisions of the Federal Reserve and other agencies to the new agency and will retain the experience and knowledge that they have. We have also observed occasional successes, with the Federal Reserve and other agencies taking action to address significant consumer protection problems.

But overall, our experience has not been so positive. Year after year, in area after area, and agency after agency, we have generally found that consumer protection rarely wins the day and has simply not been a priority. The needs of consumers have usually been trumped by a deregulatory bias and faith in the free market, an antipathy to taking significant consumer protection measures that are opposed by industry, an excessive reliance on fine print disclosures when the agencies have acted, and just plain inertia.

II. History is Replete with Areas Where the Federal Reserve and the Other Bank Regulators Have Failed to Protect Consumers

The various federal consumer protection statutes proposed to be moved to the CFPA, as well as the sweeping authority in the FTC Act to stop unfair and deceptive acts and practices, could have been used to address many of the abuses directed at consumers over the years. Though there have been examples where the banking agencies have issued important rules or otherwise acted to protect consumers, those examples are the exception rather than the rule. Below I summarize the history of several of the failures of consumer protection.

A. For Well Over a Decade, All of the Federal Agencies Ignored Requests to Address Mortgage Abuses

The Federal Reserve Board was granted sweeping anti-predatory mortgage regulatory authority by the 1994 Home Ownership and Equity Protection Act (HOEPA). Final regulations were issued on 30 July 2008 only after the world economy had collapsed due to the collapse of the U.S. housing market triggered by predatory lending.[18] Even then, the FRB ignored pleas to address unfair and deceptive practices in the entire market, not just in subprime loans.

Advocates for consumers badgered the federal banking agencies, particularly the Federal Reserve Board, to address predatory mortgage lending steadily since HOEPA passed. The Board did little, despite numerous and repeated requests to

a) improve Truth in Lending to make mortgage disclosures more meaningful and relevant, and

b) specifically address and prohibit abusive mortgage practices under its HOEPA[19] and unfair practice authorities.

[18] 73 FR 147, Page 44522, Final HOEPA Rule, 30 July 2008.

[19] 15 U.S.C. ' 1629(l)(2).

1. ***The FRB Would Not Improve Disclosures***

For several decades, advocates told the FRB that disclosures must be improved considerably to make them meaningful and truly helpful to consumers as a shopping tool.

- In the mid-nineties, advocates pushed the FRB to close loopholes to make APR comparisons more meaningful to help consumers protecting themselves in the mortgage market.[20] The FRB and HUD actually agreed and recommend with advocates on this point and recommended in its Joint Report to Congress in 1998 that the finance charge definition be amended to encompass all of the costs of credit.[21] However, in the face of heavy industry opposition, these efforts were abandoned.[22]

- During the same period, consumer advocates encouraged the FRB to improve the confusing and meaningless disclosures for variable rate mortgages.[23] Advocates recommended, among other things, that the information provided be based on the consumer's actual loan, rather than the fictitious one currently required by TILA.[24]

- Advocates efforts to improve the disclosures have continued over the past decade. However, neither the Federal Reserve Board nor the other federal banking supervisory agencies responded with anything more than minimal improvements in either the definition of the finance charge, or disclosures related to the risks of variable rate mortgages.[25]

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[20]For example, NCLC and other groups participated in a series of dockets before the Federal Reserve Board relating to improving TILA's disclosures. *See, e.g.* "How the Finance Charge Can More Accurately Reflect the True Cost of Credit" R-0969 (June 17, 1997).

[21]Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act (July 1998).

[22]*See, e.g.* Margot Saunders, Testimony before the Subcommittees on Housing & Community Opportunity and Financial Institutions & Consumer Credit House Committee on Banking and Financial Services regarding the Rewrite of Truth in Lending Act and Real Estate Settlement Procedures Act, September 16, 1998, available at http://www.consumerlaw.org/issues/predatory_mortgage/testimony.shtml.

[23]*See, e.g.* Federal Reserve Docket on How to Improve Variable Rate Disclosures, R-0960, Feb 28, 1997.

[24]*See, e.g.* Margot Saunders, Testimony before the Senate Committee on Banking, Housing and Urban Affairs regarding S. 1405 The "Financial Regulatory Relief and Economic Efficiency Act of 1997" March 10, 1998, available at http://www.consumerlaw.org/issues/predatory_mortgage/content/1998_MS_test-regword.pdf.

[25]*See, e.g.* Comments On RESPA Proposed Rule to Simplify and Improve the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers Department of Housing and Urban Development 24 CFR Part 3500, [Docket No. FR-4727-02] RIN 2502-AH85, November, 2002, available at http://www.consumerlaw.org/issues/predatory_mortgage/content/final_RESPA.pdf; Letter from the National Consumer Law Center to the Board of Governors, Federal Reserve Board, regarding Variable Rate Disclosures, January 17, 2006, available at http://www.consumerlaw.org/issues/predatory_mortgage/content/2006ARMproposal.pdf; National Consumer Law Center and others, Comments to the Federal Reserve Board, Docket No. R-1267, regarding the Proposed

2. The Agencies Failed to Adopt Substantive Prohibitions Against Predatory Mortgage Terms

HOEPA went into effect in 1995. Advocates immediately recognized that was inadequate to stop predatory mortgages and continued bringing new problems to the attention of both banking agencies and Congress. The Agencies were well aware of problems, issuing a variety of fairly meaningless pronouncements telling the industry to "clean up their act."

Between 1996 and 1998, there had been ongoing discussion with both the Federal Reserve Board and HUD to convince both agencies to make serious changes to rules dealing with predatory mortgages as part of TILA/RESPA reconciliation efforts that began in 1996. Advocates repeatedly pointed out that comprehensive rules were necessary to address the continuing and growing predatory features of mortgage loans.[26]

The report issued by HUD and Treasury jointly in 2000 reflected the wide-spread recognition of the problem of predatory lending. Yet it was absent of any clear prohibitions that would address or reduce the problems.[27] Little – if anything – was included in their 2000 report that actually stopped abusive practices. Federal agencies responded with simply more studies and, worse, more regulations that exacerbated the problems rather than addressed them (such as the OCC's issuance of the preemption regulations allowing national banks and their subsidiaries to ignore state consumer protections).[28]

In 2000, OTS acknowledged that it may have gone too far in preempting state prohibitions against prepayment penalties in its AMTPA regulations. Overcoming tremendous and vehement opposition from the mortgage industry (including litigation in federal court), the OTS succeeded in amending its own rules to remove the preemptive effect on prepayment penalties and late

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Illustrations of Consumer Information for Nontraditional Mortgage Products Home Equity Lending Market, November 28, 2006, available at http://www.consumerlaw.org/issues/predatory_mortgage/content/nontradillustrationscomments.pdf; National Consumer Law Center and others, Comments to Office of the Comptroller of the Currency (Docket No. OCC-2007-0013), Federal Reserve Board (Docket No. OP-1292), Office of Thrift Supervision (Docket No. OTS-2007-0016), Federal Deposit Insurance Corporation,
AProposed Illustrations of Consumer Information for Subprime Mortgage Lending,@ October 15, 2007, available at http://www.consumerlaw.org/issues/predatory_mortgage/content/subprime_illustrations_comments.pdf.

[26] *See record* in Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, July, 1998.

[27] Curbing Predatory Home Mortgage Lending, HUD, TREASURY, June 20, 2000. *See*, http://www.treas.gov/press/releases/ls719.htm.

[28] For an analysis of the devastating consequences of as well as the mistaken basis for the OCC preemption rule, *see* Elizabeth Renuart and Margot Saunders, *Banking Activities and Operations; Real Estate Lending and Appraisals*, OCC Docket No. 03-16, October 6, 2003. Available at http://www.consumerlaw.org/issues/preemption/10_6_occ.shtml.

fees.[29] This action was hailed as a great consumer victory, but it merely reinstated existing state protections. OTS itself did nothing to directly address the abuses.

HOEPA mandated the Federal Reserve Board to hold regular hearings to gather information about ongoing problems. More importantly, it mandated that:

> The Board, by regulation or order, *shall* prohibit acts or practices in connection with:
>
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this (HOEPA) section; and
>
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the borrower's interest.[30]

The Federal Reserve Board held hearings across the country in 2000[31] at which droves of homeowners and advocates testified,[32] beseeching the Board to use its authority under HOEPA and make significant changes to *stop* the abuses in mortgage lending. Our testimony, which was *typical of the requests of most advocates before the Board*, sought, among other items:[33]

- Coverage of many more loans under the protections of HOEPA;
- Changing the Swiss cheese approach of determining which fees charged on a mortgage loan should be included in the trigger for HOEPA loans;
- Elimination of the current incentives for originators to increase the price of mortgage loans by limiting the amount of points and fees that could be financed;
- Elimination of financing of credit insurance premiums;
- *Clear guidelines for lenders to determine the borrower ability to repay loans under all scenarios;*
- Prohibition of refinancing low-rate mortgages (such as those provided by Habitat for

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[29]*See,* National Consumer Law Center and others, Comments Regarding the "Advance Notice of Proposed Rulemaking, OTS Docket Number RIN 2550-AB37, 12 C.F.R. Part 560, No. 2000-34, July 5, 2000. Available at http://www.consumerlaw.org/issues/predatory_mortgage/NCLC_CFA_comments.shtml.

[30]Pub. L. No. 90-321, *as added* Pub. L. No. 103-325, 108 Stat. 2191 (Sept. 23, 1994), 15 U.S.C. ' 1639(l)(2).

[31]*See, e.g.* Elizabeth Renuart, Testimony before the Board of Governors of the Federal Reserve regarding Home Equity Lending and HOEPA, August 4, 2000. Available at, http://www.consumerlaw.org/issues/predatory_mortgage/hoepa_fl.shtml.

[32]Typically legal services attorneys brought multiple clients to the hearings, allowing the clients to explain their own cases; and following the clients= testimony with explanations of how the stories told by the homeowners were **B** unfortunately **B** simply typical of hundreds more cases in that community.

[33]National Consumer Law Center, *Comments to the Federal Reserve Board s Proposed Revisions to Regulation Z Truth In Lending regarding Proposals to Address Predatory Mortgage Lending* **B** Docket No. R-1090 March 9, 2001. Available at http://www.consumerlaw.org/issues/predatory_mortgage/comments_frb.shtml.

Humanity); and

- Elimination of deceptive practices relating to variable rate loans.

As a result of these HOEPA hearings, the Federal Reserve Board made minor but important adjustments to HOEPA. The most significant of these changes were:[34]

- Including premiums for credit insurance in the trigger for HOEPA, and
- Tightening the requirements for verification of repayment ability for HOEPA loans.

The inclusion of single payment credit insurance premiums in the HOEPA points and fees trigger had the dramatic impact of effectively banning the sale of these exorbitantly priced products from the entire mortgage market. This change impacted all home loans, not just the high cost loans governed by HOEPA.

The new rules for verification of income for HOEPA loans exclusively applied to the tiny fraction of the mortgage market covered by HOEPA, but at least established a federal policy of the minimum activity necessary to truly evaluate a borrower's ability to pay the loan.

After OTS's salutary amendments to its AMTPA rules in 2000 and the 2001 HOEPA changes, consumer protection activity stopped. Consumer advocates continued asking the agencies to address the escalating problems of predatory lending.[35] At one 2003 Consumer Advisory Council meeting with FRB Governors – illustrative of many comments made on many occasions – one consumer advocate pleaded for the Board to listen:

> And, you know, I hate to be this kind of – you know, as I say, you know, consumer advocates are from Mars, and bankers are from Venus. (Laughter)
>
> I sometimes feel that way. But, you know, we are – you know, there are parts ofthe country where we are going to – I really feel it's going to be a nightmare. I think the horse it out the barn door. And, you know, I hope I am wrong. I really hope I am wrong. But I think it's in the interest of the financial institutions to figure out how to fix this problem, which some unregulated institutions created, but which then the financial institutions went and purchased.[36]

[34]Other changes were also made to Regulation Z §§ 226.32 and 226.33. These two changes were the only ones that could be said to truly impact the entire mortgage market.

[35]. *See, e.g.* Comments of the National Consumer Law Center and the Consumer Federation of America to Federal Deposit Insurance Corporation re FDIC Draft Staff Guidance *"How to Avoid Purchasing or Investing in Predatory Mortgage Loans"* January 31, 2001. Available at http://www.consumerlaw.org/issues/predatory_mortgage/fdic.shtml.

[36] Transcript of the Consumer Advisory Council Meeting at 66 (June 26, 2003) (statement of Ruhi Maker, attorney with Empire Legal Services).

until 2006, when the five federal banking agencies dipped their collective big toes in the regulatory waters by issuing the Interagency Guidance on Nontraditional Mortgage Products in March 29, 2006.[37]

The 2006 Interagency Guidance was hailed as a great consumer victory. It indicated that prudent lenders making the new types of loans (like Payment Option ARM loans and Interest Only loans) should at least to evaluate the borrower's ability to repay the loan on the fully indexed rate.[38] But the excesses of the mortgage market continued unabated for over a year and a half, showing that the Guidance did little to actually rein in the industry.

NCLC and other advocates recommended that lenders be *required* to verify that borrowers have the ability to repay their loans based on the maximum payments possibly due under the loan and that lenders be prohibited from steering borrowers into costlier loans.[39] The industry objected vigorously, saying that such stringent prohibitions would inappropriately stifle the availability of credit.[40]

The five federal banking regulators bowed a bit to consumers but mostly responded to the industry's fears of constricting credit. The Guidance did not prohibit stated income loans. The regulators did not require full underwriting of the maximum payments under the loans. The regulators did not establish any clear prohibitions; these were just guidelines. No remedies or enforcement for consumers was hinted at; the regulators even attempted to provide some cover for industry players who had previously engaged in the circumscribed behavior.[41] This Guidance, as well as the Statement on Subprime Lending issued a year later by the same agencies, was simply not strong enough to make the industry behave.[42]

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[37] 71 Fed. Reg. 58,609, 58,613-58,614 (Oct. 4, 2006).

[38] *Id.* 18The fully indexed rate is the interest rate that would be in effect at the time of origination, based upon the index identified in the loan note plus the listed margin, absent a teaser rate. Even the fully indexed rate does not reflect the possible risk that interest rates will increase; it is not the maximum rate that can be charged under the note. It is only the rate that would be charged on the note had the interest rate calculations under the note been imposed at the outset.

[39] Alys Cohen and Margot Saunders, Comments of the National Consumer Law Center to the Office of the Comptroller of the Currency Docket No. 05-21, Office of Thrift Supervision No. 2005-56, Federal Reserve System Docket No. OP-1246, Federal Deposit Insurance Corporation, National Credit Union Administration, Interagency Guidance on Nontraditional Mortgage Products, March 29, 2006. Available at http://www.consumerlaw.org/issues/predatory_mortgage/content/NontraditionalMortgageComments.pdf.

[40] Examining the Role of Securitization, Hearings Before the S. Comm. on Banking, Hous., & Urban Dev., 110th Cong. (2007) (statement of Sandor Samuels, Executive Managing Dir., Countrywide Fin. Corp.) (60% of borrowers from Countrywide could not qualify at the fully indexed rate), available at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=256; Steven Sloan & Joe Adler, How Freddie Cutbacks in Hybrids May Reverberate, Am. Banker, Feb. 28, 2007 (quoting Wright Andrews, a lobbyist for nonbank lending institutions, as saying that most subprime borrowers cannot afford the fully indexed rate and requiring underwriting to the fully indexed rate would prevent adjustable rate mortgages from being made).

[41] *Id.*

[42] Statement on Subprime Lending, 72 Fed. Reg. 16 37,569 (July 10, 2007).

The loans written after the Guidance are expected to default at a greater rate than those written before.[43] All indications are that the loans issued *after* the Guidance and the Statement on Subprime Lending will default at a much higher rate than the loans issued in the years previous to these regulators' meager attempts to address the issues.[44]

3. *The Final HOEPA Rules Are Helpful But Are Too Little, Too Late*

In June 2007, at a hearing on Improving Federal Consumer Protection in Financial Services, Chairman Barney Frank gave the Federal Reserve an ultimatum:

> I am going to make a statement with regard to your rulemaking authority: use it or lose it.... And I think I speak here probably for the majority of this committee. If the Fed doesn't start to use that authority to roll out the rules, then we will give it to somebody who will use it. You reinforce my sense that the Fed is not the best place to do consumer protection.[45]

Under pressure of losing its authority, the Board in 2008 finally issued proposed amendments to two of the HOEPA protections (ability to repay and prepayment penalty provisions) and two sets of proposed rules addressing a larger part of the mortgage market.[46] Relatively quickly thereafter, the Board finalized these changes to Regulation Z on July 30, 2008.[47]

One set applies to loans – now scarce – with points and fees that meet HOEPA triggers:[48]

- The prohibition against prepayment penalties for high-cost loans covered by the Home Ownership and Equity Protection Act was broadened.
- The pattern and practice requirement in the HOEPA repayment ability rule was

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[43] *See, e.g.*, American Home Mortgage Assets, LLC Prospectus supplement (August 29, 2006) (supplement to prospectus dated April 21, 2006), American Home Mortgage Assets Trust 2006-4; Issuing Entity: American Home Mortgage Servicing, Inc.; Servicer: American Home Mortgage Corp. at 9 (showing that the lender underwrote these POA loans only for the first year's payments and that 73% of the loans covered by this prospectus were refinance loans).

[44] Nearly 61% of option ARMs originated in 2007 will eventually default, according to studies by Goldman Sachs and Countrywide, as reported in the Wall Street Journal earlier this year. Ruth Simon, *Option Arms See Rising Defaults*, Wall Street Journal, January 30, 2009.

[45] Improving Federal Consumer Protection In Financial Services, Hearing Before The Committee On Financial Services, U.S. House Of Representatives, One Hundred Tenth Congress, First Session, Serial No. 110-40 at 37-38 (June 13, 2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:37556.pdf.

[46] 73 Fed. Reg. 1,672 (Jan. 9, 2008).

[47] 73 Fed. Reg. 44,522 (July 30, 2008). The Board also amended the advertising rules for home equity lines of credit (Reg. Z § 226.16) and for closed end credit generally and closed-end loans secured by a dwelling (Reg. Z § 226.24).

[48] Proposed Reg. Z §§ 226.35.

removed.

The other set regulates "higher priced" loans, above an APR trigger but likely below HOEPA triggers.[49] These rules cover all higher-priced loans secured by the consumer's principal dwelling, *including* purchase loans:[50]

- First, the creditor must evaluate the consumer's ability to repay using the same standards that appear in the revised rule applicable to HOEPA loans.
- Second, a higher-priced loan may not include a prepayment penalty unless certain tests are met.
- Third, creditors before consummation must establish escrow accounts for the payment of property taxes and premiums for *required* mortgage-related insurance, insurance covering the loss or damage to the home, or insurance protecting the creditor against the consumer's default or other credit loss for all covered first lien loans.
- Fourth, as with HOEPA loans, the creditor cannot structure a home-secured loan as an open-end plan to evade the higher-priced loan protections.[51]

While these rules will no doubt have some salutary effect, they will by *no means* address the serious problems in the mortgage marketplace. Many consumers are still unprotected because *the rule excludes prime loans and home equity lines of credit*.

One – and probably the most serious – example of the serious limitations of the Board's new rule is that the ability to repay rule and other higher-cost restrictions do not apply to the many borrowers with nontraditional prime mortgages and other abusive bank loan products and the increasingly sizeable pool of homeowners with HELOCs. Failure to consider a borrower's ability to repay has been endemic in parts of the prime and Alt-A market not covered by the rule.

Even in the midst of the most serious crisis in credit underwriting in this nation's history, neither the Federal Reserve nor any other agency has proposed or promulgated effective regulations that will truly address the abuses in the mortgage marketplace.

[49] Proposed Reg. Z §§ 226.36.

[50] Excluded are loans to finance the initial construction of a home, a temporary or bridge loan with a term of twelve months or less, and a home equity line of credit. A first lien loan secured by the consumer's principal dwelling meets the APR trigger if its annual percentage rate exceeds the average prime offer rate for a comparable transaction by 1.5% or more percentage points. The APR on a subordinate lien loan must exceed the average prime offer rate for a comparable transaction by 3.5% or more percentage points. Unlike HOEPA loans, there is no points and fees trigger.

[51] Reg. Z § 226.35(b).

B. Until Pushed by Congress, the Federal Reserve Board Responded to Pleas to Address Credit Card Abuses with Fine Print Disclosures

The new credit card rules adopted by the banking agencies in 2008 are one of the exceptions that prove the rule. The rules are a significant, though not complete, step forward in consumer protection and address several abuses in the credit card market.

But the rules were a break from the historic pattern of responding to evidence of abuses with only more fine print disclosures. As with the HOEPA rules, only after Congress threatened the banking agencies in 2007 to "use it or lose it" regarding their power to address unfair and deceptive practices, and only after it became clear that Congress intended to address credit card abuses itself, did the agencies react to preserve their turf. In the meantime, the abuses contributed hundreds of millions (if not billions) of dollars in interest and fees to consumers' credit card debt.

The need for credit card protections was especially acute because of the ever-expanding scope of federal bank preemption. The Supreme Court first preempted state interest rate caps in 1978,[52] and the OCC later expanded that preemption to permit national banks to ignore state laws regulating fees such as late payment, over-limit, and cash advance fees. After the *Smiley* decision,[53] the average late fee soared from $12.83 in 1995 to over $33.64 in 2005, and over-limit fees similarly jumped from $12.95 in to over $30.81 in 2005.[54] By the end of 2008, credit card debt was over $960 billion.[55]

The preemption of state law encouraged credit card issuers to devise abusive tricks and traps to increase rates, impose fees and make inordinate profits from beleaguered consumers. From the 1990s to the early 2000s, consumer advocates[56] and academics[57] repeatedly documented the horrific abuses by credit card companies against consumers. A limited list of these practices included:

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[52] *Marquette National Bank of Minneapolis v. First of Omaha Service Corp,* 439 U.S. 299, 99 S. Ct. 540, 58 L. Ed. 2d 534 (1978).

[53] *Smiley v. Citibank (South Dakota), N.A* , 7 U.S. 735 (1996) (upholding OCC regulations).

[54] Government Accountability Office, Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers 20/-/21 (Sept. 2006) (GAO-06-929), *available at* www.gao.gov/new.items/d06929.pdf.

[55] Federal Reserve Board, Statistical Release No. G.19, Consumer Credit (Feb. 2009), *available at* www.federalreserve.gov/releases/G19/20090206.

[56] For example, Consumer Action issued regular Credit Card Surveys documenting the abuses *du jour*. *See also* USPIRG, The Credit Card Trap: How to Spot It, How to Avoid It (April 2001), available at www.truthaboutcredit.org.

[57] Elizabeth Warren and Amelie Warren Tyagi, The Two-Income Trap: Why Middle-Class Mothers and Their Families Are Going Broke (2003), Ch. 6.

- Skyrocketing penalty rates of 30% APR or more, often triggered without a violation of the card agreement.
- Unjustified late and over-limit fees of $25 to $35.
- Hair trigger excuses for imposing these penalty rates and fees, such as being a day or even an hour late
- Rate increases imposed on existing balances
- Shrinking time periods to pay a credit card bill
- Setting payment cut-off times early in the morning
- Manipulating how payments were applied to increase interest charges;
- Double cycle billing
- Failing to properly underwrite so that consumers (especially college-age consumers) took on more debt than they could afford

Advocates repeatedly urged Congress and regulators, such as the Board, to take strong, substantive steps to regulate credit card abuses.

In December 2004, the Board announced it was undertaking a major overhaul of the credit card disclosures. Consumer advocates responded by submitting extensive, detailed comments discussing the enormous problems with credit card abuses and the burden they placed on American consumers.[58] In the comments, we urged the Board to issue strong, substantive regulations regulating credit cards. We explained that simply revising the disclosures under TILA would not be adequate to protect American consumers.

Two years passed. During that time, consumer advocates met with the Federal Reserve staff to urge strong protections. The Government Accountability Office issued a landmark report confirming the credit card abuses that consumer advocates and academics had long complained about.[59] Congress held repeated hearings.[60] Hundreds of media articles were written about the tricks and traps of credit cards.

On June 14, 2007, the Board responded with its solution: it issued a proposal rule that exclusively focused on revamping the disclosures for credit cards under TILA.[61] While the rule

[58] *See,e.g.*, National Consumer Law Center, et al, *Comments to the Federal Reserve Board's Advance Notice of Proposed Rulemaking - Review of the Open-End (Revolving) Credit Rules of Regulation Z, Docket No. R-1217*, March 28, 2004, at 40-41, *available at* www.consumerlaw.org

[59] Government Accountability Office, Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers 20/-/21 (Sept. 2006) (GAO-06-929), *available at* www.gao.gov/new.items/d06929.pdf.

[60] Hearings were held in both the Senate, Committee On Homeland Security And Governmental Affairs, Permanent Subcommittee On Investigations Regarding Credit Card Practices: Fees, Interest Rates, and Grace Periods, 110th Cong. (March 7, 2007); Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong. (2007), and in the Financial Services Committee of the House of Representatives, *see, e.g.* Credit Card Practices: Current Consumer and Regulatory Issues (Apr. 26, 2007); Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives (June 7, 2007).

[61] 72 Fed. Reg. 32948 (June 14, 2007).

made significant improvements to the formatting and understandability of these disclosures, the Board did *nothing* about fundamental abusiveness of credit card tactics. In fact, the Board even proposed eliminating a key disclosure for credit cards – the "effective APR," which is specifically mandated by TILA.[62]

The next day, June 15, 2007, Chairman Barney Frank gave the Federal Reserve the ultimatum quoted above: that it would lose authority over unfair and deceptive practices if it did not use it.

Consumer advocates once again sent extensive comments urging the Board to substantively address abusive credit card practices.[63] We proposed that the Board to use its authority to ban unfair and deceptive practices under the Federal Trade Commission Act, or in some cases under TILA itself. Consumer advocates were not the only ones to submit comments to the Board. Over 2,000 consumers sent in their stories about how they had been victimized by credit card abuses.

The drumbeat of complaints, media articles and studies on credit card abuses continued. Key members of Congress continued to hold hearings, organize summits, and introduced bills to regulate credit cards.[64]

In the fall of 2007, the Office of Thrift Supervision finally heeded the threat from Congress and opened its own rulemaking on prohibiting abusive or deceptive practices under its independent authority under the FTC Act.[65] In May 2008, the Federal Reserve, joined by the OTS and NCUA, issued a proposed rule addressing some, but not all, of the most serious abuses in credit card practices. The rule prohibits retroactive rate increases unless the consumer misses a payment; requires a reasonable time to pay a credit card bill; prohibits double cycle billing; and requires that payments be applied proportionally to high APR and low APR debt.

The rules were a significant step forward. But they omitted some profitable abuses that Congress was forced to address, including crushing, punitive rate increases on consumers who have missed one payment; tricks that induce consumers to incur over limit fees; fees that eat up half of the credit limit (Congress lowered the FRB's cap from 50% to 25%); and excessive penalty fees. More importantly, the regulators acted only after threats from Congress and a huge amount of pressure.

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[62] The Board did indeed eliminate the effective APR in the final regulation.

[63] *See, e.g,* National Consumer Law Center, et al, Comments to the Federal Reserve Board's Notice of Proposed Rulemaking - Review of the Open-End (Revolving) Credit Rules of Regulation Z, Docket No. R-1286, available at www.consumerlaw.org.

[64] Hearings in the House Financial Services Committee include The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers (March 13, 2008); The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers (April, 17, 2008); Problem Credit Card Practices Affecting Students: The Need for Legislative Action (June 26, 2008).

[65] 72 Fed. Reg. 43,570 (August 6, 2007).

C. The Federal Reserve Permitted Overdraft Fee Abuses to Take Off and Grow into a Huge Profit Center

Overdraft loans, or "courtesy pay" as the banking industry euphemistically likes to call them, are one of, perhaps the only, form of involuntary credit imposed unknowingly on consumers. Like many of the other abuses discussed in this testimony, overdraft fee abuses took off after the Supreme Court in 1996 upheld the OCC's regulation declaring that state laws against unfair and deceptive practices are preempted and do not apply to bank fees.[66]

Overdraft fees used to be a penalty for something that only the consumer, not the bank, could prevent: paying for a good or service with a check that later bounces. With the advent of electronic banking in the form of debit cards and ATM cards, it became possible for banks to deny the transaction instantaneously, enabling the consumer to choose another payment method. In the early days, that is exactly what happened, with no fee to the consumer.

But in the late 1990s and early 2000s, bank consultants started promoting services to banks and credit unions that would *encourage* consumers to overdraw their accounts so that the banks could increase their overdraft fee income. Essentially, the banks added a hidden line of credit that allow overdraft transactions to be approved, even at point of service and ATM terminals where they were formerly denied. One website promised that banks would raise overdraft fee income by "100%, 200%, 300% or more!"[67]

Sadly, little has changed in a decade. Specialized Bank Services continues to boast: "Courtesy Pay® is the leading overdraft program. It can increase your NSF fee income up to 400%, and you can rest assured of compliance."[68]

Banks can "rest assured of compliance" because, over the years, the Federal Reserve and the other banking regulators have chosen to allow these programs to continue. Overdraft fees have been, or have the potential to be, governed or impacted by several statutes administered by the Fed: the Truth in Savings Act (TISA), the Truth in Lending Act (TILA), the Electronic Funds Transfer Act (EFTA), and the Federal Trade Commission Act's (FTC Act) ban on unfair and deceptive acts and practices. The other banking agencies enforce those statutes with respect to their regulated entities.

In addition to being unfair and deceptive, overdraft loans violate TILA by extending credit without consumer consent or providing disclosures required of other credit. But banks claimed that the programs fell into a loophole in TILA that allowed banks to pay overdrawn paper checks as an occasional, discretionary courtesy. One member of industry admitted that overdraft plans

[66] Smiley v. Citibank (S.D.), N.A., 517 U.S. 735 (1996).
[67] *See* NCLC & CFA, BOUNCE PROTECTION: HOW BANKS TURN RUBBER INTO GOLD BY ENTICING CONSUMERS TO WRITE BAD CHECKS: An Examination of Bounce Protection Plans at 6 n. 33(January 2003), available at http://www.nclc.org/issues/bounce_loans/appendix.shtml.

[68] *See* http://specializedbankservices.com/sbs3.htm (visited July 11, 2009).

were supposedly designed to "slip through" regulatory requirements by stating that bounce protection is discretionary.[69]

Some state banking departments, including those in Alabama and Iowa, initially rejected this ruse.[70] But abuses continued.

On August 3, 2001, the OCC sent an interpretive letter to one bank consultant about its program. The letter noted a number of regulatory and policy concerns, including the lack of safeguards for consumers, and the fact that the banks "will, in essence, entice their customers to write NSF checks more frequently and on purpose in order to generate fee income."[71] But the letter stopped short of telling consultant that the program was unlawful or should be discontinued.

In January 2003, NCLC and several other groups sent detailed comments making a number of recommendations to the Federal Reserve,[72] including:

- Require TILA disclosures, including the finance charge and Annual Percentage Rate.
- Prohibit banks from claiming that overdraft is "discretionary" when they promote it as credit.
- Prohibit banks from imposing overdraft protection plans on consumers without their consent.
- Require banks to inform consumers about more reasonable alternatives, such as overdraft lines of credit and transfers from savings accounts.
- Prohibit banks from seizing Social Security, SSI and veteran's benefits, which are protected exempt income under federal law, to repay bounce protection loans.

But the FRB refused to take any of these measures, and merely issued regulations under the Truth in Savings Act requiring the fees to be disclosed in bank account fine print.

The other regulators played their part in encouraging overdraft abuses. Banks began manipulating the order in which debits are deducted from an account, so that the account will be overdrawn sooner and incur more bounce check fees. CFA and other national consumer groups wrote to the Comptroller and other federal bank regulators in 2005 regarding the unfair trade practice of banks ordering withdrawals from high-to-low, while at the same time unilaterally permitting overdrafts for a fee.

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[69] Charles Cheatham, Legal Briefs "Overdraft Plans," Oklahoma Bankers Association, August 2000.

[70] The Alabama Banking Department advised banks that charging a $2 daily fee on overdrawn accounts was considered a finance charge under Alabama law. V. Lynne Windham, Associate Counsel, Alabama State Banking Department, letter to redacted company (August 14, 2001); See also Iowa Consumer Credit Code Administrator, Informal Advisory # 88, "Per Diem Charge on Honored NSF Checks As A Finance Charge Under the ICCC and Iowa Common Law" (August 12, 1999).

[71] OCC Interpretive Letter #914 (August 3, 2001), available at http://www.occ.treas.gov/interp/sep01/int914.pdf.

[72] NCLC et al, Comments on Open End Credit and HOEPA Triggers and Solicitation for Comments on Bounce Protection Products, Docket No. R-1136 (January 27, 2003) available at http://www.nclc.org/issues/bounce_loans/frb.shtml.

When banks began to face court challenges, the OCC issued guidelines that allow banks to use this dubious practice, as long as review various "considerations," none of which relates to consumer protection.[73] The OTS, by contrast, advised thrifts that transaction-clearing rules should not be administered unfairly or manipulated to inflate fees.[74] The guidelines issued by the other federal regulatory agencies merely urged banks and credit unions to explain the impact of their transaction clearing policies.[75] CFA's survey of the sixteen largest banks earlier this year found that all of them either clear transactions largest first or reserve the right to do so.[76]

The FRB watched these overdraft fee programs from their early days, and could have stopped them before they became entrenched. Instead, they allowed them to take off and spread throughout the bank and credit union world, to the point where they are an important profit center that is now much harder to attack. As a result, American consumers spend at least $17.5 billion per year on cash advances from their banks.

In 2007, Representative Carolyn Maloney introduced legislation to address overdraft fee abuses and began holding hearings on the problem.[77] At the same time, lawmakers were pressuring the banking agencies to use or lose their authority to ban unfair and deceptive practices.

In fall of 2007, the OTS opened a rulemaking into various potentially unfair and deceptive practices, but did not list overdraft fees among them.[78] Consumer groups responded with voluminous comments documenting the unfair and deceptive nature of overdraft fees.

When the time came for proposed rules, the OTS, now joined by the FRB and NCUA punted on overdraft fees. They proposed banning unfair and deceptive credit card practices, but decided to postpone deciding what to do with overdraft fees. Instead of using their authority to address unfair and deceptive practices, the Federal Reserve opened a rulemaking under its authority to regulate electronic transactions under the Electronic Funds Transfer Act.

Eventually, the FRB made two alternative proposals, both dealing only with overdraft credit extended at ATMs and point-of-service debit card terminals. One would allow unsolicited overdraft loans and overdraft fees on approved transactions unless the consumer "opts out" of automatic overdraft "protection." The other would require that consumers "opt in" before overdraft credit could be extended, for a fee, on an ATM or debit card transaction.

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[73] 12 C.F.R. 7.4002(b).

[74] Office of Thrift Supervision, Guidance on Overdraft Protection Programs, February 14, 2005, p. 15.

[75] Dept. of Treasury, Joint Guidance on Overdraft Protection Programs, February 15, 2005, p. 13.

[76] Consumer Federation of America, Comments to Federal Reserve Board, Docket No. R-1343, Reg. E, submitted March 30, 2009.

[77] H.R.946, Consumer Overdraft Protection Fair Practices Act (introduced Feb. 8, 2007); House Financial Services Committee, Hearing on: Congress Overdraft Protection: Fair Practices for Consumers (July, 11, 2007).

[78] 72 Fed. Reg. 43,570 (August 6, 2007).

Neither proposal gives consumers TILA disclosures that enable the consumer to compare "courtesy pay" overdraft loans to other forms of overdraft protection, such as an overdraft line of credit or a linked savings or credit card account. Neither of the FRB's proposals gives consumers opt-in, opt-out, or TILA disclosures for overdraft loans extended for checks or electronic transfers, which would provide an impetus for the consumer to consider better options.

More than a decade after abusive overdraft practices began, consumers are still waiting to see whether the banking agencies will give them any protection.

D. The Banking Agencies Refused to Deal with Student Loan Abuses

For years, lenders fought and clawed to get into the largely unregulated world of predatory private student lending. During this time, a particularly unholy alliance developed between unlicensed and unaccredited schools like Silver State Helicopters – which recently shut down and filed for bankruptcy – and mainstream banks and lenders. The creditors didn't just provide high-interest private loans to students to attend unscrupulous schools; they actually sought out the schools and partnered with them, helping to lure students into scam operations. They then turned around, and like subprime mortgage providers, made big money on these loans by securitizing them and shifting the risky debt onto unsuspecting investors.

Lenders got away with this because no one was paying attention. Regulatory agencies simply ignored their responsibility to stop unfair lending practices.

The FTC Holder Rule (more accurately referred to as the Federal Trade Commission Preservation of Claims Rule), puts lenders on the hook when they have "referring relationships" with trade schools that defraud students or shut down unexpectedly. The rule requires these lenders to put a "holder notice" in the contract. Under the provision, students are entitled to recover any payments they have made and to have their remaining indebtedness canceled.

But most private student loan providers flaunt the rule. In a March 2008 report surveying 28 private loan agreements, we found that 40 percent didn't include the holder notice in them at all. Nearly all the rest contained the notice but undermined it by including contradictory clauses - saying, for example, that students would be responsible for repaying the loans in full no matter how dissatisfied they were with the schools.

A favorite tactic of national banks is to simply ignore the holder rule, saying that it doesn't apply to them. Among other arguments, they claim that they are outside the reach of FTC enforcement. The main problem is that the FTC can only enforce the law only against schools that fail to include the notice, not the lenders.

Advocates have asked the Federal Reserve and other banking agencies to adopt the FTC Holder Rule themselves and to enforce it against the lenders they regulate.[79] But they have refused.

[79] *See* Transcript of Federal Reserve Board Consumer Advisory Council Meeting at 63-64 (Oct. 23, 2003) (statement of NCLC staff attorney Elizabeth Renuart).

In the meantime, thousands of students at Silver State Helicopters have been harmed and left in the cold trying to figure out how to get out from under incapacitating debt for worthless educations.

E. The Federal Reserve and Other Banking Agencies Have Failed to Ensure that Financial Institutions Furnish Accurate Data to Credit Reporting Agencies

Consumers face considerable frustration trying to fix the significant numbers of errors in credit reports.[80] Many of those errors are caused by the deficiencies of furnishers, such as re-aging of stale debts, failing to update accounts discharged in bankruptcy, and reporting authorized users as liable on the debt.

Under the Fair Credit Reporting Act, many of the provisions that regulate furnishers cannot be enforced by consumers harmed by their violation, including the all-important accuracy requirements. These furnishers requirement can only be enforced by federal regulators, including the banking regulators for banks.

The banking regulators have almost entirely ignored their enforcement responsibilities with respect to this critical function. We do not know of any FCRA enforcement actions that federal banking regulators have taken with respect to banks under their supervision. If there have been any such actions, they have not been made public. The banking regulators are the sole entities capable of enforcing the accuracy requirements of the FCRA against bank furnishers, which include almost all of the major credit card lenders. They have abandoned this responsibility, leaving consumers unprotected against inaccurate and even deliberate misreporting by bank furnishers.

Enforcement is not the only function for which the banking regulators have failed to adequately protect consumers. They have also failed to write vigorous regulations to ensure the accuracy and completeness of information furnished to credit reporting agencies. For example, the Fair and Accurate Credit Transaction Act of 2003 required the Federal Trade Commission and banking regulators to develop guidelines for accuracy and integrity. The FTC and banking regulators did not issue a proposed rule until the end of 2007, four years later.

Part of the delay was due to disagreements between the FTC and banking regulators over how strong the regulations and guidelines would be, with the banking regulators presumably urging less stringent provisions. We know that the FTC and banking regulators could not agree on a definition of "integrity" or whether to place that definition in regulations or guidelines, because this disagreement could not be resolved prior to the issuance of the Notice of Proposed Rulemaking. This disagreement was openly reflected in the Federal Register notice, which included two competing versions of the proposal.[81] Ultimately the FTC and banking regulators

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[80] *See* Chi Chi Wu, National Consumer Law Center, *Automated Injustice: How A Mechanized Dispute System Frustrates Consumers Seeking To Fix Errors In Their Credit Reports* (January 2009), available at http://www.nclc.org/issues/credit_reporting/content/automated_injustice.pdf.

[81] *See* 72 Fed. Reg. 70,944 (Dec. 13, 2007).

reached a compromise[82] – a compromise that would not have been necessary if the banking regulators had not objected to stronger, more protective provisions.

F. The Banking Agencies' Track Record on Payday Loan Abuses Reveal One Significant Success (An Exception That Proves the Rule) and Several More Recent Failures

1. Years of Campaigns Against Bank Regulators Were Needed to Stop Rent-a-Bank Payday Loan Abuses

Payday loans are small loans until the next paycheck. They typically cost $15 to $20 per $100 for a 2-week loan, which translates to 390% to 520% APR. The borrower gives the lender a post-dated check or electronic access to the bank account for the loan amount plus the fee. The loans trap borrowers in a cycle of debt. A borrower who does not have $100 today likely will not have $120 in 2 weeks, forcing a new loan for an additional fee. The initial debt of a few hundred dollars can explode into thousands of dollars of debt they cannot escape.

In the 1990s, payday lenders began to circumvent state laws by partnering with banks to make high cost loans and piggyback on the bank's preemption abilities. Eventually all of the federal banking regulators, through supervision and guidance, put a stop to the practice. But it took numerous enforcement actions by state regulators, private litigation on behalf of consumers, and a protracted campaign aimed at the regulators by national and state level consumer groups.

Beginning in 1998, advocates at the Virginia Poverty Law Center and CFA wrote to the OCC's New York and national offices, respectively, about Eagle National Bank's partnerships with an unaffiliated nonbank check cashing organization in Virginia engaged in abusive lending. The letters asked for a Community Reinvestment Act examination. The OCC replied that the bank's payday lending did not have a negative effect on the CRA rating since the loans were made outside the bank's assessment area.

Lawsuits against rent-a-bank operations began in 1999.[83] Soon, class action lawsuits were filed by consumers in Maryland, Texas and Indiana attacking the rent-a-bank arrangements between Ace Cash Express and Goleta National Bank. State regulators in several states took enforcement or other actions to stop rent-a-bank payday lending in their states. Seventeen state attorneys general filed *amicus curiae* briefs in support of Ohio's motion to dismiss Goleta National Bank's challenge to its authority.[84]

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[82] *See* 74 Fed. Reg. 31,484 (July 1, 2009).

[83] Complaint, Phanco v. Dollar Fin. Group, Clearinghouse No. 53,034 (C.D. Cal. Filed Feb. 8, 1999).

[84] *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses at 116 (3d ed. 2005 and Supp.)

Consumer groups engaged in extensive efforts to urge federal regulators to prevent banks from undermining states' abilities to enforce small loan and usury laws against storefront lenders. CFA, NCLC and several other groups wrote to the Comptroller of the Currency in mid-1999 to protest the "Satisfactory" CRA rating given by the OCC despite Eagle National Bank's 400 to 500 percent APR payday lending with Dollar Financial Group check cashing stores.[85] The Comptroller's initial reply on November 30, 1999 was that "In the final analysis, there may, practically speaking, be little that bank regulators can do to eliminate abusive payday lending practices that comply with existing law."

Groups also met with the Chairman of the Federal Deposit Insurance Corporation in 2002 and with other FDIC staffers in 2003, with the Comptroller of the Currency, and raised payday lending issues with the Federal Reserve Board's Consumer Advisory Council. National groups protested rent-a-bank lending by First Bank of Delaware to a Federal Reserve Governor.[86] Those are just a few of the efforts directed at the bank regulators. Consumer groups also sought Congress's help in curbing the misuse of federal bank powers by payday lenders and their partner banks to evade state consumer protection laws.[87]

The Federal Reserve, OTS and OCC, in a change of course, all began cracking down on rent-a-bank operations. But the rogue banks starting switching charters. First Bank of Delaware initially said it would withdraw from payday lending due to Federal Reserve requirements, but then decided to stop being a Federal Reserve member bank in order to switch to FDIC supervision. CFA and other groups protested the FDIC's decision to permit First Bank of Delaware to switch regulators to avoid the Federal Reserve's scrutiny of its payday loan operation.[88]

In November 2003, national and state consumer organizations staged a walk-out and forum at the National Press Club during an FDIC conference on serving unbanked consumers. The Community Reinvestment Association of North Carolina conducted a Financial Freedom Tour to protest along with New York advocates outside the FDIC building in Manhattan and at County Bank in Rehoboth Beach, Delaware.

The North Carolina group also protested the role of the FDIC in permitting rent-a-bank payday lending by staging a 2004 protest outside the FDIC headquarters in Washington. The group handed out toy sharks to FDIC staff and held a basketball game between the "peeps" (consumers) and the "sharks" (payday lenders) which was refereed in favor of the sharks by the

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[85] California Reinvestment Committee, Consumer Federation of America, Consumers Union, Greenlining Institute, National Community Reinvestment Coalition, National Consumer Law Center, U.S. Public Interest Research Group, Woodstock Institute, Letter Re: Eagle National Bank and "Payday Loans," Address to The Honorable John D. Hawke, Jr., Comptroller of the Currency, July 27, 1999.

[86] CFA et al letter to Federal Reserve Board Governor Gramlich, April 14, 2003, www.consumerfed.org/FRB_letter_rent_a_bank041503.pdf

[87] Letter from national and state organizations to Congress (October 2, 2002), available at http://www.consumerfed.org/pdfs/paydayletter100802.pdf

[88] http://www.consumerfed.org/pdfs/fdicletter10-2003.pdf

"Chairman" who kept his head buried in the FDIC guidelines and refused to call fouls on the "sharks."[89]

Chicago-based Woodstock Institute, Illinois's Monsignor John Egan Campaign for Payday Loan Reform, and North Carolina groups protested the FDIC's CRA rating for Brickyard Bank after the Illinois bank partnered with Check 'n Go to make payday loans in North Carolina. A protracted campaign of leafleting, protests, and media outreach by community groups eventually ended that partnership.

Finally, in February 2005, the FDIC reportedly sent letters to all the remaining rent-a-bank payday lenders, asking the banks to consider terminating their arrangements. Since this was not an enforcement action, the FDIC did not issue the letters publicly, but payday lenders and banks impacted filed notices with the SEC and issued press releases making it clear that the FDIC had lowered the final curtain on rent-a-bank payday lending. Rent-a-bank payday lending ceased by mid-2006.

2. OCC and OTS Preemption Rules are Allowing Bank and Prepaid Account Advance Payday Loans to Spread and Perhaps Become the Next Widespread Abuse, Replacing Overdraft Loans

For several years, Wells Fargo and U.S. Bank have offered payday loan products through their bank accounts. The newest is Fifth Third Bank's Early Access loan, which the bank developed in response to pressure against abusive overdraft fees.[90]

Bank account advance payday loans may well spread like wildfire if the Federal Reserve cracks down on overdraft fees by requiring consumer consent before overdraft credit is extended. Fifth Third boasts that consumers "overwhelmingly accept" payday advances and see them as "value add."[91] But consumer approval seems to be judged by the fact that "80% of those trying it becom[e] repeat users.... [The fees] have been the gift that just keeps giving."[92] In the traditional payday loan context, frequent rollovers are seen as a problem that turns a small loan into a huge debt, not an indication of approval. But state payday loan laws will not be able to touch them because of preemption.

The fee structure for all three bank account advance payday loans is similar to traditional payday loans: $2 per $20 advanced, automatically repaid with the next deposit. The banks claim an APR of 120%, but the true APR is 520% if the advance is taken a week before payday. All three banks are able to take advantage of rules preempting state usury and payday loan laws.

[89] Community Reinvestment Association of North Carolina, Newsletter "Melee Breaks Out at Game: Outcome Unresolved," March 11, 2004.
[90] *See* Heather Landy, "Turning Fee Revenue into Customer Opportunities," American Banker (June 24, 2009).

[91] *Id.* (quoting Terry Zink, executive vice president at Fifth Third Bancorp).

[92] *Id.*

The recent move by Ohio-based Fifth Third is particularly distressing because the state's residents recently succeeded after years of struggle in passing a payday loan law capping rates at 28%. Payday lenders have complained about the bank's ability to ignore that law while they must comply with it.

Meta Bank, a federally chartered savings association, has developed a similar predatory payday loan feature – iAdvance -- on its Visa- and MasterCard-branded prepaid cards that receive direct deposit of wages and government benefits.[93] The loans cost $25 per $200 and are automatically repaid by the next deposit. The disclosed APR is 150%, but the rate is closer to 650% because the loans are likely taken out late in the month when money runs out, not a full 30 days before payday. They have the similar problem of repeat renewals and escalating fees that traditional payday loans have.

Because MetaBank's home state has no interest rate caps, the bank can and does ignore state laws limiting payday loan interest rates in other states where the card is offered. The loans are only available to those who sign up to have their paycheck or public benefit check directly deposited onto the prepaid card. The loans are automatically deducted from income before food or other necessities and escape laws against garnishing Social Security and other benefits and laws that protect a minimum amount of income. An iAdvance official boasts that demand for the line of credit is "insatiable and not price sensitive" and that its regulator – the OTS – has been very "flexible" with them and "understands" this product.

3. Other Banking Agency Failures on Payday Loans and Telemarketing Schemes

The Federal Reserve also enables payday loans by failing to close other loopholes in consumer protection:[94]

- Since at least 2005, consumer groups and state officials have asked the FRB, without success, to address abusive uses of remotely created checks, which are used by telemarketing scams and by payday lenders seeking to circumvent the right to stop checks and electronic transfers.[95]

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[93] *See* NCLC, "Bank Payday Loans ... They're Baaaaaaaack" (June 2009), available at http://www.nclc.org/issues/payday_loans/content/Bank_Prepaid_Payday_Loans.pdf.

[94] These problems are discussed at greater length in Testimony of Travis Plunkett, Consumer Federation of America, and Edmund Mierzwinski, U.S. PIRG, Before the Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation (June 24, 2009).

[95] *See, e.g.,* NCLC et al, Comments: regarding Proposed Amendment to Regulation J and Regulation CC Regarding Remotely Created Checks (May 2005), available at http://www.nclc.org/issues/banking/content/RCCommentsFed5.pdf; Press Release, "Massive Telemarketing Scheme Affected Nearly One Million Consumers Nationwide; Wachovia Bank to Provide an Additional $33 Million to Suntasia Victims," Federal Trade Commission, January 13, 2009, viewed at http://www.ftc.gov/opa/2009/01/suntasia.shtm.

- In 2006, consumer groups met with Federal Reserve staff, and sent a follow up letter in 2007, to urge them to take regulatory action to protect consumers whose accounts were being electronically accessed by internet payday lenders, who often ignore state payday laws. Nothing has happened.

- The Federal Reserve has failed[96] to close loopholes in the Truth in Lending Act that have allowed payday lenders and federal credit unions to dramatically understate the annual percentage rate (APR) in order to avoid usury caps.[97] The Nevada Federal Credit Union – which is subject to an 18% usury cap – claims a 0% APR for its daypayday loans, but the nonrefundable "application" fee brings the true annual rate to 222% to 1,820%, depending on the size of the loan and repayment period.

G. Banking Agencies Have Acted as Anti-Consumer Protectors by Preempting State Laws

As reflected in many of the problems discussed above, Prof. McCoy's testimony today, and in earlier testimony before Congress,[98] the banking agencies have often gone beyond inaction to affirmatively oppose consumer protection. The OCC and the OTS, in particular, which have authority to interpret the National Bank Act and the Home Owner's Loan Act, respectively, have used that power to wipe out state consumer protection laws with nothing to replace them at the federal level. The OCC's efforts began with interpretative letters stopping state enforcement and state standards in the period up to 2004, followed by OCC's wide-ranging preemption regulations in 2004 purporting to interpret the National Bank Act. Though the National Credit Union Administration has been less aggressive, it too has preempted a number of important consumer protections.

The preemption actions of the banking agencies reinforce the view that they see their mission primarily as protecting industry *from* consumer protection, not as protecting consumers from industry abuses.

H. The Current System Has Not Promoted Fair Lending

The Federal Reserve has responsibility for writing rules under the Equal Credit Opportunity Act, and each of the banking agencies, as well as the Department of Justice, has enforcement authority over ECOA for the institutions they regulate. Of course, rules to ensure consumer protection generally can also be used to address fair lending.

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[96] NCLC has pointed out many gaps that undermine the APR in

[97] Payday lender Advance America charged a $150/month "participation fee" on top of 6% interest to avoid Pennsylvania's usury cap. That scam was finally shut down under state law, not federal. *See* Pennsylvania Dept. of Banking v. NCAS of Delaware, LLC, 948 A.2d 752 (Penn. May 29, 2008).

[98] Testimony of Kathleen Keest, Travis Plunkett, Consumer Federation of America, and Edmund Mierzwinski, U.S. PIRG, Before the Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation (June 24, 2009).

The latest, most blatant example of the disregard for civil rights is the OCC's regulation prohibiting states from enforcing their own fair lending statutes. Even after the failures of consumer protection became evident with the collapse of the financial system, the OCC continued *this year* to cling to an extreme view of preemption under which a state cannot even enforce state civil rights laws that are *not* preempted – a position opposed by all 50 attorneys general. Even the Supreme Court, which is typically very deferential to the banking agencies, found that the OCC went too far, though it did uphold the OCC's view that the states are not allowed to ask for information ahead of time from banks about potential violations – a significant crimp on the states' enforcement authority.

Overall, the current system clearly has not promoted fair lending. Predatory lending practices and the ensuing crisis have had a particularly harsh impact on communities of color. African Americans and Latinos suffered the brunt of the predatory and abusive practices found in the subprime market. While predatory and abusive lending practices were not exclusive to the subprime market, because of lax regulation in that sector, most abuses were concentrated there. Several studies have documented pervasive racial discrimination in the distribution of subprime loans. One such study found that borrowers of color were more than 30 percent more likely to receive a higher-rate loan than White borrowers even after accounting for differences in creditworthiness.[99] Another study found that *high-income* African-Americans in predominantly Black neighborhoods were three times more likely to receive a subprime purchase loan than *low-income* White borrowers.[100]

African-Americans and Latinos receive a disproportionate level of high cost loans, even when they qualify for a lower rate and/or prime mortgage. Fannie Mae and Freddie Mac estimated that up to 50 percent of those who ended up with a subprime loan would have qualified for a mainstream, "prime-rate" conventional loan in the first place.[101] According to a study conducted by the Wall Street Journal, as much as 61% of those receiving subprime loans would "qualify for conventional loans with far better terms."[102] Moreover, racial segregation is linked with the proportion of subprime loans originated at the metropolitan level, even after controlling for percent minority, low credit scores, poverty, and median home value.[103] The resulting flood of high cost and abusive loans in communities of color has artificially elevated the costs of homeownership, caused unprecedented high rates of foreclosures, and contributed to the blight

99 See Bocian, D. G., K. S. Ernst, and W. Li, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages, Center for Responsible Lending, May 2006.

100 Unequal Burden: Income and Racial Disparities in Subprime Lending in America (Washington, D.C.: HUD, 2000).

101 See the Center for Responsible Lending's Fact Sheet on Predatory Mortgage Lending at http://www.responsiblelending.org/pdfs/2b003-mortgage2005.pdf, and The Impending Rate Shock: A Study of Home Mortgages in 130 American Cities, ACORN, August 15, 2006, available at www.acorn.org.

102 See "Subprime Debacle Traps Even Very Creditworthy," *Wall Street Journal*, December 3, 2007.

103 Squires, Gregory D., Derek S. Hyra, and Robert N. Renner, "Segregation and the Subprime Lending Crisis," Paper presented at the 2009 Federal Reserve System Community Affairs Research Conference, Washington, DC (April 16, 2009).

and deterioration of these neighborhoods. It is estimated that communities of color will realize the greatest loss of wealth as a result of this crisis, since Reconstruction.

The Federal Reserve has been helpful in increasing the amount of information collected under the Home Mortgage Data Act and in identifying and referring to the other banking agencies institutions whose HMDA data warrant a closer examination. But not one case has been brought at a result.

In fiscal year 2007-08, the Federal Reserve Board referred only eight cases of lending discrimination to the Justice Department in fiscal year 2007: four based on discrimination against unmarried people; two based on mortgage discrimination against minorities, one based on racial discrimination in auto loans, and one based on an institution's loan policies that discriminated on the base of race, in the case of one policy, and on Native American lands, in the case of the other.[104]

In recent years, the Department of Justice has received few referrals of alleged ECOA violations from any federal agencies. In 2005, the Department received thirty-eight referrals and, in 2006, it received thirty-four.[105] The downward trend continued in 2007, when it received only twenty-seven referrals.[106] Most referrals have been from the FDIC, and most have been returned to the respective agency for administration resolution. The referrals that the Department kept for review from 2007 included cases alleging discrimination on the basis of race, national original, marital status, age, and the exercise of rights under the Consumer Credit Protection Act.

With numbers this low, and devastation across communities of color, one has to wonder whether the banking agencies are looking at all.

I. Other Failures of Consumer Protection

In earlier testimony before the Financial Services Committee,[107] witnesses described other instances in which the Federal Reserve and the other banking agencies have failed to protect consumers, including:

[104] *See* Board of Governors of the Federal Reserve System, 93d Annual Report: 2007 126-27 (Apr. 2008), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/annual07/pdf/AR07.pdf.

[105] *See* The Attorney General's 2005 Annual Report to Congress Pursuant to the Equal Credit Opportunity Act Amendments Of 1976 (Mar. 7, 2006), available at www.usdoj.gov/crt/housing/documents/ecoa2005.htm; The Attorney General's 2006 Annual Report to Congress Pursuant to the Equal Credit Opportunity Act Amendments Of 1976 (Mar. 13, 2007), available at www.usdoj.gov/crt/housing/documents/ecoa2006.pdf.

[106] The Attorney General's 2007 Annual Report to Congress Pursuant to the Equal Credit Opportunity Act Amendments Of 1976 (Apr. 2, 2008), available at www.usdoj.gov/crt/housing/documents/ecoa2007.pdf.

[107] *See* Testimony of Travis Plunkett, Consumer Federation of America, and Edmund Mierzwinski, U.S. PIRG, Before the Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation (June 24, 2009)

- The Federal Reserve is allowing a *shadow banking system, prepaid debit cards*, to develop for the unbanked and immigrants. Except for narrowly defined payroll cards, the Board has rejected requests to extend protections for wages, unemployment and other benefits, and other funds deposited on those cards against unauthorized charges, billing errors, stop payment rights, and other protections given to other forms of debit cards.

- The regulators have failed to enforce the *Truth In Savings Act* requirement that banks provide account disclosures to prospective customers. A 2008 General Accounting Office study found that 22% of banks visited by secret shoppers did not give consumers access to the detailed schedule of account fee disclosures required by federal law. TISA is one of the few consumer protection statutes that is not privately enforceable.

- The Federal Reserve actively campaigned to eliminate a Congressional requirement that it publish an *annual survey of bank account fees*.

III. A NEW APPROACH: THE CONSUMER FINANCIAL PROTECTION AGENCY

The old system has failed; we need a new approach. We believe that the proposed Consumer Financial Protection Agency corrects the errors of the past and is needed for several reasons. First, it will give consumer protection the attention and clear focus it deserves. Second, by consolidating functions that are now in seven different agencies, it will provide consistent protection no matter who offers the product or service, will be able to take a holistic view, and will be able to act quickly to prevent harm. Finally, the agency will be set up to ensure regulatory independence and freedom from regulatory arbitrage.

A. Consumer Protection Needs More Focus and Attention

A CFPA, with consumer protection as its sole mission, will be able to focus much-needed attention on the needs of consumers, the pitfalls of the marketplace, and the protections needed for both consumers and honest competitors. The agency will not be distracted from this paramount role by other duties, or have its perspective warped by other missions. It can direct its research, data collection and various activities in a consistent direction: determining the impact of products and services on consumers and the best ways to ensure that they can achieve financial stability and are protected from abuses. The CFPA's focus on ensuring safe and sustainable credit and banking products for all borrowers would ensure that these products are offered in a transparent, uniform, nondiscriminatory manner.

The Federal Reserve has far too much on its plate and comes from a very different perspective. Though the agency certainly could have done better, in retrospect it may simply have been unfair to expect the FRB to play so many different roles. Its governance structure, the role of the regional banks, its focus on the profitability and health of the institutions it supervises, and its macro role in monetary policy all leave consumer protection as an afterthought. With so much of its time, energy and budget focused on entire portfolios, large institutions, and indeed on the state of the entire economy, the needs of individual families and the ins and outs of how products work one-on-one are simply not part of the agency's mindset.

The marginal role of consumer protection is already true under the FRB's current mission, but it will become even more so if the Board becomes the systemic risk regulator. Two former Board Governors agree. Their perspectives are relevant whether or not greater systemic risk authority is given to the Board.

Last week, former Fed Gov. Frederic Mishkin testified:

> *I believe that the Federal Reserve should give up its role as a consumer protection regulator.* My reasoning for this conclusion is as follows. *The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator.* Protecting consumers involve setting and then enforcing the appropriate rules under a transparent legal framework. The orientation of an effective systemic regulator must be different from that of a rule-enforcing consumer protection or conduct of business regulator. A regulator charged with both enforcing rules and managing systemic risk may end up devoting too much of its attention to rule enforcement.[108]

Lawrence Meyer, another former Fed governor, agreed, even though he does not believe that adding systemic risk increases the Board's responsibilities significantly:

> *[I]f something is to be given up, the most obvious choice is consumer protection and community affairs. These are not seen around the world as core responsibilities of central banks.* The case for giving up consumer protection and consumer affairs is strengthened by the Treasury's proposal to unify these responsibilities in a single agency.[109]

For all of the banking agencies, the present regulatory system is institution-centered, rather than consumer-centered. At the federal level, major agencies are funded by the institutions they oversee, giving them inordinate influence within the agency.

The agencies' bank-centric focus on the health of the institution has led to an exclusive reliance on a collaborative and secretive bank examination and supervision to protect consumers. Though supervision is definitely one part of the picture, it lacks transparency and accountability, fails to set clear rules for others to follow, and gives bank regulators a high degree of discretion to decide what types of lending are harmful to consumers, a process that involves negotiating behind-the-scenes with bank officials.[110] Secret deals do not have the same impact on consumer protection as public enforcement actions or rules, which act as a deterrent for other providers.

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108 Testimony Of Frederic S. Mishkin To United States House Of Representatives Subcommitee On Domestic Monetary Policy And Technology at 2 (July 9, 2009) (emphasis added).

109 Testimony Of Laurance H. Meyer To United States House Of Representatives Subcommitee On Domestic Monetary Policy And Technology at 2 (July 9, 2009) (emphasis added).

110 "Findings made during compliance examinations are strictly confidential and are not made available to the public except at the OCC's discretion. Similarly, the OCC is not required to publish the results of its safety-and-soundness orders....Thus, the OCC's procedures for compliance examinations and safety-and-soundness orders do not appear

Regulators have often treated consumer protection as less important than their safety and soundness mission or even in conflict with that mission. The examples above describe in detail how regulators failed time and again to protect consumers. Because regulators apparently decided that their overriding mission was to ensure that the short-term balance sheets of the institutions they regulated were strong, they were less likely to perceive that questionable products or practices were harmful to consumers. Moreover, the relative resources that agencies devoted to the two goals and the priorities they articulated frequently minimized consumer protection, and were more likely to focus on *reducing* regulatory restrictions on the institutions they oversaw.[111]

As we've learned in the current crisis, focusing exclusively on consumer and civil rights protection would often be positive for lenders' stability and soundness over the long term. However, the agency would be compelled to act in the best interest of consumers even if measures to restrict certain products affected bank products. The leadership of a CFPA would be held to account based on its ability to inform consumers and help protect them from unsafe products. In order to function effectively, the leadership would need to show expertise in and commitment to consumer protection.

B. Consolidate Consumer Protection Functions of Seven Agencies in One Place for a Consistent, Holistic View of Consumer Protection

Right now, four federal regulatory agencies are required both to ensure the solvency of the financial institutions they regulate and to protect consumers from lending abuses.[112] Jurisdiction over consumer protection statutes is scattered over several more agencies, with rules like RESPA and TILA, which both regulate mortgage disclosures, in different agencies.

The Administration's plan consolidates rule-making authority for the existing consumer protection laws related to the provision of credit in one agency, including the Truth in Lending Act (TILA), Truth in Savings Act (TISA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Protection Act (RESPA), Fair Credit Reporting Act (FCRA), Electronic

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to provide any public notice or other recourse to consumers who have been injured by violations identified by the OCC." Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, before the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee, April 26, 2007.

[111] For example, in 2007 the OTS cited consumer protection as part of its "mission statement" and "strategic goals and vision." However, in identifying its eight "strategic priorities" for how it would spend its budget in Fiscal Year 2007, only part of one of these priorities appears to be directly related to consumer protection ("data breaches"). On the other hand, OTS identified both "Regulatory Burden Reduction" and "Promotion of the Thrift Charter" as major strategic budget priorities. Office of Thrift Supervision, "OMB FY2007 Budget and Performance Plan," January 2007.

[112] The Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTC) charter and supervise national banks, and thrifts, respectively. State chartered banks can choose whether to join and be examined and supervised by either the Federal Reserve System or the Federal Deposit Insurance Corporation (FDIC). The FTC is charged with regulating some financial practices (but not safety and soundness) in the non-bank sector, such as credit cards offered by department stores and other retailer.

Fund Transfer Act (EFTA), and Fair Debt Collection Practices Act (FDCPA). Current rule-writing authority for nearly 20 existing laws is spread out among at least seven agencies. Some authority is exclusive, some joint, and some is concurrent.

However, this hodge-podge of statutory authority has led to fractured and often ineffectual enforcement of these laws. As cited in several places in this testimony, federal regulators dithered for years in implementing regulations to stop unfair and deceptive mortgage and credit card lending practices. One of the reasons for these delays has often been that regulators disagree among themselves regarding what regulatory measures must be taken. The course of least resistance in such cases is to do nothing, or to drag out the process.

The new CFPA would *not* be a redundant layer of bureaucracy. To the contrary, the new agency would consolidate and streamline federal consumer protection for credit, savings and payment products that is now required in almost 20 different statutes and divided between seven different agencies. As the New Foundation document continues:

> The core of such an agency can be assembled reasonably quickly from discrete operations of other agencies. Most rule writing authority is concentrated in a single division of the Federal Reserve, and three of the four federal banking agencies have mostly or entirely separated consumer compliance supervision from prudential supervision. Combining staff from different agencies is not simple, to be sure, but it will bring significant benefits for responsible consumers and institutions, as well as for the market for consumer financial services and products.[113]

Given that multiple regulators oversee similar institutions, the process has also resulted in different standards for different types of financial institutions. As discussed above, reordering a consumer's checks to increase overdraft fees is or is not considered unfair depending on what type of institution holds the account.

A CFPA with expertise, jurisdiction and oversight that cuts across all segments of the financial products marketplace will be better able to see inconsistencies, unnecessary redundancies, and ineffective regulations. As a market-wide regulator, it would also ensure that critical rules and regulations are not evaded or weakened as agencies compete for advantage for the entities they regulate.

Additionally the CFPA would have exclusive "organic" federal rule-writing authority within its general jurisdiction to deem products, features, or practices unfair, deceptive, abusive or unsustainable, and otherwise to fulfill its mission and mandate. This includes the flexibility to set standards that are adequate to address rapid evolution and changes in the marketplace. The rules may range from placing prohibitions, restrictions or conditions on practices, products or features to creating standards, and requiring special monitoring, reporting and impact review of certain products, features or practices. Such authority is not a threat to innovation, but rather levels the playing field and protects honest competition, as well as consumers and the economy.

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[113] The Obama Administration, Financial Regulatory Reform: A New Foundation p. 57

C. Prevent Regulatory Arbitrage and Ensure Regulatory Independence.

The ability to "charter shop" – change regulators to avoid strict supervision – and the banking agencies' fear of losing fee revenue have undeniably led regulators like the OTS to compete to attract financial institutions by keeping regulatory standards weak. Institutions were able to increase their leverage over regulators by taking a significant chunk of the agency's budget away when it changed charters and regulators.

Two of the most notorious examples are Washington Mutual and Countrywide,[114] which became infamous for promoting dangerous sub-prime mortgage loans on a massive scale.[115] Both switched their charters to become thrifts regulated by the Office of Thrift Supervision (OTS). The threat of charter shopping has also encouraged the OTS and OCC to expand their preemptive authority and stymie efforts by the states to curb predatory and high-cost lending. The OCC in particular appears to have used its broad preemptive authority over state consumer protections and its aggressive legal defense of that authority as a marketing tool to attract depository institutions to its charter.[116]

Although the credit card rule adopted late last year by federal regulators was ultimately finalized over protests from the OCC, these objections were likely one of the reasons that federal regulators delayed even *beginning* the process of curbing abusive credit card lending practices until mid-2008.

Charter shopping is not confined to the OCC and OTS. As described above, in the early 2000s rogue banks switched to charters supervised by the FDIC to escape enforcement actions aimed at ending rent-a-bank payday lending.

The "charter shopping" problem would be directly addressed through the creation of a single CFPA with regulatory authority over all forms of credit. Federal agencies would no longer compete to attract institutions based on weak consumer protection standards or anemic enforcement of consumer rules.

The CFPA will not have to fear retaliation if it takes action against an abusive product. It will be able to focus on the safety of credit products, features and practices, no matter what kind of lender offered them.

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[114] Of course, following their stunning collapses, Countrywide was acquired by Bank of America and Washington Mutual by Chase, both in regulator-ordered winding-downs.

[115] Arthur E. Wilmarth, Jr., "The OCC's Preemption Rules Threaten to Undermine the Dual Banking System, Consumer Protection and the Federal Reserve Board's role in Bank Supervision," Proceedings of the 42nd Annual Conference on Bank Structure and Competition (Fed. Res. Bank of Chicago, 2006) at 102, 105-106.

[116] For a detailed analysis, see brief amicus curiae of Center for Responsible Lending et al in the Supreme Court case Cuomo v. Clearinghouse and OCC (08-453) available at http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-453_PetitionerAmCu10ConsumerProtectionOrgs.pdf (last visited 21 June 2009) at pages 20-39.

IV. THE TOOLS THE CONSUMER FINANCIAL PROTECTION AGENCY NEEDS AND ITS INTERACTION WITH THE FEDERAL RESERVE AND THE OTHER AGENCIES

A. The CFPA Needs Full Data Collection, Rule-writing, Supervision and Examination, and Enforcement Capabilities

In its work to protect consumers and the marketplace from abuses, the CFPA needs a full set of enforcement and analytical tools, as reflect in H.R. 3126 and President Obama's white paper.

1. *Data Collection and Information Gathering*

The first tool is the ability to gather information about the marketplace, institutions and consumers so that the agency itself can understand the impact of emerging practices in the marketplace. The agency could use this information to improve the information that financial services companies must offer to customers about products, features or practices, to identify risks, and to tailor its rules and enforcement proceedings. For many products, features or practices, the agency might determine that no regulatory intervention is warranted. For others, this information about the market will inform what tools are used. Without adequate information, the agency would simply be operating blind, and its consumer protection activities will be cruder and less effective.

2. *Rule-writing*

A second tool is rule-writing. The historical description above shows that rule-writing by Federal Reserve and other banking agencies has failed to protect consumers. Rules have focused on narrow, technical compliance with disclosure statutes. The banking agencies completely failed to use their broader authority to address unfair and deceptive practices except when under the recent gun of Congress to "use it or lose it." The OCC admits that it was not until 2000 that *ever* invoked the long-dormant consumer protection authority provided by the 1975 amendments to the Federal Trade Commission Act.[117]

The CFPA can ensure that the various consumer protection statutes passed by Congress will get appropriate periodic updating to address new issues, technology, holes and evasions. In addition, the agency will have more flexible authority under its enabling statute to address unfair, deceptive or abusive practices that Congress has not anticipated. In some cases, these rules will focus on disclosures, though hopefully with greater emphasis on simple, understandable disclosures and not more fine print. On other occasions, the rules will ensure that consumers have the option of choosing a more simple, safer "plain vanilla" product. And occasionally, the agency will feel the need to restrict or ban specific product features or even entire products that

[117] *See* Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246 & n.25, 1253 (2003) (citing authority from the early 1970s indicating that OCC had the authority to bring such an action under Section 8 of the Federal Deposit Insurance Act, noting that OCC brought its first such case in 2000, and conceding that "[a]n obvious question is why it took the federal banking agencies more than twenty-five years to reach consensus on their authority to enforce the FTC Act").

are harmful or not suitable in some circumstances, or that don't meet ordinary consumer expectations. The rules may range from placing prohibitions, restrictions or conditions on practices, products or features to creating standards, and requiring special monitoring, reporting and impact review of certain products, features or practices. We can only wonder how much less pain would have been caused for our economy if a regulatory agency had been actively exercising that power during the run up to the mortgage crisis.

The CFPA should have exclusive rule-writing authority. Giving other agencies authority will only lead to inconsistent rules and conflicts. It may also encourage the banking agencies to act quickly, to pass weak rules, in the hopes of preempting the CFPA from addressing a subject.

3. *Supervision, Examination and Guidance*

A third tool necessary to give the agency the full range of flexible options is supervision and examination. Though the banking agencies placed too much exclusive reliance on supervision in the past, they are right that it can be a useful approach in some circumstances. As former FRB Governor Randall Kroszner explained:

> Where Federal Reserve examiners observe weaknesses or compliance failures by supervised institutions, examiners document them in a report to bank management. The required corrective actions are stated in the examination report. We find that in the overwhelming majority of cases, management voluntarily addresses any violations or weaknesses that we have identified without the need for formal enforcement actions. In those rare instances where the bank is not willing to address the problem, we have a full range of enforcement tools at our disposal and use them to compel appropriate corrective action.[118]

Supervision is also a useful tool to ensure that guidance is appropriately followed. In some circumstances, the CFPA will issue clear, binding rules, but in other instances it might decide to issue more flexible guidance. As Governor Krozner explained,

> Principles-based guidance is particularly useful when dealing with practices that may be inappropriate in some circumstances but appropriate in others.... Through the issuance of principles-based guidance, backed-up with regular examinations, the federal depository institution regulators are able to have a significant impact on institutions' practices.[119]

Comptroller of the Currrency John Dugan has made similar points:

> In short, we believe that the OCC's comprehensive approach to consumer protection regulation -- integrating guidance, supervision, enforcement, and complaint resolution – is

[118] Testimony of The Honorable Randall S. Kroszner, Governor, Federal Reserve Board before the Committee on Financial Services - U.S. House of Representatives on Improving Federal Consumer Protection in Financial Services at 12 (June 13, 2007).

[119] *Id.* at 14.

> effective in achieving the objectives established by Congress.... Such guidance also advises national banks on emerging and significant risks; on our expectations for bank practices for managing those risks and preventing problems from arising; and on likely areas of focus by bank examiners. The OCC's strategy is to prevent problems before they arise, and because we can issue supervisory guidance expeditiously, we can address issues quickly as they surface.[120]

The CFPA should have this tool and should not be forced to use enforcement alone. As described above, the rent-a-bank payday preemption abuses of the past were addressed through supervision.

Supervision cannot bear the entire weight of consumer protection, but it can be more efficient and less heavy handed than enforcement actions when problems do not deserve more public or severe measures. Supervision can be used to address problems early on, to work with the institution to develop a more subtle approach that takes into account the institution's legitimate concerns while addressing consumer protection issues.

Supervision and examination also supplements the agency's data collection activities and allows the CFPA to see problems of which it is unaware. Preventing the agency from looking inside institutions to see what is really going on would leave it with a "catch me if you can" mandate. The agency could not act unless it had the evidence that a punitive enforcement action was warranted – evidence it would have difficulty obtaining.

Consumer protection supervision should also be an exclusive power of the CFPA. There is no reason to duplicate this supervision at the federal level. Of course, when consumer protection issues present safety and soundness considerations, they will be examined in the traditional safety and soundness examinations.

4. *Enforcement*

Finally, where appropriate, the agency will have the ability to engage in administrative or judicial enforcement actions. Unlike the banking agencies, whose mission of looking out for safety and soundness led to an exclusive reliance on supervision, the CFPA will have no conflict of interest that prevents it from using its enforcement authority when warranted. Under H.R. 3126, the agency will have the full range of enforcement powers, including subpoena authority; independent authority to enforce violations of the statues it administers; and civil penalty authority. The bill also enables states to supplement the agency's resources to bring enforcement actions. States routinely receive consumer complaints and see local violations first.

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[120] Testimony of the Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency before the Committee on Financial Services - U.S. House of Representatives on Improving Federal Consumer Protection in Financial Services (June 13, 2007), available at http://www.house.gov/financialservices/hearing110/htdugan061307.pdf.

The proposal should also be strengthened by giving individual consumers remedies when rules are violated.[121] Expecting consumers merely to complain to a federal, or even a state, agency and hope that someone will attend to their individual case will not achieve full consumer protection. Full accountability and compliance are best promoted by making wrongdoers answer to those who they harm.

Enforcement is the one place where it makes sense to give the banking agencies back-up authority. H.R. 3126 wisely provides that if the CFPA fails to act 120 days after a referral from another agency, that other agency is free to take an enforcement action against entities within its jurisdiction if it feels one is warranted. This back-up authority acts as a check on the CFPA and ensures that serious problems are not placed solely in the hands of a single agency.

Another key feature to enforcement needs to be empowering frontline financial employees. They need whistle blower protections and an end to compensation schemes that pressure them to sell at any cost. They know the products they are directed to push are often harmful to their customers, they have no alternative other than to be fired. With whistle blower protections and proper compensation systems, these workers can provide the regulation from below that we will need when banks begin to try to find their way around new regulations.

B. The CFPA Will Consult and Coordinate with the Banking Agencies; The Scope of Conflicts Has Been Overstated.

The financial industry, and to a lesser extent the banking agencies, have raised concerns about how the CFPA will coordinate its work with the banking agencies, and how conflicts will be resolved if consumer protection and safety and soundness supervision are separated. The Administration's carefully thought-out blueprint for the new agency, which is reflected in H.R. 3126, contains several features that will ensure that the agency will consult with other federal regulators to promote consistency with prudential, market, and systemic objectives. Moreover, the potential for significant conflicts is overstated.

1. One of the CFPA's Five Board Seats Will Belong To A Prudential Regulator.

The most direct measure to ensure coordination is actually putting the views of the prudential regulators *inside* the CFPA as part of the CFPA's own decision-making process. The importance of this measure cannot be overstated. The prudential regulator will have the full authority of any other commissioner to ensure that the board itself, and the work of the agency overall, take into account any appropriate safety and soundness or other prudential considerations. As the CFPA embarks on its new mission, it will undoubtedly work for consensus among its board members whenever possible, and it can be expected that the prudential regulator will have significant

[121] The importance of giving consumers remedies when rules are violated is described in greater length in the Testimony of Travis Plunkett, Consumer Federation of America, and Edmund Mierzwinski, U.S. PIRG, Before the Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation (June 24, 2009).

influence (some might fear too much influence) within the agency. Dissention among board members will not be good for the agency, and the prudential regulator can be expected to have particular influence with Congress, the President, and other important players. It is highly unlikely that the views of that board member will be disregarded.

2. The CFPA Is Directed To Consult With Prudential Regulators.

Throughout the bill, the CFPA is directed to consult and coordinate with the banking agencies and other agencies as appropriate. The CFPA will take this statutory mandate seriously. Agencies throughout government routinely coordinate on overlapping areas of authority, and there is no reason to expect that this agency will do any less. Consultation is the norm rather than the exception.

The critical fact is that other agencies should *not be given a veto* over the CFPA's rules. The GAO, for example, has identified time delays in interagency processes as a contributor to the mortgage crisis.[122] Similarly, the requirement for joint rulemaking under the Fair and Accurate Credit Transactions Act has been a nightmare that has only led to paralysis. Similarly, one can imagine that if the OCC had a veto over the credit card rules, it would have used it, to stop rules that not only achieved consensus among FRB, the OTS and the NCUA, but also were overwhelmingly endorsed by strong bipartisan votes in both houses of Congress.

In fact, the bill should also be improved to make clear that industry players who are dissatisfied with CFPA rules cannot use the consultation requirements as a basis for challenging those rules. The consultation requirements exist to give the Agency statutory direction, and to provide a framework for consideration of various viewpoints within the federal government. Industry should not be able to drag that consultation process into court for judicial review as an excuse for challenging a rule. New York University Law Professor Rachel Barkow testified last week that the consultation requirements, as currently written, could "make any rules that the CFPA does pass vulnerable to innumerable legal challenges on the ground that the CFPA did not adequately consider a competing agency's objectives. This is the kind of sweeping substantive standard that allows industry participants to tie up agency rules for years with challenges."[123]

[122] "As we note in our report, efforts by regulators to respond to the increased risks associated with the new mortgage products were sometimes slowed in part because of the need for five federal regulators to coordinate their response." "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, February 4, 2009, pages 15-16.

[123] Statement of Rachel E. Barkow, Professor of Law, Faculty Director, Center on the Administration of Criminal Law, New York University School of Law on The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC Before the House Subcommittee on Commerce, Trade, and Consumer Protection at 7 (July 8, 2009) ("Barkow Testimony"), available at http://energycommerce.house.gov/Press_111/20090708/testimony_barkow.pdf.

3. The CFPA and Prudential Regulators Will Share Examination Reports

The bill requires the CFPA to share confidential examination reports with the prudential regulators and vice versa. This confidential exchange of information will give the CFPA greater insight into any significant safety and soundness concerns expressed by prudential regulators, and will also help the banking agencies to understand consumer protection concerns exposed by CFPA examinations.

4. Congress will have Oversight over the Agency

Congress will also have the ability to oversee the CFPA and to ensure that appropriate consultation and coordination is occurring between the agencies. It is likely that at least part of the Agency's funding will come from appropriations, as a backup to fees, giving Congress regular input into the functioning of the Agency. Congress of course also has the ultimate ability to amend the statute and to restrict the Agency's authority if it is used inappropriately.

The CFPA will be well aware of the history of the FTC, which incurred the wrath of Congress and had its powers severely curtailed when it got out in front of congressional expectations. The agency will be forewarned about the importance of consulting with the banking agencies and considering safety and soundness concerns, and Congress can ensure that it does so.

5. The Seriousness of Potential Conflicts is Overstated

These measures, built into the structure of the CFPA, will ensure that significant safety and soundness and other concerns of prudential regulators are taken into serious consideration.

But equally important, the likelihood of significant conflicts between safety and soundness and consumer protection, or between the CFPA and the banking agencies, is exaggerated. As should be fully apparent today, consumer protection can actually bolster safety and soundness. Indeed, consumer regulators – who approach the issue differently – may be more attune to the risks of dangerous products at an earlier point in time than prudential regulators, when they are only affecting a handful of families and not entire portfolios.

Though the link between consumer protection and safety and soundness is now obvious, the two functions are not the same, and do lead agencies to have different perspectives. In some circumstances, such as with overdraft loans, a financial product might well be profitable, even though it is deceptively offered and has a financially devastating effect on a significant number of consumers.[124] A prudential regulator, who sees the role those profits play in the balance sheet, may resist changes that require restructuring the product.

But ending or correcting profitable but abusive practices will *rarely* affect the overall safety and soundness of an institution. If it does, that institution is probably unsustainable over the long run

[124] Testimony of Travis Plunkett, Legislative Director, Consumer Federation of America and Edmund Mierzwinski, Consumer Program Director, U.S. PIRG, Before the Subcommittee on Financial Institutions and Consumer Credit of the U.S. House of Representatives, Committee of Financial Services, March 19, 2009.

in any event, as evidenced by the collapse of numerous subprime lenders. *The mere fact that prudential regulators see the industry's perspective and take their side does not mean that a consumer protection rule hurts the health of an institution.*

Consumers themselves have an interest in seeing that safety and soundness concerns are taken seriously. If the rules go too far, they could backfire and harm consumers themselves. Consumers and financial institutions share a common interest in seeing that financial products and services are made in a sound, fair and sustainable basis. If access to credit is shut off, that will harm consumers too. But more typically, access to credit is a red herring trotted out any time that a bank wants to preserve a profitable activity, even one that is predatory and destructive.

Contrary to the arguments of opponents of the CFPA, protecting consumers from traps and tricks when they purchase credit, savings or payment products should encourage confidence in the financial services marketplace, spur innovation, and ultimately create a win-win situation good for everyone. As Nobel Laureate Joseph Stiglitz has said:

> There will be those who argue that this regulatory regime will stifle innovation. However, a disproportionate part of the innovations in our financial system have been aimed at tax, regulatory, and accounting arbitrage. They did not produce innovations which would have helped our economy manage some critical risks better—like the risk of home ownership. In fact, their innovations made things worse. I believe that a well-designed regulatory system, along the lines I've mentioned, will be more competitive and more innovative—with more of the innovative effort directed at innovations which will enhance the productivity of our firms and the well-being, including the economic security, of our citizens.[125]

C. Congress Should Consider Making the CFPA a Fully Independent Agency

In last week's testimony before a Commerce subcommittee, New York University Professor of Law Rachel Barkow noted that the bill as drafted appears not to make the CFPA a fully independent agency, but rather to subject it to review by the President's Office of Management and Budget and to the requirements of executive orders.[126] Thus, the CFPA will have *less independence* than these independent agencies, including the FTC and the CPSC after which the CFPA is modeled:

Board of Governors of the Federal Reserve System
Commodity Futures Trading Commission
Consumer Product Safety Commission
Federal Communications Commission
Federal Deposit Insurance Corporation

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[125] "Too Big to Fail or too Big to Save? Examining the Systemic Threats of Large Financial Institutions," Joseph E. Stiglitz, April 21, 2009, page 10.

[126] Barkow Testimony at 13-15.

Federal Energy Regulatory Commission
Federal Housing Finance Agency
Federal Maritime Commission
Federal Trade Commission
Interstate Commerce Commission
Mine Enforcement Safety
Health Review Commission
National Labor Relations Board
Nuclear Regulatory Commission
Occupational Safety and Health Review Commission
Postal Regulatory Commission
Securities and Exchange Commission[127]

As Professor Barkow testified:

> The more susceptible an agency is to presidential oversight, the more likely the agency's policies will shift as new administrations take power. Dramatic shifts hinder business planning and create legal uncertainty, which can be damaging to any market, including the one for financial products and services. In addition, [the OMB's Office of Information and Regulatory Affairs (OIRA)] has traditionally had a deregulatory bias. Although many urge OIRA to take a more aggressive role in policing agency inaction as well, OIRA's history is to the contrary. There remains the risk, then, that OIRA review could put pressure on the CFPA to be less ambitious in its regulatory positions. The potential for OIRA to delay the implementation of regulations in the future is also a possibility.[128]

Professor Barkow cited a recent Government Accountability Office (GAO) finding that OIRA review expands the President's influence over an agency's substantive policies, frequently leading to significant and material modifications in the agency's regulations.[129]

OMB review could be one method of ensuring that the banking agencies views are seriously considered before a CFPA rule is adopted. Professor Barkow did note advantages to OMB review, including the coordination of policies across the executive branch and the requirement of cost benefit analysis.[130]

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[127] The term "independent regulatory agency," which entitles to agency to independence from executive orders, is contained in the Paperwork Reduction Act, 44 U.S.C. § 3501(5).

[128] Barkow Testimony at 14 (footnote omitted).

[129] Barkow Testimony at 13; U.S. Gov't Accountability Office, Report to the Chairman, Committee on Oversight and Government Reform, House of Representatives, Federal Rulemaking: Improvements Needed to Monitoring and Evaluation of Rules Development as Well as to the Transparency of OMB Regulatory Reviews 30 (April 2009) (reviewing 12 rules submitted to OIRA and finding that OIRA review led to significant or material changes for eight of them).

[130] Barkow Testimony at 14.

But given that the CFPA's own Board membership and consultation requirements ensure coordination from the start, and that consideration of costs and benefits is built into the Agency's unfairness authority by statute, Congress should consider whether this additional review is worth the costs.

Moreover, it is noteworthy that it is *the Paperwork Reduction Act* that defines the term "independent regulatory agency." Agencies that do not fall within that term might be expected to be subject to greater paperwork and review requirements, with resulting delays in implementation of their rules. Congress might want to consider this possibility.

V. CONCLUSION

The nearly 200 organizations that are members of American for Financial Reform, along with many other consumer, community, civil rights, and labor groups, and Americans of every stripe, believe that restoring consumer protection should be a cornerstone of financial reform. It will reduce risk and make the system more accountable to American families. We recognize, however, that other reforms are needed to restore confidence to the financial system. Our coalition ideas on these and other matters can be found at the website of Americans For Financial Reform, available at ourfinancialsecurity.org.

Thank you for the opportunity to testify. Our organizations look forward to working with you to move the strongest possible Consumer Financial Protection Agency through the House of Representatives and into law.

Governor Elizabeth Duke subsequently submitted the following in response to written questions received from Congressman Watt in connection with the July 16, 2009, hearing before the Subcommittee on Domestic Monetary Policy and Technology:

1. **If the Federal Reserve had authority to issue rules implementing the Home Ownership and Equity Protection Act (HOEPA) beginning in 1994, why did the Fed wait until 2008 to issue rules?**

The Federal Reserve Board has primary rule writing responsibility for the Truth in Lending Act and the Home Ownership and Equity Protection Act (HOEPA), which amended TILA. The Board has exercised this authority to respond to various consumer protection concerns that have arisen in the mortgage marketplace. The most recent of these rulemakings was issued in July 2008, which strengthened consumer protections, and further augmented rules finalized in 2001, and industry guidance issued in 2006 and 2007.

In March 1995, the Board published rules to implement HOEPA, which are contained in the Board's Regulation Z. These rules became effective in October 1995. HOEPA also gives the Board responsibility for prohibiting acts or practices in connection with mortgage loans found to be unfair or deceptive. The statute further requires the Board to conduct public hearings periodically, to examine the home equity lending market, and the adequacy of existing laws, and regulations in protecting consumers, and low-income consumers in particular. Under this mandate, the Board held public hearings to gather information about mortgage lending practices of concern in 1997, 2000, 2006, and 2007.

The 2000 hearings led the Board to expand HOEPA's protections in December 2001 to respond to concerns about predatory or abusive practices in the marketplace at the time. Those rules, issued in December 2001, included the following consumer protections: lowered HOEPA's rate trigger to extend the act's protections to a potentially larger number of high-cost loans; expanded its fee trigger to include single-premium credit insurance to address concerns that high-cost HOEPA loans were "packed" with products that increased loan cost without commensurate benefit to consumers; added an anti-loan flipping restriction, and strengthened HOEPA's prohibition on unaffordable lending by advising creditors generally to document and verify the borrower's ability to repay a high-cost HOEPA loan.

Most recently, the Board held hearings in 2006 and 2007, to gather information on concerns about new "predatory lending" practices that had emerged as the subprime market continued to grow. Issues cited related to increasing use by mortgage lenders of relaxed underwriting practices, including qualifying borrowers based on discounted initial rates and the expanded use of "stated income" or "no doc" loans. In 2006 and 2007, the Board and other federal financial regulatory agencies adopted interagency guidance for banking institutions addressing certain risks and emerging issues relating to non-traditional and subprime mortgage lending practices, particularly adjustable-rate mortgages. The issuance of interagency guidance was viewed as a more expedient means than rule writing to address practices of concern in the marketplace at the time, although it did not apply to nonbank lenders.

In light of the information received at the 2006 hearings and the rise of defaults that began soon after, the Board held an additional hearing in June 2007, to explore how it could use its authority under HOEPA to curb the abusive practices without unduly restricting credit. At the 2007 hearing, and from hearing-related public comments, the Board received input from a broad spectrum of informed parties. Following these hearings, in December 2007, the Board proposed sweeping new rules to strengthen protections for consumers seeking mortgage credit. Final rules were issued in July 2008.

Among other things, the new HOEPA rules strengthened consumer protections for a newly defined category of "higher-priced mortgage loans" by: prohibiting a lender from making a loan without regard to the borrower's ability to repay the loan from income and assets other than the home's value; requiring creditors to verify the income and assets they rely upon to determine repayment ability; and banning any prepayment penalty if the payment can change in the initial four years. For other higher-priced loans, a prepayment penalty period cannot last for more than two years, and creditors are required to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

For all mortgage loans secured by a borrower's principal dwelling, the rules prohibit creditors and mortgage brokers from engaging in certain practices, such as pyramiding late fees. In addition, servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request. Creditors must provide consumers with transaction-specific mortgage loan disclosures within three business days after application. Finally, the rules also address deceptive mortgage advertisements and unfair practices related to real estate appraisals and mortgage servicing.

With the benefit of hindsight, the Federal Reserve could have acted more quickly to adopt rules to reign in harmful lending practices. The process of identifying emerging issues, proposing rules, reviewing comments, developing final rules, and allowing reasonable time for implementation was too protracted given the rapid changes in the mortgage market, including loan terms, pricing, underwriting standards, and marketing practices. We also recognize the value of holding public hearings to gather information about mortgage lending practices with greater frequency, in order to identify emerging risks to consumers on a more timely basis.

The Board is fully committed to continuing its efforts to enhance consumer protections in the residential mortgage market. Last month, we proposed significant changes to Regulation Z intended to improve the disclosures consumers receive in connection with mortgage transactions. These proposed rules also prohibit payments to a mortgage broker or a loan officer that are based on the loan's interest rate or other terms; and they prohibit a mortgage broker or loan officer from "steering" consumers to transactions that are not in their interest in order to increase mortgage broker or loan officer compensation. These actions are further described in our response to question number three on page 6.

2. What is the Federal Reserve's current staffing and budget levels allocated to safety and soundness in FY 2009? What are the staffing and budget levels for consumer protection in FY 2009?

The budget and staffing numbers in the table below reflect the 2009 budget amounts for most Federal Reserve System resources that are directly involved in consumer protection and prudential supervision activities. Some costs are not included in these figures as explained further below the table. Furthermore, actual expenses and staffing levels for 2009 are likely to exceed the budgeted amounts given the additional resources needed to respond to recent events. For example, the budget numbers do not reflect anticipated costs for the development of a program for consumer compliance examinations of nonbank subsidiaries of bank holding companies. Also, prudential and consumer supervision resource needs are likely to increase due to the recent conversion of several large, complex organizations to bank holding companies.

	2009 Budget (Direct Costs)	2009 Budgeted ANP*
Consumer Protection Supervision and Rule writing	$65.3 million	396
Prudential Supervision	$330.3 million	1,851
Other Supervisory Activities for both Consumer Protection and Prudential Supervision	$145.7 million	905

*The term average number of personnel (ANP) describes levels and changes in employment at the Reserve Banks. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that calendar year; two half-time employees who start on January 1 count as one ANP. Budgeted staff positions at the Board of Governors are also included.

Consumer Protection Supervision and Rule Writing - This category includes expenses for the Board's Division of Consumer and Community Affairs, which develops and oversees programs for rule writing, consumer compliance supervision, community affairs, consumer complaint call center and complaint resolution, the Consumer Advisory Council, and consumer education and research which includes consumer testing. It also includes consumer compliance examinations and other related supervisory expenses in the twelve Reserve Banks.

Prudential Supervision - This category includes expenses for the Board's Division of Bank Supervision and Regulation, which has responsibility for developing and overseeing programs for prudential supervision and regulation of state member banks and bank and financial holding companies. It also includes expenses for the twelve Reserve Banks for examinations and related supervisory activities.

Other Supervisory Activities - This category includes those costs in the Reserve Banks for activities that benefit both consumer protection and prudential supervision and cannot be easily separated, including bank and holding company applications processing, examiner training and commissioning programs, some automation and IT support, regulatory reports processing, shared national credit review, and supervisory policy and research.

Not Included in Costs Above - It is also important to note that the budget amounts provided do not include community affairs staff in all twelve Reserve Banks as well as some general administrative support costs for both functions. Certain national IT costs, such as data processing charges related to the National Information Center, maintaining supervisory databases such as the National Examination Data, and servers and network costs are under the responsibility of the Board's and System central information technology functions and are not included. Also, the figures above do not include costs incurred by other divisions and functions at the Board, such as economic research, information technology, and bank operations, for activities that benefit consumer protection or safety and soundness supervision. Some Board research economists conduct research and collect and analyze data that support the consumer and community affairs functions, such as understanding consumer finances and wealth building, and providing analytical support for rule writing. For example, economists reviewed available data on mortgage pricing to help the Board determine the appropriate threshold to define which mortgage loans should be considered "high cost" and, therefore, subject to new rules issued under the Board's HOEPA authority as described in question one. Likewise, research economists played a significant role in the recent Supervisory Capital Assessment Program (SCAP) analysis for prudential supervision, but their costs are also not included.

3. **During the current financial crisis, the Fed was responsible for both safety and soundness and consumer protection, yet did not discover abuses in subprime mortgages and other abuses until too late. Has the Fed performed any analyses of what went wrong? If so, please provide copies of each such analysis.**

We have considered the many factors that contributed to problems in subprime lending and the recent economic crisis and have focused on identifying areas where we can make improvements in our programs for both safety and soundness supervision and consumer protection. As Chairman Bernanke and Governor Tarullo noted in their recent testimony, the roots of this crisis included global imbalances in savings and capital flows, the rapid integration of lending activities with the issuance, trading, and financing of securities, the existence of gaps in the regulatory structure for the financial system, and widespread failures of risk management across a range of financial institutions. The crisis revealed supervisory shortcomings among all regulators, and demonstrated that the framework for supervision and regulation had not kept pace with changes in the structure, activities, and growing interrelationships of the financial sector.

Consumer Protection

With respect to consumer protection, gaps in supervision and enforcement with respect to nonbank mortgage lenders contributed to the inability of supervisors to detect and contain abusive lending practices. Most subprime loans were issued by entities outside the supervisory jurisdiction of the Federal Reserve and other federal bank regulators, and consequently, these entities were not subject to examinations to assess compliance with federal consumer protection laws. With respect to nonbank entities owned by bank holding companies, the Federal Reserve's consumer compliance examination authority is limited to only certain laws.

The Federal Reserve has worked to overcome this gap through a multiagency partnership initiated in June 2007, to conduct targeted consumer compliance reviews of selected nonbank lenders with significant subprime mortgage operations. The joint effort represented the first time multiple agencies have collaborated to plan and conduct consumer compliance reviews of independent mortgage lenders and nonbank subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities. The pilot program has been completed, and the Federal Reserve is fully committed to implementing its own program of supervision of nonbank subsidiaries of holding companies on an ongoing basis. As with the pilot, we will continue to work cooperatively and share information with other agencies with overlapping jurisdictions. We have also created a special unit to oversee consumer protection issues in the subsidiaries of the largest financial institutions that are active in consumer credit and payment services and have expanded our complaint resolution program to include these institutions.

The current crisis has also illustrated clearly that consumer protection issues and safety and soundness risks are linked and can affect financial stability. We have been committed to strengthening our consumer protection program to more effectively detect and respond to changing and emerging markets and products, particularly for those that pose risks to consumers. Along these lines, we have added resources and worked to strengthen our internal processes to detect and address emerging risks and issues facing consumers. We have also expanded resources to improve timeliness of rule writing and to better identify consumer needs through consumer testing. Specifically, we have conducted extensive consumer testing as part of the rule writing process to improve the effectiveness of disclosures to provide consumers with useful information when they are shopping for credit. Consumer testing has also served to identify issues that can only be remedied through substantive regulation and to direct consumer education efforts. Finally, we have also instituted a web-based comment system to improve consumer access for making comments on proposed rules.

We have also learned that disclosures alone may not always sufficiently protect consumers from unfair practices. As such, we have taken a number of specific actions to strengthen consumer protections through rule-making. Over the last year, the Federal Reserve issued sweeping new mortgage and credit card rules that significantly expand protections for consumers of these credit products. For mortgage loans, the Board has issued rules that establish comprehensive new regulatory protections for consumers in the residential mortgage market. Importantly, these rules apply to all mortgage lenders, not just the depository institutions that are supervised by the federal banking and thrift agencies. The rules are designed to provide transaction-specific disclosures early enough to facilitate shopping and to protect consumers from unfair or deceptive acts or practices in mortgage lending, while supporting sustainable home ownership. They are intended to respond to the most troublesome practices in the mortgage industry that contributed to the recent subprime market meltdown. The Board also adopted rules governing mortgage advertisements to ensure that they provide accurate and balanced information and do not contain misleading or deceptive representations. Further, this past July the Board proposed significant new rule changes to improve consumer disclosures for all mortgage transactions. In particular, the proposed disclosures focus consumer attention on understanding the risks they are taking by identifying "key questions to ask." Many of the proposed disclosures are the result of extensive consumer testing, a technique that has become integral to the Board's rule making.

Prudential Supervision

With respect to prudential supervision, the Federal Reserve, acting within its existing statutory authorities, is taking steps to strengthen the supervision of banks and bank holding companies to respond to lessons learned from the recent crisis. Working with other domestic and foreign supervisors, we have been engaged in a series of initiatives to strengthen capital, liquidity, and risk management at banking organizations. Regarding capital adequacy, for example, there is little doubt that in the period before the crisis capital levels were insufficient to serve as a needed buffer against loss. Efforts are under way to improve the quality of the capital used to satisfy minimum capital ratios, to strengthen the capital requirements for on- and off-balance-sheet exposures, and to establish capital buffers in good times that can be drawn down as economic and financial conditions deteriorate.

Recent experience has also reinforced the value of holding company supervision in addition to, and distinct from, bank supervision. Large organizations increasingly operate and manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of individual functional supervisors. In October, we issued new guidance for consolidated supervision of bank holding companies that provides for supervisory objectives and actions to be calibrated more directly to the systemic significance of individual institutions and clarifies supervisory expectations for corporate governance, risk management, and internal controls of the largest, most complex organizations. We are also adapting our internal organization of supervisory activities to take better advantage of the information and insight that the economic and financial analytic capacities of the Federal Reserve can bring to bear in financial regulation.

Finally, we are prioritizing and expanding our program of horizontal examinations to assess key operations, risks, and risk-management activities of large institutions. In addition to onsite examination activities for the largest and most complex firms, we are creating an enhanced surveillance program that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will likely be performed by a multi-disciplinary group including experts in economic and market research, bank supervision, market operations, and accounting and legal issues.

4. If legislation is passed to create the Consumer Financial Protection Agency, what are the impediments, if any, to current Federal Reserve staff being transferred to the CFPA?

The current proposals for a new Consumer Financial Protection Agency offer some helpful ideas in considering how best to handle the challenging task of combining staff from a number of agencies with minimum disruption to those affected. Nonetheless, there are some issues with the transfer of key staff and potential loss of expertise that would need to be addressed. Federal Reserve consumer protection staff members routinely utilize the consumer expertise of staff members engaged primarily in other central bank functions. For example, research economists analyze HMDA data or other consumer data, but also perform other important research and are not likely to transfer to a new agency. Furthermore, roughly half of the System consumer compliance examiners are cross trained or have expertise in safety and soundness supervision, including expertise in accounting, audit, commercial real estate lending, information technology, assessments of corporate governance and enterprise risk management. Transferring those examiners may cause the Federal Reserve to lose important skills needed for other functions and would require additional investments in staff training to make up the lost expertise. Conversely, should some of the cross-trained examiners elect to remain with the Federal Reserve; the new agency would not have the benefit of their expertise in consumer compliance.

Additionally, the call center infrastructure that supports the Federal Reserve System consumer complaint and inquiry program also supports the call center needs of other functions across the Federal Reserve System.

Finally, there are other issues to address related to data systems and IT support. Data bases for the Home Mortgage Disclosure Act (HMDA) data, consumer complaints (CAESER), and other examination tools for analyzing fair lending and compliance with CRA, may be difficult to transfer and blend with systems from other agencies. Supervisory information for both consumer protection and prudential supervision is housed in shared databases, potentially leading to difficulties in determining how to provide access and to separate or maintain the information going forward. Given some of the staffing, information technology and operational issues, a new agency may require some time after enactment to become fully operational.

5. Describe the Federal Reserve's present statutory mission and the extent to which this mission includes consumer protection?

Through the Federal Reserve Act and other laws, Congress has assigned several duties and responsibilities to the Federal Reserve. These include responsibility for conducting monetary policy to achieve the objectives set forth in section 2A of the Federal Reserve Act, providing financial services to depository institutions, the U.S. government and foreign official institutions, and operating and overseeing aspects of the nation's payments system.

The Federal Reserve also has statutory responsibility conveyed through various laws, including the Federal Reserve Act, Federal Deposit Insurance Act, and the Bank Holding Company Act for supervising and regulating bank holding companies, state member banks, and certain other types of financial institutions (collectively, banking organizations) for prudential purposes. In connection with our safety and soundness examinations of state member banks and bank holding companies, we evaluate the adequacy of the organization's risk-management systems, including the systems used to ensure compliance with consumer protection and other laws and regulations. The Federal Reserve also conducts regular examinations of state member banks to evaluate compliance with consumer protection laws, the fair lending laws, and the Community Reinvestment Act.

In addition, Congress has vested the Federal Reserve with authority for writing regulations to implement a wide variety of consumer protection laws designed to protect consumers in financial transactions. These include the Truth in Lending Act, the Truth in Savings Act, and the Equal Credit Opportunity Act, among others. For many of these statutes, the rules established by the Federal Reserve apply to all lenders or depository institutions within the scope of the relevant act - not just those supervised by the Federal Reserve for prudential purposes.

The Federal Reserve is committed to improving consumer protections and promoting responsible lending practices through each of the roles we play as supervisor for safety and soundness and consumer compliance, and as rule writer. In my testimony, I suggested certain actions that Congress could take to help ensure that the commitment demonstrated by the Board to consumer protection in financial services is maintained over time. One way would be for Congress to formally codify consumer protection as a core mission or responsibility for the Federal Reserve, similar to banking supervision and regulation. This would provide a clear and ongoing understanding that consumer protection matters should be viewed as an integral part of the Federal Reserve's overall mission. In addition, Congress could require the Chairman of the Federal Reserve Board to report periodically regarding the "state of consumer protection" in the financial services industry, similar to the semiannual monetary policy report to the Congress. Such reporting could include a comprehensive review of the Federal Reserve's actions taken to strengthen consumer protection, the adequacy of existing consumer protection laws and regulations, planned future actions to address potentially unfair and deceptive acts and practices, enforcement actions taken on consumer protection matters, studies of consumer finances, and the availability of financial services especially in underserved areas.

6. **Please provide the Subcommittee with specific example(s) of conflicts that the Federal Reserve has experienced arising from the exercise of your consumer protection and prudential supervisory responsibilities? How were these conflicts resolved?**

Rule writing requires extensive analysis from a number of perspectives, which highlights the complementary nature of rule writing with other functions in the Federal Reserve that I mentioned in my testimony. Any effort to develop new rules involves weighing the costs and benefits of those rules to consumers, as well as implementation and compliance costs for the industry. Implementing unduly strict limitations on product features or practices can result in reduced access to affordable credit or services for consumers, and rules that are costly to implement can result in reduced efficiency for the provider and higher costs that are ultimately passed on to consumers.

Every rule writing exercise that the Board has undertaken in recent years, including rules for home equity lines of credit (HELOCs), credit cards, mortgage lending, and the current review of overdraft protections, has involved weighing a number of issues and the relative costs and benefits to consumers, as well as the impact on the institutions' ability to offer the credit or service at an affordable price. In conducting the analysis, staff routinely identifies issues for which different interests need to be reconciled at an early enough stage in the process to allow for timely issuance of well crafted rules. For example, rule changes can affect the business model, risk profile, and potentially the profitability of lending for institutions, and they also ultimately affect the pricing and availability of credit for consumers. Issues such as these have been reviewed, studied, and resolved as part of the rule writing process, with input from experts in consumer regulation, prudential supervision, payments systems, and economic analysis. If consumer protection rule writing is separated from prudential supervision, provision should be made for interagency consultation early in the rule writing process. Early consultation could reduce the likelihood of later unresolved conflicts, or extension of the time required for rule writing. In addition, such consultation could surface issues that might otherwise lessen the availability or increase the cost of financial services.

Similarly, the conduct of consumer protection and prudential supervisory responsibilities often require close coordination in order to avoid conflicting supervisory policy direction or messages to individual institutions through examinations. The recent experience with home equity lines of credit provides an example of the need for supervisors to balance prudential and consumer protection concerns. Many individuals and small businesses rely on home equity lines of credit to finance their businesses and pursue new opportunities. Given current economic conditions, prudential supervisors may have concerns about the size of individual institutions' credit exposures, while consumer compliance supervisors may cite concerns with cutting available credit lines, particularly for creditworthy borrowers who have made payments as agreed. Issues such as this are currently resolved within the agency during the course of policy development or for individual institutions, during an examination prior to issuing a final examination report. If unresolved, institutions would receive conflicting messages and direction affecting their home equity lending programs. In addition to policy issues, potential areas requiring coordination may also involve lower level issues related to coordination of examination schedules, the relative weight examiners give to supervisory concerns, and recommended corrective actions. Thus, it would also be important to determine a process to resolve differences among the agencies that arise in both rule writing and in the conduct of supervision.

7. **In your written testimony, you indicate that the Federal Reserve has completed a multiagency pilot program of targeted consumer compliance reviews for selected nonbank lenders and "is fully committed to implementing its own program of supervision of nonbank subsidiaries of holding companies on an ongoing basis."**

    a. **What clarifications of the Federal Reserve's supervisory authority for non-bank subsidiaries under Gramm-Leach-Bliley would assist in your ability to protect consumer interests and conduct consumer compliance examinations for these institutions?**

As noted in the response to question 3 on page 5, the Federal Reserve is fully committed to implementing a program for supervision of nonbank affiliates of bank holding companies for consumer compliance. To be fully effective, consolidated supervisors need the information and ability to identify and address risks throughout an organization. However, the Bank Holding Company Act as amended by the so-called "Fed-lite" provisions of the Gramm-Leach-Bliley Act, places material limitations on the ability of the Federal Reserve to examine, obtain reports from, or take actions to identify or address risks with respect to both nonbank and depository institution subsidiaries of a bank holding company that are supervised by other agencies. It also places limits on the authority of the Federal Reserve to obtain reports from or examine other non-functionally-regulated subsidiaries. Consistent with these provisions, we have worked with other regulators and, wherever possible, sought to make good use of the information and analysis they provide. In the process, we have built cooperative relationships with other regulators--relationships that we expect to continue and strengthen further.

Nevertheless, the restrictions in current law still can present challenges to timely and effective consolidated supervision in light of, among other things, differences in supervisory models. At times, organizations have used the "Fed-lite" provisions to challenge the Federal Reserve's authority to request or obtain certain information. To ensure that consolidated supervisors have the necessary tools and authorities to monitor and address safety and soundness and consumer protection concerns in all parts of an organization on a timely basis, we would urge statutory modifications to the Fed-lite provisions of the Gramm-Leach-Bliley Act. Such changes, for example, should remove the limits first imposed in 1999 on the examination and information-gathering authority that the Federal Reserve has over subsidiaries of bank holding companies in furtherance of its consolidated supervision responsibilities, and on the ability of the Federal Reserve to take action against subsidiaries, whether or not they are also supervised by another agency, to address unsafe and unsound practices and enforce compliance with applicable law.

b. What gaps, if any, still remain in the supervision and enforcement of non-banking mortgage originators?

Strong rules are the foundation for ensuring consumer protections, but strong oversight and enforcement are critically important. Gaps in enforcement and oversight, particularly with nonbank lenders, contributed to current problems in mortgage lending. Most subprime loans were originated by entities outside the supervisory jurisdiction of the Federal Reserve or other federal bank regulators and thus, not subject to examinations to assess their compliance with federal consumer protection laws. Our efforts to overcome this supervisory gap through collaboration among various agencies are discussed in the response to question three.

Currently, independent nonbank lenders and financial services providers are regulated by a combination of the Federal Trade Commission (FTC) and the states. However, the FTC does not have the authority, tools, or resources to conduct routine on-site examinations of these entities to monitor and enforce compliance, which is the norm for depository institutions. While several states have put forth noteworthy efforts in this regard, the state enforcement scheme across the country is still uneven, with inadequate resources being a primary concern. We believe it is appropriate that Congress consider alternatives to close this gap as part of ongoing discussions of regulatory reform.

Answers to Follow up Questions to the National Consumer Law Center

From a Hearing Before the Subcommittee on Monetary Policy
Committee on Financial Services
U.S. House of Representatives
The Honorable Mel Watt, Chairman

"Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve"

Original Hearing: July 16, 2009

Submitted: September 22, 2009

(1) Many opponents of the proposed Consumer Financial Protection Agency (CFPA) argue against separating "safety and soundness" and "consumer protection" regulation. During the current crisis, both functions were housed in federal banking agencies, yet these agencies failed to detect and deter the current financial crisis. Please give specific examples of how current federal banking regulators, despite having both functions, failed to protect consumers.

A: Consumer financial protection is currently handled by the same federal banking agencies that handle the safety and soundness of institutions. At the end of the day, in example after example, at the Fed and the other agencies, consumers usually come up on the short end of the stick. Legitimate concerns about consumer protection problems always seem trumped by an overreliance on more disclosures, solicitude for bank profits, and an antipathy to taking measures opposed by industry. My testimony (pages 5-28) describes many examples of banking regulators failing to protect consumers in areas covering mortgage lending, credit cards, overdraft loans, student loans, credit reporting, payday loans and fair lending, prepaid cards, and bank fees.

It is ironic that consumer protection has been such a low priority for the prudential regulators, because listening seriously to consumer concerns can help bolster safety and soundness. It was consumers who pointed out that credit card debt was wrecking havoc on family finances and was unsustainable. It was consumers, not bankers, who complained repeatedly that mortgages were being made that people could not afford to repay. As just one of many similar warnings, in 2003 Ruhi Maker vented her frustration to the Fed's Consumer Advisory Council:

> "Consumer advocates are from Mars, and bankers are from Venus. I sometimes feel that way. ... there are parts of the country where ... I really feel it's going to be a nightmare. I think the horse is out the barn door. And, you know, I hope I am wrong. I really hope I am wrong. But I think it's in the interest of the

> financial institutions to figure out how to fix this problem, which some unregulated institutions created, but which then the financial institutions went and purchased."

But those concerns were ignored.

An agency focused on consumer protection would think about things differently and focus on different problems than one focused on the safety and soundness of institutions, but their work would be complementary. As former Fed Governor Mishkin testified last week, in saying that the Fed should give up its role as a consumer protection regulator, "the skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator." The same is true of the mindset of a prudential regulator.

Precisely *because* consumer protection is complementary to safety and soundness, we need a new agency that looks at things from a different perspective. A CFPA will focus on individuals, asking questions from their perspective about whether products are fair and contribute to or harm family financial stability. It will spot problems early, before they infect the safety and soundness of an entire portfolio or an entire institution.

The balanced CFPA proposal ensures that the agency will consider real safety and soundness concerns. First and most importantly, one of the 5 commissioners must be a prudential regulator. That commissioner, present at the creation, will ensure that prudential concerns are integrated into the fabric of the agency's work.

Second, the Agency has a statutory mandate to coordinate with the banking agencies. Not every disagreement is a serious conflict, let alone one that will jeopardize safety and soundness. But the CFPA will have every reason to listen to and address legitimate prudential concerns, like fraud, money laundering, or operational issues.

Third, the proposal calls on the CFPA and the banking agencies to share confidential examination materials, so that each can see the concerns that have been raised from the other's perspective.

Finally, Congress will be exercising oversight. With the history of the FTC in mind, and a prudential regulator on the Board, one can be sure that the agency will do everything in its power to minimize conflicts.

We will all be better off with a system that takes consumer protection seriously, and that can only happen if consumer protection is handled by an agency that is not focused on industry profits.

(2) From your experience as a consumer protection advocate, is it a good idea for the federal government to pre-empt state consumer laws?

a. If state laws are not pre-empted, is there a danger of lack of uniformity of minimum standards for consumer protection?

b. If state laws are pre-empted, what are the likely consequences?

A: Consumer protection in the financial world has been dramatically weakened in the last several years by preemption of state consumer protection laws.[1] Broad preemption of state law is a recent phenomenon; for most of the 150 years since national banks were created, they have complied with state law. Preemption has harmed states' ability to respond to financial abuses in both the banking and the nonbank world. Restoring the states' role as "first responders" is an essential element of regulatory reform.

For most of this nation's history, consumers have depended on states, not the federal government, to protect them. Even in the banking world, national banks were expected to comply with state law. Only in the last decade or so have federally-chartered depositories been able to ignore state laws with impunity.

- From 1864 to 1978, state laws were preempted *only* if they prevented or significantly interfered with national banks' exercise of their powers, or the law favored state banks over national banks.
- From 1978 to 1995, preemption of state laws governing interest rates began and laws covering certain mortgage terms were preempted for any lender, including nonbanks, but otherwise banks were expected to comply with state law.
- From 1996 to the present, national banks have been able to ignore wide swaths of consumer protection laws.

The preemption of state consumer protection laws has harmed consumers. In area after area, abuses have followed preemption.

- *Mortgages.* The preemption of state laws in the mortgage area is a significant cause of the current crisis. In 2006, the peak year of irresponsible lending, national banks, federal thrifts, and their operating subsidiaries made 32% of subprime loans, 40% of Alt A loans, and 51% of interest-only and option ARM loans. A total of over $700 billion in risky loans were made by entities that states could not touch. These numbers do not include the loans made by bank affiliates, so the total bank responsibility for subprime loans is much higher and is likely over 50% of

[1] For a detailed description of the problems preemption have caused and the reasons the role of the states must be restored, see Lauren Saunders, National Consumer Law Center, "Preemption and Regulatory Reform: RESTORE THE STATES' TRADITIONAL ROLE AS "FIRST RESPONDER" (Sept. 2009), available at http://www.nclc.org/issues/legislative/content/RestoretheRoleofStates091609.pdf.

the market. States were also preempted from regulating *any* mortgage lender on the very terms that made many mortgages dangerous: balloon payments, negative amortization, exploding variable rates, and other nontraditional terms.

- *Credit cards.* The abuses that eventually led to a belated federal crackdown -- bait and switch rate increases, abusive fees, payment manipulations – were allowed to take off and wreck havoc on millions of families due to preemption.

- *Overdraft fees.* Federal regulators preempted state laws while watching programs designed to trick consumers into incurring overdraft fees grow into a $37.5 billion tax on the very consumers who need those funds the most.

- *Exploding debt, a climate of deception and high rate predatory lending.* The explosion of unaffordable debt that has destroyed many families and the growth of destructive forms of predatory lending have their seeds in preemption and the race to the bottom that preemption triggered.

States are our nation's first responders when new threats target consumers. Restoring their role in protecting consumers is a critical piece of regulatory reform.

- Only states provide comprehensive consumer protection. Flexible state laws are critical when gaps in protection or new abuses emerge.

- States see abuses sooner, react more quickly, and can address local problems before they become national ones. States have the tools and the incentives to enforce their laws and can augment federal resources.

- State laws provide the models for federal law. They are an essential element of our constitutional system of federalism.

- Exempting some entities from state laws leads to an uneven playing field and inconsistencies that are easily exploited.

- Preemption allows banks to cherry-pick those parts of state laws they need and ignore consumer protections in other parts of those same laws.

- Preemption undermines our dual banking system.

Contrary to the claims of bank lobbyists, restoring the role of states to protect individuals from banking and mortgage abuses will not impede nationwide commerce.

- When new problems arise, state approaches tend to converge, with differences in detail but not ones that impede nationwide commerce. The uniform law movement and other national organizations promote uniform and model state laws. The uniform mortgage broker licensing laws that 49 states adopted in the past year are a case in point.

- Other nationwide corporations comply with state laws, and banks do in many areas. Banks tailor their products to many niche markets and can adapt to state variations. Minor differences do not prevent banks from marketing a standard product.

- Congress can adopt uniform national rules in particular areas, but state consumer protections should not be cleaved off wholesale with a meat-ax.

The uniformity achieved by preemption comes at a heavy price. States act when there is a problem. We have a choice: we can have uniformly weak protection, or vibrant consumer protection that uses the strengths of our system of federalism.

(3) How can the CFPA avoid "capture" by the very institutions that it is supposed to regulate?

A: The problem of "capture" is a real one and I know of no perfect solution to avoid it. The best ways to avoid capture are to eliminate conflicts of interest, ensure independence, promote a race to the top of consumer protection, and minimize the consequences of capture by building in back-up protections. Specifically:

- Industry should not have opportunities to avoid regulation by changing charters;
- The agency should not be funded in a manner that subjects it to undue pressure from industry or anyone else;
- Commissioners should not come from a regulated industry and should have a consumer protection background;
- The revolving door between industry and the agency should be closed;
- States should be allowed to address abuses not addressed by the agency and to enforce laws or rules that are not being enforced;
- Individuals must have the ability to use the rules to protect themselves and should not have to wait for the agency to enforce;
- Enforcement should not be merely a matter of secretive, behind-the-scenes measures. The agency should report to Congress on the actions it takes and must use rulemaking and public enforcement measures in its arsenal so that the benefits are spread industry-wide.
- Transparency and public information should be encouraged wherever possible, both in the agency's activities and in data on industry practices and trends.
- The CFPA should be a fully independent agency, like the Consumer Products Safety Commission.

(4) What formal or informal roles should consumer advocates have in the proposed CFPA?

A: The commissioners of the new agency should include individuals with a significant consumer protection background. This could include attorney generals or consumer advocates. The commission must not be dominated by industry.

The CFPA should have a regular dialogue with consumer advocates, whether on a formal or an informal basis. There should be regulator opportunities for public input.

(5) To what extent should legislation to create the CFPA sanction or protect the rights of individuals to enforce consumer protection legislation or regulations by private actions?

A: Individuals should absolutely be able to use CFPA rules to protect themselves against violations. For example, what good would it do to have a rule that a mortgage broker must inform the consumer about the best loans she qualifies for, if a senior on a fixed income who was not offered that choice cannot use the rule to get out of an exploding adjustable rate mortgage that will quickly adjust to consume most of her fixed income?

For over 200 years, it has been a fundamental tenet of American law that "for every right, there's a remedy." The concept is common sense: wrongdoers who violate laws are accountable to those they injure.

But in recent years, abngside a deregulatory culture that valued *laissez-faire* "buyer beware" capitalism over protection for individuals, business lobbyists have successfully promoted a resistance to making laws enforceable by those whom the laws are designed to protect. Business freedom from enforcement has been valued over compliance, accountability, and protection for individuals.

Now that lawmakers are revisiting deregulatory fervor and are considering new, long needed protections, it is essential that the new rules be enforceable. Enforcement by government agencies will be insufficient either to create incentives for compliance or to adequately protect the intended beneficiaries of these new rules: consumers. If we have learned anything from the current credit crisis, it is that we cannot put all of our eggs in the government enforcement basket and expect federal agencies to protect us.

Business lobbyists have successfully created a knee-jerk resistance to laws that are actually enforceable – that give injured consumers a claim that a lawyer can help them vindicate. But the collapse of our economy should show us that lawsuits provide an important check and balance against abuses.[2] Not only individuals and the economy, but even businesses themselves are better off if abuses are checked early, rather than allowed to flourish.

Private enforcement, paid for by wrongdoers, is efficient and is an indispensable part of protecting consumers. Only private lawyers are able to stop individual foreclosures. Only private lawyers are able to articulate the particular problems with a specific homeowner's situation.

The ultimate goal of consumer protection is to shield consumers from harm. Ideally, that happens on the front end, by preventing abuses. But when abuses occur, consumers are protected when they can hold those who have wronged them accountable and have remedies for their injuries.

Both goals – deterrence and redress – are enhanced when laws provide a mechanism for individual enforcement by injured consumers. Consumers must have the ability to hold those who harm them accountable for numerous reasons:

- No matter how vigorous and how fully funded the CFPA is, it will never be able to directly redress the vast majority of violations against individuals. There are millions of actors involved in providing credit and other financial services to consumers. Government agencies cannot possibly supervise or enforce compliance by all of them.

- Agencies are susceptible to industry capture and a revolving door of agency staff to the private sector, leading to under-enforcement.

- Individuals have much more complete information about the effect of products and practices, and are in the best position to identify violations of laws, take action, and redress the harm they suffer. An agency on the outside looking in often will not have sufficient details to detect abusive behavior or to bring an enforcement action.

[2] In a different context, the Supreme Court this year, in *Wyeth v. Levine*, 129 S.Ct. 1187 (2009), explained the "complementary" roles that private and public enforcement play: "The FDA has limited resources to monitor the 11,000 drugs on the market, and manufacturers have superior access to information about their drugs, especially in the postmarketing phase as new risks emerge. State tort suits uncover unknown drug hazards and provide incentives for drug manufacturers to disclose safety risks promptly. They also serve a distinct compensatory function that may motivate injured persons to come forward with information. Failure-to-warn actions, in particular, lend force to the FDA's premise that manufacturers, not the FDA, bear primary responsibility for their drug labeling at all times. Thus, the FDA long maintained that state law offers an additional, and important, layer of consumer protection that complements FDA regulation" (footnotes omitted); *see also* Bates v. Dow Agrosciences LLC, 544 U.S. 431, 451 (2005) (noting that state tort suits "can serve as a catalyst" by aiding in the exposure of new dangers and prompting a manufacturer or the federal agency to decide that a revised label is required).

- Individuals are an early warning system that can alert states and the federal regulators of problems when they first arise, before they become a national problem requiring the attention of a federal agency. Regulators can monitor individual actions and determine when it is necessary to step in.

- Individual enforcement provides a deterrent against violations.

- Bolstering public enforcement with private enforcement conserves public resources. Neither state nor federal agencies can nor should go after every individual violation.

- Consumer enforcement is a safety net that ensures compliance and accountability after this crisis has passed, when good times return, and when it becomes more tempting for regulators to think that all is well and to take a lighter approach.

- In the end, there is no consumer protection, no accountability, and no access to justice, if individuals have no recourse when wrongdoers commit abuses.

Private enforcement is the norm and has worked well as a complement to public enforcement in the vast majority of current federal consumer protection statutes, including Truth in Lending Act, Home Owner's Equity Protection Act, Fair Debt Collection Practices Act, Fair Credit Reporting Act, Electronic Funds Transfer Act and parts of the Real Estate Settlement Procedures Act (RESPA).

Banks raise penalty fees for customers' overdrafts

By Kathy Chu, USA TODAY

As the economy weakens, banks are increasingly squeezing customers who overdraw their bank accounts.

For more than a year, Wachovia has been urging its employees not to refund too many overdraft fees because they "make up a big percentage of our revenue and is (sic) a HOT button among leadership," according to internal memos obtained by USA TODAY.

CREDIT TRAP: How rising home values, easy credit put your finances at risk

Bank of America and Washington Mutual, meanwhile, have jacked up their overdraft fees and made it easier for customers to be hit with multiple penalties.

The changes come as banks grapple with growing losses from bad mortgage loans. Overdraft fees have increasingly become a source of profits. Banks and credit unions collect about $17.5 billion in overdraft fees per year, the Center for Responsible Lending says.

Checking-account customers are "easy picking" for fees, says Jean Ann Fox of the Consumer Federation of America, because banks typically can take any money owed out of a customer's next deposit.

What banks are doing:

•In 2007, Wachovia put in place a tool that tells employees how much they can refund to customers hit by overdraft fees. The bank, in memos, also tells employees to "sell" a debit card with every account because it makes money when consumers use it.

"We are in an economy that is requiring us to tighten our belt and ensure that we are looking for every possible way to generate revenue," says a memo sent to employees in the Atlanta region on Jan. 17.

Responding to the memos, Wachovia spokeswoman Jennifer Darwin says the bank "work(s) hard to educate customers on how to avoid fees; however, we have a responsibility to shareholders to collect fees." Most customers don't pay overdraft fees, she adds.

•In April, Washington Mutual raised its overdraft fee in most states to $34 from $32. Also this year, the bank increased the number of times a day that a customer can be hit with this fee, from five to seven. Washington Mutual spokesman Gary Kishner says the bank raises fees partly due to "competitive factors."

•This year, Bank of America raised the fee charged on the first day a customer overdraws to $25 from $20. The bank also raised the number of times a customer can be hit with this fee per day to seven from five. And it's told customers that most signature debit-card transactions will reduce their balances that same day and be subject to fees if there isn't enough money in the account. Before, consumers often avoided this fee if they deposited money before a purchase cleared.

Bank of America spokeswoman Diane Wagner says the bank adjusts fees to "establish more uniform pricing for our national franchise."

Earlier this year, the Federal Reserve proposed a rule that bars financial institutions from charging a fee for paying an overdraft — unless customers have had the chance to opt out of this payment. Consumers can get more information about the proposal and directions for submitting comments to the Fed at www.regulations.gov; enter Docket R-1315 in the "comment or submission" field. Comments must be submitted by July 18.

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