# Elizabeth A Duke: The systemic importance of consumer protection

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the US Federal Reserve System, at the 2009 Community Development Policy Summit, Cleveland, Ohio, 10 June 2009.

*The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.*

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I want to thank the Federal Reserve Bank of Cleveland for sponsoring this, its seventh annual Policy Summit, and for inviting me to speak. The agenda for today's meeting is certainly an ambitious one. You will be tackling questions about how housing policy might be restructured to stabilize neighborhoods and create a more sustainable approach to homeownership. You will also be discussing how the Community Reinvestment Act (CRA) might be revised to ensure its continued role as a catalyst for private investment in low- and moderate-income neighborhoods. These are certainly important issues to consider as we try to find solutions to a set of very complex problems brought about by the turmoil in the mortgage and housing markets. I don't have to tell anyone in Cleveland, where foreclosures have harmed whole neighborhoods, about the devastating impact the foreclosure crisis has had on individuals, neighborhoods, and the broader economy – an impact so deep that we would be remiss not to reconsider current policies to ensure a lasting recovery and sustainable homeownership.

As I look at your agenda, I am struck by the fact that the problems we've seen with foreclosures and neighborhood destabilization stem from the over-provision of poorly designed credit, whereas, in contrast, CRA had its birth when credit was generally unavailable to low- and moderate-income neighborhoods. So as I talk today about the Federal Reserve and our role in consumer protection, I'd like to emphasize the importance of both the availability of credit and the ability of consumers to use such credit safely to increase their own well-being in transactions that contribute to economic growth. If we have learned nothing else in this crisis, we have learned that consumer protection is not just good for consumers; it is also necessary to restore investor confidence and promote a strong and stable economy.

### How we got here

Given economic events over the past 18 months, few would question the importance of the link between the performance of consumer-based financial products and the health of the broader economy. Even so, it is important to examine this link in order to learn how we can do a better job of both protecting consumers and protecting the stability of the macroeconomy in the future.

The current economic situation developed over a period of years as the confluence of several market developments created an environment of inexpensive and readily available credit. Advances in information technology and financial innovations over recent decades encouraged new lending products and the extension of credit to a wider spectrum of borrowers, including many who would have previously had difficulty qualifying for credit. Such developments as credit scoring lowered transaction costs and helped to evaluate risk more effectively and consistently. Similarly, advances in financial engineering encouraged and broadened opportunities to draw on capital from around the world through the securitization of debt. This inflow of capital provided creditors with new sources of funds for the expansion of credit. The securitization process was made more versatile – but also more complicated – by the introduction of structured products, such as collateralized debt obligations, which were intended to match investors to various credit and prepayment risks.

As the credit markets evolved, financial products also changed. Consumers were increasingly offered more complex, but often less transparent, products. Where once the vast majority of mortgages were 30-year, fixed-rate products, by the height of the housing boom in 2007, adjustable-rate products proliferated – such products as the 2/28 (a loan with a low introductory rate for the first two years) or the option ARM (a loan on which the consumer could choose to pay a full payment, an interest-only payment, or even a payment that did not fully cover even the interest, with the difference being added to the loan's principal balance). For large numbers of borrowers, piggy-back second mortgages substituted for down payments. These products relied primarily on rising property values and borrowers' ability to refinance for repayment. The high levels of risk posed by these products became apparent only when home prices began to fall and the rate of foreclosure increased dramatically.

Just as mortgage products were becoming more complex, credit card terms, rates, and fees also were becoming significantly more complicated and difficult for consumers to fully understand. New practices evolved, such as charging different interest rates for different transactions and double-cycle billing, whereby lenders calculated interest based not only on the current balance, but also on the prior month's balance. While such practices increased revenues for lenders, it is less clear how they benefited cardholders. Also, payment-allocation rules tended to treat consumers unfavorably and made it difficult for them to benefit fully from promotions such as balance-transfer programs.

Even as credit products were growing in variety and complexity, consumer debt was expanding dramatically over recent years. In particular, mortgage debt rose from $3.5 trillion in 1995 to $11.1 trillion in 2007,[1] while revolving credit grew from $443 billion to $939 billion over the same period and nonrevolving credit (mostly automobile and student loans) grew from $697 billion to $1.6 trillion.[2]

In hindsight, it is not hard to see how these various factors combined to create a perilous situation for consumers, investors, and the broader economy. Bad decisions resulting from poorly underwritten mortgage products with complex features or, worse, features purposefully hidden from consumers were made on such a scale that the spillover effects from the resulting defaults and foreclosures were far broader than in prior downturns. Previously, the negative impact of foreclosures had tended to be limited to local areas experiencing significant job losses or to recessionary pressures resulting from fluctuations in the business cycle. But the accelerating growth rate in the subprime lending market and the fact that so many of these risky loans were bundled into securities set the stage, so that when individual borrowers failed to keep up with payments, the result was devastating to the entire market.

Investors belatedly recognized the serious problems of poor underwriting and inappropriate loan structuring – practices that may have been facilitated by the securitization processes. Problems also spilled over to securities backed by credit card receivables, auto loans, and other asset classes. As a result, investors stopped purchasing most asset-backed securities and much of the secondary market stopped functioning. The loss of investor confidence has had enormous ripple effects in the economy as the tightening of credit has squeezed housing and automotive sales and threatened the viability of businesses reliant on credit lines to cover inventory and other expenses.

In addition to the loss of investor confidence, consumer confidence was also shaken. The collapse of the housing market exposed practices that were not consumer-friendly. Some lenders, brokers, appraisers, and investment banks were clearly motivated by transaction fees and had little incentive to ensure that borrowers would be able to sustain

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1 "Federal Reserve Statistical Release, Z.1, Flow of Funds Accounts of the United States".

2 www.federalreserve.gov/releases/g19/hist.

homeownership. Banks, under stress from losses in their mortgage portfolios, pulled back on private-label mortgage lending and increased the prices associated with other types of lending. The effect of these practices, combined with the impact of job losses and other ramifications of a shrinking economy, have had a significant impact on consumer confidence. Consumer spending has fallen off as a result, further exacerbating the negative cycle.

### A banker's perspective

In thinking about what it will take to achieve economic recovery, I often draw on my experience as a community banker. In the days when I was lending money, we kept those loans on our balance sheet. In that context success was directly related to the ability of customers to repay loans. Indeed, it was related to their ability to repay and borrow again over a career and over a lifetime. This was accomplished through effective underwriting and risk analysis and through proper loan structuring. When the incentives in the credit process are properly aligned, the benefits flow to both the borrower and the lender: the borrower is assured terms and conditions such that he or she can reasonably be expected to repay the loan, and the lender is paid interest on the money lent. While I don't necessarily believe we need to return to a time when all loans are held on balance sheet, I do believe we need a system of balanced incentives for the longer-term prosperity of all.

Credit transactions conducted to the benefit of both borrower and lender expand economic growth. This is as true on the community level as it is at the macroeconomic level. Access to capital to create and expand small businesses leads to job growth and benefits the larger community. Likewise, mortgage lending, responsibly done, gives a community a solid base of residents with a stake in its future.

The problems that we face today result, in large part, from a misalignment of incentives. Securitization, while providing liquidity, also weakened the incentives to properly underwrite loans, in many cases by passing default risk from originators to investors. Compensation structures were also problematic. Some originators were compensated on the basis of particular loan features or loan volumes rather than on loan quality. Meanwhile, loans with features that may have been appropriate for a small subset of potential borrowers – such as interest-only mortgage loans or loans requiring little or no documentation of income – were offered to a wider group of consumers. Studies have shown that if borrower income is held constant, loan features do matter to the successful repayment of a loan.

So I hope we have learned that misaligned incentives that result in harm to consumers have implications for the economy overall. If we recognize this, then we must also recognize that consumer protections cannot be viewed as an ancillary component of a scheme to regulate for safety and soundness. Rather, they are fundamental to the quality of the credit upon which the economy is built. Having said that, policymakers must also consider the desirability of a dynamic economy, one in which useful innovations are encouraged and credit is made available to as many consumers as have the ability to benefit from it. The tension between protecting consumers and making credit broadly available is one that is as important in making an individual loan as it is to ensuring the stability of the economy.

The key to successful policy formulation is to resist the temptation to regulate the problem of the moment. For example, if, in reaction to the abuses in consumer and mortgage lending over the past few years, we were to focus solely on consumer protection policies, the result could be overly restrictive access to credit, which could threaten future economic growth. On the other hand, if the policy focus is strictly on stabilizing the banking sector without giving due consideration to consumer protection, both consumer and investor confidence will remain weak and we will risk repeating the mistakes of the past. Trust in the financial system can be regained only if sufficient consumer protections are in place to give borrowers reason to believe they will be treated fairly.

## The role of the Federal Reserve

The Federal Reserve addresses its consumer protection responsibilities in a variety of ways, using its regulatory and supervisory authority as well as its consumer education, research, and outreach capabilities. We take a multifaceted approach to consumer protection, for a couple of reasons. First, our organization is in the unique position of being a central bank as well as a regulator and supervisor for the banking industry. Moreover, our experience in this arena has taught us that there is no one solution sufficient to address the information needs and substantive protection of consumers in credit transactions. By offering a broad spectrum of products, services, and activities, we aim to provide consumers with the information necessary to make good financial decisions.

For example, based on our belief that clear and well-organized disclosures can help consumers make good choices among financial products, the Federal Reserve has used its regulatory authority to develop extensive new disclosures for a variety of financial products, including credit cards. We are currently in the midst of a major overhaul of mortgage disclosures.

To ensure that new disclosures are useful to consumers, the Federal Reserve has used consumer testing to explore how consumers process information and understand important features of financial products. This has been quite an informative exercise. We have used what we learned from consumer testing to improve the disclosures we require. For example, we recently revised the credit card disclosures required to be provided to consumers at account opening. The new rules require that certain key terms be included in a conspicuous table because our field testing indicated that consumers were unlikely to read dense language but were comfortable with interpreting information in a table format.

Our consumer testing efforts have also taught us that even the best disclosures cannot offer the protection consumers need 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. In those cases, we have chosen to prohibit certain practices. For example, the Federal Reserve recently banned the practice of double-cycle billing when calculating interest rates on credit cards because we found in testing that there was no reasonable way to explain the practice. We have also banned practices related to mortgage lending that have potentially unfair and deceptive features. We found that the failure to require escrow accounts for homeowners' insurance and property taxes often caused borrowers to underestimate the cost of homeownership, so we made such escrows mandatory for high-cost loans. Similarly, we have also placed restrictions on the use of prepayment penalties.

The Federal Reserve has also become more proactive in its efforts to make consumers aware of its role in consumer education and outreach. While we have a long history of providing unbiased, research-based information to consumers on a variety of financial products, we have stepped up our efforts to get information to consumers quickly. And we have recently made use of some unconventional venues – unconventional at least for a central bank. For example, to make consumers aware of foreclosure-rescue scams, the Board recently ran a 30-second public service announcement (PSA) in movie theatres in 18 markets across 10 states having high foreclosure rates. Additionally, the coverage that the PSA campaign received on television, radio, and in newspapers carried the message about the existence of mortgage-rescue scams to a far broader audience.

As a complement to the PSA campaign, the Board developed a *5 Tips* flyer regarding foreclosure-rescue scams that provides essential information in an easily digestible format. Material developed by the Board is now being leveraged by others. Several Reserve Banks, for instance, are working to add the Board's PSA to additional theatres in their markets. And one Reserve Bank has decided to replicate the effort with a PSA tailored to its particular market. In addition, the PSA and *5 Tips* have been picked up by other public and nonprofit organizations, including the National Association of Realtors, and mortgage servicers such as GMAC.

The success of this campaign has highlighted the demand for timely information that consumers can use. Through this effort, we have learned a great deal about the importance of the Federal Reserve as an unbiased source of consumer information. We intend to build on this knowledge going forward – focusing on the content provided, leveraging the same message through multiple distribution channels, and creating awareness of the information's availability.

Finally, as a research institution we engage in efforts to measure the effectiveness of financial education, in order to understand what approaches work best. For example, Board staff, working with the Department of Defense and others, conducted a longitudinal study involving soldiers at Fort Bliss to determine whether receiving a two-day financial education course as part of their advanced individualized training improved the soldiers' financial behaviors compared to those who did not receive training. We found that soldiers who took the course were more likely to engage in positive financial behaviors (such as saving regularly, participating in retirement programs, and paying off credit card bills monthly) and less likely to engage in negative behaviors (such as paying overdraft fees and paying bills late).

The Federal Reserve Bank of Philadelphia is currently engaged in a longitudinal study to measure the effectiveness of homeownership counseling. Throughout the Federal Reserve System we continue to study and apply the lessons learned in the field of behavioral economics to improve our financial education and consumer information.

The goal of each of the Federal Reserve's actions with respect to consumer protection has been to restore consumer confidence by making credit more transparent and, where necessary, prohibiting practices that are so complex as to be unfair and deceptive. These actions are not only good for consumers, but will benefit the financial industry. We aim to promote access to responsible credit for consumers to the greatest extent possible while also recognizing the value of innovation and the need to restore fully functioning credit markets. Being attentive to the interconnection between meaningful consumer protections and broad access to credit will ensure a more lasting and sustainable economic recovery.

## Conclusion

With that, I would like to come full circle and end with the importance of dialogue between the Federal Reserve Banks and the regions they serve. This conference is an excellent example of the ways in which policy is shaped by your involvement. Every day across all 12 Federal Reserve Districts we leverage forums such as this, as well as partnerships with financial institutions and community groups, to better understand how financial products are shaping the communities that make up our vast economy. I want to commend you for taking the time to engage in thoughtful consideration of policies that will help alleviate the impact of the current housing and economic crisis on our neighborhoods. I also look forward to a continued discussion of the role that strong consumer protection must play in our economic future.