Consumers Union

Regulatory Reform Must Effectively Prevent Dangerous Financial Products and Practices
Principles and Goals

It is widely expected that the 111th Congress will examine the oversight of financial markets and financial services providers, with an eye to determining what additional steps are needed to ensure the stability and safety of the U.S. financial system.

U.S. consumers have a huge stake in regulatory reform. Individuals hold their household funds in banks, and may also hold retirement and college savings in mutual fund companies and other vehicles not subject to federal deposit insurance. Lower income consumers are increasingly exposed to the non-bank sector, often with inferior consumer protections.

The deep problems in the mortgage market and spillover effects in the broader credit markets has illustrated that no one in America is immune from the consequences of irresponsible lender conduct or from the effects of a regulatory system that failed to prevent lenders and brokers from misleading individuals and investors about the terms of the credit offered about the quality of the underwriting.

The mortgage crisis also exposed a fundamental risk factor in any financial system which is too dependent on fee income. When the fees can be retained while the risk is passed on to the next party, there is a perverse incentive to make a fee-generating loan that would never have been made if the originator of the loan had borne part of the risk of default.

The mortgage crisis has also exposed a failure of the regulators, accounting standards, and rating agencies to fully evaluate and disclose the potential risks of proposed transactions, and the more general risk of permitting off-balance sheet activity. It has also illustrated that harm to individual consumers can and does spill over into harm to the financial system and the economy.

It seems clear in hindsight that gross under-regulation of the mortgage market allowed problems not only to flower, but to take root in industry practices, creating an adverse cycle in which lenders competed with one another for market share rather than to make sound loans. The problems in subprime mortgages were ignored, not invisible. For example, in December 2006, the Center for Responsible Lending published an extensive analysis of subprime loan features likely to contribute to foreclosures. *Losing Ground*, *Foreclosures in the Subprime Market and Their Cost to Homeowners*, posted at: http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

In 1999 and the early 2000's states began to take significant initial steps to address predatory lending, but then the OCC made their job immeasurably more difficult by exempting a broad group of market participants from state law and state oversight. Between 2001 and 2003, a dozen states passed anti-predatory lending laws. In 2004, the OCC made it much more difficult for states to address harmful lending practices by adopting a pair of rules interpreting the National Bank Act to preempt state laws addressing the underwriting standards or lending practices of nationally chartered banks, and also to prevent state regulators from enforcing state or even federal law against the operating subsidiaries of national banks.

Preemption of state law does not serve consumers or the marketplace well. When states can't act, problems that arise in one part of the country have the best opportunity to spread and become entrenched before they are acted upon by federal agencies or lawmakers.

Mortgage lending is not the only area of consumer financial services that has been lightly or ineffectively regulated. The Federal Reserve Board's May 2008 proposed rule against unfair or deceptive practices in credit card and overdraft practices details the limits of disclosure and the need for substantive restrictions on certain practices. In the payments area, the technology has far outstripped the law, leaving similar-appearing products with fundamentally different levels of legal protection, and relegating some important aspects of the payments system to contract and private rules. See: *Before the Grand Rethinking, Five Things to Do Today With Payments Law and Ten Principles to Guide New Payments Products and New Payments Law*, 83 Chicago-Kent Law Review No. 2, 769 (2008), posted at:
http://www.consumersunion.org/pdf/WhereisMyMoney08.pdf.

Fundamentally, the mortgage crisis and the credit crunch it sparked has shown that products and practices that are unsafe for individual consumers can and do cause systemic harm. The mortgage crisis has painfully illustrated that consumer protection is essential to safety and soundness. Real consumer protection must extend well beyond disclosure of complex terms, features, pricing and conditions.

Consumers Union will be deeply engaged in evaluating specific proposals for regulatory reform. Any proposal should serve these goals and include these features:

1. Effective oversight is essential to protect consumers and the financial system

- Develop and sustain a proactive, transparent regulatory culture in which problems are spotted early and addressed publicly and promptly, instead of waiting for problematic practices or product features to spread nationwide or to spark a crisis.

- Create and sustain regulatory agencies with an express mandate to develop preventative standards rather than a "wait and see" attitude. Any existing or new agency in this role must have the will, authority, resources, and independence to impose and enforce high standards for itself and for the regulated community.

- Regulatory agencies must place the same strategic priority on consumer protection and the prevention of consumer harm and on safety and soundness. This may require at least one agency which has concurrent jurisdiction with existing bank regulatory agencies but whose primary job is to create a safe environment for financial services consumers.

2. Strong, "no-loophole" laws and regulations are essential to make the marketplace safer for consumers and to end dangerous financial products, features, and practices.

- Stop unfair practices, products, and features, including fees for unrequested services and product features which increase the true cost of a financial service or loan after the service or credit is accepted by the consumer.

- End practices that create a mismatch between the complexity of the financial product offered and the level of sophistication of the target audience for that product.

- Create baseline consumer protections not dependent on particular product designs, delivery technologies, or the use of traditional bank accounts.

- Extend protective mortgage rules beyond high cost mortgages.

3. Ensure that marketplace incentives facilitate responsible conduct by all players in the financial services market

- Develop and enforce affirmative suitability requirements for all types of financial services products and product providers.

- Impose fiduciary duties on all of those who advise consumers in the individual selection of financial products.

- Link credit underwriting decisions and any ability to receive loan-related fees to retaining a meaningful portion of the risk of loss.

4. No bailout of stockholders by taxpayers

- Ensure that taxpayers never bail out financial institution stockholders.

- Federal oversight powers must accompany any explicit or implicit federal guaranty.

- To strengthen the financial system and reduce the risk of future requests for bailouts, provide for direct federal oversight for each essential segment of the financial system, including payments settlement networks.

5. Strong oversight and enforcement is too important to be limited to the federal regulatory agencies

- Hold each player in the financial services marketplace fully accountable for its activities and omissions.

- Provide concurrent jurisdiction to define and to stop unfair or deceptive practices among federal banking regulators, the Federal Trade Commission, as well as state banking regulators and state Attorneys General.

- Acknowledge and support the role of state regulators and state law enforcement to provide additional "cops on the beat" to enforce both federal and state consumer protection standards.

Prepared by:
Gail Hillebrand
Financial Services Campaign Manager
Consumers Union of U.S., Inc.
West Coast Office
hillga@consumer.org
(415) 431-6747

Additional contact:
Pamela Banks
Consumers Union of U.S., Inc.
National Office
bankpa@consumer.org
(202) 462-6262

September 10, 2008